Introduction: Northeast Asian economic development: which way now?

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Setting the context

In 1983, the Nobel Laureate Amartya Sen, posed an important question. ‘Development’, he asked, ‘which way now?’¹ At the time, ‘traditional development economics’, as Sen put it, was under attack from economists with conservative proclivities. They admonished policy-makers in the developing world for adhering to the ‘dirigiste doctrine’ – a doctrine that held sway since the end of World War II. Based on the notion that the state should be the engine of growth, policy-makers in many developing economies adopted import-substituting industrialization as the path to self-sustaining growth, and generally intervened in both product and factor markets quite extensively. Often, elaborate five-year plans were drawn up to underpin a state-led strategy of industrialization.

Against the background of a turbulent international environment in the 1970s and early 1980s, characterized by oil price shocks, worldwide inflation and external debt crises, conservative economic thinkers wanted to liberate the developing world from the ‘poverty of development economics’.² They enunciated a brave new world in which the private sector rather than the state, and export orientation rather than import substitution, would be the key drivers of growth. A small group of countries in Northeast Asia, most notably Singapore, Hong Kong, Taiwan and South Korea, were often held up as rare exemplars that managed to go against the prevailing influence of the dirigiste doctrine since the 1960s and earned the enviable distinction of being some of the fastest-growing economies in the world. More importantly, they became showcases of ‘shared growth’; that is, of rapidly growing economies exhibited by sharp reductions in poverty and relatively low levels of inequality. There was a firm conviction among critics of dirigisme that Northeast Asia was the wave of the future and the iconic exemplar of a paradigm shift in development thinking.

When Sen reflected on the troubles of traditional development economics, a paradigmatic shift in developing thinking was indeed underway. In 1980, the Bretton Woods Institutions launched their ‘structural adjustment lending’ (SAL). The purpose of SAL was to use concessional lending to bring about a change in development strategy so that the developing world at large would converge to the Northeast Asian standard of private-sector-driven, export-oriented industrialization. Between 1980 and 1998, close to 1000 SALs were launched.³ The new thinking on development policy was codified in 1990 as the ‘Washington Consensus’,⁴ representing a set of ‘best-practice’ policies. The policy mantra invoked the trinity of macroeconomic stabilization, privatization and liberalization.

As the 1990s progressed, the evolution of development paradigms became more complex. In 1993, the World Bank offered its paean to the ‘Northeast Asian miracle’.⁵ To the original list of four Northeast Asian stalwarts was added a longer list of Southeast

Asian economies – most notably, Indonesia, Malaysia and Thailand. By then, China had truly emerged on the global stage and competed with its Northeast Asian counterparts for the mantle of shared growth. Yet, the interpretation of Northeast Asian success became more eclectic. The World Bank recognized that the Northeast Asian experience did not fully conform to the policy mantra of the Washington Consensus. China was, after all, still one of world's pre-eminent communist states. Admittedly, it made a transition towards a market economy in 1978 and embraced export-oriented industrialization as well as foreign direct investment, but the state still loomed large over the Chinese economy. At the same time, a well-established literature on Northeast Asian political economy demonstrated that the state played a key role in driving the process of industrialization in the first-generation cases as well. This led the World Bank to declare that the synergistic interaction between the state and the market laid the foundations of shared growth in East Asia.

Within four years of the World Bank's celebration of the 'Northeast Asian miracle', a financial crisis swept the region. In mid-1997, massive outflows of capital from the region saw an outbreak of sharp falls in the exchange rate in a number of countries. Soon, financial crises mutated into a 'real sector' crisis, as some of the economies – most notably Indonesia, Malaysia, South Korea and Thailand – experienced the worst recessions in their recent economic history. Although all the economies have seen recovery and the resumption of growth, the euphoria surrounding the Northeast Asian miracle seems to have evaporated.

The 1997 financial crisis that overwhelmed some Northeast Asian economies also paved the way – along with other global events – for both a rethinking of the Northeast Asian model and a rethinking of the Washington Consensus.⁶ The very strengths that were attributed to Northeast Asian success, most notably the close interaction between the state and the private sector, now became liabilities and were scorned as the excesses of 'crony capitalism'. Both the Northeast Asian and the global development agenda seemed to move away from 'market fundamentalism' (as reflected in more strident versions of the Washington Consensus) to a form of 'institutional fundamentalism'.⁷ Defective institutions – or poor governance – were, its advocates argued, the source of the crisis, and institutional – or governance – reform became the new policy mantra for reinvigorating East Asian growth.

It is apt to ask: whither Northeast Asian economic development? Is the institutional fundamentalism an appropriate reconfiguration of both the Washington Consensus and the pre-crisis Northeast Asian model, or is it an overreaction that misunderstands both the sources of Northeast Asian success and the 1997 financial crisis? How does one account for the rise of China? What are its implications for Northeast Asia's future? These are crucial issues and their resolution is likely to play a major role in influencing the evolution of the Northeast Asian economies in the 21st century.

