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REPORT OF THE CONFERENCE ON EAST ASIAN DEVELOPMENT: LESSONS FOR A NEW GLOBAL ENVIRONMENT

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The Conference was hosted by the Institute of Strategic and International Studies (ISIS), Malaysia, funded by the Government of Japan and organized by the UNCTAD secretariat. A series of background papers were prepared for the Conference and an overall report on the main issues was presented to the Conference by the UNCTAD secretariat.

This report of the Conference does not necessarily reflect the views of ISIS, the Government of Japan or the UNCTAD secretariat.

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A. Preface

At its 41st session held in Geneva in September 1994, the Trade and Development Board agreed there should be a follow-up to the research on East Asian development published in *Trade and Development Report 1994* and to the Board's deliberations on the subject. There was broad agreement that the process of rapid outward-oriented industrialization which underpinned the region's achievements included a well defined role for government policy. However, important aspects of this role were not fully understood and some of the specific institutional links which had encouraged high levels of domestic savings and investment required further research. It was also felt that any policy lessons for other developing countries needed to reflect ongoing changes in the international economy at both the regional level, where economic integration is advancing rapidly, and the global level, with the new challenges, opportunities and constraints upon national governments arising from the outcome of the Uruguay Round.

One important result of the Conference deliberations has been a much deeper appreciation of the differences among countries in East Asia in terms of the specific policies and institutions put in place to accelerate industrialisation and achieve rapid economic growth. It was felt that full recognition of this diversity cast serious doubts on the idea of a single development model of relevance to policy makers in all developing countries. However, it was still possible to identify some common principles in East Asia's development experience which might help other developing countries in their efforts to rethink economic policies in an increasingly interdependent world and to introduce specific institutional reforms in support of faster economic growth.

Two features common to the rapidly growing East Asian economies framed the discussion of possible lessons for other developing countries. First, all have achieved very high levels of domestic capital formation. Second, all the these economies have been strongly outward-oriented. Against this backdrop, the Conference chose to highlight the close links between an outward-orientation and capital accumulation, with the objective of designing development strategies which tie together profit-making and investment through close government-business links with policies to reinforce strong domestic growth through upgrading export capacities.

B. The visible hand of Government

There was broad agreement that the provision of various public goods by East Asian Governments, including an effective legal framework, good infrastructure and a strong human capital base, encouraged the productive activities of entrepreneurs both in the private and public sectors. Equally, macroeconomic stability has encouraged a rapid pace of investment and sustained growth in the region. However, the Conference acknowledged that rapid growth in East Asia has not emerged spontaneously from a wider role for market forces and that the state, to varying degrees, has been directly involved in the promotion of economic activities.

In particular, accelerating the pace of investment has provided a rationale for policy interventions directed at tackling a series of interrelated market failures that can hold back the process of investment and innovation in late industrializing countries. Although concerns were raised at the Conference that East Asian growth has relied too heavily on high levels of investment, it was widely recognized that a close link exists between investment and upgrading, including strengthening the technological and organizational skills of an entrepreneurial class.

1. Capital accumulation: the investment-profit nexus

In all countries in the region, positive expectations about investment prospects over the longer term have been strengthened by various measures to bolster profits. These have included a range of fiscal instruments to supplement corporate profits and encourage their retention in order to accelerate capital accumulation; tax exemptions and special depreciation allowances were applied both on a general level as well as targeted at specific industries. But trade, financial and competition policies have also been used to create rents which boosted corporate profits and the resources available for investment. This included a mix of selective policies of protection, controls over interest rates and credit allocation, and managed competition including the encouragement of mergers, the coordination of capacity expansion, restriction on entry into specific industries, screening technology acquisition, and the promotion of cartels for specific purposes such as standardization, specialization and exports. As a result of these measures, corporate savings have come to play a particularly important role in boosting capital accumulation in East Asia.

However, the Conference recognised that efforts to manage rents in support of fast growth could give way to more destructive forms of rent-seeking behaviour and considered how in East Asia, Governments have used various measures to discipline firms and generate the right kinds of investment. These have included performance criteria on rent recipients, often using the disciplining hand of the international market such as through export targets and lower protection. In addition, the timely withdrawal of subsidies as industries mature, competition policies and measures aimed at encouraging small and medium sized enterprises have also been used to prevent the abuse of monopolistic positions.

