The Maturation of the East Asian Miracle

MICHAEL WALTON

The sustainability of the East Asian miracle is being questioned as the region's economies are buffeted by problems. What are the problems, and how can East Asian countries cope with them to maximize their chances of continuing their rapid growth?

WITH THE sharp export slowdown in 1996, financial woes in Japan, Korea, and Thailand, this summer's currency turmoil, and broader fears of bursting property bubbles in 1997, the sustainability of rapid growth in East Asia has been widely questioned. The region is suffering from the strains arising from the tension between very rapid growth and significant institutional and structural constraints. Moreover, there is widespread concern about the quality of East Asian countries' growth, focusing on their congested, polluted cities, rapid exploitation of forests, and income inequality.

These circumstances have given rise to a number of questions. Will some East Asian economies experience slower growth or economic crises at much lower levels of income than Japan did? Are there new issues that the now-richer East Asian societies must face? Will they have to follow different paths to sustain their rapid social and economic development?

East Asia is a region of contrasts: it has the world's fastest rate of increase in the number of billionaires, yet some 350 million people still live on less than a dollar a day. Moreover, market-oriented economic strategies are a recent phenomenon in much of the region—more than 70 percent of East Asia's population lives in low-income countries in transition from central planning. Yet despite the region's diversity, many of the new issues East Asian countries face cut across national boundaries. This article poses seven questions concerning East Asia's prospects. Almost all of these relate not to the state intervention versus free markets debate that has been so extensively discussed in the past, but instead to the more complex issue of how to design policies and institutions that can support governments and markets that complement each other in meeting society's demands.

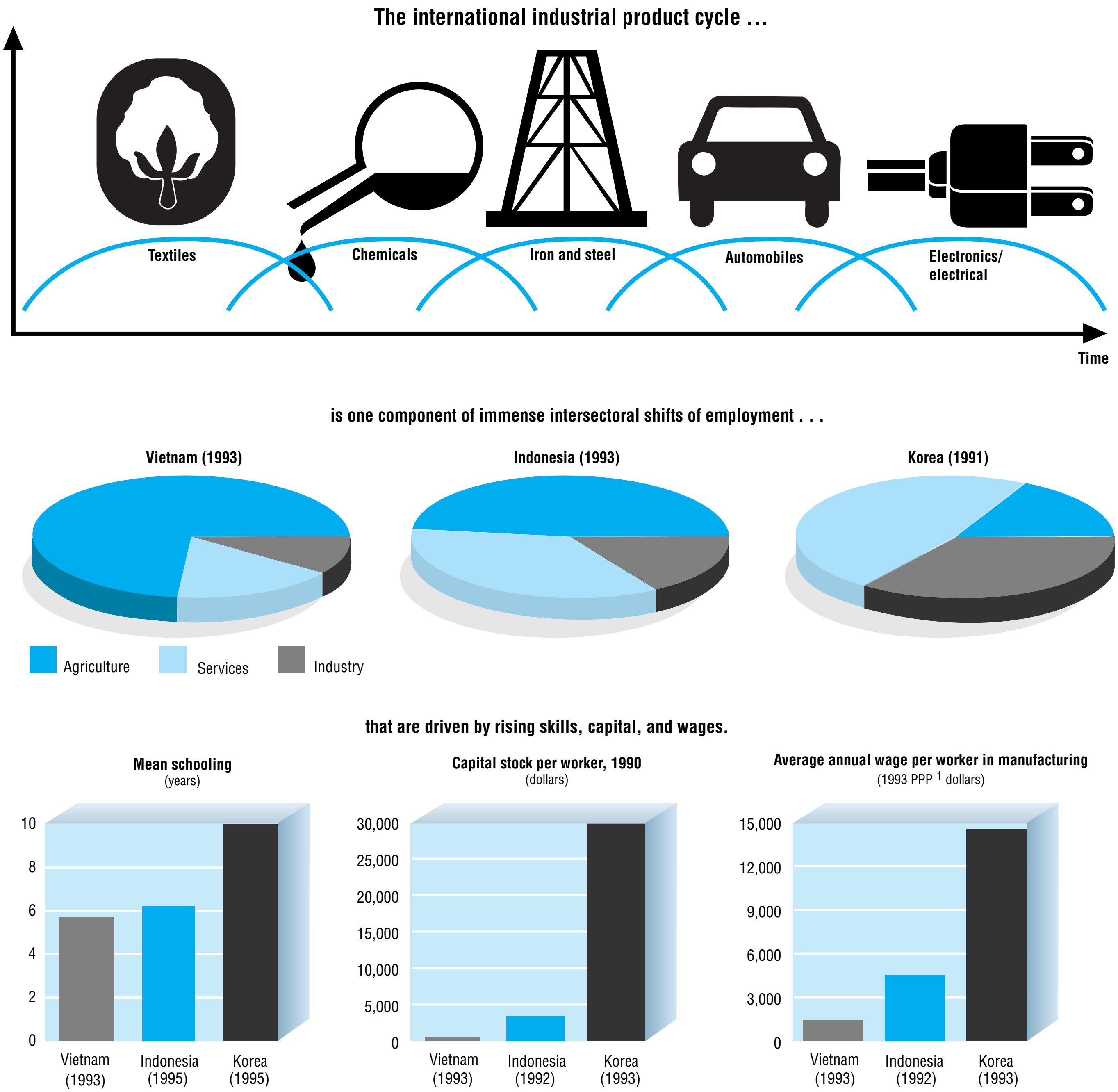
(1) *Will the flying geese stay on a smooth flight path?* The theory of flying geese, first formulated by the Japanese economist Akamatsu in the 1930s, described an international product cycle in which leader countries passed on patterns of production to follower countries as the former's capital deepened, their technological capabilities increased, and their workers' skills and wages improved (see figure). This has been a remarkably smooth process in East Asia in the past 30 years, with successive economies moving up the ladder of value added from agriculture to simple manufacturing, and on to producing automobiles and chemicals, and then to high-tech industries.