The rise of Northeast Asia: the pre-crisis years

Despite the hyperbole, the pre-crisis years of rapid growth, sharp reductions in poverty and relatively moderate levels of inequality witnessed in a number of economies in the Northeast Asian region were not a mirage. China, Thailand, Singapore and Hong Kong were among the top ten growth performers in the world between 1978 and 1994.⁸ Indonesia and Malaysia were among the top 20 fastest-growing economies between 1965

and 1985.⁹ A comparative historical perspective enables one to appreciate the scale of the achievements. For example, it took some of the rich countries of today – such as the United States and the United Kingdom – between 50 and 58 years to double their income. It took Japan 35 years to double its per capita income. By contrast, China and Korea doubled their per capita income in ten years.¹⁰

As noted, rapid Northeast Asian growth was juxtaposed with sharp reductions in poverty, prompting some observers to proclaim that the regional achievements represented the fastest reduction of poverty in human history. In 1975, 57.7 per cent of the population in Northeast Asia were poor (based on an international poverty line of US\$1 per person per day at 1985 prices). By 1995, the incidence of poverty came down to 21.2 per cent. In terms of all other indicators of social progress – life expectancy, infant mortality, basic education, literacy rates, etc. – the Northeast Asian economies outperformed many developing countries.¹¹

The analysis of Northeast Asian success should proceed on the premise of a distinction between ‘core’ and ‘non-core’ groups. The former pertains to the four ‘Asian tigers’ – Hong Kong, Singapore, Korea and Taiwan – that first came to worldwide attention for their economic achievements. Members of the non-core entail China and some of the populous Southeast Asian economies. In terms of living standards, level of technology, quality of infrastructure and human capital, these countries are some way behind the ‘club of four’ and have a lot of catching up to do. Projections made before the 1997 crisis suggest that the core group will have a per capita income ranging between US\$25 000 to US\$30 000 by 2025. Among the Southeast Asian economies only Malaysia might fall in that range. On the other hand, Indonesia, Thailand and China are expected to have a per capita income of approximately US\$10 000 by the target date.¹²

There has been a tendency among some analysts of Northeast Asian economic development to conflate the core and non-core groups. This has meant that explanations developed to explain the case of the core economies have, at times, been uncritically applied to the rest. Nevertheless, one could argue that some common attributes are shared by the Northeast Asian economies. Such similarities may be enunciated in the form of the following propositions:

- The Northeast Asian economies have generally been characterized by macroeconomic stability, thrift as reflected in a high savings rate, substantial investments in physical and human capital and the provision of basic infrastructure.
- An export-oriented industrialization strategy combined with significant reliance on either foreign capital (as in the case of Singapore and Malaysia) or imported technology (as in the case of Korea) drove economic growth.
- In some cases, such as Korea and Taiwan, favourable historical circumstances facilitated the take-off of some of the Northeast Asian economies. Salient examples include land reform and the massive inflows of US aid to these economies during the 1950s and early 1960s. Land reform in Korea and Taiwan contributed to relatively low levels of inequality. Studies show that there is a systematic correlation between rapid growth and an initially low level of inequality. This is largely due to the relative insignificance of growth-retarding ‘distributional politics’ in countries with moderate levels of inequality. The strategic benefits of US aid also should not be discounted. They engendered some degree of political and economic stability.

Furthermore, countries such as Korea and Taiwan were regarded as bulwarks by the United States against the spread of communism in Northeast Asia during the era of the Cold War. This meant that the first-generation exporters in the region had favoured access to US markets.

- Most of the Northeast Asian economies were also characterized by the prevalence of growth-promoting values. Several observers have attributed such values to the legacy of Confucianism. The latter – in its modern form – has entailed the virtues of thrift, diligence and discipline, respect for order and authority and an almost reverential attitude towards education. It is perhaps not surprising that, by 1960, the Northeast Asian economies had educational attainments that exceeded developing country standards. Thus, the necessary foundations existed for the nurturing of competent bureaucrats, risk-taking entrepreneurs and hard-working, disciplined, if docile, workers.
- Appropriate institutional arrangements – entailing close government-business collaboration – were key to the effective implementation of growth-promoting policies.

There was a time when the first-generation Northeast Asian success stories were simply seen as the product of a virtuous combination of ‘free trade and free markets’.¹³ The role of history, culture, politics and institutions were regarded as either unimportant or, at best, of marginal relevance. Largely because of the work of some regional specialists, this ‘naive neoclassical story’ is no longer regarded as a satisfactory explanation of the Northeast Asian miracle.¹⁴ There is now widespread recognition that growth in the core Northeast Asian economies has been state-led.

Debate persists on the extent to which an activist industrial and trade policy contributed to Northeast Asian economic development. Some authors maintain that the governments were able to ‘pick winners’ through a combination of selective protection and exposure to international competition. Others are less confident about the efficacy of such policies. While conceding that the policies of picking winners could have worked in the particular institutional context of Northeast Asia, the sceptics argue that these policies are vulnerable to a range of risks. For example, the support of loss-making industries might be driven by political expediency rather than a rational calculation of the ex-ante social benefits that could conceivably flow from productive investments in ‘infant’ industries. Trade policy interventions that are typically associated with Northeast Asia of the 1960s are incompatible with current international trading agreements. There is the risk of retaliation by major trading partners. Industries in the fast-moving high-tech sector are not easily amenable to government intervention.¹⁵

Given such concerns, and given the inherent difficulty of empirical verification of competing hypotheses, it is best to focus on the ‘policy fundamentals’ (macroeconomic stability, outward-orientation, rapid physical and human capital accumulation) and the institutional framework that drove Northeast Asian growth in the pre-crisis era.

