

**The Sustainable Development of East Asia and
Accompanying Issues**

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Introduction

The East Asia region achieved high economic development over the past 30 years and the fruits of its growth and development came to draw global attention in the 1990s (Note 1). Geographically speaking, East Asia consists of two regions — the Northeast Asian region consisting of Russian Far East, China, the Korean Peninsula, Japan, Taiwan and Hong Kong, and the Southeast Asian region that includes the current 10 ASEAN members (Brunei, Cambodia, Indonesia, Malaysia, Laos, Myanmar, the Philippines, Singapore, Thailand, and Vietnam). The East Asian economy, seen as a whole, has distinctive economic characteristics. For instance, the region has the largest population in the world; it has economic diversity; it has achieved the highest economic growth rate in the past 40 years; a convergence of policies implemented during the course of its economic development and their direction can be recognized despite economic diversity; economic development and growth spread rapidly throughout the region; the region contains market economy systems based on strong interdependence between government and private sector; economic development and growth was led by increased exports and investment, and rapid progress was seen in internationalization during the course of development and growth. These economic characteristics drew keen attention and came to be known as the “East Asian miracle” in the 1990s, before subsequently inviting international debate over the evaluation of the economic miracle.

Judged by various economic indicators, such as economic growth rate and the change in industrial structures, the economic growth of East Asia in the past 40 years should be given a high degree of evaluation. The East Asian economy that had seen relatively smooth development and growth fell into a currency and financial crisis in 1997 and the economic development and growth came to a turning point. The currency and financial crisis expanded and spread throughout the whole East Asian region in a short period of time and the countries directly hit by the crisis posted negative economic growth or zero growth at most. Even the countries that were not directly hit by the crisis saw their economic growth decline sharply. Various factors can be cited as the cause of the currency and financial crisis, such as a rise in international capital movement, failure of exchange policies, and fragile governance of the financial systems and market systems. Following the currency and financial crisis of 1997, East Asian countries have been promoting economic adjustment and structural reform to recover from the crisis and achieve new growth. The large-scale economic crisis that East Asian countries experienced for the first time had not only economic but also social and political impacts, and some countries are still unable to fully restore social stability. The nearly 40-year economic development and growth of East Asia had a strong aspect of being a catch-up process for modernization and industrialization. However, the economies of Asian NIEs reached the

level of semi-developed countries by the end of the 1980s and in effect achieved the level of developed countries by the end of the 1990s. Leading ASEAN countries also achieved the economic level of semi-developed countries in their urban areas and advanced regions by the mid-1990s. And, as a result of the expansion of economic size and a sharp increase in industrial production brought about by the economic development and growth, environment issues in East Asia came to be recognized as an important problem in the 1990s. Consequently, East Asian countries as a whole reduced the weight on the aspect of catching up with developed countries in the 1990s and have come to seriously study a new paradigm for economic development and growth amid irreversible moves toward internationalization. However, there are countries in East Asia that started the process of modern economic growth only recently and there are also countries, like China, that have widened regional disparities on their way to rapid economic development and growth. We should not forget that for the countries that are in transition to market economy or having problems of regional disparity, catching up with developed countries is still their challenge or goal. At the beginning of the 21st century, it can be said that East Asian countries as a whole have already achieved significant results in the catch-up type of economic development and growth that had been their challenge in the second half of the 20th century. After the 1980s, East Asian economies as a whole have come to be strongly integrated into the international economy, and the weight of international trade and international capital movement has increased sharply. Amid the trend toward internationalization and globalization of East Asian economies, the importance of open macroeconomic policies has increased and shifting to a new economic system has become a problem in connection with the internationalization and globalization. It can be said that the currency and financial crisis in East Asia in 1997 prompted East Asian countries to seek establishment of a new paradigm to continue sustainable economic growth and development.

Now, I would like to review the economic development and growth of East Asia and then study establishing an economic system for new sustainable development, as well as the growth and policy problems involved.

1. Economic Development and Growth of East Asia: Results and Growth Pattern

(1) Long-term economic development: Factors and results

East Asian economies continued economic development and growth for more than 30 years. The results of such development and growth deserve attention in that East Asia maintained a relatively high economic growth rate and that it was accompanied by major structural changes, such as changes in the industrial structure and labor employment structure as well as rapid progress in urbanization. A comparison with the economic development of other developing regions in the world shows how conspicuous the economic development and growth of East Asia was. Table 1 shows region-by-region comparisons of annual average real economic growth rate and per-capita economic growth rate from 1966 to 1998. The growth rate of East Asia's real GDP was close to 8%, or 4-5 points higher than in other developing regions. Moreover, East Asia's per-capita GDP growth rate, which takes into account the rate of population increase, was 6%, far higher than in other developing regions. What is noteworthy is that the growth rate of per-capita GDP in the Middle East and North Africa and sub-Saharan Africa was 0.3%, indicating their economies remained stagnant for more than 30 years. Latin America's per-capita GDP growth rate also remained stagnant at 1.4%. The growth rate of population in East Asia was 1.8%, lower than the 2% level in other developing regions, and this contributed to the rise in the growth rate of per-capita income in East Asia. It is by no means an exaggeration to say that the fact East Asia countries as a whole achieved an annual growth rate of nearly 8% for more than 30 years is an "economic miracle" (Note 2).

Table 1 Real Economic Growth Rate and Per-capita Economic Growth Rate: 1966-1998

	Real GDP growth rate	Per-capita GDP growth rate	Growth rate of population
East Asia	7.8	6.0	1.8
Latin America	3.6	1.4	2.2
Middle East/North Africa	3.1	0.3	2.8
Sub-Saharan Africa	2.8	0.3	2.5
Advanced industrial countries	3.1	2.4	0.7

Source: World Bank (2000) Global Economic Prospects and the Developing Countries 2000

Much research was conducted with regard to the results and factor analyses of East Asia's economic development and growth. The conclusions of such research are as follows:

- (a) The region as a whole achieved a high economic growth rate for a long period of time.
- (b) The high growth rate of East Asia was supported by high investment rates and labor input brought about by production factor inputs. The contribution to growth of a rise in productivity was smaller than that of capital and labor inputs (Note 3).
- (c) On the demand side, the weight of investment expenditure and exports were relatively large.
- (d) The weight of foreign trade increased rapidly during the course of economic development and growth.
- (e) The problem of income distribution did not deteriorate much during the course of economic development and growth.
- (f) Relatively clear catch-up processes, such as the “flying geese” pattern, were observed during the course of the long-term economic growth and development, and a long-term convergence was also observed to a certain extent in the economic growth and development (Note 4).

The high economic growth rate is the most important point, but as is pointed out in (b), it can be largely explained by product factor inputs. In other words, this means that the contribution of higher productivity brought about by technological progress was relatively small. In this connection, how to evaluate the economic growth of East Asia has been hotly debated since the mid 1990s (Note 5).

The fact that the weight of investment and exports increased during the course of the economic development and growth of East Asia is also a distinct characteristic. Table 2 shows a comparison of the weight of investment and exports in nominal GDP between major East Asian economies and other regions' economies. It shows that there was no major difference in the ratio of investment amounts to nominal GDP between East Asia and other regions in 1965. In fact, the ratios in Latin America and Middle East/Africa were higher than those in the countries in East Asia, with the exception of Taiwan. However, the ratio rose to over 25% in many of the East Asian economies in 2000, while the ratio stood at 15-25% in many of the other regions. As for export ratio, there were differences among the economies depending on natural resource endowments and economic scales. As might be expected, in Malaysia and Venezuela, countries blessed with abundant per-capita natural resources, the export ratio was high. Excluding those countries, however, there was not much difference in the ratio in 1965. Nonetheless, a calculation made as of 2000 shows that East Asia on the whole has a high export ratio. The export ratios of Hong Kong and Singapore are extraordinary high at over 100%, as they are urban economies and as their figures include re-exports. But China's export ratio is also quite high at 23%, given the scale of its economy. In any case, in many of the East Asian economies,

the export ratio stands at 40-60%.