2. Outward orientation: the investment-export nexus

In most East Asian economies, as in most other developing countries, initial investment opportunities have been in industries where local resources, including labour, could be quickly mobilised and where local demand offered a stimulate growth. But a rapid pace of investment in these industries also increases imports of intermediate and capital goods, giving rise to a potential balance-of-payments constraint on growth which makes export promotion essential. The Conference recognised that the initial success of many East Asian economies was built on improving international competitiveness in these industries. However, an export-led industrialisation drive relying on initial endowments is vulnerable to rising domestic wages, a slowdown in productivity growth and loss of competitiveness. Sustaining rapid economic growth must, therefore, be accompanied by a shift in the direction of investment towards a new set of export industries.

Although the Conference highlighted differences among countries in East Asia in the way industry has evolved, in large part reflecting differences in natural resources and the size of the domestic market, one feature in common has been the anticipation of limits to static comparative advantages and the purposeful nurturing of a new generation of industries with greater potential for innovation, productivity growth and export success over the long run.

In the initial phases of growth when industries could rely on abundant local resources, Governments in East Asia concentrated primarily on measures to accelerate investment. Even when more direct efforts to promote exports were introduced, these tended to be quite general in scope. But from an early stage, more selective measures were introduced to encourage investments in new export industries. These measures took the form of subsidized finance, direct subsidies, selective protection from imports and other forms of financial and administrative assistance regarding international marketing and R&D. However, it was recognised that, in light of the less successful application of similar policies in other developing countries, the monitoring, testing and ultimately the withdrawal of these measures by East Asian Governments was just as important as their initial design and implementation.

This selective approach also extended to foreign direct investment (FDI). Governments across the region have recognised that if their domestic firms were to close the productivity and technology gaps with more advanced competitors they must interact with firms from countries higher up the development ladder, including through FDI. However, because the technologies and organizational skills of foreign affiliates do not automatically spill over to domestic firms, policy makers in East Asia have experimented with a range of policies to better connect the activities of transnational corporations (TNCs) with their development objectives, some encouraging FDI across a wide range of activities, some favouring other forms of interaction with foreign firms.

3. Encompassing development strategies

The Conference recognized that a better distribution of income -- compared not only to other developing countries but also to some developed countries -- was an integral part of successful development strategies in many East Asian countries. In part, this was attributed to policies designed to strengthen the agricultural sector even as the locus of economic development shifted towards industry. But in addition, the Conference considered the contribution of various measures introduced to correct market biases against small and medium-sized enterprises in both the rural and industrial sectors. These biases are particularly strong in such areas as access to finance, the diffusion of technology and marketing, and can lead to the formation of marginalized sectors even as economic development is progressing rapidly.

The Conference confirmed the potential benefits of policy-based lending and directed credits, but also considered the value of other measures introduced by East Asian governments to establish closer links between small enterprises and the formal sector, including technological support services and subcontracting arrangements. In addition, it was recognised that the extension of credit on concessional terms to the marginal sectors raised many of the more general issue surrounding institutional capability building in developing countries.

C. Institution building

1. Building the capacities of the State

Drawing lessons for other developing countries was qualified in two important ways during the Conference deliberations. First, weak financial and administrative capacities in many developing countries appeared to exclude the state from successfully undertaking some policy initiatives. Second, any efforts to strengthen the government's role in managing economic development must recognize the potential dangers of failure, particularly through the capture of policies by narrow interest groups.

However, neither of these qualifications was taken to mean that policy efforts should exclude longer-term development options. Indeed, there was general agreement that the design of development strategies must be tied to efforts at rebuilding and reforming the institutions of the State. In this respect, both the range of institutions present in East Asia in support of long-term development goals, and the fact that appropriate administrative capabilities were only gradually built up in many of these economies were taken as hopeful signs that deliberate and cumulative reforms could produce impressive results in other developing countries.

The Conference discussed a number of factors which could contribute to the creation of more competent states. First, priority needed to be given to the creation of a meritocratic and competent bureaucracy where public decision-making capacities are recognised as a scarce resource and given appropriate attention, support and rewards. Second, this bureaucracy needed manageable goals and not be unduly overburdened with excessive political demands. Governments should initially pursue a limited number of selective interventions in strategic industries accumulating capabilities and know-how that can prove extremely useful in conducting more sophisticated policies for promoting the next generation of industries. Finally, a permanent staff of high quality personnel should be subject to new challenges and opportunities to avoid complacency. In this context, special career tracks and the recruitment of outsiders can often strengthen bureaucratic capabilities.

The Conference also stressed that attention should not just be given to strengthening the larger and more prestigious institutions of government. In many cases, selective industrial policies designed by national policy makers are made effective only at the sectoral and sub-sectoral levels. In East Asia, sector-specific agencies have often taken a lead role in promoting new investment opportunities, forging links with foreign suppliers and investors, and facilitating technological upgrading.