The salient features of the institutional framework that lie behind the Northeast Asian miracle might be summarized as follows:

- a system of governance that shielded ‘technocrats’ or key policy-makers from the pressures of special interest groups – sometimes known as ‘technocratic insulation’;
- merit-based civil service with considerable in-house expertise in economic policy-making;

- close collaboration between the government and key representatives of the private sector through both formal and informal networks that facilitated information-sharing.

The existence of ‘technocratic insulation’ meant that economic and social policies could be pursued in the ‘public interest’ rather than being beholden to the sectarian interests of lobbies. A merit-based civil service meant that the administrative ability existed for the effective and timely implementation of key policies and the collaboration between the government and key business groups for the creation and sustenance of a common national vision that underpinned rapid growth.

Northeast Asia and the 1997 financial crisis: contested perspectives and controversial policy responses

As noted, events in mid-1997 transformed the Northeast Asian economic boom into a growth collapse in a number of cases. Equity prices and exchange rates plummeted to well below their pre-crisis levels. Korea, Malaysia, Thailand and Indonesia experienced steep recessions, while at times, poverty and unemployment rose sharply. There has, over the space of two to three years, been the recovery and resumption of growth, but in a number of cases, the boom conditions of the pre-crisis era are yet to materialize.

What went wrong in Northeast Asia? What are the lessons to be learnt from the painful experience? What lies ahead? An attempt to resolve these issues has spawned a sizeable literature. A comprehensive coverage is beyond the scope of this introductory chapter, but some broad observations are worth making.

First, there is the paradox of the ‘miracles’ that, almost overnight, became crisis-afflicted economies. Here, the pre-crisis literature seems to be caught in an intellectual straitjacket. Recall that pre-crisis Northeast Asia was held up as a rare exemplar of macroeconomic prudence and a distinctive style of growth-promoting governance. It is now difficult for the cheerleaders to condemn these countries as victims of either unsustainable macroeconomic imbalances or crony capitalism. Yet, this is what some influential protagonists in the debate on the 1997 financial crisis tended to do without reflecting on the internal contradictions of such a position. Perhaps the most conspicuous is the case of the IMF and the role that it played in dealing with the crisis-affected economies.

The IMF diagnosed the 1997 financial crisis as the twin products of unsustainable macroeconomic imbalances and institutional imperfections. The design of its initial rescue package bore the imprint of such a mindset. The IMF recommended sharp fiscal contractions and substantial increases in interest rates to stabilize the exchange rate. At the same time, it proposed wide-ranging structural and institutional reform to rectify alleged deficiencies in the financial system, the corporate sector and public administration. The expectation is that this dual approach of attacking perceived macroeconomic imbalances and institutional vulnerabilities would win back the confidence of international investors, and engender a resumption of capital inflows that would, in turn, nurse the crisis-affected economies back to recovery. It is now recognized that the IMF package probably worsened the severity of the crisis.¹⁶ As the IMF notes, it did not anticipate that the region ‘was heading for a major economic slowdown’.¹⁷

It is possible to take a radically alternative view that the Northeast Asian crisis had little to do with internal causes. In this analytical framework, the 1997 financial turmoil was

externally driven by the particular way in which the global capital market functions. In an era of high capital mobility, 'hot monies' can typically move in and out of regional economies with breathtaking speed because of adverse shifts in investor sentiments. Such shifts can be entirely rational responses, reflecting a correct assessment of poor economic fundamentals, but can also be 'overreactions'. This can also be due to a number of factors, such as herd behaviour, or even an inaccurate appraisal of the underlying economic situation. In such a situation, regional economies can become the innocent victim of 'contagion' – or the notion that a financial crisis in one economy can spill over into another related economy, as nervous international investors pull out funds from a region and seek safe havens elsewhere. Some prominent economists have argued that the primary cause of the Northeast Asian crisis was indeed financial panic (or 'contagion' as noted above), driven largely by foreign investors. Hence, an approach that penalized national economies for the sins committed by others was fundamentally flawed.¹⁸

This alternative interpretation of the Northeast Asian crisis seems to have had some influence in shaping post-crisis developments. Global opinion has shifted from merely trying to engender reforms within Northeast Asia to reforming the international financial system as well. An important element of this initiative entails tighter checks on short-term capital flows across the world. At the same time, attempts have been made, and continue to be made, to foster greater regional cooperation across Northeast Asia on the premise that greater policy coordination and the pooling of financial resources can stave off the next financial crisis.¹⁹

One can, of course, craft a middle path between views that attribute the causes of the 1997 crisis to largely internal factors and views that interpret it as essentially an externally driven phenomenon. The notion that the crisis was simply driven by longstanding macroeconomic imbalances seems overstated. After all, the Northeast Asian economies were for decades before 1997 well known for their credible commitment to macroeconomic stability. These economies saved and invested at a very high rate – in the order of 30–40 per cent of GDP – but against a background of low inflation (usually well below 10 per cent) and relatively sound government fiscal positions.