Table 2 Comparison of Investment Ratio and Export Ratio

(Unit: %)

	Investment/nominal GDP ratio		Export/nominal GDP ratio	
	1965	2000	1965	2000
East Asia				
South Korea	14.9	28.4	8.6	44.8
Taiwan	22.7	22.5	19.4	53.5
Hong Kong	*21.7	26.3	*95.7	150.1
Singapore	*15.3	29.4	*81.9	148.7
Indonesia	6.8	24.3	5.5	38.6
Malaysia	15.7	25.6	47.6	124.8
Philippines	17.4	18.1	17.0	56.3
Thailand	19.0	22.1	18.3	67.1
China	*29.0	36.5	*0.7	23.1
Vietnam	*13.1	27.6	*26.4	55.0
Myanmar	10.4	*11.0	14.0	*5.2
South Asia				
India	17.1	21.9	3.9	9.1
Pakistan	15.3	14.0	8.8	16.2
Latin America				
Brazil	18.2	19.4	6.8	10.8
Mexico	17.5	21.2	9.9	31.0
Argentina	17.1	16.2	7.7	10.9
Chile	15.9	21.0	14.0	31.7
Venezuela	18.4	14.2	30.7	28.4
Middle East/Africa				
Turkey	*15.9	22.2	*6.2	23.8
Egypt	16.2	21.7	18.6	16.1
Algeria	15.8	21.3	22.4	42.8
Nigeria	18.3	5.4	17.2	58.9

Source: International Financial Statistics, IMF

Note: Figures with asterisks (*) are comparisons between the following years; Hong Kong and Singapore: between 1970 and 2000; China: between 1980 and 2000; Vietnam: between 1990 and 2000; Myanmar: between 1965 and 1999; and Turkey: between 1966 and 2000.

It is also noteworthy that income distribution did not particularly deteriorate in East Asia during the course of its economic development and growth. There was no major deterioration of income distribution at least until the beginning of the 1990s and high growth and income distribution were compatible. However, we cannot deny the possibility that income distribution has been deteriorating in many of the East Asian economies, as they are in the process of recovery accompanied by structural reforms, following the sudden investment boon in the first half of the 1990s and the currency and financial crisis that ensued. We need to keep a close watch on the relationship between economic development and income distribution during the course of growth (Note 6).

South Korea, Taiwan, Hong Kong, and Singapore, which are known as the Asian NIEs, accelerated their economic growth led by investment and exports one after another from the beginning of the 1960s to the 1970s. Leading ASEAN countries (Indonesia, Malaysia, the Philippines, and Thailand) began economic growth in the 1970s in the same manner as the Asian NIEs. From the second half of the 1980s to the mid 1990s, many of the ASEAN countries further accelerated their economic growth on the strength of the yen's sharp appreciation and domestic investment booms based on direct investment from abroad. Elsewhere in East Asia, China shifted to a reform policy of opening up its economy to the outside world in 1978 and the transition to a market economy began to make gradual progress. In the first half of the 1990s, China's transition to market economy picked up momentum and at the same time its economic growth accelerated on the strength of the inflow of foreign capital and the expansion of exports. Such a policy of shifting from a socialistic controlled economy to a market economy and open-door policy was adopted by Vietnam in the second half of 1980s and by other countries in Indochina in the early 1990s, leading to their admission to APEC and the establishment of the 10-member ASEAN. As a result, the establishment of the market economy and open-door policies has become fixed in East Asia, except for North Korea. The countries that shifted to a market economy and open-door policy in and after the 1980s immediately began implementing policies designed to achieve economic development and growth led by investment and exports. In East Asia, economic development and growth first began in Asian NIEs, spread to leading ASEAN countries, and then to less-developed ASEAN countries. The long-running development and growth of East Asia that began in the 1960s came to be called the "flying geese" pattern of economic development or the "catching-up" pattern of economic development in that each individual economy participated in economic development and growth one after another.

As the East Asian NIEs that began economic growth ahead of other countries in the region continued their flying geese or catching-up pattern economic development and growth for more

than 30 years, their economic levels almost caught up with those of advanced countries in the 1990s and their catching-up process is now in its final phase. If the smooth economic development and growth that was seen up to the first half of the 1990s continues, there is no doubt that ASEAN countries and less-developed East Asian countries will get closer to the final phase in their catching-up process in the next 20-30 years. In this sense, it can be said that the economic development and growth of East Asia, if compared with the economic growth of other regions, including advanced countries, is in the “process of the convergence of economic development and growth” that follows a development and growth process by taking advantage of leapfrog benefits (Note 7).

The currency and financial crisis that East Asia experienced in the second half of the 1990s frustrated the development and growth of East Asia, albeit temporarily. The currency and financial crisis in East Asia took place in some of the Asian NIEs with a relatively advanced stage of economic development and growth and in leading ASEAN countries, forcing these countries to adopt severe economic adjustment policies. The fact that the currency and financial crisis broke out mainly in East Asian NIEs and relatively advanced developing countries raised an important issue. It is true that the East Asian economies that pursued the “flying geese” pattern or “catching-up” pattern of development and growth produced good results in terms of economic development and growth. But as the catching-up process approached its final phase, the function of the existing economic system that produced the good results has come to its limit, raising the need to create a new paradigm for economic system.

(2) Economic development and growth pattern

Economically speaking, East Asia is high in diversity, such as differences in population sizes and in natural resource endowments. But the region as a whole had more or less the same pattern of economic development and growth. In hindsight, East Asian economies shared a catching-up pattern of development and growth that takes advantage of growth led by exports and investment and leapfrogging benefits. However, it must be pointed out that behind this lies Japan’s economic recovery and high economic growth after World War II. It is true that there are several similarities in economic growth patterns between Japan and East Asian. There are also similarities in the system that supported development and growth, such as relatively high investment rate and domestic savings rate, government’s relations with the private sector and markets, and financial system centering on indirect finance. On the other hand, the ratio of exports to nominal GDP in Japan has been consistently lower than that in other East Asian economies. It cannot be said that Japan’s growth was led by exports. Moreover, Japan did not utilize foreign capital, except for food assistance shortly after the war, and did not introduce foreign capital as a policy tool, except on special occasions. Above all, there is quite a large

difference between the economic conditions of postwar Japan and the initial conditions for development and growth at the time when each East Asian economy began economic growth.

The economic development and growth pattern that East Asian economies are believed to have eventually shared is inextricably linked to growth factors and the result of such factors and to the policy system that supported growth. In the ultimate sense, they boil down to the following two points:

- A) Growth led by investment and exports and its policy
- B) Economic system based on wide ranging cooperative relationship between government sector and private sector

It goes without saying that there are considerable differences in economic development and growth mechanism and in detailed policies. But the most important characteristics of the growth pattern are growth led by investment and exports and the similarity between the economic system and the policy systems that supported the growth. Policy characteristics and patterns are often described as industrial policy and it is used as a synonym for wide-ranging distribution of resources during the course of economic development and growth. The term “industrial policy” has come to be used in the analysis and policy process study of the economic development and growth process of Japan and East Asian economies, and it is inseparable from the economic development and growth of Japan and East Asia. Industrial policy essentially means a dynamic resource allocation policy. But it is normally used to mean not only a specific policy of resource allocation but also a wide-ranging policy pattern covering policy systems and economic systems, including mechanisms ranging from the policy-formation process to the policy execution process. Still, its substance is growth led by investment and exports, and the economic system of East Asia that supported the growth pattern.