In all these cases of institution building, as with specific policy measures, the Conference recognised that East Asian economies had not always achieved optimal results. Other developing countries should not, therefore, not be overwhelmed by this experience. Rather, they should recognize that in an imperfect world the emphasis needed to be placed on improvement rather than perfection.

2. Strengthening the government-business partnership

It was clear from the discussions during the Conference that giving full recognition to the State's role in East Asian development in no way diminished the contribution accorded to a domestic entrepreneurial class in sustaining growth across the region. It was generally accepted that much closer attention needed to be given to how firms evolve in a context of rapid economic growth, how industries organise themselves and voice their particular needs, and how governments have found ways to ensure that satisfying those needs converges with national development objectives.

A strong conclusion to emerge from the Conference is that the design of policies to establish a profit-investment and an investment-export nexus must be accompanied by a constant interflow of information between the business community, government officials and policy makers. In East Asia, consultative councils have played a prominent role in enhancing the transparency and fairness of administrative decision-making, facilitating information flows and providing a forum for solving conflicts and coordination problems. But less permanent forums, including government-sponsored conferences and more informal meetings have also played a similar role.

East Asian experience also strongly suggests that better government-business relations to correct the information imperfections and coordination problems that might hamper economic growth depend upon effective organization of the business sector. In this respect, the intertwining of business and family ties have played an important role in building trust across corporate activities in East Asia. But closer links between industry and finance have also been an important source of business coordination in East Asia. As a result, a variety of institutional links between corporations and banks have evolved -- sometimes involving close government supervision -- to provide the means for overcoming many of the imperfections and problems common to financial markets in developing countries, and establish a better investment regime.

D. Regional growth dynamics

Over the past decade, regional trade and foreign investment flows have assumed growing importance in East Asia, and strong complementarities between these flows and domestic resources may explain much of the region's rapid growth. The Conference believed that a clear understanding of these links was necessary when extending the lessons of East Asia to other developing countries and regions.

The rapid upgrading of economic activity from resource-based and labour-intensive industries to more skill- and technology-intensive manufacturing activities by a leading economy could generate a regional dynamic where less developed neighbouring countries pick up the discarded activities and develop these through closer trade and investment linkages. However, this was not considered to be necessary for a successful outward-oriented development strategy to emerge in any particular country.

In this context, it was noted that Japan's longstanding influence as a role model for other countries in the region had only been matched by strong trade and FDI ties since 1985. Consequently, the first wave of regional industrialisation -- including Republic of Korea, Taiwan province of China, Hong Kong and Singapore -- did not appear to have relied strongly on close Japanese involvement. However, Japan's expanding regional trade and FDI ties have been a more prominent factor in a second wave of industrial growth -- including Indonesia, Malaysia and Thailand. These ties have been especially prominent in the automobile and electronic sectors and largely conform with the idea of a recycled comparative advantage from a more advanced to a less advanced economy. Moreover, this recent

wave of FDI has also been accompanied by a significant rise in exports to Japan from the region. Although the Conference noted that future links in the region were becoming more difficult to assess in light of Japan's status as a mature economy and the uncertain role of China, participants generally expected closer regional economic ties in the future.

In its deliberations of these regional ties, the Conference confirmed that although trade and FDI links were, to a large extent, market conforming, the recycling of industries had not been an automatic process driven by spontaneous market forces. Many of the regional spill-overs encouraging growth within East Asia were found to have been generated because of the successes of industrial policy measures introduced in Japan and the first-tier newly industrialising economies (NIEs). Moreover, because Governments in East Asia -- including the second-tier NIEs -- have been clear about the task of industrial upgrading, measures to strengthen regional ties have been designed and implemented to complement national economic capacities.

An important feature of regional ties in East Asia particularly over the last decade, and which was highlighted during the discussions at the Conference because of the potentially important lessons for other developing countries, has been the rapid expansion of trade and FDI links between the second-tier of newly industrialising economies in the region and the first-tier. Trade between these economies is growing much faster than trade with the outside, and there has been a mushrooming of FDI from the first to the second-tier NIEs. The Conference considered that such examples of South-South integration deserved more attention in discussions of development policy options.

E. Policy options in a changing world economy

The policy mix adopted to accelerate capital formation and strengthen technological and entrepreneurial capacities in East Asia have allowed domestic firms to adapt successfully to international pressures, including multilateral constraints, and to take full advantage of closer integration with the regional and the world economy through trade and FDI linkages. This policy mix generally involved: (a) flexible protection for infant industries, (b) the channelling of investment into sectors and activities deemed to be of development priority, (c) export promotion through various types of subsidies, (d) various benefits, including market access, to foreign firms made conditional upon the transfer of technology.