However, in some cases, a favourable internal balance (reflected in a sound fiscal position) has not been matched by a comparable external balance. One could argue that an inflexible exchange rate regime compounded this mismatch and intensified the problems of a slowdown in export demand for key exports of the regional economies (such as semi-conductors) that emerged in 1996. It is pertinent to recall here that most of these economies had tied their currencies to the US dollar. When the dollar appreciated 50 per cent against the yen, it led to a predictable loss of international competitiveness. This widened the trade deficit in many of the Northeast Asian economies and raised concerns about its sustainability. In the case of Thailand, for example, the current account in the 1990s approached 8 per cent of GDP. Furthermore, an increasing proportion of the external deficit was financed by short-term capital inflows. These developments prompted the Asian Development Bank (ADB) to speculate on the risks that lay ahead. Commenting on Thailand, it made the following remarks that in retrospect appear prophetic:

The current account deficit reached an historically high level . . . in 1995. Large capital inflows continued to cover the deficit . . . However, there was a change in the composition of capital inflows: portfolio and direct investment weakened while short-term inflows to the banking sector increased . . . This heavy reliance on foreign saving is of . . . some concern as a sudden change

in the international perception about the soundness of the Thai economy could cause serious difficulties.²⁰

When a heavy reliance on foreign saving is combined with weak financial regulation, the net effect can be deleterious. As Joseph Stiglitz has emphasized, the juxtaposition of large-scale capital inflows combined with weak financial regulation:

allowed lenders in many Southeast Asian countries to rapidly expand credit, often to risky borrowers, making the financial system more vulnerable. In Thailand, for instance, banks and other financial institutions took large, short term dollar denominated loans from foreign lenders, then re-lent the money to fuel a domestic real estate boom and stock market speculation.²¹

Weak financial regulation in much of Northeast Asia is a reflection of a weak financial system that has been saddled with a significance of non-performing loans. In the past, rapid growth masked systemic weaknesses in the financial system, but they have become exposed because of increasing financial integration.

In sum, the contested perspectives on the causes of the Northeast Asian crisis and the controversy caused by the IMF-led policy response to it suggest a greater need to develop a much more nuanced understanding of the Northeast Asian model of economic development and its future evolution. Some of the proponents of the Northeast Asian miracle made an important contribution by highlighting plausible sources of shared growth and by debunking the naive view that these economies were iconic exemplars of free markets and free trade. They also did a disservice to the region by generating a sense of euphoria and by paying insufficient attention to putative macroeconomic and financial vulnerabilities that collided with the fickle sentiments of international investors in an era of rapid capital mobility. While it is an exaggeration to argue that the 1997 financial crisis was exclusively externally driven, attempts by some of the protagonists in the debate on the Northeast Asian crisis to interpret the event as the product of inherently internal weaknesses appear to be particularly troublesome. This view, as noted, is clearly inconsistent with the collective praise that was heaped on Northeast Asia's macroeconomic performance and its institutions during the golden age of growth. One must note that the very institutional frailties that some Northeast Asian economies are accused of are evident in China – and yet it did not become a victim of the 1997 financial crisis.

Despite these concerns, it is important to appreciate that the financial crisis and its aftermath enable one to focus on some long-term issues that remain highly pertinent in projecting the likely evolution of the Northeast Asian region in the 21st century. This forward-looking discourse represents the purview of the next section.

Transcending the crisis: long-term issues and the future of Northeast Asia

In moving forward in this discussion on Northeast Asia and its future, the following propositions may be highlighted:

1. Growth in the region appears to be primarily input-driven, not productivity-driven, raising concerns about future growth.
2. Inequality has re-emerged as a significant social issue in the region.
3. The protection and management of the environment has received insufficient attention in Northeast Asia. This could become a barrier to sustainable growth.

4. The rise of China has caused considerable ambivalence in the region and has brought to the fore longstanding issues about the development of broad-based political and social institutions and their relevance to respond to the challenges of the future.

Input-driven vs. productivity-driven growth

Paul Krugman is perhaps the best-known and provocative advocate of the view that growth in Northeast Asia may dissipate permanently – in the same way that rapid industrialization in the ex-Soviet Union came to a halt. As he puts it: ‘Asian growth, like that of the Soviet Union, in its high-growth era, seems to be driven by extraordinary growth in inputs like labour and capital rather than by gains in efficiency’.²²

Krugman offers the logic of elementary economics to substantiate his apocalyptic predictions. Thus: ‘Economic growth that is based on expansion of inputs rather than on growth in output per unit of inputs, is inevitably subject to diminishing returns.’ Hence, ‘input-driven growth is an inherently limited process’.²³

The much-cited and controversial contribution by Krugman relies heavily on a very few ‘growth accounting exercises’ that aim to isolate the sources of growth into ‘factor-driven’ and ‘productivity-driven’ components. Yet, the growth-accounting exercises are notoriously sensitive to changes in datasets and parametric manipulation. Others have produced rather different results and, in many cases, quite optimistic results.

