INTRODUCTION TO THE 2003 PAPERBACK EDITION: CREATING CAPITALISMS

IN THE last two decades of the twentieth century East Asia reemerged as the most dynamic region of the world economy, as it had been before the eighteenth-century rise of the West. East Asia dramatically raised its average income in relation to the West's, while all other "developing" regions—Latin America, Africa, West Asia, and South Asia—either fell or remained constant. *Governing the Market* describes how some East Asian capitalist countries, beginning in the 1950s, upgraded and diversified their economies and eventually caught up with the living standards of the prosperous democracies, something that no other developing country has done since World War II. From their policy practice the book induces a "Third Way" development strategy—as different from today's "common sense" Washington Consensus agenda as from the discredited import-substitution agenda.[1] It bucks the trend in development economics over the past two decades away from the analysis of development strategies in favor of microanalysis of markets.

Since the book's publication in 1990 economists have tended to say that,

1. neither *Governing the Market* nor any other study proves that industrial policy—beyond market-friendly rules of property rights—contributed, net, to economic growth in East Asia;[2]
2. insofar as sectoral industrial policy might have helped in northeast Asia it was because of circumstances unique to the region; even in nearby fast-growing Southeast Asia sectoral industrial policy, to the extent that it was tried at all, failed;

[1] I thank Peter Dougherty, economics editor at Princeton University Press, for stimulating this introduction; and Stephan Haggard, Richard Doner, and Michael Rock for comments on the first draft. For a debate on some of these big issues of development strategy, see A. Wood, J. Roberts, R. H. Wade, S. Lall, 2003, "Symposium on infant industries," *Oxford Development Studies* 31(1) March:3–20.

[2] The *Economist* published a long and enthusiastic review of *Governing the Market* (1 June 1991, 102–3). The review prompted angry telephone calls to the *Economist*'s business editor from more than half a dozen World Bank staff members, who knew me from my earlier years as a World Bank economist and knew the business editor from his editing of the Bank's *World Development Report*. They complained that the magazine was lowering its standards by reviewing favorably the work of an "interventionist." The business editor asked them whether they had read the book. "No," they said, in every case. James Fallows later wrote an excoriating attack on the *Economist*, citing its review as "Exhibit A" of how the magazine distorted arguments to make them conform to its liberal predilections ("Economics of the colonial cringe," *Washington Post*, 6 October 1991).

3. the Asian financial crisis of 1997–98 showed that the kinds of relationships between state and big business fostered by the "developmental state" are prone to inefficiency and breakdown;
4. Taiwan, South Korea, China, and the other countries of the region have been reforming themselves in line with the Anglo-American economic model, discarding the remnants of a "governed market" system;
5. therefore, even if governed markets, sectoral-industrial policy, and the developmental state had some validity in the early postwar decades, their time is past; and WTO rules are making sure that it stays past. The only viable option for developing countries is some variant of the neoliberal Washington Consensus agenda—maximum integration into the world economy plus domestic reforms to stabilize integration and make domestic markets more efficient (including "good governance" reforms to bring the poor into the process). Sectoral-industrial policy, and anything intended to foster nationally controlled industries over foreign-owned, or to transfer technology beyond the speed desired by private foreign firms, is out.

In short, economists have said that East Asia's experience supports the proposition that liberalized markets are the best way to organize economies, developed or developing. The state should protect property rights and ensure the supply of public goods, but not impart directional thrust.[3] More specifically, the state should create and sustain (a) efficient, rent-free markets, (b)

[3] For accounts of shoehorning East Asia into free market theory see Wade, 1992, "East Asia's economic success: conflicting perspectives, partial insights, shaky evidence," *World Politics* 44(2):270–320. Within the economists' profession, however, there is a odd twist. Since the 1980s much work on the frontiers investigates the heterodox world of increasing returns, linkages, technological learning, oligopolistic pricing, imperfect information, herding behavior, and the like, which at least in principle provides justifications for governments to implement capital controls and industrial policy measures (including performance requirements, non-uniform tariffs, etc.). On the other hand, the dominant "structural adjustment" prescriptions of the Bretton Woods organizations assume orthodox decreasing returns, stable equilibria, and no significant non-market linkage effects. Sometimes the same economists straddle both worlds, setting aside their knowledge of the heterodox when they deal with development policy in order to hammer home the orthodox "fundamentals."

Economists' studies of development policy and East Asia's success that do go beyond the efficient markets and good governance agenda include D. Rodrik, 2001, "Development strategies for the 21st century," in *Annual World Bank Conference on Development Economics 2000* (Fall); D. Rodrik, 1995, "Getting interventions right: how South Korea and Taiwan grew rich," *Economic Policy* 20(April):53–97; J. Stiglitz and S. Yusuf (eds.), 2002, *Rethinking the East Asian Miracle*, New York: Oxford University Press; S. Lall, 2001, *Competitiveness, Technology and Skills*, Cheltenham: Edward Elgar; A. Amsden, 2001, *The Rise of "The Rest": Challenges to the West from Late-Industrializing Economies*, New York: Oxford University Press; L. Westphal, 2002, "Technology strategies for economic development in a fast changing global economy," *Economics of Innovations and New Technology* 11(4–5):275–320; L. Taylor, 1994, "Financial fragility: is an etiology at hand?" in G. Dymski and R. Pollin (eds.), *New Perspectives in Monetary Macroeconomics: Explorations in the Tradition of Hyman P. Minsky*, Ann Arbor: University of Michigan Press, 21–50; work of H. Chang cited later; and the *Trade and Development Report* published annually by UNCTAD under chief author Yilmaz Akyuz.

efficient, corruption-free public sectors able to supervise the delivery of a narrow set of inherently public services, and (c) decentralized arrangements of participatory democracy. The more these conditions are in place the more development and prosperity will follow.

The remarkable thing about the core Washington Consensus package is the gulf between the confidence with which it is promulgated and the strength of supporting evidence, historical or contemporary. There is virtually no good evidence that the creation of efficient, rent-free markets coupled with efficient, corruption-free public sectors is even close to being a necessary or sufficient condition for a dynamic capitalist economy.[4] Almost all now-developed countries went through stages of industrial assistance policy before the capabilities of their firms reached the point where a policy of (more or less) free trade was declared to be in the national interest. Britain was protectionist when it was trying to catch up with Holland. Germany was protectionist when trying to catch up with Britain. The United States was protectionist when trying to catch up with Britain and Germany, right up to the end of the World War II.[5] Japan was protectionist for most of the twentieth century up to the 1970s, Korea and Taiwan to the 1990s. Hong Kong and Singapore are the great exceptions on the trade front, in that they did have free trade and they did catch up—but they are city-states and not to be treated as economic countries. In Europe some countries abutting fast-growing centers of accumulation were also exceptions, thanks to the "ink blot" effect. But by and large, countries that have caught up with the club of wealthy industrial countries have tended to follow the prescription of Fried-

[4] The emphasis on "anticorruption" in the "good governance" agenda of the international development community obscures the distinction between modalities, some of which are more developmentally damaging than others. As a stylized fact, Indian civil works corruption takes the form of correct pricing of substandard structures, which wash out in the next monsoon; Korean civil works corruption takes the form of inflated prices for properly built structures, which endure.

[5] Alexander Hamilton, the first U.S. Secretary of the Treasury (1789–95), set out a strategy for building up American industry behind tariffs to the point where American manufacturers would be able to compete against foreign competition unaided, in *Reports of the Secretary of the Treasury on the Subject of Manufactures*, 1791. The United States followed a protectionist industrial strategy for most of the period from then right up to the early post–World War II years, when U.S. industry had achieved supremacy. At this point the U.S. government started to champion free trade. Now it is difficult to get hold of Hamilton's writings, whereas any decent U.S. bookshop has shelves of writings by Hamilton's enemy, Thomas Jefferson, notwithstanding that Hamilton was every bit as important to the invention of the United States as Jefferson. See F. McDonald, 1982, *Alexander Hamilton: A Biography*, New York: Norton. For a history of U.S. industrial development strategy see H. Chang, 2002 *Kicking Away the Ladder: Development Strategy in Historical Perspective*, London: Anthem, 24–32; and R. Kozul-Wright, 1995, "The myth of Anglo-Saxon capitalism: reconstructing the history of the American state," in H. Chang and R. Rowthorn (eds.), *The Role of the State in Economic Change*, Oxford: Clarendon, 81–113.

rich List, the German catch-up theorist writing in the 1840s: "In order to allow freedom of trade to operate naturally, the less advanced nation [read: Germany] must first be raised by artificial measures to that stage of cultivation to which the English nation has been artificially elevated."[6]

Today's fast and populous growers—mainly China, India, and Vietnam—have certainly benefited from the more open markets and international investment of the past two decades. But they began their fast economic growth well before their fast trade growth and even longer before their trade liberalizations. They have constrained their trade liberalizations by considerations of the capacities of domestic firms to compete against imports, in just the way List recommended.

Within the "transitional" countries (moving from communism to capitalism) the comparison between Russia and China provides the extreme case in point: Russia—massive liberalization and privatization (shock therapy), catastrophic economic performance; China—gradual liberalization and privatization, excellent economic performance (by standard measures). Within each region (Central Europe, southeastern Europe, the former Soviet Union, East Asia), one finds that the more radical liberalizers performed worse economically in the 1990s than those that moved more gradually. For example, the Czech Republic pursued the most ambitious economic liberalization and privatization compared to Slovakia and Poland, and has had substantially worse economic performance.[7]

At the global level policies have "improved" markedly during the past two decades; the world has experienced a surge of market liberalization and integration across borders (big reductions in all kinds of policy-based market restrictions, big rises in trade and investment to GDP). But policy improvement has not yielded better aggregate economic performance. On the contrary, world economic growth has fallen sharply, as also for the OECD countries and developing countries taken separately. Per capita growth in the OECD fell from 3.5 percent between 1965 and 1979 to 1.8 percent between 1980 and 1998. Per capita growth of developing countries fell from 2.4 percent between 1965 and 1979 to 0.0 percent between 1980 and 1998.[8] Yet these depressing results have only served to lock-in the Washington Con-

[6] F. List, 1966 [1885], *The National System of Political Economy*, New York: Augustus Kelley (ch. 11), 131.

[7] L. King, 2003, "Explaining postcommunist economic performance," Working Paper No. 559, William Davidson Institute at the University of Michigan Business School, May. The New Zealand/Australia comparison suggests the same conclusion. Before 1984 the two economies performed very similarly. From 1984 to the late 1990s the New Zealand government undertook much more radical liberalization than Australia's, and economic performance has been substantially worse.

[8] W. Easterly, 2002, "The lost decades: developing countries' stagnation in spite of policy reform, 1980–1998," *Journal of Economic Growth* 6:135–57. Unweighted averages. The weighted average for developing countries in the second period (which emphasizes the fast growth of China and India) is still only 0.8 percent.

sensus: they are taken to show the need for even more market liberalization. So the communiqués from the regular meetings of the finance ministers of the G7 (the seven biggest industrialized economies) have consistently emphasized—from the beginning in the mid-1980s all the way to the late 1990s—the need to raise growth rates, cut unemployment, and stabilize exchange rates by curbing budget deficits, tightening monetary policy, and making labor markets more flexible. The G7 finance ministers continued to affirm this recipe long after the G7 countries became more convergent in these respects than at any time since the World War II, while economic performance remained poor overall.[9]

There is much evidence against the Washington Consensus. But perhaps the most compelling is the subject of this book, the experience of the East Asian capitalist countries since World War II. The record of these countries in the use of state power to impart directional thrust via market mechanisms stands as an enduring reproach to the Washington Consensus. Or does it?

Effects of Industrial Policy

Governing the Market describes industrial policies, on the one hand, and industry performance, on the other. But it goes beyond the correlations to describe state capacity in the form of the institutional/political arrangements for public- and private-sector interactions. It tells a story of well-motivated state industrial officials functioning not as all-knowing directors but as learning-directors—even if the power field in which they learned put *them* in the position of aggregating the preferences of industrialists, rather than organizations of industrialists. And the book explores the sources of state motivation, state strength, and policy credibility. Missing, though, is analysis of the external economies of human capital that are a major source of increasing returns to production in Taiwan and other East Asian countries—microanalysis of firm capabilities and corporate governance, and mesoanalysis of interfirm input-output networks, factor markets, and tacit knowledge.[10] But *Governing the Market* says enough about the invisible strings between industrial policies and economic performance to make it plausible that the policies and their implementation agencies were too important in East Asia's success to ignore.