This progress has been facilitated by a shifting international division of labor and, in the past decade, by a burst in intraregional trade and the large-scale relocation of industrial capital from Japan and the four tigers (Hong Kong, China; the Republic of Korea; Singapore; and Taiwan Province of China) to their poorer neighbors. This development has been associated with broader transitions to urbanized societies, increasingly based on the provision of modern services and characterized by an emerging middle class. Labor has been absorbed from agriculture; schools have produced large numbers of increasingly skilled new entrants to the workforce; and huge numbers of urban jobs have been created, offering rising wages and better working conditions. Rising incomes and better education and health have led to a deeper modernization of society and a rapid demographic transition.

Yet throughout the region, questions have been raised as to whether these transitions can continue to occur smoothly. Rising international integration, rapid technological change, and new societal developments point to challenging new demands that could disrupt this pattern in many countries in the region.

(2) *Can private involvement eliminate infrastructure bottlenecks?* Massive expansion of public infrastructure was central to the East Asian miracle, but this model is no longer viable. By the early 1990s, as the importance of providing efficient telecommunications, transport, power, and other infrastructural services in maintaining a country's competitive edge continued to increase, it had become clear that private involvement would be necessary on both public finance and efficiency grounds. There were initially euphoric expectations of a happy marriage between vast East Asian infrastructure needs and private sector delivery (at attractive profits). There have been significant advances: elimination

Michael Walton,
a UK national, is Director, Poverty Reduction in the World Bank's Poverty Reduction and Economic Management Network. When this article was written, he was the Chief Economist in the Bank's East Asia and Pacific Regional Office.



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[1] Purchasing power parity.

of the power bottlenecks in the Philippines, privatization of telecommunications in many countries, across-the-board private sector involvement in Malaysia, and pioneering transport and power build-operate-transfer projects (BOTs) in China. Even with some $9 billion of foreign inflows into East Asian countries in 1995 and 1996, however, private capital amounted to only some 10 percent of total infrastructure spending. There is a gap between private demands for high returns and substantial risk mitigation and the levels of profits that would be acceptable to society. Most projects have been "fenced off" from the broader economy, requiring complex, project-specific negotiations. As a result, the leaders in attracting private investment in infrastructure are outside East Asia and include Australia, Chile, and the United Kingdom.

Success in this area is not a question of mobilizing private finance and securing amicable deals. Fundamentally, it requires forming an institutional framework for awarding contracts, delivering infrastructure, and setting the rules to satisfy societal concerns for equity, humane resettlement, and prudent environmental management. An essential prerequisite for success is making a market (with market-based pricing) and reducing risks through setting the framework for fair markets. Where elements of natural monopoly remain—as, for example, in power transmission, toll roads, and water supply—a market can be made through competitive contract awards and periodic rebidding. There are complex regulatory issues of balancing fair price adjustments against incentives to improve efficiency; ensuring adequate investment in, and rehabilitation of, infrastructure networks; and maintaining environmental standards, all of which need to be resolved without permitting regulatory capture by powerful private utilities. East Asian economies are moving in these directions at varying speeds. Successful implementation of these deep reforms will help ease external financial constraints and increase provision of private domestic finance.

