CHAPTER 7

GLOBALIZATION AND ECONOMIC DEVELOPMENT IN EAST ASIA:
A New Model for Development

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Introduction

The process of globalization is both subversive and addictive. It is subversive because it undermines the status quo and challenges vested interests. It is addictive because choice, freedom, knowledge, and greater material gain, once tasted, raise expectations for even more of the same, expectations that are not easily managed politically.

The economies of East Asia are among the world's greatest beneficiaries of globalization. Robust exports and large flows of foreign investment have driven economic growth and rapidly improved welfare, reflected in rising social indices. However, globalization has also brought new challenges to the old order. Increasing competition from without and the call for greater economic and political freedom from within are combining to undermine the model of development that served the region so well in the 1980s and the first half of the 1990s, as they create new pressures to improve policy and governance.

Sound policies—including responsible fiscal and monetary policy, a robust foreign exchange regime, and a pro-competitive regulatory environment—will be more important than ever. However, they are not sufficient to assure success. Governance—the traditions and institutions of a nation by which authority is exercised and legitimacy is established—is now even more critical to success than in the past.

The pressure that globalization has triggered to improve policy and governance could result in a new East Asia model, or models, that would boost productivity and propel the region back to previous high levels of growth. The growing importance of governance as a factor of competitiveness could create a "race to the top" in good governance that could have a profound impact on the political development of the region.

This chapter states the author's personal views, and does not necessarily reflect U.S. government policies.

This chapter will examine how globalization has changed the status quo in the East Asian region and has made good economic governance a necessary centerpiece of progress towards a new East Asian model of development.

Success of the East Asia Model

The team of American and Japanese engineers that invented the integrated circuit in Texas in the mid-70s and the East German teenager waving his T-shirt from atop the Berlin wall in 1989 both played key roles in the rise of globalization. The IT revolution coupled with the growing embrace of free market policies in the wake of the demise of communism, have led to the unprecedented integration of economies and mixing of cultures over the past decade around the world, a process that has been dubbed globalization.

For nearly all the countries of East Asia, globalization has meant faster growth and more prosperity for a larger share of its population than at any other time in their histories. The gross national product (GNP) of APEC economies over the past decade has increased by a third, the number of people living in poverty has fallen by a third, and literacy rates are among the highest in the world, thanks to education expenditures that have risen faster than GNP. The citizens of the emerging economies of the Asia-Pacific region are among the most literate, healthy and prosperous in the developing world.

Though development policies varied somewhat from country to country, they generally followed a pattern described in the well-known 1993 World Bank study of eight high-performing Asian economies, *The East Asian Miracle: Economic Growth and Public Policy*. That study described a "winning mix" of sound macroeconomic fundamentals and "disciplined" government intervention. According to the report, the eight economies compelled and promoted high savings, kept a tight rein on fiscal spending, and pursued a government-led export-oriented industrial policy. They maintained relatively high-quality primary and secondary education, and largely flexible labor markets. Most controversially, the government intervened heavily in credit allocation through the activities of public and private financial institutions.

The model worked. State involvement in capital formation and allocation allowed the countries to quickly mobilize domestic savings and direct them to infrastructure and export production. The model yielded exceptionally high investment in the eight countries (more than 20 percent of GDP on average between 1960 and 1990), well-endowed human capital and high levels of productivity. Though much has been made of "crony capitalism" after 1998, in fact, policy-makers for the most part adopted the system not with the intent of benefiting traditional elites (though it undoubtedly did so), but as an expedient and efficient way to quickly allocate capital.

Relatively disciplined fiscal and monetary policy provided a stable macroeconomic environment, and an export-oriented policy allowed some governments to open up rapidly certain sectors to eager foreign investors without having to go through the politically difficult task of a broader liberalization of their societies. A rules-based trading system and a fast-growing, open American market were also critical to their success. The economies grew as they became increasingly integrated into world markets. The eight emerging Asian economies grew an average 5.5 percent per year over the past three decades and all but Japan roughly doubled trade as a share of GNP over the past two decades (Japan is one of the few nations in the world where trade's share of GNP has actually dropped in the postwar period).

The Model Breaks Down

However, as Japan learned in the early 1990's and the rest of the region discovered in 1997, that model had vulnerabilities, particularly in the financial sector. As economies grew and became more prosperous, and as trade and investment expanded, the East Asia model came under strain, both from outside and from within. Indeed, it appears that globalization itself, while benefiting the emerging economies of East Asia, also carried with it the seeds of destruction of the economic model that many countries in the region used with considerable success.