We can tell the same broad story for three cases (Taiwan, South Korea, and Japan); and at a stretch for Singapore too.[11] They have in common state

[9] Wade, 2000, "Out of the box: rethinking the governance of international financial markets," *Journal of Human Development* 1(1) February:145–58.

[10] R. Lucas, 1988, "On the mechanics of economic development," *Journal of Monetary Economics* 22(July):3–42.

[11] R. Doner, 2001, review of *The Rise of "The Rest": Challenges to the West from Late-*

policies to transfer resources away from "unproductive" toward "productive" uses—often in the form of transfers from unproductive groups to productive groups and sometimes in the form of policies to convert unproductive groups into productive ones. Creating "rents" (above normal market returns) by "distorting" markets through industrial policies was essential, first, to induce more-than-free-market investment in activities that the government agreed were important for the economy's transformation, and second, to sustain a political coalition in support of these policies. Disciplining rent-seeking so that it remained consistent with these two objectives was also essential. All these states had either authoritarian regimes or tightly circumscribed democracies until late in the transformation, which limited the scope for those seeking rents in unproductive activities from paralyzing the polity until they got their way.

They also have in common that they built up their manufacturing apparatuses during the Cold War when they abutted major sites of "communism," which gave the United States an overriding interest in fostering their state-led capitalisms in order to prove that capitalism was superior to the communist systems next door. By the start of the 1980s, when the United States began to move from competing in manufactures to dominating through finance—and importing a rising fraction of manufactured goods—capitalist East Asia was well-placed to ride the surge of U.S. import demand and even to provide out of its growing financial surpluses the savings needed to cover escalating U.S. current account deficits.

The East Asian Miracle

In this story, capitalist East Asia's industrial and technology policies have a central role. But what is the quantitative evidence on their impact? Consider the World Bank's *The East Asian Miracle*, published in 1993, the most serious attempt to examine quantitatively the impact of "interventionist policies" in East Asia. It was written because the Japanese government, angry at the Bank's criticisms of its aid program in Asia in support of capitalist transformation, paid the Bank US$1.2 million to cover non-staff costs, thereby giving the Bank no excuse for continuing to decline its number-two-ranked shareholder's requests for research on the region as a whole.[12]

The four-hundred page report finds that "in large measure, the HPAES [High Performing Asian Economies, eight across East and Southeast Asia]

Industrializing Economies, A. Amsden, New York: Oxford University Press. Also, G. Noble, 1998, *Collective Action in East Asia: How Ruling Parties Shape Industrial Policy*, Ithaca: Cornell University Press.

[12] See Wade, 1996, "Japan, the World Bank, and the art of paradigm maintenance: *The East Asian Miracle* in political perspective," *New Left Review* 217(May/June):3–36.

achieved high growth by getting the basics right."[13] The "basics" mean macroeconomic stability, including: low inflation and stable and competitive exchange rates; "relative prices of traded goods . . . closer on average to international prices than other developing areas"; and heavy and sustained public investment in social infrastructure, particularly education. The report finds, second, that the HPAEs benefited from a government-led push for exports of manufactures; third, that directed or "selective" credit programs (subsidized credit to targeted uses) were effective for promoting exports and perhaps R&D; but fourth, sectoral industrial policies to support specific industries "generally did not work and therefore [hold] little promise for other developing economies." From the point of view of the Japanese sponsors, the Ministry of Finance, the third conclusion was most important because it gave the ministry a defense against the Bank's criticism of Japan's aid program for Southeast Asia—that Japan's assistance to directed credit for industrial promotion was distorting the financial system and spoiling the Bank's efforts to make the countries remove financial "distortions."

How solid are these conclusions? Not very, because the report uses standards of inference so elastic that practically anything could be confirmed. For example, the point that East Asia's relative prices were closer on average to international prices than for other developing areas is important for the larger—much desired—conclusion that although industrial policies (including protection and subsidies) did exist, their magnitude was slight. But the report contains evidence—that is not put to use—that the relative prices for Japan, South Korea, and Taiwan deviated more from international prices than those of notorious interventionists like India, Pakistan, Brazil, Mexico, and Venezuela in the period 1976–85. The conclusion about the low regional average rests on the average price distortion scores of all eight (unweighted) countries in the wider East Asia area, including the Hong Kong and Singapore "minnows" whose price distortions were necessarily negligible.

The conclusion that sectoral policies were ineffectual rests not on an examination of the effectiveness of specific policy instruments used to promote targeted industries but on the answer to two broad questions: Did high-wage or high value-added industries expand faster than would have been predicted on the basis of cross-country evidence or factor endowments; and, Was productivity growth more rapid in the promoted sectors than in others? I have shown elsewhere (in addition to Dani Rodrik and others) why one cannot accept the report's operationalization of these questions or its interpretations of the results.[14]

[13] World Bank, 1993, *The East Asian Miracle: Economic Growth and Public Policy*, Washington, D.C., 5.

[14] Wade, 1994, "Selective industrial policies in East Asia: is *The East Asian Miracle* right?" in Albert Fishlow, et al. (eds.), *Miracle or Design? Lessons from the East Asian Experience*,

All in all the most serious effort to show the ineffectiveness of East Asian sectoral ("rent-creating") policies is not compelling.

Southeast Asia and Elsewhere

What about the rest of the world? The economists' fallback position is that even if sectoral promotion policies were effective in northeast Asia they have not worked elsewhere.[15] Even in fast-growing Southeast Asia—often thought of as northeast Asia's cousin and successor as development champion—government efforts at directional thrust have been thin and unsuccessful.

Total factor productivity does seem to have grown more slowly in Southeast Asia than in northeast Asia, suggesting that Southeast Asia's fast growth (until 1997) relied more on "perspiration than inspiration." But is the growth of total factor productivity a good indicator of the impact of industrial policy? No, for several reasons. One is that the trend is very sensitive to how labor and capital are measured. Different analysts measure them in different ways and get quite different results. The trend is also very sensitive to the time period. In the early years of the promotion of automobiles and steel in Korea, for example, total factor productivity growth was very low and it looked as though the promotion measures were having no effect, until the trend turned sharply positive. Industrial promotion efforts in Thailand and Indonesia have been cut short from time to time by abrupt political change, and this has to be factored in.

Microstudies suggest that selective interventions have been effective in rice agriculture and in creating large conglomerates that have come to dominate the industrial sectors, particularly in Indonesia and Thailand. At the industry level, there is some evidence that total factor productivity growth has been high in two heavily promoted industries in Indonesia, wood processing and aircraft building, but it is not clear that such productivity growth has been sustainable.[16] Other microstudies argue against the success of in-

Washington, D.C.: Overseas Development Council; D. Rodrik, 1995, "King Kong meets Godzilla: The World Bank and *The East Asian Miracle*," in ibid; A. Cappelen and J. Fagerberg, 1995, "East Asian growth: a critical assessment," *Forum for Development Studies* 5(2):175–95.

[15] For example, Adrian Wood, chief economist of the Department for International Development, the U.K. aid agency, and distinguished academic development economist, says, "I am persuaded that selective interventions contributed to East Asia's success and to the industrialization of continental Europe and the United States. . . . I am also persuaded, however, that most selective interventions in most countries have been ineffective, costly and corrupt." Wood, 2003, in "Symposium on infant industries," *Oxford Development Studies*, 31(1) March:3–20.

[16] M. Rock, 2002, "Exploring the impact of selective interventions in agriculture on the growth of manufactures in Indonesia, Malaysia, and Thailand," *Journal of International Development* 14:485–510; 1999, "Reassessing the effectiveness of industrial policy in Indonesia: can the neo-liberals be wrong?" *World Development* 27(4) April:691–704; 2000,"Thailand's old bureaucratic policy and its new semi-democracy," in M. Khan and K. S. Jomo (eds.), *Rents and*

dustrial promotion—though sometimes by comparing plants in Malaysia, Thailand, or Indonesia against similar plants in Singapore or northeast Asia, rather than in other parts of the world.[17] In short, the debate about industrial policies in Southeast Asia remains open. Neither side has conclusive evidence; but it is not true that the evidence is all on the side of those who say industrial policy failed.

Outside Asia, Brazil has at certain times shown distinct similarities to Taiwan and South Korea in the alignment of political order, public administration, sectoral targeting, and positive results.[18] Not only Brazil but also Mexico and Argentina (the three biggest Latin American economies) have used sectoral promotion policy to good effect in the auto industry. It is one of their most successful export sectors. It is dominated by multinational corporations (MCNs), to be sure, but the engineering capabilities that sustain it are local, and were built up slowly during decades of protection. A new export-oriented auto industry could not now be set up in another Latin American country under today's WTO free trade rules.

Beyond Sectoral Targeting

But the debate about industrial policies and the developmental state has concentrated too much on the sorts of issues just discussed, eclipsing other important parts of state development strategy. One of the missing parts is the "below-the-radar" kind of industrial policy that I describe for Taiwan (pages 284–86), involving Industrial Development Bureau officials "nudging" foreign firms to switch supplies from imports to domestic producers, or nudging established industries quickly to provide markets for firms in innovative industries, hence accelerating the rate of innovation—as distinct from programs like the Ten Year Plan to Develop Industry X, whose effects might occur on a large enough scale to be picked up with quantitative measures. The nudging policies have been sectoral, not "horizontal" or "across the

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Rent-Seeking and Economic Development: Theory and the Asian Evidence, Cambridge: Cambridge University Press, 183–206; 2002, "The politics of development policy-making in new order Indonesia," paper presented at graduate seminar on Economic Policy Reform in Asia at the Department of Political Science and the William Davidson Institute, University of Michigan, Ann Arbor, 12 September. Also, importantly, J. Mathews and D. Cho, 2000, *Tiger Technology: The Creation of a Semiconductor Industry in East Asia*, Cambridge: Cambridge University Press.

[17] D. McKendrick, R. Doner, S. Haggard, 2001, *From Silicon Valley to Singapore: Location and Competitive Advantage in the Hard Disk Drive Industry*, Palo Alto: Stanford University Press.

[18] P. Evans, 1995, *Embedded Autonomy: State and Industrial Transformation*, Princeton: Princeton University Press. B. Schneider, 1999, "The *desarrollista* state in Brazil and Mexico," in M. Woo-Cumings (ed.), *The Developmental State*, Ithaca: Cornell University Press. J. Krieckhaus, 2000, "The politics of economic growth in the Third World: Brazilian developmentalism in comparative perspective," Ph.D. dissertation, Princeton University.

board"; but they have been going on across swathes of industrial sectors. They involved a mix of methods, including "jaw-jaw" and promises of good will for future ventures, fiscal incentives, higher tariffs, and lengthening delays in permission to import (that had earlier been approved quickly and automatically). The industrial officials who sought to persuade were on the whole well trained in technical subjects, and not routinely corrupt. I expect that research on this phenomenon in East Asia would find that the nudging efforts of bodies such as Taiwan's Industrial Development Bureau were effective—but not likely to influence any of the usual ways of measuring industrial policy impacts. This kind of low-powered industrial policy, whose scale can be cut according to the cloth, is much more implementable in a wider range of state capacities than the big-scale "make the winners" kind.[19]

Next, the developmental state has to be judged not only in its role of influencing the allocation of resources between different sectors (rice, shipbuilding, hard disc drives) and different functions (infrastructure, R&D, small enterprises), but also in its role of mobilizing resources within the public sector.[20] The East Asia developers have had very high levels of savings, both public and private. Their capacity to mobilize savings went with a high level of public investment; and high public investment (including in support of sectoral industrial policy) stimulated high private investment. There is likely to be reciprocal causation between high savings, high domestic investment, and high growth; but certainly some of it did run from high savings—mobilized by a developmental state—to high growth. Cross-national evidence suggests that countries with high public savings and high growth tend to have certain political features in common: a relatively high degree of political order, an antisocialist and antipopulist ruling coalition, a strong state commitment to industrial promotion, and a relatively effective state bureaucracy. Any one country may have these features to a more pronounced degree at one time than at another, and we would expect it to show higher public savings and higher growth in the more pronounced phase than in the less pronounced. Brazil from 1964 to 1974 was a "developmental state" in these terms, and had exceptionally high levels of public savings and growth.

