1. Introduction: responding to the challenges of the post-crisis era

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The financial and economic crisis that hit the Southeast and East Asian economies in the late 1990s has generated a voluminous literature just as their successes did. Pundits, including those who were upbeat in their assessment of the continued virtuous circle of growth in these economies, have been quick in condemning the very model of development that was claimed to lie at the heart of their successes. This shows that a prevailing paradigm is in disarray, and both the successes and failures of Asian economies remain an insufficiently understood phenomenon.

The rapid transformation of a small band of Southeast and East Asian economies has been termed one of the greatest revolutions in the history of economic thought. It was seen as ushering in the dawn of a new 'Asian Century'. Sadly, with the sudden and unexpected crisis that has wreaked havoc on the lives of millions of people in the region, 'Asia approaches the new century in an introspective and apprehensive mood' (Tadashi and Chia, 1999: 7). As Asia examines the causes of a sudden fall, and searches for a way forward, there is unprecedented turmoil in current thinking on development policy.

As the dust settles after the turbulence of 1997 and as growth returns to Southeast and Northeast Asia, this collection of contributions by both Asian and international scholars adopts a reflective approach. They attempt to bring together the current thoughts on the crisis and seek to navigate pathways to sustainable development. While the individual country studies vary in terms of the importance of various factors that contributed to the crisis, most point to the necessity of paradigm changes in development policy. For those who believe that a 'strong state' is essential for economic growth, the sudden collapse of these economies means that the system of semi-democracy or 'strong state' can no longer serve the purpose of further development. For innovation-driven sustainable development, any society must be open to ideas and democratize its polity. And for those who used the success of East Asian economies as a vindication of the neoclassical orthodoxy, referred to as the 'Washington consensus', the crisis points to the

follies of progressive withdrawal of the government from the economic sphere and unfettered flows of short-term capital. To appreciate the issues involved, we provide a brief review of the debate in this introduction.

IMPLICATIONS FOR THE STATIST SCHOOL

One has to accept that Southeast and East Asian political systems have, until the recent movement towards democratization, been authoritarian. They were characterized as strong states, insulated from the narrow interests of vested groups. As a result, it was argued that the leaderships in these economies were able to formulate and vigorously pursue a national goal of growth. Admittedly, rapid growth in such economies provided durable political legitimacy even in the absence of democratic institutions. In trying to attain 'technocratic insulation', attenuation of human rights and the political exclusion of the labour movement have been quite conspicuous. However, it is also the case that wealth-sharing programmes in a context of rapid growth (such as affordable public housing in Singapore and the tapping of oil wealth to alleviate rural poverty in Indonesia) have made the process of social and economic change more 'inclusive'. Thus many believe that there is a 'cruel choice' between democracy and economic growth, at least at the early stage of development.

The Asian crisis has clearly demonstrated that, even if the authoritarian regimes could deliver rapid growth, they remained fragile. According to Romer (1993: 88) 'strong, authoritarian government[s] . . . require a configuration of bureaucratic competence and ruthless dedication to national economic success that is relatively rare and may be impossible to sustain'. Olson (1982: 52) also argues in the same vein when he observes that political systems characterized by insufficient 'diversity of advocacy, opinion and policy and fewer checks on erroneous policies and ideas . . . may perform unusually badly in some periods and unusually effectively in others'. Sen (1991: 425) makes the point more forcefully: 'the view that the "harder" the state the more effective it must be, [is] dead wrong'.

Once East Asian-style governance was widely perceived as a system that could deliver spectacular results, it ended up creating a durable culture of compliance. Why question a system that has created such remarkable outcomes within one's lifetime? The political leadership in turn, inspired by its success and the legitimacy that such success confers, constructed an ideology that rewarded compliance and consensus. In investing in the unsubstantiated view that there are distinctive Asian values that promote economic growth, the political leadership may well expose their politics to the risk that ideas and human ingenuity – the wellsprings of innovation-driven growth – are insufficiently recognized and rewarded. Ideas and

human ingenuity are not simply market-driven outcomes. They require a conducive institutional context characterized by a robust civil society, free-flowing information, debate and dissent. The costs and risks inherent in sustaining a culture of compliance may not become evident to the current leadership or even to society at large because input-driven growth may take a long time to experience diminishing returns.

It is in this context that one has to analyse the region's thirst for foreign capital when there was no shortage of domestic savings. To begin with, the authoritarian regimes can maintain their legitimacy only through their success in generating rapid economic growth. However, their claim to legitimacy becomes increasingly tenuous as the economy confronts diminishing returns to scale. Their inability to make the transition to an innovation-driven stage of development to counteract diminishing returns eventually causes them to crumble.

The East and Southeast Asian authoritarian regimes found, in the surge of foreign capital inflows since the early 1990s, a reprieve. The access to foreign capital helped them in at least two ways. First, it enabled them to push for grand projects that could be used to justify their continuance on nationalistic/patriotic grounds. Second, to the extent that the capital flows were private and the regime had lax control, it kept the business community happy. The general citizenry also remained placated as the economy continued to grow despite increasing inefficiency. Thus the regimes that were once hailed for their relative autonomy from interest groups and for their growth-promoting relationship with the business community soon degenerated into 'crony capitalism'.

Furthermore, a vicious circle developed in the economic front. To maintain the capital flows, governments had to follow policies that were inconsistent. First, they had to maintain a stable or semi-fixed nominal exchange rate to encourage capital inflows, but this led to an appreciation of the real effective exchange rate, to the detriment of their export growth and current account developments. Second, in order to keep the financial sector pleased, governments had either to reduce budget deficits or to maintain a surplus budget that was achieved predominantly by cutting infrastructure investment. This had adverse impacts on the productivity of, and hence returns to, private investment. In other words, the infrastructure bottlenecks added to the problem of diminishing returns as more and more investment was required with the rise in the incremental capital-output ratio (ICOR). Thus the demand for foreign capital continued to rise.

As the profitability of investment in the real sector declined, funds moved to financial and speculative investment. The investment in the financial sector was also encouraged by governments' low inflation rate policy as it removed uncertainty about real returns. However, the policies of nominal

exchange rate targeting and low inflation come under increasing pressure from capital flows although, paradoxically, these policies are designed to attract capital inflows. Policy makers find it increasingly difficult to sterilize the developments in the capital account. Either they have to let the money supply increase, and hence accept higher inflation, or let the exchange rate appreciate. In both cases, they cannot avoid the adverse impact on the current account. The more they try to hold out, the more vulnerable they become to speculative attacks and capital flight.

Thus, by prolonging the durability of growth-oriented authoritarian regimes in the region, foreign capital inflows have, ironically, been responsible to a large extent for delaying the democratization of East and Southeast Asian countries and also for prolonging investment-driven growth. Furthermore, to the extent that foreign capital inflows hindered the development of a robust civil society, they contributed to the authoritarian regimes' restraining of social movements that heighten public awareness of such issues as environmental degradation, the plight of those left behind by fast-paced growth, gender discrimination and so forth. This in turn reduced the capability of the state to develop effective mechanisms for dealing with emerging social problems.