If growth led by investment and exports is maintained for a long period of time, the internationalization of the economy makes progress as a natural consequence. As is shown in Table 2, East Asia experienced a sharp rise in its dependence on trade. Since the export/nominal GDP ratio and import/nominal GDP ratio cannot remain wide apart for a long period of time, the table suggests a sharp rise in East Asia’s dependence on export. Since East Asia’s relation with international economy has already been extremely strong, the region as a whole is susceptible to fluctuations of the world economy. Moreover, international capital continued to flow into East Asia. In addition to the inflow of direct investment, the inflow of short-term international capital into East Asian financial and capital markets increased sharply in the 1990s. Many of the East Asian economies began to be steadily incorporated into the globalization and networking of the international economy in and after the 1980s, and their economic development and growth patterns increasingly heightened in similarity.

2. Economic Development Policies and Macroeconomic Policies of East Asia

(1) East Asian Economic Systems and Development Policies

<The “cooperative game” structure of economic systems in East Asian economic development>

The economic and policy systems that have supported the economic development and growth of East Asia are not so straightforward. At the beginning of the 1960s, East Asian nations, which had mostly achieved political independence over a decade before, still showed strong traces of traditional cultural features and historical influences, while at the same time, their economies had the typical characteristics of developing countries. Although national disruptions and conflicts lingered long and without respite thereafter in some parts of East Asia, once the conflicts and political confrontations came to a temporary halt, economic recovery and growth became the priority targets for the national economies of the region. Under such circumstances, it was only natural that Japan, an East Asian nation that had already entered a high economic growth phase, drew the attention and keen interest of other East Asian nations at the time.

As already reported, Taiwan and South Korea took note of the economic success of Japan and made reference to Japanese policies and systems in formulating their own economic development and growth policies from the end of 1950s to the early 1960s (Note 8). Taiwan and South Korea strove to establish their respective economic and policy systems in the harsh international political environment of the times by adopting what they found useful from Japan’s policy experiences. In the early 1970s, Singapore began to make vigorous efforts to build an economic system for its development and growth. This was done over a short period of time under strong political leadership. At the same time, other leading ASEAN countries also gradually started to move forward, although at a slow pace, toward establishing economic systems and policy systems for achieving development and growth. There is no doubt the ASEAN countries found not only the Japanese systems, but also those of Taiwan and South Korea, useful references to that end. Aside from these, the influences of international organizations on policies cannot be overlooked in the economic development and growth of East Asia. Particularly in the initial phase of economic development, U.S. aid agencies and international organizations had a considerable impact because aid played a relatively weighty role in the process. In this manner, East Asian nations formed their respective economic systems and policy systems by making their own choices from various available references, such as policy advice from international organizations and experiences of Japan’s policy system.

In establishing and introducing a market system and specific system/policy tools, advice from international organizations also made large contributions. What is particularly noteworthy is that East Asian economies have a considerably strong characteristic common to all in their

system and policy operations after the establishment and introduction of the system and policy tools. In the initial phase of economic development and growth, cooperation and exchanges of information between the government sector and the private sector are important in order to succeed in economic development, as neither the government sector nor the private sector has sufficient experiences of executing development policies. When fostering new industries, it may be necessary to start in the form of government-run corporations, as the risks involved in fostering industries are not clear. Even when fostering new industries in the form of private corporations, it is often necessary to give preferential treatments such as prioritized allocation of public funds. Moreover, since distortions in resource allocation must be eliminated as much as possible even under such fostering measures, it is necessary to give careful consideration to the problem of industrial protection and monopolistic prices and to work out detailed measures to allow new entry into the market. Since economic development and growth models, such as those of advanced countries and Japan, were already available and catching up with the models was a specific goal, it was easy to set a relatively clear goal and reach an agreement on the goal during the course of economic development and growth. Such a situation seems to indicate that a structure close to “cooperative game” was in place among each sector making up a national economy. In order for a “cooperative game” structure to be established, there must be a basic social goal shared by each sector, hierarchy and domestic region and there must be mutual trust among each sector with regard to the burden sharing and mutual concessions to achieve the goal. Clear explanation and persuasiveness concerning the social goal to enhance and maintain the mutual trust are also prerequisites along with strong political leadership.

A comparison of the results achieved during the course of economic development among regions and nations show that the countries that have achieved smooth development and growth maintain domestic political stability for a long period of time and this is often responsive to the fact that there are no serious social confrontations or conflicts between various social strata, sectors, and regions in such countries. On the other hand, the performance of economic development and growth of the countries having conspicuous domestic political confrontations or social conflicts is not good in many cases, even if they are not directly involved in an international confrontation. A society having strong confrontations or mutual distrust becomes a “non-cooperative game” structure, making it difficult for the society to move forward toward economic development and growth. Many of the Latin American and African countries were unable to shift to sustainable development. It is safe to say that one of the reasons was that the economic system of such countries had not been able to form a “cooperative game” structure. It is true that there were internal confrontations in East Asia and that the confrontations sometimes became serious, exerting a negative influence on economic development and growth (Note 9). It is also true that a “cooperative game” by no means presupposes social democratization or

political democratization. There were many cases where East Asian countries had the same administration for a long period of time during the course of their economic development. But even in such a case, the countries maintained an economic system close to a “cooperative game” structure for a relatively long period of time.

<Characteristics of East Asian economic systems>

East Asian economies achieved development and growth under a system that is essentially based on the market mechanism. As has already been pointed out, they formed their respective market systems and economic systems by making their own choices from various available references, such as advice from international organizations and the experiences of Japan. But in operation of the economic systems, they formed a market economy system that is slightly different from those of European countries and the United States, under a “cooperative game” structure. The East Asian market economy system, which is common to that of Japan to a certain extent, can be called a “relations-dependent market economy system,” as it strongly depends on a reciprocal relationship between the market and the government. The system is not based on relatively clear-cut rules. What characterizes the system is that it has relatively loose rules and that the government has discretion to intervene in or supplement the market depending on the situations. On the other hand, the market economy system of European countries and the United States has the characteristics of a “rules-dependent market economy system,” as it is based on clear-cut market rules (Note 10).

The “relations-dependent market economy system” has considerable diversity even between the systems in Japan and East Asia and there are differences in the relationship between the market (private sector) and government, particularly in terms of the characteristics of government’s ruling pattern. In postwar Japan, the government functioned under the rule of democracy, but in East Asia there were many countries that had authoritarian government functions until around the second half of the 1980s. Figure 1 shows the characteristics of the “relations-dependent market economy system,” which is commonly found in East Asia, and the “rules-dependent market economy system,” which is represented by Britain and the United States in particular, from the aspects of rule setting and market intervention by government.

Figure 1 Characteristics of Market Economy Systems

	Rule setting	Market intervention by government
Rules-dependent market economy system	Highly transparent, detailed rules	Intervenes only when market function is hampered
Relations-dependent market economy system (East Asia’s system)	Setting the outline of rules	Intervention by discretionary policy

The specific policy that characterizes the “relations-dependent market economy system” of East Asia is resource allocation policy for growth and development based on the cooperative relationship between government and market (private sector) that is represented by “industrial policy.” The system was consistent with related sub-systems, such as policy system (fiscal policy, monetary policy, trade policy, exchange policy, regional development policy, education/technology policy, etc.), the financial system, and the business system. It can be understood that an economic system like this is easy to establish under a “cooperative game” structure that has a clear-cut objective of attaining economic development and growth for catching up. The relations-dependent market economy system had both positive and negative aspects from the beginning. As positive aspects, it can be pointed out that the government and the private sector can cooperate in sharing risks and that the system facilitates information exchanges between producers and suppliers, making it possible to take prompt actions in resource allocation policies. Among the negative aspects are that the system lacks in transparency and industry protection remains in place for an excessively long period of time as information is not communicated to people other than the parties concerned, and that in some cases the system may cause collusion and corruption. The relations-dependent market system functions relatively efficiently in the catch-up process. But once the economy approaches the final phase of the catch-up process, it is natural that its role should come to an end.