[19] To advance understanding of the developmental state we need tighter conceptualization and systematic testing. With better measures of the "developmental state" and "industrial policy" variables we could construct a middle-N sample in which countries with developmental states represent a significant fraction of the total; and a large sample of microlevel industry case studies. J. Krieckhaus, "The politics of economic growth in the Third World," makes a good start; see also L. Weiss, 1998, *The Myth of the Powerless State*, Cambridge: Polity; A. Kohli, 2003, *In Search of Development: Constructing States and Industry in the Global Periphery,* forthcoming; C. Kay, 2002, "Why East Asia overtook Latin America: agrarian reform, industrialisation and development," *Third World Quarterly* 23(6):1073–1102.

[20] See the important paper by J. Krieckhaus, 2002, "Reconceptualizing the developmental state: public savings and economic growth," *World Development* 30(10):1679–1712.

From 1985 until now it has been an incoherent democracy, with public savings well below the developing country average and very low average growth.

In short, we should not forget, as most analysts do, that a developmental state may be effective at promoting development not only through reallocative effects but also through resource mobilization effects and investment stimulation effects. Whatever their record of shifting resource allocations away from free market patterns and toward more strategic patterns to support the economy's future growth, the East Asian states were better than others at mobilizing resources and stimulating public and private investment.

The East Asian Financial Crisis

When the East Asian financial crisis hit in 1997–98 many of the commentators who had earlier attributed East Asia's "miracle" to its free enterprise system suddenly changed tack. The crisis was due to excessive government intervention in markets, especially financial markets, they said, intervention aimed at supporting investments by government "cronies." The crisis marked the beginning of the end of the outmoded state-directed Asian system. The flavor is caught in the explanation offered by the U.S. Federal Reserve Chairman, Alan Greenspan:

> "The current crisis [in East Asia] is likely to accelerate the dismantling in many Asian countries of the remnants of a system with large elements of government-directed investment, in which finance played a key role in carrying out the state's objectives. Such a system *inevitably* has led to the investment excesses and errors to which all similar endeavours seem prone."
>
> The Asian crisis accelerated a worldwide move towards "the Western form of free market capitalism" and away from the competing Asian approach that only a few years ago looked like an attractive model for nations around the world. "What we have here is a very dramatic event towards a consensus of the type of market system which we have in this country."[21]

Note the implied asymmetry: an economy's success is due to its integration into the world economy; an economy's crisis is due to "homegrown causes" (in the phrase from Stanley Fischer, Deputy Managing Director of the IMF). Laying the blame on homegrown causes protects the current international financial regime behind an ideational shield. Ironically, it even legitimizes arrangements for international financial players that are similar to the crisis-affected countries' arrangements that those same international players identify as the main cause of the crisis and in need of reform: if no blame rests with international financial players or the international financial system,

[21] Quoted in D. Sanger, 1998, "Greenspan sees Asian crisis moving world to Western capitalism," *New York Times* (13 February), section D, 1, emphasis added.

but does rest with *irresponsible* governments in the crisis-affected countries (who did not insist on full "transparency" in company accounts, for example), then the international private financiers are entitled to be protected from private losses just as they are entitled to keep the private profits. And the homegrown causes explanation also legitimizes the use of the IMF to subject the governments, banks, and firms of developing countries to the kind of discipline demanded by private international capitalists (who saw themselves shut out by "cronyism"), but not to subject those capitalists to the kind of discipline that might operate to the advantage of developing countries.

My own explanation of the East Asian crisis is different. It grows directly out of *Governing the Market* and, to borrow a line from former President Nixon, has the added advantage of being true.[22] But before I come to the explanation, a reminder of what the crisis amounted to. Right up to the eve of July 1997 the continued fast growth of the "miracle" economies of East Asia looked to be one of the certainties of our age. None of the four main crisis-afflicted countries (South Korea, Thailand, Malaysia, Indonesia) had had a year of significantly less than 5 percent real GDP growth for over a decade by 1996—Korea not since 1980, Thailand not since 1972. The crash was even more devastating to people's living standards and sense of security than the Latin America crash of the 1980s. The tragedy is caught in the story of a bicycle rickshaw driver in Indonesia who, as people began to save money by walking, had to chose between continuing to meet the down payments on the rickshaw or buying painkillers for his mother dying of cancer in his own house.[23] Some estimates suggest that around 50 million of the combined over 300 million people of Indonesia, Korea, and Thailand fell below the nationally defined poverty line between mid-1997 and mid-1998. Many millions more who were confident of middle-class status felt robbed

[22] My analysis of the Asian crisis is elaborated in 1998, "From 'miracle' to 'cronyism': explaining the Great Asian Slump," *Cambridge Journal of Economics* 22(6); 1998, "The Asian debt-and-development crisis of 1997–?: causes and consequences," *World Development* 26(8) August:1535–53; 2000, "Wheels within wheels: rethinking the Asian crisis and the Asian model," in N. Polsby (ed.), *Annual Review of Political Science*, v.3, Palo Alto: Annual Reviews, 85–116; 2001, "The US role in the long Asian crisis of 1990–2000," in A. Lukauskas and F. Rivera-Batiz (eds.), *The Political Economy of the East Asian Crisis and its Aftermath: Tigers in Distress*, Cheltenham: Edward Elgar, 195–226; 2000, "National power, coercive liberalism, and 'global' finance," in R. Art and R. Jervis (eds.), *International Politics: Enduring Concepts and Contemporary Issues*, fifth edition, New York: Longman, 482–89; also Wade and F. Veneroso, 1998, "Two views on Asia: the resources lie within," *Economist* (7–13 November), 19–21, and Wade and Veneroso, 1998, "The Asian crisis: the high debt model versus the Wall Street-Treasury-IMF complex," *New Left Review* 228(March/April). I exclude China and Hong Kong from the East Asian model.

[23] The case of the Indonesian rickshaw driver is described in the four *New York Times* articles about the crisis, 15–18 February 1999. In Java the minimum legal daily wage could purchase 6.3 kilograms of rice in January 1997, and 2.6 kilograms in June 1998. See ILO/UNDP, 1998, *Employment Challenges of the Indonesian Economic Crisis*.

of lifetime savings and security. Public expenditures of all kinds were cut, creating "social deficits" that matched the economic and financial ones. Nature was pillaged as people fell back on forests, land, and sea to survive.[24] Indonesia's real GDP shrank 17 percent in the first three quarters of 1998, Thailand's 11 percent, Malaysia's 9 percent, and Korea's between 7 and 8 percent. It took nearly two years to reach the bottom.

The miracles led to the biggest financial bailouts in history. The IMF mounted refinancing to the tune of US$110 billion, almost three times Mexico's US$40 billion package of 1994–95 (the biggest in the IMF's history to that date). Yet the investor pullout continued through 1997 and 1998, the panic feeding upon itself. The fact that the collapse continued in the face of the largest bailouts in history suggests that something was awry with the IMF's bailout strategy, a matter of concern to countries elsewhere that might find themselves needing IMF emergency funding in future.

The contractionary wave hit many other middle- and low-income countries beyond Asia, particularly through falls in the price and quantity of commodity exports like grains, cocoa, tea, minerals, and oil. Russia's renewed financial crisis and default in August 1998 triggered more contractionary shockwaves. Even countries that had diligently followed free market policy prescriptions (such as Mexico) were hurt as investors sold domestic currency for U.S. dollars in fear that *any* "emerging market" could be the next Russia or Indonesia. Brazil and some other Latin American countries in 1998 came perilously close to repeating the East Asian disaster.[25]

But the crisis was good news for the financial centers of New York and London. They had reaped high profits as capital flooded into East Asia during the 1980s and 1990s. They then reaped high profits as capital flooded out into "quality" assets, mainly U.S. and U.K. equities and bonds. They benefited as vulture funds bought up East Asian assets at firesale prices. And they were protected from default by the IMF bailouts.

The East Asian Growth Model

To explain the crisis, we first need to explain the role of finance in the precrisis growth model. The starting point is the high level of savings in the crisis-affected countries compared to elsewhere in the world. Domestic savings ran at a third or more of GDP, over twice the U.S. rate. Most of the savings were made by households, much of which went into (low risk) banks

[24] Little systematic information is available on the social and environmental impacts. See E. Lee, 1998, *The Asian Financial Crisis: The Challenge for Social Policy*, ILO, Geneva.

[25] Wade, 1998, "The fight over capital flows," *Foreign Policy* (Winter): 41–54. Wade and F. Veneroso, 1998, "The gathering world slump and the battle over capital controls," *New Left Review* 231(September/October):13–42.

rather than into (higher risk) equities. Banks financed most corporate investment.

Financial intermediation from households through banks to firms permitted extraordinarily high rates of investment. In the United States, by contrast, most household savings go to financing the households' own investment in housing and equities and most corporate investment in real productive fixed capital is financed by depreciation funds and retained profits, with less reliance on bank debt. Corporate investment is therefore more constrained than in a debt-based system.

Firms carrying high debt-to-equity ratios must be buffered by long-term financial relations between firms and banks, with the government standing ready to support both firms and banks in the event of shocks that impact swathes of the economy at once (such as sharp rises in interest rates or sharp falls in demand). If long-term relations between banks and firms did not exist, such shocks would prompt creditors to call their loans and liquidate firms; and where debt levels are high, the failure of some firms propagates the failure of others much faster than where debt levels are low. This is the financial rationale for some of the features of the developmental state, also known as "relationship" or "alliance capitalism" or, post-crisis, "crony capitalism." It is also the rationale of the "convoy" system of Japan, where strong companies support weak ones under various kinds of government encouragement.

In some Asian countries more household savings have been transferred to the enterprise sector through equity markets. Singapore and Malaysia have specialized institutions, such as pension and provident funds financed partly by payroll taxes, that purchase large quantities of equities. In Taiwan both government- and party-directed funds buy equities. However, these are all forms of government-sponsored forced investment regimes; they share with the debt transfer systems long-term relationships with finance and industry.

In a pure Anglo-American free market model, competition and short-term profit maximizing would cause high debt structures to become unstable in the face of shocks that interfere with debt service payments. Creditors seeking to safeguard their assets would call in loans and liquidate firms. Bank depositors would "run" on banks that might be exposed to defaults. This collective behavior would cause the whole financial system to shrink, triggering price deflations and even depressions. To avoid these outcomes Anglo-American nations long ago agreed that the state had to create a lender of last resort and a body of regulation that placed limits on the indebtedness of private banks, firms, and households. In the absence of East Asia's long-term relations these limits of prudent indebtedness were set far below the levels permitted in Asian "alliance capitalism."

Asian governments used this structure—able to support high levels of savings and debt—to carry through a high-investment industrial upgrading strategy. The ability to influence the supply of credit to firms (and to affect their cash flow and profits by other instruments like tax incentives and protection) allowed them to coordinate investments and advance the frontiers of technical capabilities in *national* firms. Even Thailand and Indonesia, not normally thought of as developmental states, have done this to a degree.

Alliance capitalism sounds like an invitation to corruption and insider dealing, resulting in excessive loans and inefficient investments—exactly Greenspan's argument. And the crisis showed truth in the allegation, most conspicuously in Indonesia. But the larger truth is that—helped by policy-created "rents" that generated massive "rent-seeking" in the form of greater-than-normal investment in activities important for the economy's future growth—Asian alliance capitalism generated the highest sustained economic growth rate and improvements in mass living standards for any region in world history until the mid-1990s. It worked not only as a "catch up" strategy for countries far from the world technological frontier, but even for Japan as it reached the frontier in the 1980s. Alan Greenspan and other neoliberal commentators miss this point.

But there was one (almost) necessary condition for the system to work: a partially and strategically closed capital account. I spelled out this condition in chapter 11 (page 367). The passage begins,

> Finally, the government must maintain a cleavage between the domestic economy and the international economy with respect to financial flows. Without control of these flows, with firms free to borrow as they wish on international markets and with foreign banks free to make domestic loans according to their own criteria, the government's own control over the money supply and cost of capital to domestic borrowers is weakened, as is its ability to guide sectoral allocation.