Moreover, as the contrasting experiences of Thailand, Korea and Indonesia show, the authoritarian regimes were not able to handle sudden economic shocks better as such regimes attempted to protect themselves with secrecy. They also show that the impact of short-term economic crisis falls disproportionately on poor and weaker sections of the population as they do not find a voice in an authoritarian society. This leads to a divisive social crisis and in turn deepens the economic crisis, which Sen, in Chapter 2 of the present volume refers to as 'divided we fall'.

To be fair, it has to be conceded that the financial crisis has brought the above issues into the public domain and has given impetus to democratic reform. Although the event has been dramatic, the financial crisis brought the simmering social and economic tensions to the boil, as is evident in Indonesia. It is now abundantly clear that the sustainability of the 'Asian Century' crucially depends on the ability of the Asian countries to move to a more accountable, responsive and transparent form of governance. Ultimately, such governance requires the nourishing of durable democratic traditions (see Sen, 1994; also Chapter 2).

IMPLICATIONS FOR THE 'WASHINGTON CONSENSUS'

The 'Washington consensus' reflected the intellectual imprint of Washington-based institutions: the US Treasury, the International

Monetary Fund (IMF) and the World Bank. Its emphasis was on a constellation of virtues – free markets, free flow of trade and capital across the globe, macroeconomic management characterized by sound money, fiscal prudence and limited governments – that was regarded as the source of sustained economic prosperity both for poor and rich nations. It was an important set of ideas. It was operationally powerful because of its simplicity.

However, the East Asian crisis has exposed its limitations and has demonstrated that, in important respects, it was also misguided. In a series of speeches and papers, Stiglitz has led the way in pronouncing the demise of the conventional wisdom, or the Washington consensus in the domain of development policy.¹ The success of the Washington consensus as an intellectual doctrine rests on a number of factors. 'It focuses on issues of first-order importance, it sets up an easily reproducible framework . . . and it is frank about limiting itself only to establishing the prerequisites for development' (Stiglitz, 1998a: 6). Despite its global influence, the Washington consensus could not satisfactorily explain growth in pre-crisis Asia and could not satisfactorily explain why such economies were, almost overnight, thrust into a crisis of such stark magnitude. After all, these economies were paragons of macroeconomic stability and embraced the programme of privatization and the cause of globalization as a centrepiece of their economic strategy.

One may even argue that the very Washington consensus-based policies partially contributed to the Asian crisis. First, the adoption of a consensus policy framework meant a significant departure from the 'Asian development model' (Brownbridge and Kirkpatrick, 1998) in at least two significant areas: (a) control over external borrowing and (b) state guidance of investment. Second, fiscal prudence was achieved by drastically cutting government investment in infrastructure. This removed a significant source of externality for private investment and contributed to inflationary pressure arising from shortages of critical inputs such as electricity (see Chowdhury, 1999). Third, there has been a rise in the likelihood of business cycles entailing both longer duration and higher amplitudes with the forsaking of the stabilization of economies in the presence of increased capital mobility. This has encouraged short-term speculative investment rather than longer-term investment (Porter, 1992; Eatwell, 1996).

In other words, capital account liberalization and the deregulation of the domestic financial sector (two important planks of the consensus policy) have severely constrained the macroeconomic policy mix. As pointed out by Alan Greenspan, the chairman of the US Federal Reserve:

A consistently disciplined monetary policy is what our global financial system increasingly demands and rewards . . . While there are many policy considerations that arise as a consequence of the rapidly expanding global financial system, the most important is the necessity of maintaining stability in the prices

of goods and services and confidence in domestic financial markets. Failure to do so is apt to exact far greater consequences as a result of cross-border capital movements than those which might have prevailed a generation ago. (*New York Times*, 21 June, 1995: A-1 and D-9)

The Asian Development Bank (1999: 19) echoes the same sentiment when it concludes:

As the domestic capital market becomes integrated with the international capital market, domestic policy makers become subject to scrutiny by global investors. The discipline that this scrutiny brings helps to discourage the pursuit of excessive monetary and fiscal expansion (which can quickly lead to reserve outflows and currency depreciation).

Thus increased internationalization constrains governments to a conservative fiscal and monetary policy mix independent of exchange rate regimes regardless of shades of governments.

The deregulation of the financial sector has resulted in an unprecedented growth in both financial institutions and financial products. Financial institutions have a vested interest in keeping inflation low because a rise in interest rates reduces the value of fixed interest securities. Also a rate of inflation that is consistently above that in most other countries is a reliable sign that sooner or later the currency will be devalued, which adversely affects those who hold fixed foreign exchange liabilities and those who need to repatriate foreign capital income. This financial market sentiment was echoed by the former governor of the Reserve Bank of Australia, Bernie Fraser, when he commented that 'monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to inflation than unemployment' (*Sydney Morning Herald*, 16 June 1996). Financial markets also worry about large budget deficits. They fear that such deficits may lead to a rise in interest rates or devaluation.

Thus what we observe is the progressive withdrawal of governments from regulating both the real and financial side of the economy since the mid-1980s in line with the Washington consensus. This meant a substantial dismantling of the Asian growth model where governments played a very vital role in terms of both high infrastructure investment and strong relationship with business. Prior to becoming hostages to financial markets (both domestic and international), governments maintained fiscal discipline through a virtuous circle of growth. Governments invested in infrastructure and human capital formation which increased the productivity of private investment and international competitiveness, as explained by the new growth theory (Barro, 1997; Lucas, 1988). This meant governments were able to maintain fiscal balance (surplus or a small deficit) through

growth dividends as their revenues continued to rise, with the private sector paying more and more tax as they grew.²

However, the above model of fiscal balance works with substantial lags as infrastructure investment usually comes to fruition after a long gestation period. As a result, it has an inflationary bias. Given the vested interest of the financial sector in low inflation, this model becomes inoperative with the increased influence of financial markets. So governments were forced to achieve fiscal balance more quickly. Furthermore, they had to reduce tax on capital income, as higher capital tax may encourage capital to fly out. The Washington consensus also suggests that lower taxes foster entrepreneurial innovation. Hence governments had to achieve fiscal balance by cutting their expenditure. For example, as can be seen from Table 1.1, the share of tax revenues in most Asian economies remained stable between 1985 and 1995, while government expenditure as a proportion of gross domestic product (GDP) fell drastically in all except in Korea, the Philippines and Taiwan, where it increased marginally during the same period. Since cuts in current expenditure are politically difficult as they affect social services, which are meagre to begin with in Asian countries, governments chose the easier option of cutting infrastructure investment (see Figure 1.1). But the decline in public infrastructure investment was not offset by a rise in private participation in the sector as was expected within the neoclassical framework (Walton, 1997; Malhotra, 1997).