<Policy mix of liberalization and protectionist policies>

When economic development and growth are at their early stage or when the shift to a market economy has yet to make sufficient progress, even development policies aimed at investment- and export-led growth are generally implemented without removing their protectionist elements. In East Asia, NIEs and ASEAN implemented import substitution types of development policies when their development and growth were at a relatively early stage. Asian NIEs did not take import substitution policies for a long time and they began to shift to import promotion policies as early as in the second half of the 1960s. But their foreign trade policy and foreign-capital induction policy remained mixed with protectionist policy and liberalization policy, with import restrictions and regulatory compliance areas in direct investment remaining for a considerable long period of time. On this point, among the Asian NIEs, those that are urban economies and do not have a large economy, such as Singapore and Hong Kong, were positive about promoting liberalization policies. But for ASEAN as a whole, it took a considerable time to shift from the import substitution policies they adopted in 1960. Malaysia, Thailand, the Philippines, and Indonesia that were ahead of other ASEAN countries in development and growth shifted to positive policies in the promotion of exports, the

utilization of foreign capital, and in particular in the introduction of direct investment in the first half of the 1970s, but protectionist elements and various restrictions still remained. It was only from the mid 1980s that they were able to shift to all out to growth led by exports. Still, the economy of the Philippines remained stagnant for nearly 10 years due to the outbreak of political turmoil in the first half of the 1980s and the political insecurity that ensued.

Rapid internationalization led by investment and exports over a long term was attained in the process of economic development and growth of East Asia. But we need to ascertain that the policies adopted in the process were not straightforward liberalization and deregulation policies but rather a mixture of protectionist policies, regulatory policies, and liberalization policies. It was from the second half of the 1980s and the first half of the 1990s that East Asian region as a whole sharply shifted to liberalization and deregulation. APEC adopted expansion and promotion of trade and investment as the pillar of cooperation in the 1980s and the movement to liberalize trade investment picked up momentum in the 1990s. The appreciation of the Japanese yen and Asian NIEs' currencies against the U.S. dollar in and after the second half of the 1980s also promoted active trade and investment in East Asia.

(2) Development Policies and System of Macroeconomic Policies

<Macroeconomic performance of East Asian economies>

The macroeconomic performance of East Asia was generally good along with its economic development and growth, except for the currency and financial crisis of 1997. The real economic growth rate was high at 7-8% and the inflation rate was relatively low, while double digit inflation was posted only in an exceptional case. Although the international balance of payments of some East Asian economies deteriorated several times before the currency and financial crisis, none of them developed into major crises. Until the first half of the 1990s, the macroeconomic performance of East Asian economies was on the whole better than that of other developing areas.

A study of the long-term trends of macroeconomic indicators shows that there were no extremely large differences in growth rate and inflation rate among East Asian economies. Though the differences in average growth rates and inflation rates were small, short-term fluctuations were large in some economies in the region and small in some others. A comparison of South Korea and Taiwan, two of the Asian NIEs, shows that while there were no large differences in long-term growth rate and inflation rate between the two; Taiwan is higher than South Korea in terms of short-term stability as the fluctuation of South Korea's growth rate was greater. A similar trend can also be observed in ASEAN countries. While Thailand's stability is relatively high, the fluctuations of macroeconomic indicators of Indonesia and Malaysia were slightly greater. The differences in short-term macroeconomic stability among

East Asian economies are caused by various factors. The cause of the differences is quite complicated. Some of them may be caused by characteristics of economic structure, etc. and some other may be caused by the difference in macroeconomic policy. However, in the case of East Asia, the difference in economic endowments and the strength of leadership in economic policy management appear to have had something to do with macroeconomic stability.

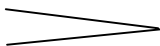
When economic development and growth were in their early stages, economic endowments may have been important, especially for economic stability. Many of the East Asian countries are producers and exporters of mineral products, such as crude oil, tin and copper, and agricultural and marine products, such as rice, palm oil, coconut, lumber, tapioca, and farm-raised shrimp. If the international prices of these primary products fluctuate wildly, an impact on macro-economy cannot be avoided. Especially when production and exports are concentrated on a specific primary product, it is not easy to maintain macroeconomic stability. East Asian has increased the ratio of industrial products to its total exports. But the ratio of oil and natural gas in Indonesia and that of primary products in Malaysia are still high. Even if the rates of production and exports of primary products are high, it would contribute to stability if the products were diversified. In fact, ASEAN countries aggressively diversified production and exports of primary products from the 1960s to the 1970s and Thailand and Malaysia promoted policies to diversify internationally traded commodities.

Leadership in economic policy also affects macroeconomic stability. In East Asia, there were clear differences in economic policy leadership among the economies in the region. The strength of economic leadership and the strength of political leadership often overlap. Economies with strong political leadership often adopted and implemented aggressive and large-scale development and macroeconomic policies in a relatively short period of time. Therefore, the fluctuation of the macro-economy of such countries was great due to drastic revisions or changes of macroeconomic policy when, for example, the economy overheated. Although it is impossible to measure leadership in economic policies with objective indicators, it appears that South Korea, Singapore, and Malaysia implemented aggressive and sometimes ambitious policies and took relatively prompt measures to cope with economic recessions.

<Development policies and system of macroeconomic policies>

The economic policy system of East Asia can roughly be summarized as being based on the “relations-dependent market economy system” centering on discretionary policy and relatively loose market rules under an economic system that has a “cooperative game” structure. The specific content of the development policy and macroeconomic policy was to aim for development and growth lead by investment and exports. Figure 2 shows the concrete system for each sector’s economic system and policy in East Asia.

Figure 2 East Asia's Economic System and Policy Tools

Economic policy system		
Fiscal policy	—————	Resource allocation through taxation (Investment-oriented tax system, etc.), Infrastructure building
Monetary policy	—————	Monetary easing and low interest rates; Resource distribution through public financing
Trade policy	—————	Fostering domestic industry and cautious deregulation policy; Introduction of foreign direct investment/import of technology
Foreign capital policy	—————	Introduction of direct investment, ODA, foreign borrowing
Exchange policy	—————	Exchange control and maintenance of fixed exchange rate
Financial system		
Dependence on indirect finance	—————	Strong dependency relation between bank and corporation
Public finance	—————	Resource distribution by public financing
Business system		
Low capital Cross shareholding		Imbalance of interests among stake holders

Since the business system was in the process of development and growth, the capital ratio was basically always low and reliance on debt financing was high. In order to supplement it, cross shareholding was high. In the business system, private corporations' balance sheets were not so strong, as conglomerates were formed in many of the economies and the reliance on debt financing was excessively high due to cross shareholdings within conglomerates and the restraint on public stock offerings. The financial system was mostly based on indirect financing mainly by the banking sector due to a delay in the establishment of capital markets. Capital markets began to develop gradually in the second half of the 1980s and the weight of direct financing increased, but the weight of indirect financing is still high in East Asia as a whole. The weight of government-run financial institutions was also high.

In the economic policy system, development policies for medium- and long-term development and growth and short-term macroeconomic policies were mixed with specific fiscal policy, financial policy, trade policy, foreign capital policy, and exchange policy. In the fiscal policy, infrastructure building and investment-oriented tax system played central roles and the ratio of indirect taxes, such as customs duties, was high (Note 11). In the financial system, low interest rate policies were adopted to hold down real interest rates. But since low-interest rate policies had a negative impact on domestic savings, fund allocations of public funds were given preferential treatment. As has already been pointed out, the trade policy was a

combination of domestic industry-fostering policies and liberalization policies. Overseas investment was promoted in a way consistent with domestic industrial development and with technology transfer in mind. The exchange policy maintained links to the U.S. dollar in principle, but when the balance of payments imbalance expanded, relatively large-scale exchange rate devaluation was implemented. A comparison of these economic policy systems over the long term shows that there are quite distinct differences in policy systems and policy tools between the 1960s-1970s and the 1990s. For example, in the 1990s, when international capital movement increased, the relationship between exchange policy and the financial policy became inseparable in East Asia and the exchange rate fluctuation band widened. In the relationship between development policy and macroeconomic stabilization policy, the higher a country's economic level was as a result of economic development and growth, the more emphasis was placed on the stabilization of macro-economy.

