Remarks at the UNCTAD thematic lunch of the 2013 Astana Economic Forum / World Anti Crisis Conference on the subject of '50 Years of Development: What have we learned?'

Joe Studwell
Author, *How Asia Works*

What are the Ingredients of Successful Economic Development in East Asia?

An historical review of east Asian economic development shows that the recipe for success has been as simple as one: household farming (backed by credit, marketing and agronomic extension support); two: export-oriented manufacturing (in which infant industry subsidy is conditioned on export performance); and three: closely controlled finance that supports these two sectors.

The reason the recipe worked in Japan, South Korea, Taiwan and now mainland China is that it enabled poor countries to get much more out of their economies than the low productive skills of their populations would otherwise have allowed at an early stage of development. Governments manipulated economies which thereby forged ahead and created wealth that paid for people – who cannot be neatly transformed by government policy – to catch up.

Neo-classical economists do not like political intervention in markets. They claim that markets are inherently efficient. But history shows that markets – with the primordial exception of what the institutional economist Ronald Coase dismissed as 'individuals exchanging nuts for berries on the edge of the forest' – are created. Which is to say that in a functioning society markets are shaped and re-shaped by political power.

Without the dispossession of landlords to enable land reform programmes in Japan, Korea, Taiwan and China there would have been no increased agricultural surplus to prime industrialisation. Without the focus on manufacturing for export, there would have been no way to engage tens of millions of former farmers in the modern economy. And without financial repression, it would not have been possible to pay for an accelerated economic learning process. In all of the above, markets and competition were made to serve development.

Small-scale, very high-yield agriculture that followed successful land reform programmes in north-east Asia increased crop output by between half and three-quarters in 10-15 years. The key was to maximise yields and output per hectare by utilising all available labour, rather than concentrating on profits per farmer (or investor) as larger farms tend to. The income distribution from household farming was also conducive to rapid development, creating as it did broad-based demand for basic goods that could be produced locally.

An acute focus on manufacturing was the best mechanism to make use of surplus labour as it migrated out of farming. Manufacturing features few of the skills 'hurdles' that characterise services (as when a person cannot, for instance, begin to write software until he has learned software code), being defined instead by a smoother learning curve. Manufactures are also much more freely traded in the world than services. And the machines with which to manufacture are readily available on the world market (more so today than ever).

The traditional problem with manufacturing policy has been the abuse by entrepreneurs of the requisite protection and subsidy extended to infant industries -- a problem variously termed 'rent seeking' and 'crony capitalism' (this latter term originated, tellingly, in the Philippines). North-east Asian states resolved the problem by forcing entrepreneurs to become exporting manufacturers; the policy mechanism that achieved this was state control of domestic financial credits, production licences and other incentives. A firm's capacity to export indicated whether its policy-supported production was of an internationally competitive quality; it also sent vital credit quality signals to banking systems. The use of what I term 'export discipline' differentiated north-east Asian development from the failed Import Substitution Industrialisation programmes of the post-war era in Latin America, south-east Asia and elsewhere (including South Korea in the 1950s).

The financial systems that catalysed north-east Asian development were characterised by capital controls that gave governments discretion over both domestic capital and footloose international capital. Domestic finance was characterised by a heavy dependence on banks, which transmitted state industrial policy with minimal distortion compared with stock and bond markets.

In contrast to north-east Asia, south-east Asia became a beacon for what not to do if you want economic transformation. Despite many announced plans for land reform, governments allowed landlordism and scale farming to continue despite the presence of vast numbers of underemployed peasants capable of growing more. Crop yields for key staples in south-east Asia are as low as one-third those in north-east Asian states despite soil and climatic conditions that are typically more favourable.

South-east Asian states sometimes announced industrial programmes in efforts to emulate north-east Asian development, but did so without conditioning subsidy support and protection on export performance. In many cases, enterprises given state support were also not subject to domestic competition. The vast majority of exports in south-east Asia were and are manufactured by multinational companies and local processing firms operating at their behest. Today, south-east Asia has no globally recognised, branded manufacturing firms of its own.

In the financial sector, south-east Asian states proceeded much quicker than north-east Asian ones to deregulated banking, stock markets and international capital flows, following the advice of multilateral institutions and economists in the neo-classical tradition. Economies were encouraged to maximise short-run returns on portfolio capital before they had invested in substantive technological development. As we meet here in Astana, it is telling that among the nine major economies of east Asia the best-performing stock market belongs to the industrially most backward state -- the Philippines (which has gone from being wealthier than Taiwan or South Korea in the past half century to being 10 times poorer).

It must be noted, however, that the 1, 2, 3 approach of north-east Asian states was not a panacea. Although Japan, South Korea, Taiwan and mainland China exhibited the fastest sustained economic growth the world has seen, each exhibited increasing signs of what I term ‘institutional drag’ on economic potential because institutional development failed to keep pace with economic growth. Institutions are important. Inadequate institutions, and vested interests created through a long period of accelerated growth, underlie Japan’s 20-year growth hiatus. Taiwan is presently struggling to establish a new institutional equilibrium that can restore its development momentum. And China shows increasing signs of institutional and vested interest drag as the amount of investment it requires to produce a fixed amount of economic growth increases year by year. By contrast, South Korea’s relatively superior economic performance compared with Taiwan in recent years may be attributable to the IMF programme of deregulation and enhanced competition introduced after the Asian financial crisis. It is entirely consistent with the arguments I set out in How Asia Works describing the roots of developmental success that the interventions required to nurture development are also ideally accompanied by institution building and followed by a period of aggressive de-control and de-regulation.

Economists have begun to study the interaction between economic structures and the major institutions of a state. Important work has been published in this field and some of it has been recognised by what might be called the ‘economic establishment’. However a vast amount of research remains to be done. For now, all that is clearly understood -- because it is a matter of historical fact -- is the 1, 2, 3 structure of accelerated economic take-off. Small scale farming, an acute focus on manufacturing and financial repression were not invented in Japan, South Korea, Taiwan and China. These policies were expanded and refined in those states, but their origins go back much further, to the formative eras of the British, US, German and other continental European economies, as anyone who has studied history knows.

In this sense, it is time to answer Charles Kindleberger’s question as to whether there is only one kind of economics. The answer, surely, is that there are at least two. There is an economics of development that requires nurture, protection and competition. Then there is an economics of efficiency, applicable to a later stage of development that requires less state intervention, more deregulation, freer markets, and a closer focus on near-term profits. The proof that the two economics are different is that no rich country in the world (outside anomalous offshore centres) has ever developed through policies of free trade from the get-go. If we can only concede this, then the two kinds of economist can stop talking past each other -- as they have done ever since Friedrich List took issue with the work of Adam Smith -- and start working together for the common good of all humanity.

Joe Studwell, 24 May 2013