Beyond Market-Driven Development

Drawing on the experience of Asia and Latin America

Edited by

Costas Lapavitsas and Makoto Noguchi

Routledge studies in development economics

Beyond Market-Driven Development

For many years the countries of East Asia presented a challenge to the Washington consensus and were considered to be an alternative development paradigm because of their regulated economies, 'repressed' financial systems and interventionist states. However, the standing of East Asian capitalism suffered a severe blow in the 1990s due to Japan's stagnation and the region's financial crisis in 1997–8.

Beyond Market-Driven Development treads the unexplored theoretical terrain created by the simultaneous decline of the Washington consensus and Asian developmentalism, and analyses the comparative political economy of East Asia and Latin America.

Through the juxtaposition of countries in East Asia and Latin America, leading development economists analyse the impact of government intervention, institutional malfunction, social transformation and financial change as well as conflict and power on economic development.

This book will prove to be invaluable to students and academics of development economics.

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Preface

Beyond Market-Driven Development is concerned with neo-liberal globalization and its generally negative implications for economic development. The idea of the collection was conceived in 2001, and a Japanese version was published by Iwanami Shoten in 2003 with the title *Economic Development against Globalism*, edited by Makoto Noguchi, Makoto Sano and Hitoshi Hirakawa. From the beginning, the book was intended to be more than simply another theoretical critique of the Washington consensus, the core of neo-liberal globalization. The Washington consensus, after all, has been in decline for several years. It is now accepted, even within the circles of the World Bank and the International Monetary Fund, that successful capitalist development requires more than free markets and a minimal state.

The spur to producing the collection was given partly by the simultaneous decline of the alternative paradigm of development that is usually associated with East Asia. For years, the Asian countries of the Pacific Rim – Japan, Korea, Taiwan and several others – were considered to offer a challenge to the Washington consensus because their economies were regulated, their financial systems 'repressed' and their states interventionist. The success of East Asian capitalism in the 1980s and 1990s gave encouragement to a broad swathe of critics of neo-liberalism. But Japan's gradual descent into economic stagnation in the 1990s and the gigantic crisis of 1997–8 in East and Southeast Asia tarnished the image of success beyond repair. The turmoil into which Asian capitalism was thrown in the 1990s appeared to confirm the final end of the developmental state, following the earlier failures of Latin America.

Thus, the book had to tread the unexplored theoretical terrain created by the simultaneous decline of the Washington consensus and Asian developmentalism. This is a difficult and complex task, but the comparative political economy of East Asia and Latin America can offer rich rewards. The juxtaposition of several countries in East Asia and Latin America creates fresh scope for analysis of government intervention, institutional malfunction, social transformation and financial change, as well as of conflict and power in economic development. Several essays in this

volume, for instance, demonstrate the subtle and pernicious ways in which international organizations reproduce structures of power and exploitation across the world.

In a similar spirit, several essays show that there has been no convergence among countries participating in the world market during the globalization years of the 1980s and 1990s. On the contrary, divergence is inherent in capitalist development, partly because of institutional, social and historical differences between countries, and partly because of the sheer domination of international markets and organizations by some developed capitalist countries. The interests of developed countries can result in stagnation for the less developed, or even in reversal of previous successes. In less conformist times such phenomena used to be discussed under the rubric of imperialism. This term became very unfashionable during the brief ideological triumph of globalization, when liberal capitalism was proclaimed to be the destiny of humanity. But it captures important aspects of the current role of the USA, several European countries and Japan in the world economy.

The political economists who participated in this collection have brought to bear a variety of skills and fields of expertise. The soul of the project was Makoto Noguchi, who sadly died before the Japanese edition was published in 2003. Noguchi was one of those modern Marxist economists that Japan seems so good at producing. He was a graduate of Tokyo University, the *alma mater* of leading Japanese economic theorists and economic policy-makers. In Noguchi's university days, Marxist political economy dominated theoretical teaching at Tokyo University, in sharp contrast to the current ascendancy of US-inspired neoclassicism. One wonders if it is entirely a coincidence that those were also the days when the Japanese economy performed miracles.