However, extending the lessons from East Asia's experience poses a dilemma for much current development-policy thinking. On the one hand, it strengthens the consensus in favour of export-oriented development strategies. On the other hand, there is a perception that new international pressures have made the policy mix followed by many East Asian countries either unnecessary, because of the increase in international financial flows and FDI, or impossible, because the conclusion of the Uruguay Round Agreement.

The Conference purposefully avoided generalizations on these matters concentrating instead on a more balanced analysis of the possible trade and economic policies still available to developing countries in full cognizance of their multilateral rights and obligations. It was generally felt that these obligations would not preclude lessons from earlier development strategies, albeit in the context of more open markets.

Attracting capital flows continues to be crucial to high rates of investment and growth in many developing countries. But this does not exclude the kinds of prudential regulation of financial flows employed in East Asia particularly when inflows of speculative short-term capital pose a threat to macroeconomic stability. Nor was it felt that their pragmatic approach to interacting with foreign firms was any less desirable in today's world economy, particularly for countries trying to upgrade their industry beyond those relying on traditional endowments. While the benefits from hosting TNCs are particularly strong in sectors where specific knowledge and capital equipment are closely tied together, where entry barriers are particularly severe or the pace of technological change particularly rapid, these same concerns make development prospects even more difficult to predict. In this case, the lessons from East Asia, both the first and second-tier NIEs, strongly suggest that strategic industrial policies must set out a clear role for FDI.

A defining feature of the WTO is the imposition of a more homogenous set of multilateral obligations which strengthen the disciplining role of the market. As such, the WTO has reduced the scope for using some policy measures, but it has also improved security of market access for exports from developing countries. The Conference recognised that the more generalized protection which provided a backdrop for targeted policies in East Asia is no longer possible, and many of the export promotion policies no longer appear permissible. However, a range of policies designed to establish a dynamic profit-investment nexus remain permissible under the new trading rules. These include general fiscal concessions to corporations, the provision of subsidized R&D and measures to promote corporate savings and investment.

Given that these policies can have considerable influence on technological upgrading and international competitiveness, strengthening these areas of policy making remain central in today's global environment.

The Conference also stressed the room for constructive policy options in specific trade areas which still exists for signatories to the Uruguay Round Agreement. Unbound duties can still be increased for infant industry protection, as well as applied duties up to ceiling bindings. The Agreement on Subsidies and Countervailing Measures exempts least developed countries with a per capita income below $1000 from the prohibition on export subsidies, and they also have an extended period to implement the prohibition on local content subsidies. Other developing countries have eight years to comply subject to certain quantitative thresholds.

The Conference recognised that constraints stemming from TRIMs, GATS and TRIPs appear to have tightened some options, particularly on middle-income developing economies. However, these agreements also contain a number of provisions which should allow developing countries considerable freedom to accelerate technology transfer, improve access to distribution channels and deal with anti-competitive practices. Moreover, the formulation of these agreements and the tacit role of business practices in their application provide opportunities for innovation and experimentation in the policies pursued by developing countries.

There was a general agreement at the Conference that many important challenges for developing countries lie in the future with pressures to direct multilateral trade rules to deal with phenomenon of competition between regulatory regimes. Preparing developing countries for the new issues which might emerge from these discussions will be critical in determining which policy options will remain open in the future.

F. Conclusions

The Conference recognized that East Asian development offered important lessons on how poor rural economies can make an effective transition to labour-intensive manufacturing, and then more complex manufacturing activities essential for the attainment of high standards of living. In particular, the kinds of selective policies to help channel resources to firms and sectors with the capacity to invest in such a way as to increase long-term productivity deserved careful attention from policy-makers in other developing countries. However, it was also recognized that such policy measures cannot be divorced from efforts to reform the State and to ensure effective organization of the business sector in ways that strengthen coordination and ensure better flows of information and coordination between the public and private sectors.

In the light of recent changes in the world economy, the outward orientation of East Asian economies was seen to be particularly compatible with the current direction of development strategies. However, due recognition needed to be given to their selective integration with the world economy and the contribution of regional integration to the rapid pace of economic growth. The Conference was cautious in its assessment of the opportunities and costs of the Uruguay Round, stressing instead the room still available to developing countries in redesigning policies to establish competitive industries and lift economic growth, as well as the need to quickly test and improve their chosen policies to ensure these ends are reached.