What is also disturbing is that there has been a decline in expenditure on education in some countries, such as Indonesia and Malaysia, as a percentage of their respective GDP between 1985 and 1995. This led to a vicious circle. The more reductions there were in infrastructure and education, the larger was the decline in productivity, the slower was economic growth, and hence the greater were pressures on governments to reduce expenditure (Eatwell and Taylor, 1998; Taylor, 1998).

Moreover, as Rajan and Zingales (1998) point out, when the availability of capital becomes surplus in relation to opportunities for profitable investment, the efficient allocation of capital requires a financial system which operates at arm's length and is based on a legal framework rather than on personal relations and political connections as is found in Asian economies. The domestic financial system could not change at the speed at which capital flowed in. The problem was compounded by the rapid withdrawal of the government as financial deregulation under the weight of international capital markets and IMF–World Bank pressure was taken to be synonymous with *laissez faire* or no regulation. Thus the financial system remained relations-based and lacked prudential regulation. This meant that, when the increased flow of capital was channelled through the

Table 1.1 Government finance indicators (% of GDP)

	Tax revenue				Expenditure				Fiscal balance/deficit			
	1975	1985	1995	1996	1975	1985	1995	1996	1975	1985	1995	1996
Economy												
Hong Kong	8.6	10.4	11.1	11.6	12.8 (2.7)	15.3 (2.8)	13.9 (3.1)	14.6 (3.2)	1.9	0.4	-0.3	2.2
Indonesia	16.9	18.3	14.1	14.6	21.6 (0.9)	23.5 (1.9)	15.5 (0.6)	15.1 NA	3.9	3.7	-0.4	1.2
Korea	13.8	14.8	16.9	18.6	15.7 (2.2)	16.3 (3.0)	17.6 (3.6)	18.3 (3.1)	2.1	1.2	0.2	0.5
Malaysia	20.5	21.6	19.0	18.9	31.4 (6.1)	32.9 (5.6)	22.4 (4.8)	22.6 (5.0)	8.5	5.7	-0.8	0.7
Philippines	13.2	10.7	16.3	16.7	16.0 (1.9)	14.1 (2.0)	18.2 (3.2)	18.3 (3.4)	1.4	1.9	-0.5	0.3
Singapore	17.1	17.3	16.4	17.7	26.3 (3.1)	39.1 (4.6)	20.8 (NA)	NA	-0.8	4.4	NA	NA
Taiwan	16.5	8.5	10.8	9.8	21.4 (0.8)	14.0 (1.6)	15.1 (NA)	14.3 (1.5)	-1.3	0.2	1.1	-1.4
Thailand	11.5	13.7	17.0	17.0	14.9 (NA)	18.9 (NA)	15.4 (NA)	17.8 (NA)	1.7	4.3	-3.0	0.9

Note: Figures in parentheses are expenditure on education as a percentage of GDP.

Source: Asian Development Bank, *Key Indicators for Member Countries*, 1998.

Sources: World Bank, *World Development Report* (various issues) and Asian Development Bank, *Key Indicators* (various issues)

Figure 1.1 Public investment/GDP (%)

banking sector, banks could venture into risky loans and thereby increase the fragility of the financial system.

Furthermore, inefficient uses of capital had adverse affects on productivity. As productivity of investment fell, people increasingly directed their high savings to speculative financial investment, which was facilitated by financial deregulation. The incentive for short-term speculative investment also arose from the lack of confidence in the economy as the prospect for long business cycle swings increases with governments' withdrawal from their stabilization role. The shift to short-term speculative capital had further adverse effects on productivity. As the productivity-driven economic growth tended to slow, governments needed to encourage more foreign capital to drive demand-led growth, given that a slowdown in economic growth would threaten their legitimacy. Thus they increasingly became hostages to financial markets, especially to international capital, which constrained their ability to respond to macroeconomic shocks, for which they once gained a reputation.

Furthermore, the need to win the confidence of international money markets may well lead governments towards a resolute commitment to fixed exchange rates. This may be regarded as a means of assuring the domestic corporate and financial lobby that the servicing costs of foreign currency-denominated liabilities will be protected. It is, at the same time, a signal to international money markets that governments will not allow the domestic

private sector to default on its foreign debt, thus sustaining the capital flows. Unfortunately, such a 'deal' comes at potentially great costs. It builds up contingent or unfunded liabilities of the government.³ This is a cruel paradox because it impairs the long-run fiscal position of the government, even though the need to win investor confidence pushes governments in the direction of macroeconomic conservatism in the short run.

More importantly, a strategy of attaching a premium to maintaining investor confidence exposes governments to the problem of the 'impossible trinity' in macroeconomic management (Krugman, 1998b). That is, policy makers are faced with the difficulty of managing a fixed exchange rate, an open capital account and policy independence. It can at most retain two objectives. Recent events in the wake of the East Asian crisis have shown that governments gave up – or were forced to give up – policy independence to defend the fixed exchange rate regime and open capital accounts. This means, of course, that governments forfeited the ability to fight an incipient recession through expansionary demand management policies. In the initial stages of the crisis, the policy preoccupation became, with the support and exhortation of the Washington-led international community, the need to win the 'confidence game' at all costs. Thus interest rates were raised and budgets were tightened. The Keynesian compact was broken, albeit temporarily, but its inexorable logic prevailed. A prospective recession became a stark reality.

Thus the answer to the puzzles pertaining to the sudden demise of the miracle economies of Asia now seems to lie in an undue faith in the virtues of globalization that made macroeconomic policy subservient to the interests of international money markets. In fact, prominent economists (for example, Corden, 1999; Krugman, 1998a, 1999; Sachs, 1998; Stiglitz, 1998b) have concluded that the very IMF adjustment package aggravated the crisis.⁴

LONG-TERM ISSUES AND CHALLENGES

The Asian economic crisis has understandably focused attention on rectifying errors in macroeconomic policy and achieving broad-based reform in the financial sector. The re-creation of the Asian miracle requires a vision about the future that has to go beyond the crisis and cope with a range of long-term issues and challenges. These pertain to the need to manage environmental degradation, to improve human rights and labour relations, to cope with the problem of demographic transition and growing inequality and to develop a tradition of democratic governance in order to foster and sustain productivity-driven growth.

