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13th Raúl Prebisch Lecture

**South and East Asia:
Leading the World Economy**

by

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South and East Asia: Leading the World Economy

It is a great honor for me to be giving a lecture at the home of UNCTAD, where our annual meetings of Project LINK in cooperation with the United Nations are being held. My first encounter with the United Nations took place at Lake Success (a very interesting name for the early site of United Nations work for the world in many diverse fields). The first encounter involved the economic outlook for some major industrial countries, but over the years in cooperation with UNCTAD and with the UN Secretariat, it has been an extremely fruitful working relationship between academia and international civil service to improve our understanding of the functioning of the total world economy, and not simply the leading industrial countries that led me to visit Lake Success in the early work of the United Nations.

The main interest of Raúl Prebisch was usually with efforts to use knowledge of performance throughout the World Economy to improve the relative status of the developing world. Times have changed greatly, and we are here now to assess World economic prospects at a time when developing countries are the star performers. In recent years, we often approached such meetings with the thought that there was a main, sole locomotive for the World economy, but that situation has run its course, and the motive power presently comes from China and India, with the economy of the United States stumbling with twin deficits, an elevated inflation rate, and a costly war, in which an unexpected casualty rate has become serious..

Our World Summary tables at these Project LINK meetings have changed in such a way that the strong growth comes now from China and India, at very high figures, followed by moderately high growth figures from other developing countries and unusually weak growth figures from the advanced industrial countries. Of course, there are still poor performers in the developing world and some moderately good figures from the advanced industrial countries. Also, developing actions are not in immediate sight of high levels; for the most part they enjoy impressive growth.

Dr. Prebisch in one, among many, interesting papers which was published in the *American Economic Review*, looked upon the world economy in the following way: He called the advanced countries the industrial center and the developing countries the periphery.¹ He did not pay special attention to the centrally planned economies, in a third grouping, but one of these (China) is now in a locomotive role, and Russia is a major power source for the world train as the world's second largest oil exporter. The economies in transition, encompassing more than China and Russia, have made striking turnaround efforts and rank today among the leaders. One grouping is called the BRICs, with Brazil included as a developing country, together with India, Russia, and China. It is plausible to consider that a "real" BRICK is in the offing, namely by adding Korea (ROK).

In 1959, Raúl Prebisch stressed the role of large income elasticities of imports for the periphery, especially in Latin America, vis-à-vis low elasticity of demand for

¹ Raúl Prebisch, "International Trade and Payments in an Era of Coexistence: Commercial Policy in the Underdeveloped Countries", *American Economic Review*, 49, May, 1959, 251-73.

agricultural imports on the part of the industrial center. To fight this imbalance Dr Prebisch said, "... import substitution ... is the only way to correct the effects of peripheral growth..."

In this era of globalization, advanced technology, and a tripartite world economy – advanced industrial countries, transition countries, developing countries – we now find a very interesting new arrangement in which import substitution does not seem to be the answer. Nevertheless there do seem to be answers that differ from Prebisch's vision but do provide hope for the countries of the periphery in dealing with the prospects for economic gain of the sort that Prebisch wanted for the developing countries. Globalization is here to stay, one cannot back away from that fact, but today's new order can be tapped for the advancement of the entire world economy through peaceful economic efforts.

The target for developing countries should be one of generating higher and higher value added output, while at the same time improving productivity wherever possible, even in the primary production sectors, but not exclusively there.

The world economy is made up of excellent examples of countries who excel in primary products, but their accomplishments in that sector alone would not have been enough to bring them into the groupings of advanced industrial nations. I have in mind the Netherlands, Denmark, New Zealand and other prosperous and wealthy countries where technical expertise in finance, shipping, the most advanced branches of manufacturing, and higher education prevail on important scales. For them to have focused alone on their agricultural skills would not have brought them into the top grouping, but the fact that they also can produce a broad span of goods and services for their own consumption and for that of the world at large, through trade, has brought them to positions of high rank on a world scale of material well being.