Kenneth Kasa proposes an alternative approach. He focuses on a measurable notion of dynamic efficiency at the national level: if gross investment exceeds gross capital income (profit, rental and interest income) ‘then the financial sector is draining resources from the economy. This is inefficient, since the whole point of investment is . . . [augmenting] future consumption possibilities’. A dynamically inefficient economy, Kasa argues, is unlikely to be characterized by high productivity growth. Applying this method to Singapore using the 1975–95 data allows him to suggest – or at least does not allow him to rule out the possibility – that Singapore is over-investing and is not dynamically efficient. The IMF has also applied this criterion to Korea and come up with similar conclusions.²⁴

In sum, the Krugman hypothesis can by no means be dismissed, although it is difficult to support it conclusively. Yet, by engaging in a provocative discourse on the need to shift to productivity-driven growth as the only effective insurance against long-term economic slowdown, Krugman has certainly asked the right questions.

The re-emergence of inequality in Northeast Asia

As noted, pre-crisis Northeast Asia was hailed by many commentators as a rare example of ‘growth with equity’. New evidence compiled by several scholars suggests a less optimistic picture. As one author observes:

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.²⁵

The phenomenon of growing inequality in a number of Northeast Asian economies became discernible in the 1980s. A scrutiny of the available evidence for that period suggests the following trends:

- Inequality rose sharply in Hong Kong (1980–91), Singapore (1980–89) and Thailand (1980–90).
- Moderate increases in inequality occurred in Indonesia (1987–93).
- Inequality remained either constant or declined slightly in Korea (1980–88), Malaysia (1979–88) and the Philippines (1986–99).²⁶

Other observers have also highlighted cases of growing inequality in Northeast Asia. Focusing on the case of China and Thailand, one writer notes that they bear the unenviable distinction of registering one of the highest increases in inequality in recent decades.

What has happened since the 1980s? The evidence is mixed. Data for the 1990s indicate that inequality in Hong Kong and Taiwan appears to have improved. In South Korea, inequality declined until 1993 and rose thereafter. The evidence for Singapore is mixed, with one set of estimates showing a decline in inequality and another showing widening disparities. The evidence also shows that, while the 1997 financial crisis paradoxically led to a reduction in the shares of the top income groups in Southeast Asia (the ASEAN-4), emerging trends indicate a rise in inequality since then.²⁷

Most of the studies cited so far report findings based on the well-known Gini ratio. One study uses an alternative index – the Theil index – to decompose trends in inequality between 1990 and 1997 into a ‘between-country’ and ‘within-country’ effect for eight Northeast Asian economies (China, Viet Nam, Thailand, South Korea, Philippines, Malaysia, Laos, Indonesia). With the exception of South Korea, inequality – based on the Theil index – rose in all the countries that were reviewed, signifying the importance of intra-country inequality as a key component of Northeast Asia-wide inequality. Not surprisingly, inequality in the region as a whole rose between 1990 and 1997. Given China’s large weight in the regional economy, the sharp increase in inequality in China – which doubled between 1990 and 1997 in urban areas – played the most significant role in the increase in inequality in Northeast Asia in the 1990s.²⁸

It appears that inequality may well be emerging as a significant social concern in the future of the Northeast Asian region. As Francois Bourguignon has noted, growth, poverty and inequality represent the ‘eternal triangle’.²⁹ Higher growth leads to lower poverty, but this can be offset by growing inequality. At the same time, rising inequality runs the risk of triggering growth-retarding effects. This can happen in a number of ways: by adversely affecting social cohesion and parity of opportunities; by lowering productivity and efficiency as scarce resources can be diverted into inefficient redistributive policies; by reinforcing credit constraints in a context of imperfect credit markets that impair the capacity of individuals in unequal societies to finance much-needed investments in human capital. In sum, policy-makers in post-crisis Northeast Asia can no longer seek comfort from the somewhat outmoded notion that the inequality does not matter as long as growth takes care of the problem of poverty. The eternal triangle of growth, poverty and inequality cannot be neglected.

The state of the environment in Northeast Asia

It is generally agreed that the Northeast Asian region has a poor record in terms of a range of environmental indicators. As the ADB notes: ‘For far too long, Asian policy-makers ignored the environmental impact of rapid growth. Concern about pollution or degradation was simply not a priority’.³⁰

A UN agency has recently released a major audit of the 'state of the environment in Asia'.³¹ The report assesses the health of the environment by monitoring overall conditions and trends in air quality, freshwater supply, forests and land resources, biodiversity and marine and coastal resources. The audit concludes that the air pollution is unacceptably high, leading to continuing deleterious effects on health and mortality rates. In the cities that were reviewed, over 50 per cent had incidence of air pollution that exceeded WHO standard limits. There is evidence of growing water scarcity and contamination by nitrates and heavy metals. Significant land degradation is evident due to agriculture and deforestation. The region also contributes significantly to the rapid global decline of biodiversity. There has been a dramatic decline in fishery resources and a continued degradation of coastal ecosystems. It is also important to note that, in the post-crisis era, some Northeast Asian economies decided to cut back on resources allocated to environmental protection measures as part of their fiscal adjustments.