(3) Will high growth founder on financial sector weakness? Perhaps. Institutional development in East Asia's financial sector has lagged real sector development everywhere except Hong Kong and Singapore. Financial sector development was not a drag on growth in the past. Indeed, in Japan, the close relationship between leading banks and enterprises achieved both large-scale financing of industrial investment and effective corporate control. In other East Asian countries, family-based corporate structures relied heavily on informal networks for finance. Financial problems were dealt with swiftly when they occurred, as in Malaysia and Thailand in the 1980s. But rapid overall growth hid financial weaknesses; with increasing international financial integration, they are becoming exposed. Weaknesses include: significant amounts of nonperforming loans; poor lending practices; and, in most countries, basic accounting, auditing, and disclosure standards that fall well short of international norms.

The region's most urgent need is to build robust banking by strengthening regulatory and supervisory structures, developing effective exit mechanisms for weak banks, and—in former centrally planned economies and Indonesia—resolving the problems of state banking systems. Capital markets will play an increasing role, especially in the management of risk, as the large-scale transition from family-based firms to publicly held corporations proceeds. Equity markets are already important in the region, but its bond markets are unusually small, in large part owing to the limited amounts of contractual savings available. This could change as pension and insurance reforms foster the development of institutional investors and capital markets become major intermediaries in infrastructure and housing finance, in addition to playing a role in corporate finance. Finally, East Asian countries have been cautious in liberalizing financial services, fearing a loss of domestic control. Although phased liberalization may be desirable on political economy grounds, a faster approach will be necessary if East Asian countries are to maintain their competitive edge.

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(4) *Will the state wither away or threaten economic advance in China and Vietnam?* Although China and, more recently, Vietnam have followed an East Asian strategy of combining rapid growth with structural reform, they differ fundamentally from the rest of the countries in the region, since they have large state-owned sectors. For a while (18 years in China's case), their extraordinary growth appeared to contradict the view that widespread state ownership was inimical to growth. This view, however, is based on an incorrect understanding of the principal sources of past growth—liberalization and institutional transition away from state production. (For example, in China, nonstate activities now account for 65 percent of industrial production.) And in China, at least, the state enterprise sector is now recognized by the government as the major medium-term economic management problem.

The strategy of encouraging growth outside the state sector and exerting competitive pressure on state firms has reached its limits in China and has barely started to be pursued in Vietnam. The strategic risk is that—de facto, at least—decent assets in state firms will be privatized, leaving the government and financial system to assume responsibility for the liabilities. In China, this course of action could heighten existing concerns about rising urban unemployment, which, though officially still around 3 percent, is actually substantially higher owing to surplus workers in state enterprises, many of whom are now working only part time at reduced wages.

Will there be a smooth resolution of the state enterprise problem? The answer is uncertain. In both China and Vietnam, it is possible to envisage a rapid decentralized privatization of small activities and a managed process of change for medium- to large-scale enterprises involving some mixture of the liquidation of loss-making activities and the transition to modern forms of corporate governance for potentially profitable activities. At the same time, private and market-based ownership would increase. Such an approach would need to go hand in hand with the transformation of the two countries' banking systems and capital markets. It is also possible, however, that the outcome might not be so favorable, which could lead to a deep crisis in the financial sector.

(5) *Will inequality emerge as a central social and political issue?* Growth with equity is an oft-cited feature of the East Asian miracle model. From Indonesia to Korea, educational advance effectively complemented the rising demand for skilled labor as economies evolved. This helped reduce poverty and generated political support for fast growth, the benefits from which were correctly perceived to be widely shared. Even Malaysia, whose income distribution was initially relatively unequal, significantly reduced both overall and inter-ethnic inequalities. But this smooth evolution faces two distinct threats. First, there is evidence that inequality (either in overall incomes or labor earnings) is on the rise in some economies, particularly in China; Hong Kong, China; Japan; Malaysia; Taiwan Province of China; and Thailand. In Thailand, the Gini coefficient (a measure of relative inequality) for consumption expenditure rose from 36 to 46 between 1975 and 1992, and in China (for incomes) it rose from 30 to 39 between 1985 and 1995. These are the two largest increases in inequality recorded internationally in the past thirty years. Second, there is a broader societal concern over inequality that extends to Indonesia, the Philippines, and Vietnam, despite a lack of evidence of actual increases in income differences.

The emergence (or return) of inequality as a central concern appears to be tied up with three issues. First, overall rises in inequality are most directly tied up with the race between shifts in the demand for skilled workers—driven by technological change and international integration—and their increasing supply, which is driven by education and training. This is a complex problem, but a key part of any solution will be the development of effective and inclusive systems of education that provide workers with flexible skills. This should be complemented by labor market, firm, and training structures that help workers enhance their skills and make the transition to better paying jobs.