In a conference last year of economists from Latin America and the Caribbean (LAC) in Costa Rica, one speaker after another lamented that economies in their native area could not reach the markets of the world with efficiently produced items of higher value added. Chile, for example, where praise falls upon them for their advanced market reforms, for supplying fine wines to the world, for sending Southern Hemisphere fruits and vegetables to the North during cold winter months there, and even for supplying much of the world's primary copper was described by one of her economist sons of not being in a position to make its economic ranking a great deal higher without going on to supply of higher value-added products in its impressive list of exports.

Some economists look toward higher values of total factor productivity (TFP) as the required ingredient and not import substitution. Paul Krugman declared in the late 90s, with considerable foresight, that the Asian Miracle was just a mirage because production was elevated to great heights without corresponding increases in TFP. He drew partly upon the work of Lawrence Lau, who also could see possible crisis situations in Asian development, following Mexico's crisis of 1994-95, and later refined his productivity analysis of developing Asian countries to allow for TFP if embedded productivity were allowed for in the production specification. Also, if some of the Asian countries had not foolishly pegged their currencies to the US dollar throughout the 90s, they may have avoided the worst damages of the crisis. Their

policy prevailed at a time when the dollar was so strong that they priced themselves out of the world market. In Latin America, Brazil, among the BRICs, may indeed make advances beyond coffee, sugar, iron ore, soybeans, orange juice and grow at sustained rates above 5% through their efforts in the secondary sector, producing aircraft, cars, computers, and other products of higher value-added.

Mexico, Venezuela, Ecuador, Colombia and others have such vast resources of oil, together with ecotourism that they may, indeed, advance at somewhat higher sustained rates, but are not realizing their full potential.

At the LAC Conference in Costa Rica, as I watched and listened to the area's economists lament the fact that they were not making sufficient progress because of their attachment to low value-added activities, I waited patiently and in vain for some mention of military spending. No speaker followed that line of reasoning, but Costa Rican economists had asked me to speak the following day about the concept of the PEACE DIVIDEND. I was able to show contrasts among the Central American nations who had sizable defense outlays, whereas Costa Rica, our host country, had no standing army, very low defense spending and better economic performance. Costa Rica will have to do more than simply follow its path of negligible military spending, in order to enhance its economic performance, beyond good results from ecotourism and traditional Central American products, in order to gain more striking economic improvement.

A new Asian Miracle has appeared; the central characters are BRIC members, India and China. They have very different specializations in economic performance but are establishing very impressive records. Both have long histories of cooperation with the international research activities in Project LINK, now meeting here at the United Nations in Geneva, and their ascension to the heights of national economic performance in an international setting provides much to watch, study, emulate, admire, and congratulate.

The China Story: By now (2005), many people have been witnesses, scholars, investors in the Chinese economy and have their own interpretations of what has taken place since reform in 1978 and where it is heading at the present time. It does not fit primarily with the concept of import substitution; it has become, in recent years, a case of export-led growth, but it did not become that way immediately. My interpretation is that under the guidance of Deng Xiao Peng, China set out to grow on the concept of market-socialism, with a Chinese flavor. Many observers and participants might say that market-socialism is an oxymoron concept; in fact they have said so. Others have conceded that the logic of mathematical general equilibrium systems could, in principle, be a target, as argued in the economic literature of the 1930s, but without private ownership there would be a lack of innovation and that the logic of such general equilibrium could not be realized in practice because it is too complicated, even in the IT era. My quite different interpretation is that China adopted policies of step-by-step gradualism in a one-party environment by introducing such economic changes as land reform, special economic zones (with important international trade features), and opened academic centers (including elementary primary education) following the cultural revolution. In these early steps they also solved a basic food supply problem. In visits during this period it was judged that if agriculture could be put on a 3% or stronger growth path, the basic

food problem could be managed. On top of this approach, there was the very significant demographic policy of one child per family (with some exceptions).