Despite such grim statistics, there are some areas in which progress has occurred. There has been:

significant progress in establishing legislative and institutional frameworks for environmental protection. There has been a measurable improvement in urban air quality in some cities, slowed rates of forest loss, increased forest planting rates and considerable success in reducing ozone-depleting substances.³²

Yet, an emphasis on environmental protection, while a useful development, is by no means enough to cope with the unrelenting pressure on Northeast Asia's environmental carrying capacity unleashed by decades of industrialization and urbanization. A much more fundamental transformation is necessary in which the prevailing orthodoxy of 'grow now and clean up later' needs to give way to a 'green growth' development framework. The latter would entail policies and institutions that seek to alter fundamentally the way Northeast Asian societies produce and consume in order to attain sustainable growth. Whether the political will and the resources exist to bring about a transformation in the shift of the development paradigm remains to be seen.

The rise of China and its ambivalent implications

The rise of China in the last decades of the 20th century as an economic powerhouse has acquired mythical status. China strides like a colossus in export markets and acts as a magnet in attracting foreign investment. Rapid growth has been accompanied by historically unprecedented reductions in poverty. Given its large weight in the world's population, the 'China effect' makes the reductions in global poverty in recent years rather impressive, and lies at the source of so-called income convergence between rich and poor countries. China seems to have shed its isolation and insularity that characterized the Mao regime. Gone are the days of the chaotic Cultural Revolution. One is struck by a political leadership that is still wedded to the ideology of communism and yet prepared to selectively embrace the ethos of capitalism. China's coming of age in an age of globalization was marked by its accession to the WTO in 2001.

Despite such dazzling achievements, current discourse among China-watchers is characterized by a certain degree of angst. Will the Chinese economic boom last? How is the rest of Asia reacting to the rise of China?

In a recent issue of *Foreign Policy*, the prestigious Washington-based international affairs magazine, Mixin Pei has vigorously argued that the inability of the Chinese political leadership to make a democratic transition will fatally impair the Chinese 'economic miracle'.³³ The author maintains that China has graduated, at best, to 'neo-Leninism' from the traditional one-party communist state of the '50s and '60s. Under the traditional system, Chinese communism was essentially a one-party rule, constrained by Mao's personal authority. The country was isolated from the global economy and pursued an anti-Western foreign policy. Internally, there was a firm commitment to egalitarianism. Private wealth was divorced from political power. There was strong state support for health and education as well as support from workers and peasants. Yet, the state relied on mass terror and repression to sustain its authority, while cultivating a vengeful anti-elitism that persecuted intellectuals and entrepreneurs.

Contemporary China, Pei argues, is best described as 'neo-Leninist'. It is still a one-party rule, but constrained by rules and procedures. The self-imposed isolationism has been replaced by an open trade and investment regime, most notably since 1978, but with firm state control of key industries. The state still controls 56 per cent of the country's industrial assets and is responsible for 70 per cent of GDP. The anti-Western foreign policy of the past has been replaced by pragmatic diplomacy. Unlike the Mao era, there is dwindling state funding for social services. The anti-elitism has given way to a culture that actively flatters and co-opts elites and seeks support from technocrats, the military and the police. There is selective targeting of political opponents. What is most conspicuous is the monetized corruption on a grand scale spurred by a wealth creation process that relies heavily on political connections. The predictable outcome is a sharp increase in income and wealth disparities. Pei claims that 1 per cent of Chinese households control 60 per cent of the national wealth.

There are also concerns about China's heavy reliance on foreign investment. One study notes that, in the absence of FDI inflows, Chinese economic growth would be 3–4 per cent lower.³⁴ This means that if FDI inflows reach a plateau, Chinese growth will be adversely affected. This will in turn affect the legitimacy of the Chinese political leadership. Indeed, the Chinese ruling elite currently have to contend with growing dissenting voices with a distinct anti-FDI tone.³⁵ These nationalist stirrings, combined with concerns about sharp economic disparities, represent threats to the durability of the Chinese political class. How will these tensions be resolved over time?

A well-established view in the democratic transitions literature is that growth spawns a middle-class that in turn sows the seeds of political pluralism. Paradoxically, argues Pei, 'China's economic growth is having the perverse effect on democratization: It makes the ruling elite even more reluctant to part with power'.³⁶ Rapid growth lends legitimacy to Beijing and puts less pressure on the ruling elite to engage in any significant political liberalization.

Of course, other scholars contest Pei's pessimistic prognosis. They note that dire predictions about an impending Chinese implosion have often been made in the past, but they have yet to materialize. Admittedly, there is a dark side to Chinese-style capitalism, but this grim view overlooks the ability of the Chinese political leadership to make tactical adjustments and respond to emerging social concerns. Such pro-China scholars argue that there is now a more 'balanced regional strategy' to offset the obsession with a highly iniquitous coastal development. One can also detect a more 'populist approach that seeks

to protect the interests of farmers, migrant workers, the urban unemployed and other vulnerable social groups'.³⁷ More importantly, the 'peasant apartheid' system (instituted through the urban household permits) that seriously curtailed the free movement of people between rural and urban areas is scheduled to be abolished. These changes both in strategy and philosophy might appear modest, but they are in effect monumental, given the political leadership's prolonged obsession with economic growth.