Protection and Management of the Environment

It is generally agreed that the East Asian region has a poor record in terms of a range of environmental indicators (see Table 1.2). As the ADB (1997: 200) proclaims: 'For far too long, Asian policymakers ignored the environmental impact of rapid growth. Concern about pollution or degradation was simply not a priority.' As many as 15 of the 17 indicators pertaining to air and water pollution, access to safe water and sanitation, deforestation and land degradation, and energy consumption in East Asia show either 'very severe' or 'severe' environmental problems (*ibid.*: 203, Table 4.1). Most Southeast Asian countries have relied heavily on the export of their natural resources to import capital goods to support rapid growth. This has resulted in a rapid clearance of land. For example, in Malaysia, the area of land under cultivation increased from 15 per cent to 23 per cent from 1980 to 1994. Over the same period, the area of land under cultivation in Thailand rose from 36 per cent to 41 per cent. Their forestry policies have failed to recognize the scarcity of forest resources and sustainability. In Indonesia, for example, the annual sustainable harvest is estimated at 22 million m³, but the annual production of forest products is in excess of 40

Table 1.2 *Environmental indicators*

	Carbon dioxide emissions per capita (metric tons)		Energy use (oil equivalent), average annual growth rate		Annual deforestation (% change)
	1980	1992	1980–90	1990–94	1980–90
Indonesia	0.6	1.0	7.4	9.3	1.1
Hong Kong	3.3	5.0	7.0	7.7	–0.5
Korea	3.3	6.6	8.5	10.2	0.1
Malaysia	2.0	3.8	9.4	11.2	2.1
Philippines	0.8	0.7	2.6	8.3	3.4
Singapore	13.2	17.7	7.2	10.5	2.3
Taiwan					
Thailand	1.9	1.7	9.5	10.0	3.5
Middle-income countries	2.9	4.8	NA	NA	0.5
South Asia	0.4	0.7	7.0	5.1	0.8
Latin America	2.4	2.3	2.5	2.7	0.7

Source: *World Development Report* (various issues).

million m³. As a result of over-dependence on natural resources, high performing Asian economies (HPAEs) have lost more of their forest area in the last 30 years than any other region in the world (World Bank, 1998: 102).

The economic and social costs of environmental degradation are enormous. World Bank estimates suggest that the annual cost of air pollution is as high as US\$3.1 billion in Bangkok, US\$1.6 billion in Kuala Lumpur and US\$800 million in Jakarta. These estimates would be as much as 40 per cent higher if one included additional costs due to congestion (Brandon, 1994: 22). As a proportion of GDP, economic costs stemming from environmental damage appear to be as high as 8.5 per cent in the PRC (Smil, 1984) and between 1 and 2 per cent in Indonesia, the Philippines and Thailand (World Bank, 1992, 1993).

What are the factors that have shaped this sorry evidence of environmental degradation? To some extent, this reflects the by-products of factor-driven rapid economic growth and consequent urbanization. One of the drawbacks of investment-driven or capital-intensive industrialization is that it is inevitably energy-intensive, which is notorious for its emission-related pollution. However, to a considerable extent the evidence reflects more deep-seated problems: the lack of political will and governance to tackle environmental problems; and widespread market failures compounded by inefficient policies, such as sub-optimal pricing of infrastructure services.

The countries of East Asia are slowly beginning to recognize the need for much greater vigilance with respect to managing and maintaining environmental standards. This awareness is due primarily to two factors. First, domestically, an assertive middle class is increasingly demanding reduced air, water and noise pollution. Second, internationally, industrialized countries are imposing stiffer environmental standards on trade. For example, there is a move to label all imported timber products as to whether they are from sustainable forests or not. Thus the long-run viability of export oriented HPAEs depends crucially on improving their environmental standards.

Labour Relations

There is wide agreement among the observers of HPAEs that most of them maintained relatively unfettered labour markets during their early stage of economic transformation, at the expense of workers' rights. For example, until the late 1980s labour conditions in Malaysia, Korea, the Philippines, Taiwan and Thailand were determined unilaterally by employers with or without the assistance of government (World Bank, 1998). However,

observers disagree on the virtues of labour subordination. For example, neoclassical economists believe that the cost of infringement of labour rights has been more than compensated by exemplary results of rapid growth in real wages and full employment. On the other hand, critics regard the failure to uphold basic rights of workers as one of the glaring weaknesses of the pre-crisis period. In any case, progressive affluence in the region has made workers more assertive of their rights. For example, both Korea and Taiwan witnessed waves of industrial unrest in the late 1980s. In both countries, the role and power of unions have increased substantially. Malaysia agreed to allow unionization in the export-oriented, foreign direct investment (FDI)-dependent electronics sector in 1988. Both Thailand and Indonesia were forced to raise the minimum wage a number of times from the mid-1980s.

Added to the pressure is the International Labour Organization (ILO)'s determination to improve labour standards in the region. The ILO is pressing for a new 'social contract' for East Asia, which will have full respect for basic labour rights (ILO, 1998). There are also attempts to bring labour standards under the purview of the World Trade Organization (WTO). Major concerns are expressed in industrialized countries about the prevalence of child labour in countries such as the Philippines, Thailand and other countries of Southeast Asia, and the discrimination against women in terms of work conditions and pay.

Thus failure to improve labour standards and industrial relations could be very costly for HPAEs in the coming years. It may not only lead to growing industrial unrest, it is also highly likely that industrial countries will use labour standards as a protectionist device against exports from HPAEs.

Demographic Change

The high performing economies of East and Southeast Asia have gone through the demographic transition from both high fertility and mortality rates (the burden phase) to both low fertility and mortality rates (the gift phase). Between 1965 and 1990, the working-age population in East Asia grew 2.39 per cent per year, which is nearly twice the rate of annual population growth (1.58 per cent) and substantially higher than the annual rate of growth of the dependent population (0.25 per cent). Although less dramatic, the working-age population grew at a faster rate than the entire population in Southeast Asia as well. According to the estimates of Bloom and Williamson (1998), this demographic transition can explain between 1.37 and 1.87 percentage points of growth in GDP per capita in East Asia or between one-third and half of the 'miracle' in Northeast and Southeast Asia.

However, the East Asian economies are predicted to enter the final phase of demographic transition (a decline in working-age population and a rise in the older dependent population) in the immediate future. For example, according to the United Nations (1991) projections, the ratio of working-age population to non-working-age population will peak in East Asia in 2010. The Asian Development Bank (ADB, 1997) estimates show that by 2025 more than 10 per cent of the population in Singapore, Hong Kong, China and Taiwan will be aged 65 and above. The transition to this final phase of demographic transition will have at least two important implications. First, as the share of the working age population declines, the economic growth rate will fall unless either (a) the participation rate rises or (b) there is technological upgrading. According to Bloom and Williamson (1998), this is likely to shave off between 0.14 and 0.44 percentage point from the growth rate of GDP per capita. The loss is estimated to be higher for some countries such as Hong Kong (2.0–2.4 percentage points), Singapore (2.5–3.0 percentage points) and Korea (1.9–2.2 percentage points).

Second, ensuring financial security and providing age care will become a major challenge in the future. Currently, most HPAEs do not have a universal pension or social security system. Traditionally, families look after elderly persons. But as these societies are rapidly losing their traditional values with economic transformation, there will be a growing need for the state to provide age care and income support for the elderly. As a consequence, the budget deficit is likely to rise as the share of tax revenue declines and demand for public provision of age care and pensions rises (Heller, 1998). Some countries may have to depend increasingly on migrant labour, which in turn could create social tension.

The Re-emergence of Inequality

A common view – reaffirmed by Fields (1995: 103) – is that the East Asian economies are characterized by moderate degrees of inequality and trends have generally been egalitarian. Cross-country evidence compiled by Medhi (1994) suggests a less optimistic interpretation. As he observes (Medhi, 1994: 70): ‘The available data indicate that the distribution of income in . . . [East Asia] . . . has shown a tendency to become more unequal in recent years. This is in contrast to their earlier periods of development where income inequality declined as the economies grew.’