(3) Development/Growth under Open Economy and its Change

<International trade and utilization of foreign capital>

During the course of its economic development and growth, East Asia aggressively utilized external trade and foreign capital. At an early stage of development, East Asia exported natural resources and labor-intensive products in which it had a comparative advantage and imported capital goods. During the course of more than 30 years of long-term economic development and growth, the ratio of industrial goods to exports rose and the ratio now stands at over 90% in Asian NIEs and at 60-70% in Thailand, Malaysia and the Philippines. East Asia has become a global production center for industrial products, with its production and exports of industrial goods increasing their weight in the global economy even now. In particular, China's production and exports expanded sharply in the past several years.

During the 1960s and 1970s, direct investment in East Asia was compatible with investment receiving countries' import substitution development and growth, but from the second half of the 1980s, the purpose of direct investment changed drastically to exports from investment receiving countries. In the second half of the 1980s, East Asian countries came to recognize that international trade and direct investment are strategic levers for economic development and growth and they began to aggressively seek an APEC accord on trade and investment liberalization policy and active participation in or admission to the WTO. Moreover, they concluded a free trade agreement (FTA) within East Asia and began negotiations for a new FTA.

Expansion of trade and direct investment has come to be promoted not only by Japanese and western multinational corporations but also by companies from Asian NIEs, ASEAN and China and this has drastically expanded trade within East Asia. The expansion of intra-regional trade means that a production network has expanded throughout East Asia. In this sense, it is

noteworthy that trade and its related systems as well as infrastructure have been smoothed out in East Asia on the whole. When there is a wide disparity between systems and policies on one hand and actual infrastructures on the other, a production network cannot be established. Since various parts and raw materials of industrial products have come to be produced in multiple countries in recent years, a country whose system, policy and infrastructure are not at the same level as those in countries participating in a production network, the country cannot join the international network of production. It is true that the fact that East Asian countries became positive about liberalization policy from the second half of the 1980s to the 1990s is closely related to the formation of international production networks by multinational corporations. Nowadays, it can be said that an East Asian economy that cannot take part in a production network can no longer expect a sustainable development and growth. Direct investment in East Asia began to show a new trend after the turn of the century. This is that the innovation centering on information technology (IT) in the 1990s may change international production networks. IT has made efficient inventory control and automation of the production process possible for corporations, enabling them to replace the conventional labor-intensive production process with a capital- and technology-intensive production processes. Therefore, conventional direct investment in Asia aimed at a labor-intensive production process can be made in advanced countries. The expansion of direct investment in East Asia may slow down depending on the circumstances. In fact, such a change in production process has begun gradually. In order to expand direct investment in East Asia, it is necessary to further deregulate investment and establish physical and social infrastructures in East Asia.

<Change in international trade pattern>

The international trade pattern of East Asia has undergone drastic changes from what it was in the 1960s. The most popular international trade pattern in East Asia from the 1960s to the 1980s was the one that reflected each East Asian economy's comparative advantage in economic endowments. However, the international trade pattern rapidly shifted toward the intra-firm division of labor based not only on comparative advantage but also on international networks of production following the start of a direct investment boom in the second half of the 1980s triggered by large-scale exchange rate adjustments in East Asia. Currently, there are two international trade patterns in East Asia. One of them is a vertical trade pattern that strongly reflects comparative advantage, such as trading primary products or labor-intensive standardized products. The other is a horizontal trade pattern that is mainly based on intra-firm division of labor but also reflects product differentiation. Although the United States still remains the largest importer of finished products from East Asia, if semi-manufactured goods, such as components, are included, trade within East Asia can be said to have been increasing

rapidly.

Though East Asia's international trade pattern has changed, the convergence of its international trade structure has increased on the whole as the weight of each country's product exports increased rapidly in line with the establishment of production networks in East Asia. A rise in similarity and convergence of trade structure means that a major change in exchange rate by one economy would have an impact on the whole region in a short period of time, raising the possibility of forcing the whole region to make large-scale exchange rate adjustments in the same direction. The fact that the currency and financial crisis in East Asia in 1997 spread to many of the economies in the region in a short period of time and forced them to make major exchange rate adjustments reflected the fact that the similarity of the trade structure of East Asian economies had increased.

3. Lessons of Currency and Financial Crisis and its Recovery Process

(1) Lessons of currency and financial crisis

<Background of the currency and financial crisis and its cause>

The currency and financial crisis that broke out in Thailand in 1997 spread rapidly to Indonesia, Malaysia, the Philippines, and South Korea. In 1998, Indonesia's economic growth rate contracted by as much as 14% and Thailand and South Korea also posted negative growth. In addition, the economic growth rate of the East Asian region as a whole slowed down substantially in 1997-1998. It was the first time that East Asian economies suffered a large-scale currency and financial crisis at almost the same time.

East Asia that posted continued economic development and growth until the first half of the 1990s had been implementing investment- and export-led policies under the "relations-dependent market economy system" that was essentially based on a cooperative game structure between the government sector and the private sector. However, direct investment from abroad increased sharply in and after the second half of the 1980s and exports of industrial products also increased sharply. Moreover, the inflow of foreign capital not in the form of direct investment also increased, as concerns about international balance of payments had receded due to the expansion of exports and the inflow of direct investment and as the deregulation of capital transactions began to make headway in the late 1980s. In particular, the inflow of long- and short-term funds into ASEAN countries increased sharply as their interest rates were comparatively higher due to the domestic investment/direct investment booms in the first half of the 1990s and as the countries' currencies had been virtually linked to the U.S. dollar. Since the domestic investment boom in ASEAN countries had shifted from the manufacturing industry to the non-manufacturing industry by the mid-1990s, exports by manufacturers slackened, but ASEAN countries' imports continued to increase as the domestic investment boom in the non-manufacturing sector (non-tradable goods sector) remained active. As a result, current account deficits increased and concerns about exchange rate depreciation increased, leading to a sharp increase in the outflow of capital, mainly short-term capital, in 1997. Since ASEAN countries kept their currencies pegged to the U.S. dollar despite these circumstances, selling of Asian currencies increased sharply. The following three points can be cited as the background or cause of the currency and financial crisis in East Asian countries in 1997:

- A) East Asian countries kept their currencies linked to the U.S. dollar despite changes in their international balance of payments and domestic real economy.
- B) The movement of international capital, including short-term capital, in East Asia had been active since the late 1980s due to the liberalization of capital transactions, etc.

- C) As the domestic investment boom shifted from the tradable goods sector to non-tradable goods sector, widening current account deficits sharply increased concerns about exchange rate depreciation.

The currency and financial crisis that broke out in Thailand spread to other East Asian countries. As we already described, since the export structures of East Asia countries were considerably similar, a sharp depreciation of one country's currency led to a similar depreciation of the currencies of neighboring countries. In addition, since East Asian countries had quite similar economic systems and policy systems, the currency and financial crisis spread to the whole East Asia. After the outbreak of the currency and financial crisis, East Asian countries suffered a major impact they had never experienced before and the severe adjustment process is still continuing. Due to the substantial devaluation of exchange rates, foreign currency-denominated medium- and long-term debts held by private corporations increased sharply in terms of domestic currency and many of the corporations' debts exceeded their assets or the debts became non-performing. Since the debt problem of private corporations is inextricably linked to the problem of non-performing loans of the financial sector, the crisis also exposed the problems of the financial system. As has just been described, since the currency and financial crisis in East Asia from 1997 to 1998 is highly related to the economic system and policy system of East Asia, how to reform the economic system and the policy system and what kind of new system to be established are current problems.