Second, some groups are at risk of being left out of the growth process. These include those living in poor areas, such as Indonesia's Eastern Islands or villages in inner China. Sometimes particular ethnic groups gain less from growth—in Vietnam, apart from those of Chinese ancestry, all ethnic minorities have higher incidences of poverty than the majority ethnic group. Reaching these disadvantaged groups is likely to require targeted public action, ranging from providing additional subsidies for schooling to assisting people who wish to migrate (as is done under the South West China poverty project, for example).

Last, but not least, is a rising concern that the super-rich are getting richer through connections to the powerful. The best way to tackle this problem is by enforcing competitive and transparent contract award procedures, and ensuring competition in production.

(6) *Can competitiveness be consistent with compassion?* It is sometimes argued that East Asian countries' high level of competitiveness is due to the absence of the sort of extensive public social safety net system prevalent in the industrial countries and the relatively favorable age structure of their populations. There is some truth in this. Demographic dynamics did contribute to past successes. A swift passage through the demographic transition, which was facilitated by initial income growth, improvements in health status, and education expansion, contributed to a highly favorable dynamic of rapid growth in the numbers of adaptable young entrants to the workforce, limited old-age burdens, and low birth rates that allowed households and governments to raise spending per pupil for schooling. But the widely held view that East Asian societies rely on families to care for the old, sick, and needy is wrong, for two reasons. First, there is widespread public provisioning now in East Asian countries. Malaysia and Singapore have unusually well-developed public provident funds, with assets equivalent to more than 60 percent of GDP. The 100 million or so workers in China's state enterprise sector have cradle-to-grave protection that is far more comprehensive than what is available in many European countries. Second, all of the East Asian countries are now undergoing the very rapid aging of their populations. At the same time, by 2025, most East Asians will be living in urban areas.

An older, more urbanized society will demand more formal provisioning for old age, illnesses, and disabilities. Are compassionate societies consistent with continued East Asian competitiveness? Yes, but the design of formal insurance-based schemes will be of central importance, with maintenance of a close link between contributions and benefits a key to success—as it has been in the Latin American- and Singaporean-style pension schemes. Some reforms of existing structures will be necessary—most notably in China—but East Asia has an opportunity to have compassionate societies without encountering the severe funding or incentive problems that have been experienced by many other countries.

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(7) *Can booming cities be clean and efficient?* The old East Asian model involved letting cities boom, become congested and dirty, and then cleaning them up when time and money allowed. Tokyo was notoriously polluted three decades ago. Seoul remains highly congested. Bangkok is already both an unhealthy and a highly inefficient city, with interminable delays in internal transit commonplace. This model for achieving rapid economic growth was never desirable, and it is also no longer viable, for two reasons. First, the human costs in ill health in cities such as Bangkok, Chongqing, Jakarta, and Shanghai are intolerable. In East Asia's major cities, air and water pollution are the sources of some 200,000 premature deaths, 650,000 cases of bronchitis, and 2 billion person-days of respiratory symptoms each year. Second, with deeper and broader integration, economies can ill afford the cost-raising effects of poorly functioning cities. The locus of international competition will increasingly shift from the nation to the town and city. Dirty and congested cities will lose out to cleaner and more efficient ones, owing to high costs and the high mobility of professionals.

Continuation of current trends will bring a worsening of conditions in East Asia's cities. Policy and institutional changes can reverse this deterioration by removing infrastructure bottlenecks, establishing efficient pricing or taxing of polluting activities, formulating and implementing sound regulations, and engaging society in these changes. Civic action is a key complement to government action, especially because the bulk of pollution comes from small-scale activities that usually fall outside the nets of government inspectors. In Indonesia, the national program to reduce industrial pollution has had great success through a system of publicly grading industries and monitoring by nongovernmental groups to reduce the risks of inspectors being bribed. As with many of the new generation of issues, although it appears to be a question of judicious policy choice, at a deeper level it involves designing institutions to make them responsive to society's needs and demands. Heightened competition between cities in the region could be a powerful spur to better institutional performance.

Conclusion

East Asia has, in many respects, entered new territory in the pursuit of development. Past successes have sometimes led to problems being brushed under the carpet, and new issues are emerging. The region, however, retains major advantages. Saving and investment rates of 30–40 percent, vibrant entrepreneurial classes; intense intraregional (and intercity) competition and sharing of experiences; rising intraregional integration; and a longstanding commitment to macroeconomic stability all provide both immense forward movement and substantial resilience. But sustaining this momentum into the twenty-first century will require tackling the structural and institutional challenges outlined in this article. The region's past success provides cause for optimism, but the transition to the next century will undoubtedly include interesting times. F&D