Other observers have also highlighted cases of growing inequality in East Asia.⁵ Focusing on the experiences of China and Thailand, Walton (1997: 5) notes that they bear the dubious distinction of registering one of the highest increases in inequality in the developing world in recent decades.

The findings of these studies have been corroborated by the World Bank (1998), which shows that inequality has risen in China, Hong Kong, Thailand and the Philippines. The World Bank (*ibid.*) has attributed the recent rise in inequality to two factors: (a) a rise in returns to higher education which has driven a wedge between the earnings of skilled and unskilled workers, and (b) concentration of economic activities in certain areas, which has contributed to regional income disparity.

High inequality undermines poverty alleviation. Despite substantial reductions of poverty in HPAEs, the World Bank (1998: 77) study shows that people are still very vulnerable. For example, a 25 per cent increase in the poverty line more than doubles the head-count index, from 11 to 25. It also reports a high incidence of poverty in pockets of regions. For instance, in 1990, poverty incidence in Indonesia ranged from 1.3 per cent in Jakarta to 46 per cent in West Nusa Tenggara. Likewise, northeast Thailand has the highest incidence of poverty and the highest concentration of poor people.

Table 1.3 Trends in income inequality (Gini ratio; year)

Indonesia	Hong Kong	Korea	Malaysia
0.34; 1976	0.49; 1966	0.34; 1964	0.50; 1968
0.34; 1980	0.44; 1971	0.33; 1970	0.53; 1976
0.32; 1987	0.37; 1980	0.39; 1976	0.49; 1979
0.32; 1990	0.42; 1986	0.39; 1980	0.46; 1988
0.34; 1994	0.45; 1991	0.40; 1988	0.47; 1995
Philippines	Singapore	Taiwan	Thailand
0.49; 1961	0.50; 1966	0.36; 1964	0.41; 1965
0.49; 1965	0.46; 1973	0.30; 1970	0.43; 1968
0.48; 1971	0.41; 1980	0.31; 1980	0.45; 1975
0.45; 1986	0.46; 1986	0.32; 1985	0.50; 1986
0.45; 1989	0.49; 1989	0.31; 1990	0.50; 1990

Sources: Medhi (1994: Table 1); Shari, I. (1998), 'Economic Growth and Income Inequality in Malaysia, 1971–1995', paper presented to the International Conference on Economic Growth, Poverty and Income Inequality in the Asia Pacific Region, UNSW, 19–20 March.

The re-emergence of inequality (see Table 1.3) is a cause of concern, particularly in ethnically diverse societies such as Indonesia and Malaysia. If the inequality is perceived to be due to the concentration of economic power in one ethnic group, this may trigger social tensions and race riots, as witnessed as recently as May 1998 in Indonesia or in 1969 in Malaysia.

It could potentially sow the seeds of demands for redistributive measures that in turn retard growth through policy distortions – a phenomenon sometimes characterized as ‘distributive politics’.

TOWARDS IMPROVED GOVERNANCE

As noted, a major challenge facing East Asia in the 21st century is the need to foster and sustain democratic governance. The agenda of building democracy in the region also encapsulates issues of social protection and the nourishing of enabling institutions that could invigorate the policy-making capacities of new democracies.

Fostering and Sustaining Democracy

For a while, robust and historically unprecedented growth in East Asia led to the view among elites in the region that such outcomes were also facilitated by ‘Asian values’.⁶ These values, it was argued, led to a resolute commitment to the work ethic, an almost reverential attitude towards education, and respect for order and authority. Some pundits, in analysing the sources of hyper-growth in pre-crisis East Asia, also discovered quintessential Asian institutions. These were identified as close government–business relations, internal capital markets and ‘technocratic insulation’ by authoritarian governments that shielded policy makers from the rapacious, rent-seeking proclivities of societal groups.

Now, in the wake of the 1997 financial crises, these views have been dramatically reversed – often by the very same pundits who espoused them! Quintessential Asian virtues have become, almost overnight, conspicuous vices. As noted, ‘crony capitalism’ is now used as a metaphor for capturing fatal institutional weaknesses in the region. Muted concerns about past problems, particularly in the domain of human rights, have come to the forefront of discussions about designing social policy in the region that would suit the mood and the requirements of the 21st century.

A key goal is the inculcation and consolidation of democratic governance. Considerable progress certainly appears to have been made. Korea and Taiwan have continued their bold journey towards the democratization of their political systems since the mid-1980s. Thailand and the Philippines have also become important players in the pan-Asian trend towards democratization. Indonesia is the latest example of a large East Asian economy engaged in the difficult transition towards political liberalization. With the successful completion (in June 1999) of reasonably free and fair elections, after 44 years Indonesia is poised for major political and social changes.

However, the risk of the process being derailed by racial and intraregional tensions is still considerable

Also enigmatic cases and conspicuous exceptions remain. Malaysia and Singapore may be typified as 'semi-democracies', despite the trappings of parliamentary institutions, primarily because of the lack of a free press and the stringent constraints within which political dissent has to operate.⁷ China is resolutely stuck in an authoritarian mould. Despite the 1989 tragedy of Tiananmen Square, China is far from showing any sign of political liberalization. It continues to profess unwavering faith in the separation of politics and economics, thus enabling it to combine communism in the political sphere with the progressive introduction of capitalism in the economic domain. Apparently, the Chinese political leadership has declared that such a system can last 'tens of generations'.⁸

Despite the fact that some countries in the region are resisting the transition to democratic governance, the spotlight on these issues will not go away. As Sen (1997: 14–15) notes, 'the case for them stands, even without having to show that democracy actually encourages growth'. Democracy and human rights are intrinsic values and may be regarded as ends in themselves as well as a means to an end.⁹

In more concrete terms, there are a number of areas in which policy makers in East Asia can work more diligently to improve on its poor record of human rights. In particular, the issue of labour rights needs a lot more attention. A start could be made by ratifying the core ILO conventions pertaining to labour standards by all the countries in the region and by incorporating 'social dialogue' with relevant stakeholders (the government itself, employers, trade unions, civil society) as a core principle of designing social policy. Korea has set an example by showing how this can be done. Indonesia agreed to ratify the core ILO conventions in the midst of considerable economic and political turmoil.

The issue of social dialogue need not simply be confined to the domain of social policy. It should become a general principle of policy formulation. Greater public discussion, openness and accountability pertaining to the policy formulation process will expedite the consolidation of democratic governance in the region.

Building a Sustainable Social Protection Policy

In the domain of social equity, the crisis has demonstrated that one cannot simply rely on rapid, employment-intensive growth to act as a *de facto* social safety net or social protection policy. Certainly, in the pre-crisis period, rapid growth brought about sustained reductions in poverty without any marked worsening of income inequality. But this proud record

is now badly tarnished. Even on the eve of the crisis, countries such as China, Indonesia and Thailand exhibited evidence of rising inequality. There have been significant reversals in poverty, particularly in Indonesia.