<Problems of economic system and policy mistakes>

If economic development and growth continues for a relatively long period of time under a constant, stable structure or system and achieves an economic result, confidence in the economic system and policy system becomes strong and in some cases could lead to excessive confidence. We should not overlook the fact that since the economic success of East Asia had been called an "economic miracle," it was difficult to modify or reform the economic system and policy system due to the success. Although the economic environment of East Asia began to change drastically in the second half of the 1980s, no major changes of the economic system and policy system were made. In other words, East Asia fell into a typical "success trap."

Though private corporations approached the level of a semi-developed economy thanks to the economic growth, there still remained elements of family-run corporations, with interests among stake holders remaining vague and information disclosure making no headway. Corporate finance was heavily dependent on debt financing, mainly loans from banks, government-run financial institutions, and foreign financial institutions. For these reasons, the development of capital markets made no progress and the weight of indirect financing remained

at a high level. Many of the corporations relied on regular borrowings of short-term funds from abroad for their medium- and long-term fund needs.

In policy system, East Asian economies had long adopted virtual fixed exchange-rate policies, as exemplified by the pegging of their currencies to the U.S. dollar. Devaluating the exchange rate is advantageous to the country's exports, but it raises domestic prices due to a rise in import prices of raw materials and capital goods. Therefore, East Asian economies tended to avoid currency devaluation as a policy choice. Moreover, since East Asian economies are regular borrowers of funds from abroad, a devaluation of their currency leads directly to an increase in their exposure to exchange risks. Therefore, once an exchange-rate level is chosen and economic development and growth remains sustainable at the exchange rate, a policy to maintain the exchange rate will be continued and a policy to adjust the exchange rate in response to changes in the environment is less likely to be selected. In fact, the exchange rate was not used as a policy tool, as East Asian currencies had been linked to the U.S. dollar for several years before the currency and financial crisis.

Many East Asian economies were hit by the currency and financial crisis. They can be divided into two groups—one that suffered a serious impact from the crisis and the other that suffered a minor impact. A study of the degree of the impact from the currency and financial crisis reveals distinct differences between the two groups. Table 3 compares the differences.

Table 3 Comparison of Economic Impacts of Currency and Financial Crisis

	Economy that suffered serious impact	Economy that suffered minor impact
Exchange rate	Sharp devaluation	Minor devaluation
Current account	Large deficit and then deficit reduction due to decrease of imports	Decrease of surplus
Foreign currency reserve	Relatively small	Relatively large
Ratio of short-term capital to total foreign capital inflow	Large	Small
Financial bubble	Large	Relatively small
Bad loans	Large	Small
Credit crunch	Large	Small
Policy of capital infusion into the financial sector	Urgent capital infusion	Not urgent
Domestic-demand expansion policy	From restraint on domestic demand to consideration of domestic demand	Domestic-demand expansion policy implemented
Exports (U.S. dollar)	Sharp decrease	Stagnant or decrease
Imports (U.S. dollar)	Sharp decrease	Stagnant
Economic growth rate	Negative growth	Slower growth

With regard to exchange rate adjustment, economies that suffered a serious impact from the crisis devalued their currencies sharply. Most of them carried out 20-30% devaluation but some economies devalued by as much as 50-60%. On the other hand, China was not affected by the crisis and the exchange rate of its currency against the U.S. dollar remained almost unchanged. As to the trade account and current account, many of the economies that suffered a serious impact had a huge current account deficit shortly before and after the crisis, but later the deficit decreased or turned into a surplus as imports decreased sharply due to the stagnation and sharp contraction of domestic production. What is characteristic is that the turn to surplus was due to a sharp contraction of trade. The economies that suffered a minor impact from the crisis reduced their current account surplus or increased their current account deficit, but did not need to reduce the volume of their trade. Foreign currency reserves played an important role in the currency and financial crisis. The economies with ample amounts of foreign currency reserves

suffered a relatively minor impact from the currency and financial crisis, as they were able to cope with sharp fluctuations of exchange rate. One of the reasons why Taiwan and China suffered only minor impacts from the crisis was that they had had ample amounts of foreign currency reserves. In the economies where a financial bubble had been formed for several years before the outbreak of the currency and financial crisis, the impact of the crisis became more acute as it was also relevant to the problem of non-performing loans in the financial sector. On this point again, in the economies that suffered a minor impact from the crisis, the financial bubble, if any, was not large in comparison. Moreover, since the currency and financial crisis was directly related to the problem of non-performing loans in the economies that suffered a major crisis, it accentuated the credit crunch of the financial sector, leading to further deterioration of the economic crunch. The countries that suffered such a serious impact had to implement stringent economic policies to reduce imports drastically, as their foreign currency reserves had decreased sharply and reducing the balance of payments deficit was an urgent problem. In the end, their GDP contracted by close to or more than 10% from a year earlier. In this way, once the currency and financial crisis became serious, the economy slipped into a vicious cycle of sharp exchange rate decline, rapid depletion of foreign currency reserves in a short period of time, sharp increase of non-performing loans, drastic credit crunch, and implementation of stringent domestic economic policies, etc. In other words, the economies that suffered a serious currency and financial crisis restored their economic equilibrium by scaling down the size of their economies. As a result, the unemployment rate in such countries rose steeply and the capacity utilization rate dropped to around 30%. The cost of adjustment through the contraction of economic activity was extremely high. In this connection, what is particularly noteworthy is that the IMF, which played a key role in emergency assistance after the currency and financial crisis and in economic policy in the subsequent economic recovery process, provided assistance on condition that aid receiving nations adopt economic adjustment policies centering on contraction of economic activity. Some people pointed out and made the criticism that the IMF-imposed economic adjustment policies resulted in the currency and financial crisis having excessively serious impacts on the aid receiving countries (Note 12). We cannot deny the fact that the IMF's macro-economy guidance resulted in excessively accelerating the contraction of economy. It is also true that there were problems in the economic system and policy system of the crisis-ridden countries and in IMF's policy screening and policy guidance. These are important problems that need to be resolved in the future.

(2) Recovery process after the crisis

<Uneven recovery process>

Considerable differences can also be observed in the recovery of each economy after the

currency and financial crisis. First of all, there are countries like Indonesia, where situations deteriorated from economic contraction to social confusions as a result of the currency and financial crisis, leading to a drastic transformation of the political system and a change in political leadership. The political leadership changed three times in Indonesia in only three years after the crisis. It is hard to say that Indonesia has restored political and social stability. In the case of Indonesia, since the authoritarian political system had come to be identified with the “relations-dependent market economy system” under the long-term government, the virtual collapse of the “cooperative game” structure caused by distrust in the political system became a reality due to the currency and financial crisis and this led to a change in political leadership and subsequent social confusion and regional conflicts. When the situation develops into such a condition, it becomes difficult to achieve economic recovery in a short period of time, and if the restoration of political and social stability is prolonged, the economic recovery would require a long period of time. In fact, Indonesia’s GDP is expected to finally recover to its pre-currency and financial crisis level in 2003, nearly six years after the crisis. The problem of economic crisis and political and social instability was by no means an exceptional experience in East Asia. Although the cause- and-effect relationship between economic crisis and political-system crisis may be different from the Indonesian case, the political and social instability in the Philippines that lasted for nearly 10 years from the first half of the 1980s also had similar problems. In the case of the Philippines, as in the case of Indonesia, the negative aspects of the “relations-dependent market system” came to the fore as a result of the long-term existence of an authoritarian political system, and this resulted in a major confusion. Once the “cooperative game” structure of a society collapses and transforms into an “uncooperative game” structure, re-switching to economic development and growth requires strong leadership to restore trust, which takes time.