Further steps in the gradualism approach were the freeing-up of small enterprises in manufacturing, retailing, and controlled trade. An important feature of this economic stage was the appearance of Town-and-Village Enterprises (TVEs), which meshed well with off-season activities in a predominantly agricultural economy. All economic trends have not contributed to smooth improvement. There was rising inflationary pressure accompanied by demonstrations in Tiananmen Square, but these disturbances were overcome and, as far as inflation is concerned, turned around, but after an interruption of more than one year, there were new steps forward such as infrastructure investment to put modern facilities in place. During the early expansion in the reform period, structures were not world-class. Even the best looked old in the first stages of use, but within a period of only a few years the highways, bridges, buildings, tourist facilities became world-class. Computers, laboratory equipment, and electronic communication came up to world standards. Reservation systems were installed; aircraft became modern; the fleets of cars and trucks were totally changed; research laboratories got progressively better equipment. In 1994, the system of exchange rates were consolidated into a uniform rate; foreign direct investment was attracted on a large scale for a developing country, and the financial system started to be reformed. China was admitted to WTO membership after having achieved Permanent Normal Trade Relationship (PNTR) with the United States; so the yearly renewal of most Favored Nation Treatment was changed to permanent status.

Economic policy support for growth was diversified towards the western and interior parts of China – mainly away from extreme coastal areas that dominated early expansionary policy. Now, new steps are being taken towards some degree of flexibility in exchange rate policy. This is all a far cry from the economic status and performance of China in the period immediately after reform, in 1978. It is so different, in this step-by-step procedure that China can look back on the elapsed period and see that the growth rate of real GDP has been between 8% and 10%, a remarkable quantitative record for more than 25 years and still going strong.

Some Western economists have argued that this statistical record is exaggerated. I strongly disagree, not only because many advanced and developed economies complain that China is an overly strong competitor, but because I have tried to make adjustments to China's inflation rate calculations, trying to account for the rapid improvement in quality of life, for the same reasons (but not by the same methods) that were used by the Boskin Committee in the United States to mark down the US rate of inflation in the early part of this century, and estimate that China's adjusted growth rate has been more than 1.0% above the former official estimates, due to the downward adjustment of the curve of price increase.

At the time of the East Asian financial crisis of 1997-98, there was great concern on the part of many countries that China was capturing a large part of their export market and causing their trade and current account balances to deteriorate to crisis proportions. It is my estimate that China's exchange rate consolidation, 1994-97, made the Chinese currency cheaper in US dollar terms, while, as noted above, many East Asian countries clung to a dollar peg and priced themselves out of the

market. China, however, grew so fast and had such a strong appetite for imported products from the global market place that exports to China have, in due course, helped these countries, and others in Latin America, to look forward now to the great locomotive strength of China's imports from partner countries, including not only East Asia, but Latin America as well. Maquiladora enterprises on the US/Mexico border, went through the same experience, although later in time, as did the East Asian countries.

On the export side, China has grown fast as a member of WTO and restrained textile exports until the quota was lifted. Many partner members felt the loss of activity when China's exports overwhelmed the market, starting in January, 2005, and China has shown some renewed restraint but is feared by many other countries in this sector of trade activity.

It is not likely that China's textile, or other, exports will be adequately restrained by exchange rate pressure to allow their currency to float upward. A basic reason is that the wage differential between China and many other trading partners is so large that this contribution to price advantage in favor of China's exports, in many sectors, dominates currency movements at this time. The World Bank's World Development Indicators for 2002, show China's labor costs (1995-99) to be 1/40 of US values. There is general estimation that this very large advantage has dwindled to a ratio nearer to 1/20, and there is judgment that it will continue to change, in favor of Chinese workers. In addition, China is encouraging and supporting Chinese imports of consumer goods through permission of more foreign tourism of Chinese people, carrying more generous allowances for international currency transfers.

When China started to introduce reforms, and diplomatic relations were started with the US, a group of American economists visited the country in order to establish contact with Chinese economists. I was chairman of the delegation and selected my colleague, Irving Kravis, of the University of Pennsylvania as an important member who had military experience in China during World War II and later specialized in comparing countries, the world over, for their relative positions in the compilation of GDP per capita for many countries. This was the first step in 1979, in carefully comparing China to the rest of the world and eventually raised extreme interest in China's relative position. Professor Kravis, in a pioneering effort, stimulated careful discussion of China's role in the world economy. He put China's real per capita GDP for 1975 at 12.3% of the US value; just below the Philippines at 13.2% and nearly double India's position at 6.6%. Resident Chinese economists protested that his estimate for China was too high, but it sparked the start of more and more careful measurement. Among US scholars, it marked the beginning of careful quantitative study of the Chinese macro economy.