That is to say, high levels of debt, which can be a source of strength (by enabling higher levels of investment than could be financed from retained earnings or sale of equity), can be a source of vulnerability if the government gives up coordinating investment, curbing excess capacity, and maintaining the economy's external liabilities within its capacity to repay. In short, opening the capital account—ending strategic engagement—is likely to end the high debt model.

External Factors in the Build Up to Crisis

In the early 1990s the economies at the core of the world economy (the U.S., "Euroland," Japan), began to generate hugely excessive liquidity.[26] Mutual funds, pension funds, other institutional investors, hedge funds and—last but not least—banks became awash with deposits. They scoured the world for high returns. Investment houses like Goldman Sachs sought the business of

[26] R. Duncan, 2003, *The Dollar Crisis*, Singapore: Wiley.

arranging the privatizations, securities placements, mergers, and acquisitions that surged on the wave of liquidity—business that became their main growth area.

Financial capital poured in to "emerging markets" (middle-income countries of recent interest to institutional investors). Total net private capital flows to emerging markets almost doubled in two years, from US$170 billion in 1994 to $328 billion in 1996. Emerging market stock markets boomed, nearly doubling their share of world capitalization between 1990 and 1993.

The inflows were justified in terms of (a) maximizing the efficiency of capital worldwide, (b) allowing a specific country to invest more than could be financed from its own savings, (c) bringing modern financial institutions into the country, and (d) deepening the liquidity of the country's financial system and lengthening investor horizons, thereby making markets more efficient and more stable. In the end the case for free capital flows came down to the classic theory of comparative advantage, as though trade in dollars was essentially similar to trade in widgets.[27]

The larger result, instead, has been a series of booms and busts ("a boom in busts"). Capital flows into emerging markets turn out to be strongly autocorrelated, especially within regions, propelled less by differences between countries in their "fundamentals" (including "good" or "bad" policy) than by "push factors"—macro push factors like the amount of excess liquidity in different parts of the core zone of the world economy; and micro push factors like the incentives on institutional money managers. Money managers tend to be evaluated relative to the median performance of money managers in the same asset class. This encourages them to move in and out of markets together, producing "herding" or "trend chasing" or "positive feedback trading."

Given the resources commanded by institutional investors relative to the size of developing country financial systems, even small shifts in investor sentiment can produce large swings in emerging market interest rates and exchange rates. As capital flooded into emerging markets, between 1992 and 1994, stock markets soared. Then capital stampeded out of Mexico in late 1994 and into 1995, causing the Mexican crash, in response to which capital also pulled out from other Latin American countries (the "tequila effect"). Capital withdrawn from Latin America headed for East Asia, causing stock markets, property markets, and foreign borrowing to boom even more. Analysts and policymakers said that East Asia was safe from a similar crisis, because the "fundamentals" were sound and the lending was mostly to (market-disciplined) private firms rather than to governments.

[27] For a critical take on this argument by a champion of free trade, see J. Bhagwati, 1998, "The capital myth: the difference between trade in widgets and dollars," *Foreign Affairs* (May/June).

Asian governments—pushed by the U.S. Treasury, the IMF, the World Bank, the GATT/WTO, and the OECD, and pulled by segments of their policy elites—opened their economies to financial capital flows in the 1990s, as part of the wider drive to implement the Washington Consensus.[28] Institutional investors were especially keen to have unrestricted access to Asia not only because the growth prospects were much better than anywhere else, but also because interest differentials between the major industrial economies and Asian economies were large, permitting high and safe profits on lending into Asia. All the more so because Asian currencies were more or less fixed to the U.S. dollar and everyone assumed the exchange rates would hold—and therefore ignored exchange-rate risk, underpricing foreign capital. It was a buyer's market. Money managers fell over each other in hotel lobbies as they rushed to find people willing to take their money. Japanese banks were especially active as Japanese households' high savings continued to flow into bank deposits while the Japanese economy stagnated, burdened by overinvestment and overindebtedness caused by the asset bubble of the 1980s.

After 1995 the rise of the U.S. dollar and the depreciation of the Japanese yen and the Chinese yuan led to a loss of export competitiveness in Asian economies whose currencies were effectively pegged to the U.S. dollar. The capital inflows exacerbated the real appreciation of the Asian currencies. The appreciation raised input prices relative to output prices, squeezing profits and hurting export growth. The Japanese recession reduced export profits. As a consequence of these external "shocks," Thailand and Malaysia developed large and out-of-character current account deficits (but Indonesia did not).

Internal Factors in the Build Up to Crisis

As manufacturing came under pressure, more and more investment went into the property market and the stock market. In Thailand, Malaysia, and Indonesia, asset bubbles began to blow out and the fringe of bad industrial investments also expanded. The rising inflow of foreign capital—mainly bank loans and portfolio capital rather than foreign direct investment—went disproportionately into unproductive activities with a high component of speculation. The continued fast growth rates (that supported the perception of an unchanging "miracle" in Southeast Asia) concealed a rise in the ratio of "bubble" to "real" growth.

The shift toward bubble growth raised the objective probability of debt

[28] For the Korean case see for example C. Bergsten and I. SaKong (eds.), 1996, *Korea-United States Cooperation in the New World Order*, Washington, D.C.: Institute for International Economics; especially the essay on the U.S. Congressional agenda by Representative Doug Bereuter (the byline reads, "Now that the Cold War is over, we can and should demand an end to the unfair treatment for the American side in this bilateral relationship").

servicing difficulties in response to external shocks. Yet foreign funds continued to pour in (a clear case of market failure). The ratio of short-term debt to foreign exchange reserves rose in Korea from 160 percent in mid-1994 to 210 percent in mid-1997; in Thailand from 100 percent to 150 percent; in Indonesia it remained constant at 170 percent. In all of the larger Latin American economies the ratio was below the danger threshold of 100 percent, except for Argentina (around 120–130 percent).

Where were governments in all this? After all, private agents were taking on foreign exchange obligations that posed a systemic risk, and it has always been a responsibility of governments to stop private agents from acting in ways that pose systemic risks. Had governments acted to stop the property bubble and stop the build up of short-term foreign debt—to maintain a short-term foreign debt to foreign exchange ratio of less than 100 percent, for example—the crisis would have been both less likely to happen and less severe when it did.

Here the downside of the East Asian model kicked in.[29] First, the demand for debt finance led firms to push governments to give them unimpeded access to cheaper foreign financing, and hence to lift restrictions and prudential regulations on capital inflows; so not only did opening the capital account end the high-debt model, the high-debt model generated pressure to open the capital account. Second, the arrangements for "buffering" firms and banks from systemic shocks—so that firms could use bank debt to finance high investment—came increasingly to be used to shift the losses of failed investments onto the public sector and taxpayers, allowing further rounds of very risky investment based on euphoric expectations. In particular, Southeast Asian governments (often as a result of their association with overseas Chinese business interests) had strongly vested interests in the property market, in which it is possible for well-placed individuals and companies to make very high short-run returns. At the same time, they gave less attention to manufacturing because manufacturing returns tend to be longer term and were controlled by foreigners. (Manufacturing in Southeast Asia tends to be dominated by foreign firms from Japan, the United States, and more recently Taiwan and Korea.)

The governments did what both the property developers and the manufacturers wanted them to do—they liberalized capital inflows and overlooked the build up of foreign debt, believing that market competition would keep it in safe limits because it was private-to-private. Capital opening, in short, was not only pressed on Southeast Asia from the outside, it was also "endog-

[29] S. Haggard's important study, 2000, *The Political Economy of the Asian Financial Crisis*, Washington, D.C.: Institute for International Economics, emphasizes this "moral hazard" downside. Also, Haggard, "Politics and institutions in the World Bank's East Asia," in A. Fishlow et al. (eds.), *Miracle or Design*.

enous" to the domestic political situation—wanted by many domestic groups who profited from cheaper foreign interest rates and lax supervision and were confident they could get public support against losses.

This is the story for Southeast Asia. As for South Korea, it did not have a property bubble but it did have an industrial capacity bubble as middle-ranking conglomerates (*chaebol*) competed against each other to expand by enough to enter the top ranking. The conglomerates wanted unrestricted access to cheaper foreign capital. By the early 1990s the government—an elected civilian government for the first time—removed restrictions on the conglomerates' access to foreign finance (some of which flowed back to government officials under the table). Most of the finance was subject to short-term payback clauses but was invested in long-term projects. Some conglomerates developed debt-to-equity ratios of 20 to 1 or more. Three conglomerates defaulted on their debts in the first half of 1997. The South Korean story, then, shares with the Southeast Asian story the failure of government to regulate foreign borrowing and to divert investment from unproductive uses. It differs from the Southeast Asian story in that the bubble occurred more in industry than property; and the South Korean government dismantled a previously effective developmental state during the 1990s, whereas the Southeast Asian countries always had a lower level of state capacity for investment coordination and financial regulation.

The figures on the build up of short-term foreign debt show that investment portfolios were *not* divested gradually as the probability of debt servicing difficulties rose; nor did any of the forecasting or ratings agencies indicate serious trouble ahead. Both points support the argument that changes in "fundamentals" cannot be assigned a major causal role. So do trends in the efficiency of capital use. Incremental capital-output ratios did rise in the crisis-affected countries after 1990, but by 1996 were still well within the range of their cyclical fluctuation over the years 1973–96. And accounting rates of return on assets of nonfinancial corporations averaged a high 5 to 8 percent, compared to 1 to 3 percent in mature market economies.[30]

Rather, the crisis was in large part self-generated within financial markets, the result of the "endogenous" instabilities of international financial markets in a bubble phase impacting on a fragile, debt-intensive domestic financial structure that should not have been exposed to unrestricted international flows. The fact that it was so exposed is due to both external "push" factors and to internal "pull" factors, the latter referring to the alliances between government and business and the interests of business in raising their private profits by borrowing cheaply from abroad while—thanks to the alliances that are a necessary condition of the developmental state—expecting to es-

[30] World Bank, 1999, *Global Economic Prospects and the Developing Countries: 1998/99. Beyond Financial Crisis,* Washington, D.C., especially figs. 2.7 and 2.8.

cape the costs. When the governments removed remaining restrictions on international flows, Western banks and portfolio investors took this as a sign that they could confidently go on providing more and more funds to Asian firms with debt ratios and long-term alliance relationships that would have been completely unacceptable in the West. When the crisis hit, the violence of the outflow owed much to the realization that a good proportion of the funds should not have been committed in the first place, according to Western prudential standards.

From doing no wrong, the miracle countries overnight became basket cases infested with cronyistic error. It amounted to a gestalt shift, like seeing the famous line drawing as a vase one moment and two faces in profile the next. Hence exchange rates fell and fell again even with high real interest rates. Capital then became much too expensive. The credit market became a seller's market. Even big-name firms could not get credit, not even trade credit, as all creditors tried to pull in their credit lines. The whole supply chain imploded. When Southeast Asia began collapsing in the second half of 1997, the combination of conglomerate difficulties and Southeast Asian devaluations triggered a panic in South Korea among creditors and a struggle to recover debts, leading to a collapse of the won in late 1997.

In short, the severity of the Asia crisis and its timing (the fact that it took place in 1997 and not, say, 1993), can be explained by the conjunction of (a) growing excess liquidity in the core zone of the world economy over the 1990s, in the hands of money managers who cared little about long-run fundamentals and sought high *short-term* returns wherever they could, (b) opening the capital account over the first half of the 1990s, (c) a surge of momentum-driven, private-to-private capital inflows into Asia that were largely unregulated by governments, and (d) a shift from real growth to bubble growth beginning in the early to mid-1990s, and a resulting rise in domestic financial fragility. This line of argument suggests that financial deregulation and unstrategic opening of the capital account were decisive factors in the build up to crisis and in the intensity of the subsequent slump. Those who pushed for it without constraining their push by the capacity of the financial regulatory apparatus on the ground—Wall Street investment banks, the U.S. Treasury, the IMF, and segments of domestic policy elites—acted with gross irresponsibility.

The International Monetary Fund

As the crisis built up the IMF was asleep at the wheel. The finance ministries had all learned how to talk the Fund's language of the Washington Consensus. The economies were all growing fast. The East Asia region had become known inside the Fund as a place where ambitious staff did not want to go, because it was a place of "no problems" (China aside).