Noguchi exhibited all the characteristic traits of the best contemporary Japanese Marxist economists: widely read and scholarly in his approach, familiar with mainstream economics, technically skilled and open-minded. He taught widely at several Japanese universities and published very extensively in Japanese. His main fields of interest included theoretical political economy, empirical analysis of contemporary capitalism, and the economic development of Asia. He brought a fresh eye to these topics as is evidenced by his contributions to this collection. Noguchi was also keen to strengthen international political economy and had started to become better known abroad. The current English edition is a tribute to this versatile economist, whose untimely death has weakened the front ranks of Japanese political economy.

Costas Lapavitsas
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June 2004

Introduction

Globalism and developmentalism

Makoto Noguchi

(translated by Mako Yoshimura, Professor of Economics, Hosei University, Japan)

The twilight of developmentalism

Development policies and economic systems of developing countries that seek to catch up with industrialized countries have come under intense criticism within the current policy regime dominated by neo-liberalism across the world. Neo-liberalism regards the failure of government as more serious than the failure of the market. As a result, the efforts of developing countries that seek to catch up through state-led development are mercilessly criticized by neo-liberals. Ulrich Beck, the German sociologist, defined globalism as the neo-liberal ideological belief that the world market will replace political activity (Beck 1999). Globalism in this sense has become a broad and deeply penetrating force emanating from the centre and reaching the periphery across the world.

Criticism by neo-liberals already started to gain irresistible power in the early 1980s. Development economics developed rapidly as an economic theory which provided a basis for developing countries' government intervention after the Second World War. However, even Hirschman, who contributed to forming the theory, published a troubling paper mourning the death of development economics and arguing that it could no longer play a dominant role (Hirschman 1981). Moreover, Lal (1983) emphasized the poverty of development economics which had hoped to become the economics of poverty. It was at that time that Thatcher and Reagan launched the neo-liberal reforms as a departure from Keynesianism.

When East Asia achieved rapid industrialization based on the policy of openness in the 1980s, its success was first seen as a result of neo-liberal policy. As it became known, however, that South Korea, Taiwan and Singapore, with a seemingly miraculous experience of high growth, had powerful governments that coordinated private corporation activities, the 'miracle' of Asia came to be regarded in the context of the developmental state or developmentalism (Deyo 1987; Wade 1990). The World Bank

Report, *East Asian Miracle* (1993), recognized the positive role of government in industrialization in East Asia, and took a step towards the view that associates the developmental state with East Asian development successes.

Nevertheless, the strong political reasons which supported developmentalism had vanished before the World Bank made its diagnosis. As a result of the end of the Cold War, the core capitalist countries lost the motivation to keep developing countries politically aligned with the West through development aid. Moreover, powerful economic reasons emerged which threatened the continuation of developmentalism. Accelerating financial liberalization eliminated borders that prevented speculative short-term capital movement. A global network emerged through the information and communication revolution integrating local regional financial markets all over the world into a global market. As a result, the developing countries, which need stable capital in-flows for sustainable development, faced more difficulties in controlling the in-flow of floating capital that aims at temporary speculative profit.

Thus, Asian developmental states and developmentalism, which seemed to have reached the pinnacle of success, now faced great difficulties. The end of the developmental state started to be preached and a new route to development, which goes beyond developmentalism, to be sought. In the years ahead we should see where these trends will lead developing countries.

The origin of developmentalism

The term 'developmentalism' is often explained with the concept of 'developmental state' introduced by Johnson (1982).[1] The basis of this concept is the initiating role of the state's industrial policy including the bureaucratic system which plans and carries out policy in the process of economic development. However, 'developmentalism' and 'developmental state' with similar meaning, are terms which had already been used broadly in Latin America.