It is now widely recognized that the sharing of the burden of the crisis has been iniquitous. Some of the most vulnerable segments of East Asian society – women, children, workers, farmers, day labourers, small businessmen – bore the brunt of the crisis even though they had no role in bringing it about. This is a reflection of a system that became hostage to the perceptions and interests of the international investor community and their domestic beneficiaries. Even worse, when the crisis struck, the vulnerable groups in society were largely left to fend for themselves. They had to seek refuge in traditional support systems (burden sharing with the help of the extended family and friends, returning to the village to participate in the family farm, finding work in the informal sector, and so on). To their credit, donor agencies ploughed substantial resources into building a social safety net system on an emergency basis, but, to be sustainable, such initiatives must eventually be financed by national governments and become a core part of their social policy.

Why have East Asian governments overlooked the need to build a sustainable social protection policy in the past (see Lee, 1998: ch. 4)? To some extent, the long boom in the pre-crisis period created a sense of complacency among policy makers that they were immune to protracted recessions and hence had no need to invest in social safety net initiatives. It is also possible that there was excessive faith in the capacity of the informal and agricultural sectors – particularly in countries such as Indonesia and Thailand, where these sectors are still significant – to act as informal social safety net schemes. Nor can one discount the possibility that elite opinion in East Asia displayed a cultural aversion to the notion of the ‘welfare state’ in the West. Welfare statism could have been associated with such Western stereotypes as the breakdown of the family, the destruction of the work ethic and general lack of discipline and social cohesion. Finally, it is possible that policy makers genuinely felt that the opportunity and fiscal costs of running a comprehensive social safety net system were unaffordable for the typical East Asian economy.

The crisis and its aftermath have shown that all the reasons that may be advanced to avoid the installation of a social protection policy in East Asia are largely misguided. Recessions are a real and ever-present danger in East Asia, as they are elsewhere in the world. Informal systems of social protection simply cannot cope in the wake of such a region-wide and severe recession. The cultural aversion to welfare statism is as misguided as the rationale of invoking ‘Asian values’ in order to justify a ‘business as usual’ syndrome. The issue of affordability also appears to have been exaggerated.

Some calculations show that 'an average required contribution of between 0.3 to 0.4 per cent of payroll from 1991 to 2000 would have been sufficient to provide all insured job losers over this period, including during the current crisis, with 12 months of benefits' in Korea, Thailand and Indonesia (Lee, 1998: 83).

Building Enabling Institutions: Combining Technocratic Independence with Democratic Accountability

The constellation of reform agenda that we have espoused here brings to the fore the issue of the capability of the state to manage such an agenda. In fact, when suggesting the restoration of the role of government, Stiglitz (1998c) makes it conditional on the capability of the state. This has been criticized as 'static and ahistorical . . . [and] minimalist' (Sender, 1999: 104). However, those who are advocating a 'maximalist' role of the state in response to market failure are silent about the risk of corresponding 'government failure'. There is plenty of evidence of unsustainable government budget deficits, financed by monetary expansion, which end up in high inflation, loss of competitiveness and a chronic balance of payments problem. The danger of populist macroeconomic policy is greater in a young democratic regime where politicians may easily succumb to interest group pressures.

Therefore the reform agenda in post-crisis East Asia should incorporate the building of enabling institutions. These include ensuring the independence of four core institutions from the executive arm of the government: an independent judiciary, an independent election commission, an independent central bank and an independent fiscal board.

The fundamental role of the state is the establishment of the rule of law. In many developing countries, not only is the legal system archaic, but also the judiciary is not independent of the executive branch of the government. This compounds the problems of market failure as politicians interfere with the operation of the private sector. Once the property rights are clearly defined and enforced by an independent judiciary, the area where government interventions are genuinely required becomes clearly delineated.

An independent election commission is essential for the survival of a vibrant democracy. Without such independence, money and wealth disenfranchise people and democracy becomes dysfunctional. The recent constitutional reform in Thailand gives much cause for optimism. The work of citizens' groups such as the People's Solidarity for Participatory Democracy (PSPD) in Korea and non-government organizations in exposing corrupt politicians can go a long way in political reforms.

In the macroeconomic policy making arena, the reform should begin

with the central bank. The evidence shows that an independent central bank with a clear mandate for price stability enhances macroeconomic performance (Alesina and Summers, 1993; Cukierman *et al.*, 1992). Therefore the central bank's mandate should be amended to enable it to control inflation only, rather than a host of conflicting objectives. This is in line with what has been proposed above in order to enhance accountability and transparency of government departments. Note that, as emphasized by Fischer (1995), the central bank independence refers to 'instrument independence', not 'goal independence'. It is not suggested that the central bank would have the independence to pursue any goal, but that it would be constrained to fulfil a clearly specified objective.

Critics of central bank independence maintain that, as a lender of last resort, the central bank will have to cave in and monetize debt if the government remains irresponsible. This 'war of attrition' may lead to considerable political instability and larger fiscal imbalance (Alesina 1992). Therefore the credibility of government's fiscal and monetary policy lies ultimately in the accountability and transparency of the budgetary process. Here lies the importance of an independent fiscal board (IFB). The IFB must have sufficient power to review government expenditure programmes, and all new initiatives must be cleared by it. The idea of IFB is akin to an independent judiciary. Just as an independent judicial system monitors political interference with institutions for greater political efficiency, an IFB will ensure that the budgetary process is transparent and is not influenced by primarily vested interests. An IFB thus will enhance efficiency in macroeconomic management; it is a superior arrangement to a 'fiscal constitution' restricting the government to a balanced budget. Such a constitutionally binding arrangement could be unnecessarily debilitating. An IFB should work closely with an independent central bank in order to avoid any coordination problem between fiscal and monetary policies.

In pursuing the notion of enabling institutions, it is important to issue a caveat. The idea of independent institutions run by technocrats according to a clearly defined mandate always runs the risk of becoming 'too independent' and hence prejudicial to societal interests. For example, a central banker could become too inflation-averse and insensitive to the possibilities of stabilizing output relative to societal preferences. This is where the notion of combining technocratic independence with democratic accountability becomes critical. Designated technocrats in autonomous agencies (election commissioners, judges, bankers and treasury mandarins) ought to be subject to democratic accountability through public scrutiny in various forms: reporting to and questioning by elected representatives, provision of information to the public and receptivity to criticism engendered by public debate.

In sum, the agenda of building enabling institutions in East Asia through new rules and restraints cannot overlook the conventional institutions in democracies: an effective parliament, a free press, a robust civil society. The aim of independent agencies is to supplement the capability of democratic institutions, not supplant their role.