Having praised the governments' economic management up to just weeks before the onset in July 1997, the Fund panicked as much as the investors, intensifying the pullout. It called for the closure of insolvent finance companies and banks without seeming to worry about how uninsured depositors were treated, which triggered bank runs; and it identified fundamental problems that had to be fixed before growth could resume, sending a message that the economies were structurally unsound.[31]

Based largely on their experience in Latin America, the Fund imposed on Thailand, Indonesia, and Korea a prescription of high real interest rates and fiscal restriction. Fiscal deficits have tended to be large and inflation chronic in Latin America. Currency devaluations set off hair-trigger inflationary expectations. So IMF-style austerity was a plausible cure. High real interest rates could be tolerated because corporate debt-to-equity ratios were quite low and inflation kept eroding the real burden of the debt.

In Asia the Fund failed to see the danger of fiscal tightening where budgets had long been roughly in balance. And—its economists were unschooled in the links between macro conditions and corporate balance sheets—it failed to see the danger of high real interest rates in economies with high debt/equity ratios and low inflationary expectations. High real interest rates have deflationary and crisis-signalling consequences that prompt capital outflows regardless of the attractions of the high rates themselves.

Further, the Fund attempted to strengthen weakened Asian financial structures by imposing Western measures of financial restructuring. Basle capital adequacy ratios were to be applied. Highly indebted banks and firms were to be closed. Labor laws were to be changed to make it easier to fire workers, facilitating the closures. Regulations on foreign ownership were to be lifted in order to allow foreign banks and firms to buy domestic banks and firms, injecting needed capital and skills.

Somewhat similar measures were applied in a much narrower setting to solve the American savings and loan crisis in the late 1980s and early 1990s, and they worked. But it is one thing to undertake such reforms where real interest rates are very low and indebtedness not high (as in the United States in the late 1980s), and another to undertake them where both real interest rates and indebtedness are high. In these conditions such restructuring leads to closures and layoffs, with deflationary knock-on effects and more investor pullout. In short, the Fund's initial insistence on fiscal contraction, cuts in aggregate demand, and large-scale institutional reform accelerated debt deflation.

[31] See ibid., especially chapter 2, "Responding to the East Asian crisis." See P. Blustein, 2001, *The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the IMF,* New York: PublicAffairs, for a remarkable "ticktock" account of how the U.S. Treasury, the IMF, and Asian governments handled the crisis.

This is why the IMF's strategy for Asia did not work. The currencies did stop falling in early 1998. But by May the deepening economic contraction, the rising unemployment and the fear of social unrest combined to produce a second wave of capital outflows and renewed falls in currencies and stock markets.

The resumption of the collapse in May 1998 is what finally forced Asian governments to begin to turn away from the initial IMF strategy. They began to bring down interest rates and turn fiscal restriction into fiscal expansion. In Malaysia—which had not been under a formal IMF program but had been following the IMF recipe (and seen a contraction of credit growth from 30 percent in 1997 to minus 5 percent in 1998, reflecting a massive pullback of bank loans)—the government slapped on exchange controls in September 1998, to better engineer an expansion at home without risking further currency falls. Western finance ministries and institutional investors protested apocalyptically.[32] Six months later the *Economist* described the controls as having done "short-term wonders" in assisting recovery.[33] In Korea the government used public funds to buy out bad loans and finance bank mergers to the tune of more than 20 percent of GDP, and installed new bank managers with a mandate to *lend*. Behind a veil of laissez-faire pronouncements the government intervened massively to restructure the large firms. In Japan the government seriously discussed nationalizing some of the banks so as to break out of its stagnation trap, in which the attempt to maintain Basle standards of capital adequacy despite falls in bank equity prevented the needed expansion of credit. The Japanese government also discussed the reintroduction of exchange controls to allow rapid monetary expansion without depreciating the yen (which might destabilize other currencies in the region and make trade frictions worse); and in discussions with the United States and the EU it pushed the need to manage exchange rates. Governing the market was back in good currency in Asia, although it was not described as such.

Free Capital Mobility

I have stressed the interaction between external and domestic causes. Most analysts, in contrast, think that the causes were primarily domestic, having to do with structural flaws in Asian economies and bad Asian policy management—"exogenous" from the rest of the world. I treat these same domestic causes as more "endogenous" to the functioning of Western financial markets and their lack of regulation in international operations. Asian policy management is implicated in the crisis first, by its willingness to bail out

[32] For more on the Western response to Malaysia's capital controls see Wade and Veneroso, "The gathering world slump and the battle over capital controls."

[33] 1999, "Asian economies: ready for more?" *Economist* (February), 70. E. Kaplan and D. Rodrik, 2002, "Did the Malaysian capital controls work?" in S. Edwards and J. Frankel (eds.), *Preventing Currency Crises in Emerging Markets*, Chicago: University of Chicago Press for the NBER; They conclude in the affirmative.

"cronies" making euphoric investments, the downside of the developmental state; and second, by its premature removal of restrictions on free capital mobility, legitimized by the U.S. Treasury and the IMF.

China, Taiwan, India, Sri Lanka, Bangladesh, and Pakistan were little affected by the crisis. The biggest difference between them and the crisis-afflicted countries lay not in homegrown things like "cronyism" or "government-directed investment" or "transparency" or "soundness of bank regulation," but in the openness of the capital account. The countries with positive growth had a more or less closed capital account and did not develop a structure of financial claims vulnerable to investor pullout.

Taiwan in the East Asian Crisis

All through the swirling contagion Taiwan sailed free—or almost. Compared to the others, its exchange rate, stock market, and GDP fell rather little. The regional traveller noticed that taxis in Taipei were as busy as ever, while everywhere else the taxis waited in long lines to pick up a fare. Moreover, Taipei's taxis were new and shiny yellow, enough to put New York City's or Washington, D.C.'s to shame. They were emblematic of a city that was at last beginning to look like the capital of an affluent nation.

Taiwan escaped lightly for several reasons, some of which reflect policy choices. First, the government has long maintained famously large foreign exchange reserves, the most in the world per capita. This reflects less some abstract principle of prudent economic management than the looming presence of China only 150 kilometers across the straights. China's number one foreign policy objective is to get Taiwan back under its control, so the Taiwan government wants the reserves as a buffer against disruptions from which China could profit.

Second, Taiwan had hardly any net debt or short-term foreign debt. Short-term foreign debt amounted to only 20 percent of foreign exchange reserves in the mid-1990s, compared to Korea's well over 150 percent. As for why it had so much less debt than the others, there are several reasons. First, it had less need to borrow abroad. It had a substantially higher per capita income (US$13,000 in 1996, compared to Korea's $10,500, Malaysia's $4,600, Thailand's $2,900).[34] It saved a sedate quarter of GDP compared to over a third in the others; and its gross investment was less than its gross savings, again in contrast to the others. Second, it was by the 1990s relying less heavily on debt as the instrument for financing investment than the other countries. Its corporate debt-to-equity ratio was lower than in some of the other Asian countries, notably Korea. (Taiwan's own statistics claim a ratio of less than 100 percent, compared to 150 percent in the United States and 200 percent or higher in Japan, Thailand, and Korea. But Taiwan statistical officials

[34] 1998, *Taiwan Statistical Data Book 1998*, Council for Economic Planning and Development, Republic of China.

readily admit the figure is biased downwards.) The lower debt-to-equity ratio in turn meant that its financial system was less vulnerable to shocks, because companies can experience greater increases in interest rates, or greater devaluations, or greater reductions in cash flow and still have enough to repay debts out of current revenues.

Third, for the same reason of limiting the economy's vulnerability to external shocks, the government maintained control over the inflows and outflows of financial capital. It did not follow Korea's radical and unstrategic integration into world financial markets in the 1990s. For example, privately-owned commercial banks—including new ones allowed to be created since the late 1980s, bringing the total to seventeen by 1993—have a reserve requirement (compulsory deposits at the central bank) of 24 percent, very high by international standards. And the government still has a large role in appointing the top-most managers of the bigger "private" commercial banks.

Fourth, Taiwan's industrial and service exports are more diversified than Korea's, and less concentrated in the big, capital-intensive commodity manufactures like steel, petrochemicals, ships, and memory chips that are prone to worldwide cycles of excess capacity.

Finally, Taiwan's population is more homogeneous, linguistically and culturally, and its institutions for conflict management more robust compared to some of the other Asian countries. The effect on economic performance of a given external shock is therefore likely to be less than in countries that have more latent social conflict and less robust institutions of government, Indonesia most strikingly.

Then there are more contingent factors, such as the fact that Taiwan had its own stock market and property bubble in the late 1980s and early 1990s.[35] The Taiwan Stock Exchange Index, having taken twenty-five years to reach 1,000 in late 1986, took off like a rocket to reach over 12,500 by early 1990. Teachers stopped teaching, government officials stopped administering, taxi drivers stopped driving, and housewives abandoned their children to sit in smoke-filled brokerages lined with flashing screens, playing the stock market in the belief that everyone could become rich. The average price-to-earnings ratio reached 100 by late 1989, roughly double the average in Japan, whose stock market was then near the peak of its own overvaluation. Then the market fell and fell, bottoming out at 2,500 in October 1990. The 80 percent fall matches the Dow-Jones average's fall of 89 percent between the 1929 peak and the 1933 trough. It did not have the same contractionary effect, however, because relatively few companies were then listed (so the impact of the fall on overall investment was not great) and because stock purchases were made out of savings, not out of borrowed money.

[35] See S. Champion, 1998, *The Great Taiwan Bubble: The Rise and Fall of an Emerging Stock Market*, Berkeley: Pacific View Press.

The relevance of all this to Taiwan's later experience is that by 1997 the damage to the banking system of the stock market and property market crash had largely been worked through. The banks' balance sheets were in good shape, thanks partly to an intensification of bank oversight and regulation instituted after the crash (by authorities, some of whom had experienced in childhood the inflation on the mainland before 1949, which was widely believed to have undermined popular support for the KMT in the civil war).[36] In short, Taiwan moved countercyclically relative to the other economies and had tighter financial regulation and oversight.

The Ministry of Finance put together a large emergency fund to deal with bank or stock market crises, and kept saying that it was ready to deal with any emergencies. These declarations, however, attracted criticism from many in the policy elite who—believing in Chicago free market economics—did not think the government had any business "intervening" in market forces. "What about moral hazard?" they asked. ("Moral hazard" is a term from the economics of insurance, referring to the proposition that insurance reduces the incentives for prudence.) So when in December 1998 a medium-sized private bank went bankrupt, the much vaunted Ministry of Finance emergency fund did *not* become involved. Rather, the bank was quickly taken over by the Party Enterprise Committee of the KMT (the ruling political party). The Party Enterprise Committee is technically an independent holding organization, so the deal can be presented as *private*; a typical Taiwanese fudge.

Again, when the Taiwanese dollar came under intense speculative attack in the middle of 1998, especially in August after the Russian default and devaluation, the government stepped in to intensify existing controls.[37] The offshore market in New Taiwan dollars was closed. The central bank shut down trade in futures instruments that had been used to pressure the local currency, and required that all foreign capital inflows destined for the stock market be subject to central bank approval. Western bankers and investors were no more happy with this intervention in market forces than they had been when the Hong Kong Monetary Authority did much the same, nor were the free marketeers in Taiwan's policy elite.

Taiwan Today: End of the Developmental State and Strategic Economics?

Certainly the role of the government in governing the market has been under intense challenge from domestic elites over the past two decades. Most Taiwanese economists, trained in the United States, would agree with a former

[36] I have not seen serious research on how exactly Taiwan recovered from this terrible boom and crash.

[37] Wade and Veneroso, "The gathering world slump and the battle over capital controls," 25.

prime minister of Korea and ambassador to Washington, D.C., who said at the height of the crisis, "The model is now clear. It's not Japan, it's the West. The current crisis has convinced almost all people that the old style doesn't work." A Korean professor of finance, who earlier taught at the Wharton School of Business, claimed, "After I studied in the States I saw that there was no other way. I accept free markets. There is only one way to organize an economy, and it will dominate the world."