Others have argued that the comparative and historical evidence on democratic transitions point in the direction of largely peaceful change in the Chinese political economy.³⁸ Ex-communist states in Eastern Europe have made a successful transition to democracy over the past decade. Within Northeast Asia, there is also the inspiring case of Indonesia that graduated from a highly centralized and authoritarian political system to a reasonably well-functioning democracy within a relatively short span of time. In the late 1980s, highly authoritarian states, such as Korea and Taiwan, have also engaged in a successful democratic transition. There is no reason why China should be an exception to such political transformations.

The current debate over China's future is a particular manifestation of the broader debate on the role of institutions in economic transformation. To the 'institutional fundamentalists', self-sustaining growth is not possible without a deeply embedded set of liberal democratic institutions. As Dani Rodrik points out, this thesis suffers from a serious flaw. It describes an idealized state of development without explaining how one approaches such a state. Furthermore, growth take-offs are typically triggered, as in the case of China, with minimal institutional reforms tailored to country-specific circumstances that remove some binding constraints on growth. It is neither necessary nor desirable to engage in comprehensive institutional reforms that seek to replicate OECD standards and norms of institutional development. Indeed, it is important to appreciate the need for alternative institutional configurations that can engender standards of good governance, such as transparency, accountability and responsiveness to social concerns.³⁹ China, as in the case of the rest of Northeast Asia, will need to engage in local experimentation and adaptation to find the appropriate mix of institutions (that may or may not approximate OECD-style, liberal democratic norms) that will enable the country to attain sustainable and equitable growth.

The rise of China has also caused ambivalent reactions among its Asian neighbours, most notably low-wage economies in Southeast Asia. Ben Anderson makes the intriguing observation that China's isolation under Mao provided the critical space for a Southeast Asian economic miracle to ensue, but ironically, China's embrace of globalization now constrains the capacity of Southeast Asia to sustain its rapid growth through exports and foreign investment. As Anderson put it:

The Maoist project of building a mighty, autarchic, socialist economy outside the global capitalist order, reinforced for a long-time by an American-orchestrated trade embargo, kept China from playing a significant role in, or competition with, Southeast Asia until the mid-eighties. Only then, under the regime of Deng Xiaoping, did the Middle Kingdom . . . start attracting huge investment from America, Japan, the EC, Taiwan and even South Korea. In the nineties, therefore, China was finally in a position to outcompete Southeast Asia in manufactured exports, *a situation which seems certain to continue indefinitely* [emphasis added].⁴⁰

Is the rise of China, then, a 'zero-sum' game, in which Southeast Asia is expected to end up on the losing side? The Anderson hypothesis seemed to find resonance even in

economic modelling studies undertaken by the World Bank and others. Not surprisingly, politicians and academic commentators in Southeast Asia are concerned about such a development. A more recent analysis using trade and investment data by John Ravenhill suggest that such fears are probably unfounded.⁴¹ FDI to Southeast Asia fell in the post-crisis period, but this reflected the aftermath of the 1997 financial crisis and country-specific factors rather than an 'investment diversion effect' created by the presence of China in world markets. FDI inflows are not necessarily extracted from a fixed pool of capital: if more goes to X, it does mean less goes to Y. FDI inflows to China are not also exceptional when one takes account of its market size. It appears that FDI inflows are exaggerated and reflect 'round-tripping'; that is 'Chinese flight capital returning home or foreign investors bringing back to China some of the profits they have made elsewhere'.⁴²

An examination of trade flows suggests that Chinese exports are supplanting ASEAN exports to the United States, EU and Japan. On the other hand, ASEAN exports to China are increasing. This suggests the emergence of a regional division of labour in which China procures components from its Southeast Asian neighbours to feed its 'value chain', which serves key export markets in the OECD. This development, if sustained over time, augurs well for the consolidation of an East Asian economic community. Nevertheless, challenges remain in which Asia's two giants, Japan and China, are embroiled in low-intensity political bickering, despite durable bilateral economic relations. The prickly political relationship between China and Japan reflect historical animosities tied to Japanese militarism before World War II. While anti-Japanese sentiments run high in China, Japan, for its part, is keen to play a more assertive role in international affairs and is unlikely to allow its role as a regional leader to be eclipsed by a rising China.⁴³ Only time will tell how the Sino-Japanese relations will evolve over time and how it will affect the project of a Northeast Asian economic community.

Concluding comment

This wide-ranging discourse on leading issues in Northeast Asian economic development has sought to make sense of the stunning economic performance of Northeast Asia in the pre-crisis period. It has reflected on the causes of the 1997 financial crisis and has offered a prognosis of Northeast Asia's evolution since then. The so-called Northeast Asian 'economic miracle' was celebrated by the Bretton Woods Institutions in 1993, but within four years of such a celebration, the 1997 financial crisis erupted and led to a remarkable transformation in the economic fortunes of some of the most rapidly growing countries in the world. What struck many observers in the pre-crisis period was the existence of 'shared growth', namely, rapid growth combined with sharp and sustained reductions in poverty and relatively low levels of inequality.