Except for Indonesia’s lengthy delays in recovery due to political and social instability and confusion, East Asian countries can be divided into two groups: one is the group of economies that are in the process of relatively speedy recovery and the other is the group of economies that are latish in their economic recovery. South Korea and Malaysia belong to the former group and Thailand and the Philippines to the latter. It is worth noting that, in South Korea and Malaysia, a succession of emergency measures were implemented promptly under strong political leadership after the currency and financial crisis. Since most emergency measures require legislative preparation, if there is a political confrontation, the implementation of the emergency measures would be delayed. But South Korea and Malaysia were able to implement strong measures promptly under strong leadership. In particular, the disposal of non-performing loans held by the financial sector made headway in a relatively short period of time, and powerful measures, such as temporary nationalization of financial institutions, were implemented steadily.

Moreover, South Korean government's policy combining the dissolution of business conglomerates and industrial reorganization to solve the problem of private sector's excessive liabilities, along with the strong performance of South Korean corporations during the course of their recovery, deliver many important messages with regard to structural reforms of the private sector. South Korea and Malaysia also made rapid progress in their macroeconomic recovery, with South Korea recovering almost to a double-digit growth rate in 2000 and Malaysia achieving a growth rate of close to 7% in the same year.

In Thailand and the Philippines, where the recovery process is making progress but is slow, political leadership was not strong. Thailand's political and social stability was not insecure, but no power measures to dispose of non-performing loans in the financial sector were implemented due to inconsistent policies caused by changes of government through elections. In the case of the Philippines, a shift in political power, though not directly related to the currency and financial crisis, caused a delay in economic policies.

In 2001, the economic growth rate of East Asia as a whole declined due to a slowdown of the U.S. economy, with the GDP of Taiwan and Singapore registering negative growth and that of Hong Kong posting only a 0.3% growth rate. South Korea's GDP, which posted a high growth rate of 9.3% in 2000, fell to 3.0% in 2001. Thailand and the Philippines, though they were also affected by the slowdown of the U.S. economy in 2001, were able to maintain a growth rate of 3-4% by implementing economic measures. Since the slowdown of the U.S. economy from late 2000 to 2001 was mainly caused by the recession of the IT-related sector that led the U.S. economic growth in the 1990s, its impact was particularly strong on the economies whose export ratio of IT-related goods are high, such as Taiwan, Singapore, South Korea and Malaysia. China has maintained a growth rate of 7-8% almost consistently for 6 years since the outbreak of the currency and financial crisis. During this period, the country maintained the fixed exchange rate system which is in effect linked to the U.S. dollar. Since China was yet to implement the liberalization of capital transaction and was unaffected by the international movement of capital, and especially short-term capital, the country was not directly hit by the currency and financial crisis. Though the country temporarily experienced a slowdown in exports after the currency and financial crisis, it maintained its economic growth by expanding domestic demand. Thereafter, China has been continuing its economic growth on the strength of brisk exports and foreign direct investment.

<Progress of the economic system reforms>

The currency and financial crisis had a major impact on East Asian economies, and at the same time, it also revealed the problems involved in the economic system that supported their economic success. Each East Asian economy, which is now in the process of recovery from the

economic crisis, is faced with problems of not only recovering a sustainable economic growth but also reforming its economic system and policy system. When economic and financial globalization is making rapid progress, East Asian economies remain diversified encompassing various economies, including those that have already achieved a high level of economic development and growth and those that have shifted to a market economy only recently. Under the circumstances, the most important point when reforming the economic system and policy system would be what economic system and policy system each East Asian economy should establish in order to continue economic development and growth. Since economic system reform not only covers wide-ranging fields but also affects the future interest of each sector and unit as well as each stratum constituting an economy, it is not easy to present a reform vision and build consensus on it. In particular, for middle-income East Asian economies, there is no longer a successful economic model they can emulate, such as the “relations-dependent market economy system” for catch-up type development and growth. Therefore, their reform would be focused on rules and principles, such as establishment of highly transparent rules and policy operations that do not allow discretion in principle. Such a system, which can be characterized as “emphasis on internationalization and competition,” would drastically change the conventional economic system of East Asian economies in terms of the method of, for example, resource allocation.

To date, no particulars have been made with regard to the reforms of economic system and policy system. However, industrial reorganization has been making a steady progress and the conventional inter-dependent relationship between government and private sector has been changing. Furthermore, each country has been promoting the overhaul of the government/public sector and is moving toward the privatization of public institutions. Meanwhile, it has been made clear that government’s role is to provide primary public goods and construct a safety net while maintaining high efficiency. Although the reforms of the economic system and policy system began to progress gradually, there are still many sectors whose reform has yet to start. As to the financial system, though various systemic changes have been made, the problem of non-performing loans has yet to be resolved. Foreigners’ participation in the financial sector has made headway, but full-scale reform in this area remains to be seen. What is most important and noteworthy in the future reforms of the economic system and policy system of East Asia is the relationship between politics and economy. Since the “relations-dependent market economy system” had been maintained for a long time and the economic system and policy system were managed by discretionary policies under loosely defined rules, the relationship between politics and economy increased in opacity. It is highly likely that the opaque relationship had been further strengthened as a result of the long-time rules of government by the same person or party in many of the East Asian countries and regions. We cannot foreclose the possibility that

the systemic defect may have gradually stymied the original functions of the economic system and policy system. East Asia's "relations-dependent market economy system" functioned efficiently as a system to achieve economic development and growth, but it was not effective as a system to check departures from rules.

4. Quest for New Economic System and Problems of Sustainable Development

(1) Quest for new economic system

<Construction of “cooperative game” structure for new paradigm>

Although East Asia experienced a large-scale currency and financial crisis, it has achieved strong development and growth for over 30 years. However, East Asia still contains economic diversity. An example of this is per-capita income levels. The per-capita income in the region varies from over 20,000 dollars in Singapore and Hong Kong to 9,000-10,000 dollars in Taiwan and South Korea to less than 500 dollars in the countries of Indochina that are in transition to a market economy. Like during the period from the 1960 to the 1980s, when many of the East Asian economies were grouped as developing countries, they were able share the same investment/exports-led “relations-dependent market economy system” for economic development and growth, despite the fact that there were disparities in per-capita income level among them. However, in the early years of the 21st century, it would be difficult for them to share a common economic system, as the level of their economic development and growth varies. Some of them have almost completed the process of catching up with advanced countries, while some others have begun the process of economic development and growth only recently. Therefore, it appears that East Asia will come to have more than one economic system model. Asian NIEs and leading ASEAN countries will have no choice but to shift from the conventional “relations-dependent market economy system” to the “rules-dependent economy system.” Also from the standpoint of “strategic complementarity,” it is necessary for Asian NIEs and some ASEAN countries that have already been incorporated into internationalization and globalization to shift to the “rules-dependent economy system” if they want to continue sustainable economic growth. It is not that the shift should be carried out in all sectors in a short period of time. Rather, the shift should be carried out steadily according to a schedule by setting a time frame of, for instance, five years or within 10 years. This method is better in that it does not cause unnecessary confusions and facilitates the construction of a “cooperative game” structure. Since a safety net has to be established for the new market system, changing the system in a short period of time would costly. On the other hand, the conventional “relations-dependent market economy system” would still function effectively for less-developed ASEAN countries. In any case, East Asia has to construct an economic system reflecting a new paradigm for economic development and growth.