Taiwan's free marketeers are today especially strong within the Council for Economic Planning and Development, which is often at loggerheads with the financially more cautious central bank and finance ministry. The council, allied to the External Trade Bureau of the Ministry of Economic Affairs (that has now grown to eclipse the Industrial Development Bureau), had its eye on joining the WTO before China became a member and tried to block Taiwan's application. Whatever the other advantages of opening the capital account, the council said, Taiwan had to open itself to free capital mobility in order to enter the WTO before China. In fact Taiwan joined (as "Chinese Taipei") one day after China in November 2001. Taiwan now maintains one of the larger WTO missions in Geneva. Headed by a former senior cabinet minister, it has a staff of around twenty. Since China continues to block Taiwan's membership in the UN, this office also liaises out of sight with UN organizations in Geneva.

For all the prestige attached to the free trade position within the government, the larger point is that the government continues to be intensely involved in technology acquisition and in driving the small- and medium-sized enterprises to upgrade their products and processes, and in mediating the integration with the international economy. Much of the regulation and the assistance is camouflaged to make the policy regime look WTO-compatible.

Consider Taiwan's current strategies in finance and biotech. In finance we see the continuing influence of those who believe in the need to insulate the economy from the short-term profit imperatives of finance. Financial liberalization has been designed to keep finance serving the larger industrial transformation strategy, in the spirit of "industry is the root, finance is the leaf," or in the words of President Lee in 1996, "manufacturing and R&D activities should be the foundation [of Taiwan's economic policy] and . . . the financial sector should be subsidiary and supportive."[38] The larger transformation strategy has aimed to turn Taiwan into an Asia Pacific Regional Operations Center (APROC), not only to propel the economy much higher up the value chain but also to counter "reunification by stealth" as Taiwanese firms move their lower value-added activities to the mainland. The basic financial liber-

[38] I base this paragraph, including the quotes, on E. Thurbon, 2002, "The developmental logic of financial liberalization in Taiwan," unpublished manuscript, Department of Government, University of Sydney, February.

alization strategy has been "internal control, external freedom," meaning that the government has liberalized the offshore operations of Taiwan's financial institutions and invited (selected) foreign firms to be active players in those offshore operations, while taking a very gradual approach to liberalizing the domestic financial system in line with the capacity of Taiwan-owned financial institutions and the financial needs of domestic industry. For example, the liberalization of foreign banks' access to the domestic market in 1994 was strongly regulated in order to extract maximum domestic benefits. Only strong and successful foreign banks were allowed in. Once in, foreign banks were subject to the same "administrative guidance" as domestic banks, for example to keep their credit lines open to local firms at a time of worries about capital outflow. Foreign access to the Taiwan Stock Exchange was liberalized in 1990 with the aim of fostering a more stable stock exchange with larger and more experienced institutional investors. But only a very select number of foreign firms was allowed in; and they were subject to conditions on inwards and outwards remittances in order to make them invest for the long term. Inward remittances, for example, could not be remitted abroad before three months after entry, and even then administrative approval had to be obtained. Strict limits have been placed on foreign takeover of Taiwanese firms. The overall approach was summarized by a senior finance official: "The door will be open but only ajar. That is typical of Taiwan. They really want technology transfer to teach the locals how to do it, then in the future they can do it on their own."

As Taiwan's negotiators at the WTO were giving up some of Taiwan's mechanisms of restraining inflows and outflows of financial capital, the central bank was busy building up a cadre of financial engineers charged with developing covert methods by which the central bank could influence capital flows.

Taiwan's recent big push into biotech shows a similarly strategic approach.[39] Since the late 1990s biotech has been identified as, in the words of President Chen, "the most important industry to Taiwan's future economic development." The promotion policies include many familiar from earlier big pushes into other sectors (as described in chapter 4). The state has established several major organizational centers within the public sector. Some are primarily administrative (such as the Biotechnology Strategic Review Board, under the umbrella of the Science and Technology Advisory Group, and the Biotechnology and Pharmaceutical Industries Promotion Office in the Ministry of Economic Affairs, the main office for coordinating government, industry and foreign firms); some are for research funding; some are "midstream" research institutes for turning basic research into usable tech-

[39] J. Wong, 2002, "Re-thinking the East Asian developmental state: biotechnology in Taiwan," unpublished manuscript, Department of Political Science, University of Toronto.

nology and commercial commodities. Publicly funded R&D increased at nearly 10 percent a year in the second half of the 1990s, and this involved a degree of directional thrust or "picking of niches." Some of these niches are found within the treatment of illnesses common in Asia that Western pharmaceutical companies have neglected. Others are found in the combining of biotech applications with Taiwan's existing strengths in information technologies and manufacturing. So, for example, the new Biomedical Engineering Center at ITRI has focused its work on biochips and bioinformatics. But only private firms can produce for the market; there are no state-owned enterprises. Private firms are steered in line with a coherent national strategy by an array of incentives for new companies, patents, new product R&D, and drug testing. State-run banks offer preferential low-interest loans for biotech start-ups. The state provides subsidized infrastructure to encourage the development of biotech clusters; and is using the existing "diaspora" program to link up Taiwan firms and public agencies with Taiwanese scientists working in bio-business abroad (see pages 190–91).

At the same time, the state is now less able to direct the strategy from above than it was earlier. Before Taiwan shifted to a democratic structure, the authoritarian mechanisms of control and the absence of direct political pressure from below gave the state the space to coordinate industrial investment from above. Today the biotech strategy is being carried out in the context of both a rambunctious democracy and economic stagnation, neither of which make the task of administrative coordination easier.

On the other hand, both the biotech case and the finance case show the state in Taiwan continuing to act more as a developmental state than as an Anglo-American liberal market state.[40] The state in Taiwan continues to exercise foresight about the future evolution of the economy and acts to pave the way; it takes a view about what industries are important for the economy's future growth, and has the legitimacy and the instruments to help shape the economy in line with this view. The liberal market state, by contrast, has no legitimacy for saying that some activities are more important than others, for acting to nurture some industries to competitiveness in a way that discriminates against others (provided that national security is not in

[40] In Korea the government reasserted *dirigisme* in the restructuring of the conglomerates, while it moved ahead with full-scale financial liberalization even beyond what the IMF wanted. But Korean liberalizations should not be taken at face value. (The best study of the two faces of Korea's trade liberalization is R. Luedde-Neurath, 1986, *Import Controls and Export-Oriented Development: A Reassessment of the South Korean Case*, Boulder: Westview.) It remains to be seen what covert financial controls the government has reintroduced and what subtle measures the government is using to prop up or grow particular industries—through government-sponsored venture capital, government procurement of information and communication technologies (ICTs), and other Singapore-like measures.

question).[41] The essential industrial policy principle of the liberal market state is caught in the remark of Herbert Stein, chairman of the Council of Economic Advisors during the Reagan years, "If the most efficient way for the U.S. to get steel is to produce tapes of 'Dallas' and sell them to the Japanese, then producing tapes of 'Dallas' is our basic industry"; or that of Sir Terence Burns, chief economic adviser to the U.K. government during the Thatcher years, "if we can't make money by manufacturing things, we'd better think of something else to do."[42]

Taiwan's Transition to Democracy

Governing the Market was finished in the late 1980s, as Taiwan switched from a one-party state to a competitive electoral democracy. In the past decade or so a vigorous democracy has taken root. The political repression I describe in chapter 8—including censorship of the print media and prison sentences for political dissidents—has disappeared. In the early years after the switch to democracy the KMT (which had ruled since the government came to Taiwan in 1949 and for decades on the mainland before then) looked like it might fall apart. An opposition party, the DPP (Democratic Progressive Party), identifying itself as pro-native Taiwanese, pro-independence from China, and anti-KMTcorruption, won many elective posts. The other real opposition party, the New Party, comprised people, mainly "mainlanders" and children of mainlanders, who used to be KMT supporters but who felt that the KMT had become too beholden to the native Taiwanese majority; it did not win many seats but it did become a real thorn in the side of the KMT.

In the "national" elections of December 1998, however, both the DPP and the New Party were wracked with internal dissension, and the KMT did much better than in several previous elections. It secured a large majority in the parliament (Legislative Yuan), having previously governed with a thin majority; and it recovered the key elected office of mayor of Taipei. In the end, decades of KMT organization and resource-mobilization right down to the grass roots paid off. For all the institutionalization of democratic institutions, Taiwan's politics remain determined less by issues or ideologies than by the appeal of individual candidates. The appeal of KMT candidates is greatly enhanced by their ability—thanks to *party* resources—to pay for votes ("pay for transport to the polling station" is the way it is legitimized), also to send high party or government officials to funerals, weddings, and birthdays of

[41] B. Scott, 1985, "National strategies: key to international competition," in B. Scott and G. Lodge (eds.), *U.S. Competitiveness in the World Economy*, Cambridge: Harvard University Press.

[42] Quoted in Wade, 1992, "East Asia's economic success: conflicting perspectives, partial insights, shaky evidence," 320.

potential supporters, and to use the vast and still Leninistically shaped KMT organization to get out the vote.

And the KMT under (native Taiwanese) President Lee Teng-hui took other steps to win support among the native Taiwanese majority. Of great importance—far beyond the electoral position of the KMT—is the constitutional amendment of 1997 to "freeze" the province of Taiwan. For many years after 1949 about the only thing that the Communist Party government on the mainland and the KMT party government on Taiwan agreed on was Taiwan's status as a province of China—they disagreed, of course, on which was the rightful ruler of the whole. To uphold this fiction Taiwan maintained a structure of government with a "national" government nominally responsible for the whole of China but in practice only for Taiwan, as well as a "provincial" government with many powers and agencies that paralleled, overlapped, and fought with the "national" counterparts, and then lower-level county and city governments. After democratization in the late 1980s all levels of government were made elective, including the post of governor of Taiwan. The constitutional amendment of 1997, however, froze the province by reducing the provincial government to a set of empty boxes, without function. But the boxes do still exist, filled by "do-nothing" officials. The structure must be kept intact to satisfy China, which has made it clear that the abolition of the provincial government would be construed as a step on the way to a declaration of "Taiwan independence"—a declaration that could provoke an armed invasion. The frozen status of the provincial government is another typically Taiwanese compromise of form but not substance. All reforms that might affect the island's constitutional position vis-à-vis China are being done very carefully, very slowly, very skillfully, making maximum use of smoke, mirrors, shadows, and dummies, on a time scale that brings to mind Chou Enlai's reply to the question, "What are the effects of the French Revolution?" "It is too soon to tell."

Meanwhile, democratization is driving the creation of several features of a social democratic system. The DDP found that it could not make independence its central issue, because open commitment to independence made the middle classes too nervous. So it made itself into the party for social issues. For example, it started to pay old age pensions in the counties it controlled as a way to attract electoral support. The counties soon ran out of money, whereupon the DDP blamed the ruling KMT and the central government for turning their back on the elderly—forcing the KMT to introduce a national pension scheme. By similar dynamics Taiwan now has a national health service providing near-universal health care in return for a small fee. Labor movements have been rather inactive through all this—except for the organization of prostitutes surrounding the parliament building in protest at government attempts to button up their activities.

In the second direct presidential election in March 2000, the DPP party candidate won by a comfortable margin, ending the KMT's decades-long hold on power. As a civil rights lawyer, President Chen Shui-Bian had spent eight months in prison in the mid-1980s on a libel charge; and his vice president spent five years in prison in the first half of the 1980s for making an anti-government speech at the infamous Kaohsiung Incident of 1979. In office they have fortified Taiwan's civil and political rights.