READER'S GUIDE TO THE VOLUME

Chapter 2, by Sen, touches on broader issues pertaining to development as freedom. While the crisis has exposed some of the weaknesses of past policies, Sen passionately argues that one should adhere to the proverbial injunction that the baby must not be thrown out with the bath water. The strengths of the past must be blended with the vision for the future, with a view to expanding human security and freedom. The hallmark of the Asian development model, according to Sen, was the effective use of complementary institutions – especially the state and the market. By widening economic entitlements through wider dissemination of basic education and basic health care, and land reform, the state helped reap the benefits of markets, as the wider population shares the opportunities offered by the market. The crisis has, however, made it clear that the institutions and policies for growth may not be the same as the ones that are required for preventing transient and short-term problems which may create havoc in people's lives. 'Success in one field may not guarantee success in the other.' Among other lessons of the crisis, according to Sen, are (a) the recognition of the fact that no economy is invulnerable to short-term problems, (b) there is an asymmetry in the relation between economic growth and social security, (c) the burden of short-term problems must be shared to prevent social unrest, and (d) democratic societies, where people have a voice, can handle short-term problems much better. Thus he concludes that the old strategy of institutional complementarities must include new institutions for ensuring protective security, participatory democracy and transparent accountability.

Sen's review of the key challenges facing post-crisis Asia sets the stage for the launching of the country-specific studies. The inaugural country-specific chapter in the volume focuses on Japan. Japan was the first East Asian country to achieve spectacular economic success. The Northeast and, later, Southeast Asian countries not only followed many of Japan's development policies, but Japan also acted as a regional 'locomotive' of growth through investment and trade. Thus the slowing of the Japanese economy in the early 1990s, to some extent, contributed to the Asian crisis. Revitalizing the Japanese economy, therefore, remains a critical factor for

the future of the region. Kwan's contribution argues that a key feature of the Japanese model of a cross-shareholding system of main banks, which allowed the corporate sector to pursue long-term goals instead of short-term profits, is no longer suitable after the catching-up phase is over. In its mature phase, Japan needs a new system, which promotes competition and risk taking. He highlights three new challenges that Japan faces: ageing of the population and a declining birth rate, keener competition in both manufacturing and service sectors in a globalized environment, and flexible and innovative business practices. According to Kwan, the failure of the traditional fiscal and monetary stimulus to restart the economy is a clear indication that the Japanese economy needs structural reforms. He highlights some of the reform programmes initiated by the Hashimoto government in late 1996 and concludes that the focus of policies must shift from 'equality of outcome' to 'equality of opportunity'.

Chapter 4, on the Republic of Korea (South Korea), is written by O. Yul Kwon. South Korea is sometimes referred to as the second Japan. No other Northeast or Southeast Asian economy followed the Japanese model of development as closely as South Korea did, and as a result it shares many features with the Japanese economy which are now obsolete. With the membership of the rich nations' club and the end of the cold war, Korea no longer enjoys any preferential treatment in the Western market. Yul Kwon argues that, in the new environment, protection of the Korean domestic market and industries by state intervention will become increasingly difficult. In a globalized environment, a country cannot wish to reap the benefits of international trade and capital flows and at the same time maintain national sovereignty and regulate its economy; it can have only one of the choices. Since Korea has chosen to remain engaged with the world economy, it must give up either national sovereignty or its desire to regulate the economy. According to Yul Kwon, the latter must go; instead of direct intervention in the economy, the state must play a complementary role and provide an enabling environment for the private sector. The enabling environment includes transparency, accountability and competition in both economic and political spheres. Yul Kwon also emphasizes that social development programmes and safety net must be an integral part of the new development paradigm. They not only protect those affected by short-term shocks, but also act as built-in stabilizers.

Thailand is the country from which the Asian crisis has spread to the other parts of the region. Pasuk and Baker argue in Chapter 5 that Thailand does not fit the so-called 'Asian model' of direct state intervention or labour repression. But it achieved almost similar results to others through the control of credit allocation by a few banks, Japanese FDI and exploitation of a large, resource-abundant rural sector. The relatively

peaceful transition to democracy also served Thailand well in coping with the crisis and responding to it. Pasuk and Baker examine economic, social and political impacts of the crisis, and express some concern about the continued urban bias in economic strategies. They highlight some of the cross-currents in Thai rural–urban politics. According to the authors, in the vision for the future, Thailand has two models to choose from: the Singapore model, with a dominant role for multinational corporations (MNCs), and the Taiwan model, where small local entrepreneurs play a dominant role. Pasuk and Baker argue that, although the Singapore model is preferred by many technocrats, it is not suitable for Thailand, with a large rural sector. According to them, Thailand has a very lively entrepreneurial culture and it should adopt the Taiwan model, which is also favoured by Japan, Thailand's main source of FDI.

Chapter 6, by Dhanani and Hasnain, argues that the marked slowdown observed in the Indonesian manufacturing sector and manufactured exports during 1993–7 was a consequence of shallow, export-led industrialization. As a result, the country reaped only some of the advantages associated with export-oriented industrialization, while suffering most of its disadvantages. The actual pattern of industrial development in Indonesia generated a number of structural as well as institutional weaknesses which dampened manufactured growth. These included a continuously high dependence on imported raw materials and components, low value-added generated in resource-based industries, a virtually non-existent capital goods sector, limited range in export products and markets, low-productivity small and medium industries, high market concentration in many segments of industry, weak human resources, a weak technology support system and weak manufacturing capabilities of domestic firms. Owing to these weaknesses, Indonesia ran a persistent deficit in manufacturing goods (\$5 billion per year) and an increasingly large deficit in the current account of the balance of payments (\$2 billion to \$8 billion) in the 1985–6 to 1996–7 period, which were offset by large inflows of private capital and external public borrowing. According to Dhanani and Hasnain, the structural weaknesses prevailing before the crisis will manifest again as the economy recovers, in so far as shallow export-led industrialization will once more produce a deficit in the balance of trade of manufactures. In this case, the constrained borrowing capacity of the public and private sectors that is likely to confront the country over the next four or five years will prevent the restoration of external payment balances maintained before the crisis. On the domestic front, in view of current trade liberalization, international competition as well as firm indebtedness, Indonesia is facing a real threat of deindustrialization. Thus the authors argue that a new strategy is required for the 21st century which combines the benefits of trade liberalization, export orientation and that of

building the manufacturing capabilities of domestic firms, to enhance their competitiveness and resilience in the export as well as domestic markets. Since domestic firms have to undergo an arduous and risky process of learning to catch up with best international technological and business practices, a path fraught with market failures, liberalization alone will not ensure their competitiveness. The chapter calls for a changing role for government, complementary to the market, to facilitate this learning process.

Rasiah (Chapter 7) maintains that some structural weaknesses of the economy were mainly responsible for the crisis in Malaysia, although it was triggered by a sudden withdrawal of foreign portfolio capital. Among them were skill shortages, inadequate R&D support and a lack of coordination to support complementarities of industries. The lack of transparency and accountability in both political and economic spheres contributed to the build-up of these weaknesses. Although unorthodox policy experimentation with capital control and expansionary policies in defiance of the IMF dictum have succeeded in halting the decline and eventually returning the economy to a positive terrain, Rasiah expresses concerns about complacency. He fears that, with the resumption of growth, some old practices of patronage and corruption may have re-emerged. Rasiah argues that, unless the judiciary is given more authority and is made independent of the executive branch of the government, the legal instruments created for transparency and accountability could be compromised.