While Professor Kravis' pioneering studies of the quantitative features of China dealt with macroeconomic aspects, a very important distributional achievement has taken place. It can be seen that hundreds of million Chinese citizens have been lifted from POVERTY status – one of the main economic targets of the world's multinational institutions.

It is noteworthy that China stood, according to Professor Kravis' figures, at twice the ranking of India on a GDP metric. India had been one of the most studied

economies of the world, not only in quantitative economic terms, but on a broad social scale after World War II. In spite of the accumulation of a great deal of knowledge about India, there was not a noticeable spurt in the performance of the Indian economy, until quite recently. Over the years of Chinese reform, since 1978, economic delegations have traveled in both directions between China and India, learning from one another; now however, India is starting to attract world wide attention to its own form of economic growth and figures in my opinion as a quite different center of Asian economic growth, but in a very positive way.

India has long been a victim of natural forces that imposed periodic fluctuations in economic activity from good and bad monsoons. The time curves of sectoral production in India show that agricultural crises were often associated with poor economic activity throughout the economy, but beginning in the 1990s the services sector became a stabilizing force in the presence of agricultural troubles. India gradually became an offshoring center for software, business services, and eventually medical and health services that are not immediately thrown in into crisis by poor monsoons.

There are well-known reasons why offshoring of services, especially to the United States, but also to other advanced economies, smoothes out the repercussions of fluctuations in agriculture. Industry can maintain more stable activity as a result of some service sector support. It is not only a matter of sustained export of business and software services, but also financial and health sector services. Indian workers excel in such activities because of their command of English language and scientific or engineering training in educational institutions that have built upon their strong British foundations. Also, as in China, the vast overseas Indian population, like overseas Chinese, put resources to work in the lands of their origins.

Indian life is well known for its bureaucratic tendencies. These persist, but sensible reforms have been introduced into Indian life to make the economy more efficient.

As in China, there is a significant, but more moderate, wage differential with advanced economies. Where we found Chinese labor costs to be 1/40 of US labor costs in the 1990s, the corresponding Indian ratio was about 1/25. In the expanding software sector the ratio is between 1/20 and 1/10.

The two Asian giants are spectacular because of their huge populations. China's birth rate is particularly managed, while India's is not, but they are both over or near 1 billion persons in total population count. It is expected that India will eventually overtake China, and become the largest country in the world.

In this respect, it is instructive to look at demographics in another East Asian country, Japan. By free choice, Japanese families, after World War II, elected to have fewer children. As this attitude persisted, and as immigration was restrictive, Japan became one of the world's most aged populations. This has brought down the national savings rate in Japan and bears some responsibility for its lost decade of the 1990's and slow growth in the 21st century. Will China avoid the Japanese pitfall? Future demographic policy is not yet clear, but India does not seem to be heading in that direction. There is a problem of HIV-AIDS for India and possible exposure to other

Asian epidemics, but there is no indication that there will be too few workers to support an expanding group of aged citizens.

There is an economic issue that can be turned into an advantage for India, namely the flow of IT services into the domestic economy. At present, software and related service sectors constitute a growing export sector for India, seeking many billions of US dollars annually and still growing, while protectionist attitudes abroad are built in abeyance.

There is, however, another economic target ahead for India, namely, the turning of IT prowess back into the domestic economy. Indian policy makers are well aware of the contribution of IT-centers in the US to lifting the curve of productivity gains throughout American industry in the 1980s, 90s and in the new century. This is beginning to happen now in India, in a promising way. At the same time the quality of life is visibly improving in India.

The title of this presentation refers to South and East Asia (India and China), but other economies of Southeast Asia and Northeast Asia are also performing well in the economic sphere, after the crisis of 1997-98, and it is likely that they may be able to realize the gains that Raúl Prebisch dreamed about for the periphery, and may be extended eventually to Latin America. As for well-endowed West Asia or North Africa, if those countries manage their natural endowments well, they too will find a sustained better economic life. In the case of most of Africa, however, the route to better living conditions will undoubtedly be more tortuous.

There have been gains in the conquering of poverty in Africa, but not on the impressive scale found in China, but if the good side of globalization can be turned on Africa, there is hope for improved economic conditions – not in the near future, on a massive scale – but eventually it can be done.