The Future of Governing the Market

The case of Taiwan shows how governments can—even in conditions of a globalized world economy and even when subject to real democratic accountability—impart directional thrust to the economy in line with an exercise of foresight about the economy's future growth. It shows how governments can restrain the financial sector so that it is treated as a quasi-public utility—even when world norms favor the idea that the success of the financial sector is to be judged by the return on capital in finance, and the larger idea that the financial sector should be the pivot of the whole economy (through institutional interlocks via stock markets and pension funds and through normative interlocks like shareholder value as the sole legitimate objective of corporate managers and returns to capital, not labor, as the measure of efficiency).[43]

Shrinking the Development Space

But the prevailing neoliberal development paradigm—enshrined as the "Official View" of the World Trade Organization, the World Bank, and the International Monetary Fund and echoed in the pages of the *Financial Times* and the *Economist*—is deeply hostile to the kind of strategic economics practiced by the Taiwan government. Earlier I described the neoliberal paradigm as the Washington Consensus but it could also be described as "globalization plus." The "globalization" part refers to the need for developing countries to integrate their economies fully into the international economy by eliminating policy-induced price differences ("distortions") between international and domestic prices and eliminating anything that would impede the operating freedom of foreign investors, such as local content requirements and restrictions on remittances; hence, eliminating barriers to trade and foreign investment. The "plus" part, that has come onto the integration agenda more recently, refers to the raft of domestic reforms required to make full integration viable. These include tighter bank supervision to prevent excessive foreign borrowing, legal reforms and intellectual property rights enforcement so as to better protect foreign direct investment, removal of performance requirements on foreign direct investment, improvements in the tax collecting bu-

[43] R. Dore, 2000, *Stock Market Capitalism: Welfare Capitalism*, Oxford: Oxford University Press.

reaucracy so that domestic taxes can be raised as tariffs are lowered, and social policy "safety nets" to buffer the poor from the external shocks to which the fully integrated economy is more exposed. Not to forget reforms to improve governance, strengthen civil society, expand participation, disclose information, decentralize authority, all so as to curb rent-seeking and corruption; also, heavy investment in basic health and primary education.

What the "plus" part does not include are proactive industrial policies to nurture new industries and new technologies and to diffuse innovations to established industries—that might have the unwanted consequence of raising the competitive pressure on industries in the industrialized countries. This is definitely not on today's development agenda. Indeed, words like "technology," "national innovation system," "entrepreneurship," "competitiveness," and "universities" are conspicuously missing from the thinking of development organizations like the World Bank and the bilateral donors. So too are words like "distribution of power," "elite capture," "trade unions," and even "freedom of association." The poor are to be lifted up by supplying them with missing assets and by gaining the knowledge with which to manage them better, not through their own engagement in collective action. Thus lifted up, they will be as good-natured as the sheep they tend.[44]

The globalization plus paradigm, which treats all countries as having the same rights and obligations in the international economy, is now institutionalized in the WTO agreements. Before the Uruguay Round (1986–94) the international trade regime recognized the right of "special and differential treatment" for developing countries, and allowed this to qualify the basic norm of "no discrimination" (no discrimination between suppliers based in different countries, as in the most favored nation principle). At that time the policies of developing country governments and the thrust of multilateral trade and investment negotiations concerned the terms on which goods from developed countries would get access to developing country markets. But during the Uruguay Round and the negotiations of the three capstone agreements—the Trade-Related Intellectual Property agreement (TRIPS), the Trade-Related Investment Measures agreement (TRIMS), and the General Agreement on Trade in Services (GATS)—all this changed.

The agreements at the end of the Uruguay Round represent a basic change of norms governing world trade. "Reciprocity" eclipsed "development"; or more exactly, "reciprocity," "uniform rights and obligations," and "all countries (except the smallest and poorest) as equal players" eclipsed "special and differential treatment for developing countries." At the same time, the earlier norm of "no discrimination" between national suppliers became the

[44] This echoes Kant's satire of the Arcadian ideal. I. Kant, 1991 [1784], "Idea for a universal history with a cosmopolitan purpose," in H. Reiss (ed.), *Kant: Political Writings*, Cambridge: Cambridge University Press, 41–53.

norm of "no (trade and investment) distortions." The "no distortions" rule makes it against WTO rules for a government to use policies that "distort" trade and investment flows—including performance requirements on incoming foreign direct investment (such as local content requirements, trade balancing requirements, export requirements, technology transfer requirements, R&D requirements, joint venturing requirements, public procurement tied to local suppliers, and the like).[45] As a specific example, Article 27.1 of the TRIPS agreement says that a "patent shall be available and patent rights enjoyable without discrimination as to . . . whether products are imported or locally produced." This makes it illegal for a government to curb a patent for a product whose domestic production the government wishes to encourage but whose producer refuses to establish a local production facility, thus blocking the process of import replacement.

The three agreements together greatly restrict the right of a government to pursue most of the industrial policies successfully implemented in East Asia. The sanction is market access: a country that attempts to implement East Asian industrial policies can now be legally handicapped in its firms' access to developed country markets. This represents a dramatic change in the dynamic of trade and investment negotiations.

In Dani Rodrik's words, "The rules for admission into the world economy not only reflect little awareness of development priorities, they are often completely unrelated to sensible economic principles. For instance, WTO agreements on anti-dumping, subsidies and countervailing measures, agriculture, textiles, and trade-related intellectual property rights lack any economic rationale beyond the mercantilist interests of a narrow set of powerful groups in advanced industrial countries."[46]

In light of the evidence reviewed earlier we should be skeptical of claims by representatives of developed countries that "ever-freer trade and investment benefits just about everybody." The claims are better understood in the light of List's observations about how countries with head-start advantages behave.

> It is a very clever common device that when anyone has attained the summit of greatness, he kicks away the ladder by which he has climbed up, in order to deprive others of the means of climbing up after him. . . . Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than to throw

[45] The latter performance requirements are not explicitly banned under TRIMS, but the United States and the EU are pushing for them to be banned and are seeking to ban them in their bilateral and regional free trade area negotiations. Wade, 2003, "What strategies are viable for developing countries? The WTO and the shrinking of development space," *Review of International Political Economy* (10)4.

[46] D. Rodrik, 2001, "Trading in illusions," *Foreign Policy* 123(March/April).

away these ladders of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in the paths of error, and has now for the first time succeeded in discovering the truth.[47]

In the same spirit, Robert Dorfman predicted in 1947 that

> Free trade is the ideal, and the US will proclaim the true cosmopolitan principles when the time is ripe. This will be when the US has a hundred million people, when the seas are covered with her ships, when American industry attains the greatest perfection, and New York is the greatest commercial emporium and Philadelphia the greatest manufacturing city in the world. And when no earthly power can longer resist the American Stars, then our children's children will proclaim freedom of trade throughout the world, by land and sea.[48]

The new WTO trade and investment rules join with other fundamental changes going on in the world economy to tip the playing field even more against most developing countries. One is China's surging manufactured exports, which are hurting manufactured exporters in most other developing countries and sending a deflationary impulse through the world economy. Another change is the skill-biased immigration policies of developed countries, which erode production and governance capabilities in many developing countries. And in a class of its own, HIV/AIDS is destroying lives, communities, economies, and governments across Africa, south Asia, and parts of East Asia, with no end in sight.

If momentum is reestablished to make all countries remove all restrictions on flows of capital, the disadvantage to developing countries, deprived of potent instruments to protect themselves from capital volatility, will be even bigger. IMF Managing Director Camdessus said in 1999, "I believe it is now time for momentum to be reestablished. . . . Full liberalization of capital movements should be promoted in a prudent and well-sequenced fashion . . . the liberalization of capital movements [should be made] one of the purposes of the Fund."[49] And the U.S. Treasury in the George W. Bush administration

[47] F. List, *The National System of Political Economy*, 368. List became a convert to the idea of industrial development strategy during his exile in the United States (1825–30), when he studied the work of Hamilton and other industrial strategists. When I tried to borrow List's book from the MIT library in 1993 I had to wait several days for a copy to be brought in from a remote warehouse for rarely borrowed books. My copy had last been borrowed in 1966. In Korea List's ideas carried weight. A German disciple advised the Korean government in the late nineteenth century in connection with the government's efforts to stave off Japanese colonialism. In Seoul, in 1979, bookshops around the universities had whole shelves of pirated copies of List's books. Today?

[48] Quoted in E. Reinert, 1995, "Competitiveness and its predecessors—a 500-year cross-national perspective," *Structural Change and Economic Dynamics* (6):23–42. For Dorfman's heterodox interpretation of Taiwan see below, 222n27.

[49] M. Camdessus, 1999 (speech, 17 May). The IMF has softened its insistence on capital

has insisted that the free trade agreements with Singapore and Chile include provisions penalizing them for the use of any restrictions on capital flows, even during a financial crisis and even if the IMF approves their use. American investors (and only American investors) would have to be compensated by an amount determined by trade arbitrators.[50] Why? Because, claims the Treasury, investor freedom to move funds in and out of jurisdictions at will is a "fundamental right"; and, because free capital mobility brings large benefits to developing countries without posing dangers beyond the capacity of "sound" bank regulation to avert.[51]

What Is to Be Done?

If the world is not moving in the right direction (as trends in world poverty and inequality suggest),[52] the precautionary principle—applied to the likely costs to the world of having a large proportion of the world's population still at a small fraction of the living standards of North America and Western Europe half a century from now—suggests the need for non-market measures of intervention and for refocusing international cooperation around development principles more than around "reciprocity" and "no distortion" principles. Here I want to amplify parts of the argument of chapter 12, with more accent on international public policy.

My argument points to the need for stronger one-way trade preferences for poor countries, and more legitimate scope for protection.[53] But it is clear from post–World War II experience that protection alone is not enough, and that it can hinder more than it helps. Protection has to be made part of a larger industrial strategy to nurture the capabilities of domestic firms and

opening since Camdessus left in 2000. A recent paper coauthored by IMF chief economist Kenneth Rogoff admits, "it is difficult to establish a robust causal relationship between the degree of financial integration and output growth performance . . . there is evidence that some countries may have experienced greater consumption volatility [hence welfare volatility] as a result [of financial integration]." E. Prasad, K. Rogoff, S. Wei, M. Kose, 2003, "Effects of financial globalization on developing countries: some empirical evidence," IMF (17 March), 6.

[50] J. Bhagwati and D. Tarullo, 2003, "A ban on capital controls is a bad trade-off," *Financial Times* (17 March).

[51] J. Taylor, 2003, Testimony before the subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Committee on Financial Services, U.S. House of Representatives (1 April).

[52] I spell out the grounds for this contentious conclusion in 2003, "Is globalization reducing poverty and inequality?" *World Development*, forthcoming.

[53] The effectiveness of nonreciprocal trade preferences for poor countries is suggested by Andrew Rose's finding that—contrary to general assumption—being a member of the GATT/WTO as such made no statistical difference to how much trade a country did with others, but receiving trade preferences under GATT's Generalized System of Preferences (GSP)—preferences that rich countries gave to poor ones—roughly doubled a poor country's trade compared to what it would have been otherwise. A. Rose, 2002, "Do we really know that the WTO increases trade?" CEPR Discussion Paper 3538.

raise the rate of domestic investment, always in the context of a private enterprise, market-based economy. The problem in many developing countries—in Latin America and south Asia, for example—has been the absence of industrial strategy and implementing agencies, and the unwillingness of the "aid" community, including the World Bank, in helping formulate and implement industrial strategy.

We need to reintroduce a distinction that has dropped out of the development lexicon. The word "integration" is currently used to refer only to integration into the world economy, and carries with it the implication that more integration is always better. We should distinguish between "external integration" and "internal integration" (or articulation), and recognize that the development of a national economy is more about internal integration than about external integration.

An economy with high internal integration has a well-filled input-output matrix—a dense set of links between sectors (a high level of sectoral articulation between, e.g., rural and urban, and consumer goods and intermediate goods), and a structure of demand such that a high proportion of domestic production is sold to domestic wage earners (a high level of "social" articulation between wages, consumption, and production). Export demand is not the main source of economic growth. Robust political coalitions between capitalists and employees become possible in this type of economy, because capitalists, employees, and the government recognize a common interest in wages as a source of sales and economic growth, not just as a cost of production.

An economy with low internal integration has a thin input-output matrix, with low sectoral and social articulation. Here wages are seen simply as a cost, not also a source of demand. Domestic consumption being only weakly connected to domestic production, exports are the main stimulus to economic growth; but sectors producing for foreign markets remain enclaves. An economy with low internal integration has no basis for class alliances and democratic regimes.