Initially, the literature that focused on this phenomenon regarded Northeast Asian success as largely the product of free trade and free market policies. Over time, this interpretation gave way to a more 'institutionalist' approach in which the shared growth of Northeast Asian economies could be attributed to an amalgam of favourable initial conditions, macroeconomic prudence, rapid capital accumulation, a unique Northeast Asian-style governance (that combined technocratic insulation with close government-business relations) and activist industry policy geared towards supporting domestic firms that served export markets.

The 1997 crisis dented the credibility of the institutionalist framework. It led to an unfortunate tendency among the international pundits to re-invent the causes of the pre-crisis miracle as the causes of the crisis. Thus, Northeast Asian-style governance was now seen, at least from the perspective of powerful external agencies entrusted with the task of dealing with the crisis, as a case of 'crony capitalism' and macroeconomic imprudence. The IMF-led rescue package in late 1997 bore the hallmarks of such a mindset. The IMF interventions left the region with ambitious policy and political agendas that emphasized macroeconomic conservatism and large-scale structural and institutional reform in order to improve the quality of governance. The presumption that the crisis was largely the product of internal deficiencies remains influential even a decade after the crisis. The economies of the region have recovered from the trauma of the 1997 crisis, but one can detect a sense of uncertainty about the future. Were the victims of the crisis primarily responsible for their victimhood and must they now atone for their sins with large-scale institutional reform?

In retrospect, the 1997 crisis was probably a combination of external and internal causes. Externally, the experience of the Northeast Asian economies testify to the risk that global capital markets can be subject to herd-like behaviour unleashing capital flights, regardless of the behaviour of policy fundamentals. At the same time, years of rapid growth probably made policy-makers complacent and led them to overlook frailties in financial markets and putative external imbalances that were exacerbated by fixed exchange rate regimes.

The rapid growth of the past and the collective praise that was heaped on the region by the cheerleaders of the Northeast Asian miracle also provided insufficient incentives to subject these economies to a closer scrutiny of some of the long-term challenges that they faced. One possibility is that long-term growth in the region could be constrained by lack of productivity growth. Admittedly, a medium-term priority is the resumption of investment on a scale significant enough to boost the recovery, but over time, productivity-driven growth is the key to durable improvements in living standards.

The Northeast Asian economies were lauded in the past for their egalitarian distribution of income, but rising inequality is an emerging social concern that cannot be overlooked. In particular, the notion that rapid growth alone will take care of poverty is no longer an intellectually tenable position. The point is, growth, poverty and inequality represent the 'eternal triangle'. Rising inequality can paradoxically undermine both growth and poverty.

The most recent audit of the state of the environment in Northeast Asia by a UN agency reveals a grim picture of a region where rapid growth, industrialization and urbanization have placed relentless pressure on air quality, fresh water supplies, biodiversity, land, marine and coastal resources. Admittedly, there is a greater degree of consciousness about environmental problems among governments of the region and there is evidence of some improvements. Nevertheless, a mindset of 'grow now, clean up later' has to eventually give way to a fundamental transformation in development paradigm, in which environmental concerns are placed at the core of a growth strategy.

Finally, it would be fair to say that the literature on Northeast Asia has been preoccupied with understanding the economic miracle in the pre-crisis period and to make sense of the ramifications of the 1997 financial crisis. Yet, the challenges facing Northeast Asia's future are likely to be shaped by China, Asia's new giant and one that has so far remained

unaffected by the 1997 financial crisis. Despite this, and despite its stunning economic success, China-watchers are divided about the country's future. At the same time, the rise of China has caused latent tensions among its neighbours. Can China, with its inimitable brand of communism and selective embrace of capitalism continue to stride like a colossus on the global stage, or will it implode under the weight of its highly imperfect political institutions? Optimists believe that China can navigate a prosperous future within its current framework as long the political leadership is flexible enough to make tactical adjustments to its economic and political strategy to respond to emerging social concerns, such as rising inequality and the need for political pluralism. Others are worried that China's future holds decay rather than democracy.

The current debate over China's future reflects in microcosm the debate over Northeast Asia's future. Does sustainable and equitable growth in the future depend on embedding a comprehensive range of liberal democratic institutions, or is this a case of 'institutional fundamentalism'? Some believe that development does not have to wait for the inauguration and consolidation of OECD-style institutions. Minimal reforms that alleviate binding constraints on growth, followed by local institutional experimentation that may or may not fully resemble liberal democratic institutions can go a long way towards meeting the developmental aspirations of many societies.

China's rise has raised concerns about the future of a Northeast Asian economic community. China's Southeast Asian neighbours are worried that the propensity of the former to attract foreign investment and to win export markets is occurring at their expense. Fortunately, recent data on trade and investment flows suggest that the rise of China is not occurring at the expense of others in the region. Despite this, there is another issue that can complicate regional cohesion. This stems from low-intensity political bickering between China and Japan that reflects innate historical animosities and barely concealed aspirations for regional and global leadership. Whether Northeast Asia's two giants will eventually collide or collude to foster a peaceful Northeast Asian economic community remains to be seen.

Notes

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