The most obvious point of pressure was from rising new competitors. Just as Japan became a competitor to the U.S. in the 1970s, the rise of the tigers put pressure on Japan, just as China is now posing a competitive challenge to Southeast Asia. Globalization means that new competitors with a new set of comparative advantages are entering the international economic arena. No country or company can afford complacency.

However, the model principally collapsed as a result of internal factors, exposed by growing integration of the Asian economies into the regional and world economy. Andrew Berg of the IMF concluded in a study of the 1997-98 crisis that the crisis was largely the result, not of macroeconomic imbalances, but instead of vulnerabilities within the Asian economies.

Most importantly, the model's system for allocating capital, while effective at rapidly mobilizing domestic and international savings, did not do a good job of allocating it to the most productive economic activities. The absence of a legal, regulatory or market mechanism to weed out failing ventures to allow new more robust ones to take their place became a growing liability. In addition, limited competition in key sectors such as telecommunication and energy made for high prices, poor service and weak infrastructure in key areas of the domestic economy.

The system also is losing popular support. The mercantilist approach to trade—sheltering local manufacturers while actively promoting exports—sacrificed consumer interests in favor of industrialists. The asset boom, stemming from policies that generated excessive capital chasing too few profitable assets, exacerbated that inequity and exploded the myth of "growth with equity" that had been a fundamental theological tenet of the Asian model. The inexorable decline over the past two decades of Japan's Liberal Democratic Party (LDP) perhaps most graphically illustrates the crumbling of that domestic consensus.

Japanese Prime Minister Junichiro Koizumi pointed to the breakdown in the East Asia model in a speech in Singapore on 14 January 2002, in which he called for a "third major reform" of the Japanese economy akin to the transformations that took place in the Meiji and post-war periods. Later in the same speech he made an intriguing proposal for an Initiative for Development in East Asia that would have Japan join Southeast Asian nations to "re-examine" development experiences to date and consider "future models for development." However, the offer apparently was not warmly embraced by the prime ministers' Asian interlocutors.

It is not surprising that Koizumi is meeting strong resistance to his ideas for reform both domestically and in the region, for the old model had created franchises for politically powerful elite, who now have strong vested interests in the status quo and the political power to maintain it. The old model's very success makes change from within difficult, slowing renewal and rejuvenation.

In examining the impact that globalization is having on the region, it is important to note that, contrary to the arguments of anti-globalists, the dynamic for change is fundamentally internal. McDonald's is a threat to the status quo, not because it is a multinational company forcing itself on defenseless countries, but because people from those countries want to eat there. In the same way, greater economic and intellectual interaction with the world has whetted the appetite for change in traditional societies across the region, pitting those who want change against those with a vested political and economic interest in the status quo.

Towards a new East Asia Model

Both Japan and the emerging economies of the Asia-Pacific region now have a formidable challenge in front of them to restore their growth potential. Growth rates, even those projected after the predicted upturn, are anemic. Some analysts are beginning to doubt that Japan and the Asian tigers will regain previous rates of growth.

East Asia's current problems stem from the allocation of factors of production to economic activities that are not yielding high returns. To address this structural problem will require a set of policies to facilitate the efficient reallocation of that capital, including disposal of non-performing loans, bank reform, corporate restructuring, elimination of corruption, pro-competitive regulatory reform (particularly in areas where privatized monopolies continue to operate), corporate governance, rule of law, property rights, and bankruptcy and commercial laws that can facilitate the Schumpeterian process of creative destruction.

The New Model and Governance

It will also require good governance. Citizens and investors alike are demanding better overall governance—i.e., more effective, transparent and legitimate operation of government institutions. While this call for better governance extends to all functions of the government, this chapter will look at four areas that have the greatest relevance for development of a new Asian growth model, that is governance as it relates to: corruption, the use of information technology, the allocation of capital, and the operation of corporations.

Corruption

Corruption has had a corrosive affect on Asian growth prospects. It scares off potential investment by undermining the credibility and legitimacy of the government and creating an uncertain business environment. For example, one of the principal reasons for Singapore's remarkable post-war success is its squeaky clean reputation, consistently sustained. Corruption also results in misallocation of capital and other factors of production as resources are moved based on personal relationships rather than return on investment. Finally, it has both quashed entrepreneurship and harmed the poor at the same time.

The 1997-98 crisis sparked a remarkably candid debate throughout the region and has led to increasing action to meet the challenge of corruption. At an international conference co-hosted by the ADB and the OECD in November 2001 Asian government officials called corruption "the most serious obstacle to democracy and sustainable development of societies" and cited estimates that corruption can cost as much as 17 percent of a country's gross domestic product. The participants, who included officials from some of the region's largest economies such as Japan, Korea, Malaysia and Indonesia, endorsed a detailed anti-corruption action plan.