How can developing countries create more internally articulated economies? The starting point is to recognize that, contrary to general assumption, more external integration does not automatically generate more internal integration; on the contrary, more external integration can erode internal integration. But also, more internal integration (if fostered by high and unstrategic protection) can undermine external integration, at the cost of future internal integration at higher income levels. Development strategy has to operate in the zone where the two forms of integration reinforce rather than undermine each other. But the fact is that the strategy of fostering internal integration—including practical nuts-and-bolts issues like nurturing supply links between domestic firms and subsidiaries of multinational corporations—has largely dropped out of the development agenda as promulgated by Western development organizations. This urgently needs remedying. Taiwan's methods are worth emulating, such as those of the Minister for Science and Technology to monitor the input-output matrix of a sliver of the electronics *filiere* with a view to seeing which sophisticated products currently being imported could, with some state assistance, be produced competitively within Taiwan.

To put the same point in more familiar terms, today's development theory assumes that the principle of comparative advantage—specialization between countries in line with the location preferences of firms in free and competitive markets—should be the capstone of development policy. It assumes conversely that the principle of import substitution—government encouragement of local production of some items currently imported—is not to be followed, because it is discredited by the evidence of what happens when it guides the policy framework.

These assumptions do not stand up to much scrutiny, for several reasons. First, as this book shows, the most successful developers of the second half of the twentieth century practiced vigorous, government-led import replacement (internal integration) side by side with growing, government-encouraged trade (external integration). As they replaced some current imports with national production they generated demands for new kinds of imports.[54] Second, the development experience of Latin America and Africa over the whole of the twentieth century shows that regions that integrate into the world economy as commodity supply regions (in line with their "comparative advantage") and that rely on "natural" import replacement in response to transport costs, growing skills, and shifting relative costs, are only too likely to remain stuck, their level of prosperity a function of access to rich country markets and prices for their narrow commodities. Third, when Latin American countries did go beyond "natural" import replacement during the post–World War II decades of "import substituting industrialization," their growth performance was in fact better by several measures than it has been during the subsequent era of liberalization and privatization. Fourth, the last point notwithstanding, there is plenty of evidence of import substitution going awry in Latin America, Africa, south Asia, and Australasia; but this no more discredits import replacement as a principle than the failure of democracy in many developing countries discredits the principle of democracy. The policy response should be to do import replacement better, not less; and to get multilateral and bilateral development agencies to help governments acquire the skill and commitment to do so.[55]

[54] J. Jacobs, 1984, *Cities and the Wealth of Nations: Principles of Economic Life*, New York: Random House.

[55] H. Bruton, 1998, "A reconsideration of import substitution," *Journal of Economic Literature*, 36(2) June:903–36.

In short, the central challenge of national development strategy is to combine the principle of comparative advantage and the principle of import replacement. Strategic economic policy does not, as is commonly assumed, favor protection universally, though neoclassical economics favors free trade almost universally; it prescribes free trade, protection, and subsidies in various combinations depending on a country's circumstances and levels of industrialization.

In some sectors and at some times, a country should give little weight to import replacement and a lot to comparative advantage; and vice versa. There are a number of small and non-growing countries that, even if untrammelled by international rules, could not hope in the foreseeable future to do more than provide a low-wage platform for rich-country outsourcing, and whose domestic markets are too small to offer more than very limited possibilities for import replacement. There are others, particularly in Latin America, where the scope for import replacement is much bigger but where "unproductive" oligarchs have long-used import replacement policy as yet another means of monopolizing opportunities, exploiting populations, and preventing the transfer of resources to productive groups. Here, more trade liberalization and more foreign direct investment can plausibly be seen as a way to force the oligarchs to cede their control over the economy and open the way to the formation of a capitalist class—after which it may make sense to promote another round of concerted import replacement. Meanwhile, China is currently doing both at once, aggressively exporting in line with changing comparative advantage and aggressively replacing some current imports, following in the footsteps of Japan, Korea, and Taiwan. Its momentum is captured in its "technicians" per million people figure: 200, compared to 108 in India, 32 in Malaysia, 30 in Thailand (and at the other end, 318 in Korea, and 301 in Singapore).[56]

The central rationale for Third Way industrial policy to force the pace of internal and external integration is not static teething problems facing newcomers; it is the need to build the firm-level capacity to master the "tacit" elements in technical knowledge, knowledge that cannot be embodied in machines, blueprints, or instructions.[57] Relying on subsidiaries of multinational corporations to bring in the tacit knowledge is only a partial solution even in those few developing countries that can expect to attract a large amount of foreign direct investment. Even in Singapore the government used a battery of interventions to provide MCN subsidiaries with the factor inputs, infrastructure and incentives need to accelerate their pace of upgrading. For the great majority of developing countries that cannot rely on MCNs except at the margins but are big enough to support some degree of import replace-

[56] UNCTAD, *Trade and Development Report 2002*, Geneva, 167.

[57] See S. Lall, "Comment," in Wood, et al., "Symposium on infant industries."

ment, the issue is how to get tacit knowledge into the heads of nationals. Building the capacity to learn can be costly, uncertain, and prolonged, and requires interaction with other nearby firms and support organizations. Industrial policy can help by targeting deficiencies within firms, across firms, and in factor markets. Since technologies differ in their learning costs and factor needs, the support must be differentiated between sectors; but it must also include support for cross-sectoral functions, such as special credit schemes to offset capital market failures for small- and medium-sized enterprises.

The standard response from economists is that even if protection and other forms of "distortive" interventions could be theoretically justified in some circumstances, developing countries do not have the state capacity to implement it effectively. They invoke the phrase "state capacity" without analyzing it, putting the argument beyond contradiction. Ironically, the world is proceeding on the assumption, in the TRIPS agreement, that developing country governments *do* have a considerable capacity to enforce patents and copyrights, and do have the capacity to implement lots of other WTO conditions. It is not obvious that a government able to do these things would not also be able to implement some industrial policies effectively.[58]

The Multilateral Economic Organizations

The rules of the international economic order—including those promoted by the IMF, the WTO, and the World Bank—should be revised to give more scope for different forms of national capitalisms to flourish, and aim for international economic stability rather than for maximum free movement of goods and capital.[59] The question is how to reconfigure them so as to legitimize expanded "special and differential treatment" for developing countries and dilute requirements for "reciprocity," "national treatment," and "international best practice."

Our dangerously weak arrangements for safeguarding financial stability should be strengthened by (a) making short-term capital to developing countries more expensive, so as better to reflect systemic risks; (b) encouraging governments to create a national structure of foreign liabilities and assets that is "positively correlated," where servicing costs are high when ability to repay is high and low when ability to repay is low;[60] and (c) establishing rules under which countries may impose capital or exchange controls as part

[58] Thanks to Ken Shadlen for this point.

[59] D. Rodrik, 1998, "The global fix", *The New Republic* (November 2). Wade, 1996, "Globalization and its limits: reports of the death of the national economy are greatly exaggerated," in S. Berger and R. Dore (eds.), *National Diversity and Global Capitalism*, Ithaca: Cornell University Press, 60–88.

[60] M. Pettis, 2001, *The Volatility Machine: Emerging Economies and the Threat of Financial Collapse*, New York: Oxford University Press.

of debt payment suspensions or standstills, and institutionalize the authority of an international organization (perhaps the IMF) to arrange them.[61]

The standard reply from economists is that all countries should commit to open the capital account *pari passu* with "sound" or "prudent" regulation; "regulation, yes, restrictions, no." But, in truth, we do not have good measures for judging the soundness of financial regulation. The World Bank published in 1997 a list of countries whose capital market regulation was strong enough to safely support full liberalization. South Korea, Malaysia, Thailand, "with Indonesia and the Philippines not far behind," Chile, Mexico, "with Brazil also ranking well."[62] The East Asian financial crisis began three months later.

If it sounds like a pie in the sky idea to call for an international economic architecture that permits different varieties of capitalism to flourish, recall that the Bretton Woods system did so and delivered magnificent economic performance. If it is said that global financial markets are now too big and digitized to be subject to any form of cross-border controls, recall that the regime for tracing drug money and terrorist money across borders has proven to be quite effective; which suggests that unauthorized capital movements could be subject to the same sort of penalties as tax evasion.

As part of this nonconvergence scenario, we need to build up regional-level organizations, so that markets can be embedded not only nationally but also regionally in distinct configurations, with policy solutions tailored to the different vulnerabilities of different countries and regions. This is the point that the two Korean labor federations had in mind in their remarkable statement to U.S. Treasury Secretary Rubin in July 1998: "The Asian development model, while containing some of the key elements which gave rise to the current crisis, also contains the very dynamic elements which made the 'miraculous' growth over such a short period. . . . The IMF policy regime, however, has overlooked . . . the positive and dynamic elements in its virtual blanket disavowal of the Asian economy. . . . It may be necessary, therefore, for Asian nations to build a body . . . which can serve as an Asian monetary fund."[63]

When the Japanese government proposed the idea of an Asian monetary fund in August 1997 and quickly got pledges of support from Asian governments amounting to roughly US$100 billion, the U.S. Treasury made killing

[61] For more radical proposals see J. D'Arista, 2000, "Reforming international financial architecture," *Challenge* 43(3) May/June:44–82; Wade, 2000, "Out of the box: rethinking the governance of international financial markets"; 2002, "On Soros: are Special Drawing Rights the deus ex machina of the world economy?" *Challenge* 45(5) September/October:112–24.

[62] World Bank, 1997, *Private Capital Flows to Developing Countries: The Road To Financial Integration*, A World Bank Policy Research Report (April), 59.

[63] "The KCTU proposal," document presented at KCTU-FKTU meeting with U.S. Treasury Secretary Rubin (1 July).

the proposal a top priority. It succeeded, with late help from China wary about Japanese leadership. But in December 1998 the Japanese government revived the idea.[64] The idea of an Asian monetary fund is an example of just the sort of regional initiative that an international economic and financial regime should accommodate.

The Politics and the Knowledge

The politics are hardly propitious. One of the disastrous effects of the disappearance of the Soviet Union as a "rival" to the West has been the disappearance of Western commitment to creating transformative capitalisms in the (non-Communist) south. Instead, the West now equates development with poverty alleviation, market access, and participatory governance. And developing country governments, for their part, are cooperating very little to push for the sorts of changes suggested here. They negotiate for better access to Western markets as an end in itself, not for "development space."

The vested interests are so strong, the legitimacy of the "globalization plus" paradigm so well-defended in the centers of power, that only economic crisis is likely to shift thinking. How many more crashes like those of the 1990s and the early 2000s will the world endure before we conclude that the project of constructing a single integrated world market with universal standards—the culmination of the European Enlightenment ideal—is a mistake? Many, quite likely, provided that the populations of the G7 states are not seriously affected. But small changes are possible even outside of crisis conditions—generated by some combination of global social movements of NGOs, companies slowly expanding their social responsibility charters, "epistemic communities" of scholars rethinking development strategies, and developing country governments pushing quietly ahead to encourage new activities (import replacement, new exports) in ways that bypass or go under the radar of the international agreements.[65] From among these various entities it may be possible to organize coalitions for a determined push to revise specific and harmful clauses in existing agreements, such as article 27.1 of TRIPS (see above).

Meanwhile, scholars can help by nurturing a development economics that is more eclectic than the current monoculture and more focused on how to create dynamic capitalisms. The approach would recognize that a development agenda focused on strengthening participation and eliminating rents

[64] 1998, "Japan in fund proposals," *Financial Times* (16 December); C. F. Bergsten, 1998, "Reviving the 'Asian Monetary Fund,'" *The International Economy* (November/December); P. Blustein, *The Chastening*; P. Bowles, 2002, "Asia's post-crisis regionalism: bringing the state back in, keeping the (United) States out," *Review of International Political Economy* (9)2:230–56.

[65] Korea and Taiwan beefed up covert trade controls even as they announced bold trade liberalizations.

and corruption has little to do with strategies for creating capitalist systems able to generate mass affluence and a decent quality of life. This development economics would draw foundationally on the dynamic theories of capitalism developed by Schumpeter, Polanyi, Marx, Minsky, and the like; and it would inform its prescriptions with knowledge of the history of how the now-advanced economies succeeded. It would subvert the hegemony of capital even in small ways by getting the terminology right—by reserving the word “investor” for someone who allows his money to be used for the production of goods and services in return for a share in the proceeds, and “speculator” or “gambler” for one who buys financial assets in secondary markets in the expectation of subsequently selling them at a profit.[66]

London
May 2003

[66] For more on economists’ tendentious use of language, see J. K. Galbraith, forthcoming, *The Economics of Innocent Fraud*, Houghton-Mifflin.