In Chapter 8, Lim maintains that the Philippines economy, the laggard, has been characterized by boom–bust cycles in the 1980s and 1990s. The Philippines' achievement in poverty and inequality reduction was not as impressive as in other Southeast Asian nations, and the crisis worsened the situation even further, especially for women, children and the rural sector. One of the worst casualties of the crisis, according to Lim, was the environment. The crisis came when environmental conditions had been deteriorating. The fiscal restraint affected many reforestation and conservation programmes. With the depreciation of currency, there is an added incentive for the mining and forestry industries to mine and log more intensively. The government lifted the ban on logging during the crisis in order to alleviate the problem through exports. Lim is not only critical of the IMF recovery package, he also finds the regional response inadequate. He argues that the Philippines has to improve its performance in the provision of a social safety net, protection of labour rights and management of conflicts. Although the Philippines achieved democracy, its polity is still dominated by the elite and lacks transparency. Lim also advocates an active stabilization role of the government in order to prevent boom–bust cycles.

Chia (Chapter 9) examines the strengths of the Singapore economy, which avoided the severity of the crisis. Political stability, social cohesion, a

highly efficient bureaucracy and a competitive economy served it well and provide a good foundation from which it can move into the 21st century. However, according to Chia, Singapore has to change its vision and modify of the 'Singapore Inc' model, where the state played a very critical role in creating entrepreneurs. Now that it has attained a critical mass of entrepreneurs, Singapore should be less risk-averse and more innovative. Risk-taking and innovation can flourish in a society which encourages open debate and questioning of the status quo. Chia does not offer any blueprint for achieving such a society, but hopes that, with the long and successful track record, the government and people of Singapore will be able to rise to the challenge.

Taiwan is the other East Asian miracle economy which was not overwhelmed by the contagion of the Asian crisis. In Chapter 10, Chen argues that, despite the frequent lumping of all East Asian economies into one so-called 'Asian model' of development, the Taiwanese economy has some distinctive features. Among them is the dominance of smaller firms as opposed to the big chaebols in Korea. The Taiwanese firms are also less leveraged. Taiwan follows a less activist industrial policy and supports private sector R&D. Chen argues that the maturity of the Taiwanese democracy also helped avoid financial mismanagement. According to him, liberalization of the political market or democratization reinforces rather than jeopardizes free competition in the financial market. Democracy has also constrained the operation of cronyism. These distinctive features helped Taiwan avoid the region-wide financial crisis.

The People's Republic of China, too, could avoid the Asian financial crisis. Dean (Chapter 11) argues that, although China was lucky this time round, it may not be so in the future, because its economic and governance structure still remains very fragile. He characterizes the Asian model of governance as a symbiotic relationship between government, finance and industry in a triangular fashion. Problems at any one corner of the triangle can easily spread to the others and destabilize the whole economy. According to Dean, China's industrial sector is still dominated by loss-making state-owned enterprises (SOEs), and its financial sector suffers from insolvency as it has to absorb the losses of SOEs. The loss-making SOEs are also one of the main causes of fragile fiscal deficits. Despite these frailties, China could avoid the crisis due to currency inconvertibility and related capital controls, reinforced by a heavily regulated domestic financial sector. However, China's capital account is increasingly becoming uncontrollable. Flows to and from Hong Kong and Taiwan are almost impossible to monitor. Moreover, as China joins the WTO, and allows the entry of foreign banks, the capital controls will slowly disappear. Thus, if China does not reform its SOEs, it will remain vulnerable to financial crisis.

In a provocative contribution, Leong (Chapter 12) claims that, at China's current stage of transition to a market economy, the optimal political system for China in the sense of maximizing economic growth will take a form different from the Western liberal democratic model. Democracy enhances economic development, but can also impede economic growth through distributive politics and populist macroeconomic policies. According to Leong, democracy is a more crucial determinant of economic growth in circumstances of high economic development, where 'inspiration' is more important than 'perspiration', than in China's current relatively low level. Therefore, in the long run, democracy should be a goal for China, for its capacity to improve the lives of the Chinese people, beyond what it can do for economic growth. Leong claims that marketization, rather than economic growth, is driving the process of political liberalization in China. Chinese success in economic reform to date has been due more to effective government than to democracy.

The last contribution (Chapter 13), by Hutson and Kearney, gives an overview of the burgeoning debate about the future role of the IMF in the proposed new international financial architecture. It begins by reviewing the main explanations that have been advanced for the onset and contagion of the Asian financial crisis. It discusses the role played by short-term capital flows, and how the IMF attempted to mitigate the crisis. Hutson and Kearney argue that the IMF's broadening of its loan conditionalities has led to increased politicization of the institution and reduced its effectiveness in managing future crises. They conclude that a thorough review of the IMF's articles of agreement ought to be undertaken, and that the institution should be moved out of Washington and rotated around the world's main financial centres.

NOTES

1. The clearest expression of this view can be found in Stiglitz (1998a). Other highly pertinent contributions include Stiglitz (1998b, 1998c). The term 'Washington consensus' was coined by Williamson (1990). The issues discussed in this chapter also bear the influence of Sachs (1998), Radelet and Sachs (1999), Krugman (1998a, 1999) and Bhagwati (1998).
2. Matthews (1968) provides a detailed account of how industrialized countries were able to have a fiscal surplus (or a small deficit) despite high expenditure prior to financial liberalization. In short, high levels of investment by the private sector, encouraged by a public sector commitment to growth and employment, resulted in healthy fiscal balances and relatively small current account deficits.
3. The concept of unfunded government liabilities – created by the implicit and explicit guarantees of the government to finance possible defaults of private sector indebtedness – has become a major issue in the wake of the East Asian crisis. In 1997, contingent government liabilities for the crisis-affected East Asian economies fell in the top decile for a sample of 46 developing and developed economies. See Polackova (1999: 4).
4. Stiglitz now argues for the need to forge a 'Post-Washington Consensus'. See citations on Stiglitz under note 1 above.

5. See *Journal of the Asia Pacific Economy*, 5(1/2), Symposium on Poverty, Economic Growth, Poverty and Income Inequality in the Asia-Pacific Region.
6. See Islam and Chowdhury (1997: pt 1, ch. 8). The most prominent advocates of 'Asian values' are Lee Kuan Yew, ex-prime minister of Singapore and Mahathir Mohammad, current prime minister of Malaysia. For a critique, see Lee (1998: ch. 4).
7. The sad case of the imprisonment of Anwar Ibrahim in Malaysia, at one time the heir-apparent to the mantle of prime ministership, by a Mahathir-led faction in government simply highlights the problems of a 'semi-democratic' regime.
8. See interview with a leading Chinese dissident (Cao Siyuan) in *Newsweek*, 21 June 1999, p. 66.
9. Sen (1999:20) has been the most influential advocate of shifting the focus of development from a "hard" view of development to a more "people-friendly" approach'.

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