China has also made eliminating corruption a priority for its domestic economic agenda. For example, under its leadership, at the APEC Leaders Meeting in Shanghai in October 2001, Leaders called on APEC economies to adopt transparency principles that would commit members to procedural transparency in critical areas such as government procurement, investment and regulation.

IT and Governance

The transformation of East Asia will be closely linked to the greater use of information technology. However, the use of IT by itself cannot boost productivity or stimulate growth. As co-authors Catherine Mann and Daniel Rosen point out in their significant APEC study on the New Economy, "while information and communications technology…substantially increases information…it is the economic environment created by policies that provides opportunity and motive to actually use the information."

Thus, it is the interplay between the policy environment and IT that allows actors in the economy to act more efficiently, resulting in a transformation that yields higher productivity and economic well-being. Mann and Rosen's analysis shows that four policy "domains" are necessary to affect that transformation: fiscal, financial, trade and investment, and competition policies.

Governance plays a central role here. For example, sound fiscal policy requires both a streamlined government function as well as a political process to help assure that spending is well allocated. A budget process that tends to allocate large amounts of resources to politically-motivated mega projects or fashionable IT infrastructure that could be undertaken by the private sector, will tend to starve funding for education and health, vital for optimum access and application of IT. Competition policy and rule of law are other areas where governance is critical, particularly, as Mann and Rosen point out, in creating a legal system that will be operable internationally.

Having created the correct fundamental policy environment that will promote investment, competition, entrepreneurship and trade, East Asian economies must also put in place a legal and regulatory infrastructure to govern economic activity carried out over the Internet. The region must have consistent and harmonized rules governing the operation of internet service providers, technical protocols, privacy, consumer confidence, dispute resolution, and digital signature, authentication and verification.

As Mann and Rosen point out in a series of case studies from the region, a combination of good policies and good governance will lead to greater investment, more use of IT, increased productivity and faster growth. The World Bank's 2001 report on capital flows made the same point: foreign investment flows have slowed to the region, but flows are likely to rise to those developing economies who have put in place the policy environment to boost the rate of diffusion of technology advances, making the expected rate of return on investment higher.

Allocating Capital

The single most important step that countries in the region must now take is to transfer non-performing assets from the hands of those who are not now productively using them to the hands of those who can. If successful, that process will entail the largest reallocation of capital to ever take place in the region's history.

To do so the region must adapt a significantly different model of capitalism, one that is closer to the American model, though certainly not identical with it. At a minimum the new system must provide for deeper financial markets, robust supervision of domestic banks, an end to the "main bank" or relationship banking system, international accounting and auditing standards, and an effective bankruptcy regime. Companies must boost return on assets by shedding assets and reducing activities to those that reflect core competencies, as a number of Japanese companies, including Toshiba, Shinsei Bank, and Nissan are doing today.

This reallocation of capital now underway will have enormous implications for the region's productivity and sustained growth. It will also have enormous political implications. Government regulations, barriers to trade and investment, subsidies, and relationship-based banking, all allow, wittingly or unwittingly, traditional elite to maintain a virtuous (for them) circle of wealth and political influence. Vested interests are the principal obstacle to structural reform in the region, which in turn is the principal obstacle to the development of more democratic institutions in the region. The strength of vested interests accounts for the slow progress in moving assets to more productive uses in virtually all countries of the region.

Corporate Governance

Corporate governance will play an increasingly important role in East Asian economic development. Good corporate governance results from governments creating the legal, regulatory and institutional framework in which corporations, stock exchanges, investors, trade unions and other private parties can most effectively pursue the interests of the company and the shareholders. Several factors have increased the need for a fundamentally different approach to corporate governance in East Asia.

First, the last decade in Asia has seen a significant shift from family-owned and -run firms to modern corporate entities, as patriarchs who launched firms in the 1940s and 1950s passed control to the next generation. The result in many cases was a separation of ownership and control of the firm that, in the absence of sound corporate governance—including requirements for transparency, fiduciary responsibility, or shareholders' rights—helped mask sub-par business performance. These firms also face new pressures from aging populations that increasingly rely on pension plans that in turn need to make sound investments.

Second, capital markets changed dramatically, shifting from bank loans to equity financing with a greater emphasis on foreign capital. The shift from bank lending to equity financing, which accelerated when bank lending dried up during the financial crisis of 1997-98, has increased the demand for better corporate governance and a greater voice for shareholders (especially minority shareholders) to satisfy portfolio investors. As the OECD Corporate Governance Principles point out, long-term, patient capital will flow to where corporate governance arrangements are "credible."

Moreover, with the increase in global capital flows, foreign investors have been increasingly demanding Western-style corporate governance norms. The most remarkable example of this was Calpers' recent decision to pull out of the Philippines, Indonesia, Malaysia and Thailand out of ethical and governance concerns.