The important lessons we can learn from the successful economic development and growth of East Asia are its characteristic economic system and the fact that every participant in the economic system (people across all level of society, private corporations, government sector, domestic regions, etc.) understood the significance of economic development and growth and

maintained a “cooperative game” structure for a long period of time. There is no doubt that a “cooperative game” structure, though not a sufficient condition in itself, is a necessary condition for the economic system for economic development and growth to function well. Since many East Asian countries are multi-ethnic nations and have traditional conflicts among domestic regions, constructing a “cooperative game” structure will continue to remain as an important problem. What is noteworthy in this regard is that one of the fruits of East Asia’s economic development and growth is that domestic income distributions did not aggravate during the course of economic development and growth until early in the 1990s. It appears that keeping a balance between economic development and growth and income distribution had an important meaning for maintaining the “cooperative game” structure. The Philippines in the 1980s and Indonesia after the currency and financial crisis of 1997 would be good examples of the collapse of a “cooperative game” structure and its transformation into an “uncooperative game” structure. In order for East Asia to continue its sustained economic development and growth, it is necessary to construct a “cooperative game” structure based on persuasive and clear visions for the establishment of an economic system with a new paradigm.

<Reformation of “relations-dependent market economy system” into “rules-dependent economy system”>

The currency and financial crisis has revealed the limit and problems of the “relations-dependent economy system” that had been conducive to the economic development and growth of East Asian middle-income countries. Therefore, these countries have focused their reforms on such problems as relations between government and private sectors, the importance of establishing corporate governance, and, in the case where the policy system is also a relations-dependent type, delays in policy response. As to macroeconomic policy, the central banks of some of the East Asian countries have adopted inflation targeting as a monetary policy. The policy is expected to limit discretionary monetary policies within the range of their relations with rules. It is also expected to enhance the transparency of and accountability for monetary policy. In any case, there is no doubt that East Asia will shift to an economic system with highly transparent, clear-cut rules.

Even if an economic system has come to be operated with highly transparent rules, it does not mean that major external economic shocks have gone out of the window. Macroeconomic policies and measures to maintain and revitalize the economy are still necessary. Whatever the economic system may be, new defects and problems of the economic system will emerge, as long as the system keeps developing or new industries, technologies, and business models continue to be created. Therefore, an economic system always needs to be reformed. In order for East Asia to continue its sustained economic development and growth, it is necessary to shift to

more rules-dependent economic system or construct one. So, the question is what economic development and growth East Asia should strive for.

<Quest for new international economic system in East Asia: Changing the export-oriented paradigm>

East Asia had maintained a high economic growth rate for a long time. The high economic growth rate raised the income level of East Asia and at the same time played the role of the world's production center. East Asia's growth was led by investment and exports and many of the economies in the region have come to have high investment ratio and export ratio. Among production factors, the high investment ratio and an increase in labor force made a major contribution to the development and growth. The input of substantial amounts of production factors supported the growth but a rise in productivity did not make a major contribution. In view of the fact that East Asian regions as a whole has developed from a low-income country to a middle-income country and is catching up with advanced countries, it is natural that the input of production factors played a major role particularly at an early stage of the economic development and growth and that the contribution of a rise in productivity and the total factor productivity was small. Since the existence of unutilized resources and a large amount of unemployment is common in the early stage of economic development, the earlier the stage of development and growth is, the higher the contribution of factor inputs to growth is, and the contribution of a rise in productivity is not large.

The future development and growth pattern of East Asia will inevitably be considerably different from what it was 30-40 years ago. Therefore, a new paradigm would support development and growth. It is difficult to predict a new paradigm and growth pattern now. But the following directions are conceivable.

- (a) The export ratio is not likely to rise above the present level. East Asia will continue its role of the world production center for industrial goods for a long time, but the growth of domestic consumption will also rise.
- (b) The investment ratio would gradually decline in line with the expansion of domestic consumption.
- (c) Given the long-term convergence of economic growth process, the economic growth rate would decline gradually.
- (d) Investment efficiency is expected to rise even if the economic growth rate declines, as the investment ratio will also decline. The growth rate of the labor force is forecasted to decline. Therefore, a rise in productivity would make a greater contribution to growth.
- (e) The internationalization of East Asian economies is forecast to continue for some time

to come, as FTAs and other moves are expected to make headway. Direct investment and the international division of labor will continue to make headway and the countries in the region are expected to have more liberalized, deregulated systems, and make further progress in their efforts to smooth out systems.

- (f) The energy problem and the environment problem are highly likely to increase in weight as constraints on sustainable economic development and growth. The weight of the energy problem and the environment problem will also increase in East Asia in its relations with the international economic system.
- (g) It is likely that East Asian economies will not only expand the scope of their policy coordination in micro-economic policy and financial policy but also set common goals, such as numerical targets for specific policies, and this will eventually enhance the transparency of policies.

The wide disparity in income level is expected to remain in East Asia of 10 years or 20 years ahead. But what is important is that the economies of East Asian low-income countries will be incorporated into the development and growth network for the whole East Asia and will continue their development and growth.

(2) Tasks for sustainable development

There are various constraints on East Asia's sustained development. Some of them have long been pointed out as major problems and some others may increase in importance as new constraints. There are also constraints that had once raised concerns but were basically resolved and are no longer a cause for such concern. In food supply, for example, production of rice, a staple food in East Asia, has ceased to be a constraint on development and growth thanks to the "green revolution," appropriate agriculture policies implemented by various countries, and international cooperation. On the other hand, energy supply and environment problems will increase in importance as constraints. As for the population problem, it is highly likely that the constraint of population composition (declining birthrate and a growing proportion of elderly people) will pose more serious problems than the constraint of population increase.

The formation of human capital for education and technology development has been stressed as the most important problem for East Asia's economic development and growth. In order for East Asia to continue more efficient development and growth, it is necessary to strive for higher productivity. For this reason, the accumulation of human capital through education and engineering training is one of the most important problems. In the future, East Asia will have to seek more efficient development and growth, such as higher productivity and higher energy efficiency, rather than a high growth rate.

(Note)

- 1) Following document makes a comprehensive evaluation of the economic growth and development of East Asia since the 1960s. It drew lively discussions.

The East Asian Miracle, World Bank 1993.

- 2) The economic growth rate achieved and its duration was really miracle. As for later evaluation of the achievement, see the following document.

Rethinking the East Asian Miracle ed. by Joseph E. Stiglitz and Shahid Yusuf. Oxford Uni. Press 2001

- 3) This was emphasized strongly in the controversial research paper below.

Paul Krugman "The Myth of Asia's Miracle," *Foreign Affairs* 73 (December 1994)

- 4) The convergence of economic growth became a major research task after the first half of the 1980s, when research on economic growth expanded to endogenous economic growth.

- 5) See the literature in Note 2.

- 6) Many empirical studies on income distribution show that the Gini coefficient did not rise in East Asia from the 1960s to the second half of the 1980s. However, it is highly likely that the Gini coefficient has risen since the second half of the 1990s due to the domestic investment boom and the currency and financial crisis that ensued.

- 7) For the basic explanation of the convergence of economic growth process, see Jones, C.I., Introduction to Economic Growth, Second edition. Norton, 2002

- 8) See the document in Note 1.

- 9) In the case of East Asia, confrontations stemming from countries being multiracial or because of religious reasons became serious, especially in the period until around 1970. Moreover, there were cases where internal regional confrontations intensified.

Under the circumstances, establishing a "cooperative game" structure for economic development and growth was a necessary condition.

- 10) For detailed analyses and characteristics of the "rule-dependent market economy system" and the "relations-dependent economy system," see Economic Development of East Asia and the Roles of Government ed. by Masahiro Aoki, Jing-Ki Kim, Masahiro Okuno, Nihon Keizai Shimbun 1997

- 11) The ratio of customs duties and consumption tax to total tax revenues is still high in many of the East Asian economies, except for Asian NIEs.

- 12) The literature below points out the problems of the IMF's prescription.

Stiglitz, J.E. Globalization and Its Discontents, W.W. Norton, 2002