Finally corporate governance is key to resolving the misallocation of capital described above. A regulatory framework that ensures that a company's activities support the interest of shareholders will also help ensure that capital in that country is well-spent. Without good corporate governance, management can continue to block a restructuring or sale that could return a corporation to profitability and enhance economic efficiency in the economy. From Japan to Indonesia, the lack of adequate corporate governance is one of the most significant impediments to supply-side structural reform.

APEC Finance Ministers took an important step in 2000 when they formally supported key economic and financial policy standards that included the OECD Corporate Governance Principles, and called for their early implementation. The ministers explicitly welcomed the work of the OECD and World Bank in raising awareness of and the commitment to corporate governance reforms in the region.

How these principles will be applied will differ among countries and legal traditions, but the thrust will be the same, including the need for a corporate structure that protects shareholder rights, putting in place international accounting standards, the growing importance of independent board directors to assure proper monitoring of a corporation's activities, and a regulatory system that can facilitate mergers and acquisitions. Closely related to good corporate governance is a regulatory and legal structure that would allow rapid debt workouts and corporate restructuring, including an efficient bankruptcy system.

Is Small Government Beautiful?

This discussion of four types of governance related to economic policy makes it clear that the role of government has not been diminished by globalization—perhaps the only myth of globalization advanced by both its advocates and detractors. In fact, globalization has made the role of government more important. Good fiscal policy is not necessarily about spending less, but about spending more wisely, for example, public investment in education and health that is more important than ever for the economic success of a nation. Good financial policy requires more active supervision by a larger number of more highly trained regulators. Sound competition policy calls for more, not less, regulation of private and public monopolies. The issue is not the size of a government—the American bureaucracy is far larger than Japan's on a per capita and absolute basis—but how the government relates to economic activity.

Conclusion: Just Like Us?

Will the pressures on East Asia to implement reform policies and improve governance inevitably lead economies in the region to adopt American-style capitalism? Will greater integration into the world economy and greater exposure to other cultures and political systems inevitably lead to economic, political and cultural convergence?

As capital markets become more global, we are likely to see more common features between Asia and the West. This is because the so-called "American" system did not arise by fiat, but through an organic and iterative process that continues to this day of interaction between government and the marketplace. Economic actors facing the same set of incentives will generally act in a like fashion. For example, the shift from bank to equity financing brings new actors to the stage with different needs and demands that corporations must respond to if they are to access capital. It is inevitable that good corporate governance practices will become more similar and identifiable under these circumstances.

As noted above, however, this is fundamentally a process of *internal* change. A rising middle class, better informed Internet-savvy youth, aggrieved consumers, and aggressive entrepreneurs have a shared interest around the region in more transparency, accountability, and competence from their governments and policies that will allow them more freedom, choice and economic opportunity.

The most powerful voice for democracy and pluralism is coming from a growing middle class that desires more control over its destiny to assure that the fruits of its labor are not taken away by a government in which they have little or no say. Thus, since the major agent for change will not come from outside but from within Asia, capitalism is likely to evolve in ways that will both vary from country to country and share some common Asian features.

There are some initial signs of what the new model will look like. Japan has dismantled an array of regulations—from repeal of the infamous Large Retail Store Law to a new pro-competitive telecom regime which helped drive DSL rates to below American levels. Japan has also passed a plethora of new legislation that will facilitate corporate restructuring and mergers and acquisitions. Assets are beginning to move slowly into the marketplace, as seen in the recent announcement of a 100 billion yen securitization of bad loans to be sold by Goldman Sachs. In South Korea the government quickly nationalized banks and wrote off bad loans shortly after the financial crisis of 1997–1998 and Malaysia also moved quickly to address financial sector weakness in the wake of the crisis. Thailand has established a new asset management company that has the potential to move underperforming assets back into the marketplace.

This is only a start on what will be a long road to change. What the final mix looks like and how soon it emerges will depend to a large extent on the outcome of the battle between vested interests and those pushing for change that is taking place today. The outcome will determine whether East Asia will reclaim its former place as the world's fastest-growing region.

Vital American security and economic interests are at stake. The economies that stretch along the Pacific littoral from Japan to Indonesia constitute a large and growing chunk of world GNP and world trade. We have an enormous interest in assuring that this transformation of capitalism, the most important economic transformation in the region in roughly half a century, takes place smoothly and quickly. We will need to continue to use APEC, multilateral development banks, cooperation with civil society, and our bilateral engagement to help assure that open trade and investment, pro-competitive regulation, strong financial markets and good governance are at the heart of the new East Asia development model.