For instance, according to Schneider (1999), *desenvolvimentismo* (developmentalism) was quite often discussed in the 1960s and the concept of developmental(ism) appeared in the late 1960s and the early 1970s in Brazil. As Schneider pointed out, Cardoso and Faletto (1979), whose original Spanish version was published in 1971, had a section on the *developmental state*. Peripheral economies have been placed under the control of core economies through their export sectors becoming integrated into the world market. These enclave economies have undeveloped industrial sectors which are supposed to focus on the domestic market. Thus, states intervene to promote industrialization with the participation of a middle class mainly consisting of bureaucrats and a new bourgeoisie, also relying on the support of workers. This is defined as the developmental state. This definition of the developmental state does not offer a precise distinction

between two contrasting aspects of developmentalism in Latin America.[2] On the one hand, the developmental state agrees with people's requests for increased consumption and maintains and even increases wages. On the other hand, it suppresses wage increases for the sake of future development assigning priority to capital accumulation over present consumption.

Sikkink (1991) considered this contrast and distinguished between developmentalism in Latin America and consumption-oriented populist policy. Developmentalism is carried out by a part of the industrial bourgeoisie and has followers among state technocrats. It comprises three elements: (1) import-substituting industrialization focused on expansion of the capital goods sector, (2) capital accumulation dependent on foreign capital, and (3) broad state intervention in the economy. The policies of the Kubitschek regime (1956–61) in Brazil and the Frondizi regime (1958–62) in Argentina are regarded as the typical model of developmentalism. Sikkink, however, considered that the origin of developmentalism could be traced back to the debate at the United Nations just after the Second World War. Sikkink insisted that the debate at the UN prior to the establishment of the Economic Commission for Latin America (ECLA) was vital, despite developmentalism in Latin America being usually linked to the discussion at ECLA, especially drawing on Prebisch's thought. Sikkink particularly stressed that development issues were closely linked with security interests. In other words, confrontation with socialism led the West to believe that aid for economic stability and prosperity was crucial for the security of the Western world and this brought about the Marshall Plan for Europe and Truman's Point Four Program for underdeveloped countries. The developmentalist model of the Kubitschek and Frondizi regimes was also strongly influenced by security considerations during the Cold War.

The view that seeks the origin of developmentalism in Truman's Point Four Program, published in his inaugural address, is repeatedly stressed in the critical discussion of development(alism) by members of the 'postmodern' school such as Sachs (1992) and Escobar (1995). For instance, Escobar (1995), placing his own work within the field of developmentalist research, focused on the Point Four Program's view of the Third World as 'underdeveloped' and its vision of creating copies of advanced societies in the Third World with the aid of capital and technology from advanced capitalist countries. In this sense, Point Four Program is the starting point of developmentalism as a field of discourse. Truman's address used the term 'underdeveloped' in this context for the first time, according to the explanation of the term 'Development' in Sachs (1992), and 'development' has been used as a term to symbolize US hegemony ever since. The 'postmodern' school claimed that 'development' led to underdevelopment, poverty, exploitation and oppression in the Third World, in the opposite direction of what was originally intended.

Developmentalism was the product of the Cold War and, therefore, was planned as a Western defence strategy against the socialist camp. It was a

programme of creating copies of Western European modernity in the Third World under US hegemony. If this is so, the role of developmentalism also ended with the end of the Cold War. This is the collapse of 'development in capital letters' referred to by Hart (2001). As a result, the 'post-modern' school refers to the age of post-development, advocates regional cultural differences and denies unitary control by the world market. Yet, strangely, the advocacy of globalism by the neo-liberals, who should be opposed to the 'post-modern' school, also sees developmentalism as an unsuccessful programme. Both sides condemn state-led development, although for different reasons.

However, on deeper reflection the critical perspective contained within developmentalism (which is also in opposition to neo-liberalism and post-modernism) reveals dissonant tendencies lurking within the development of capitalism, even if refracted, as Hart (2001) suggests. The advance of globalism, which seems to promote the end of states, brings a trend towards monistic control, on the one hand, and on the other, activates a strong movement towards pluralism and diversification. In other words, this is a movement of assimilation and dissimilation. When it is seen separately from the complex historical movement of globalization, the assertion of the trend toward monistic control of the world market appears as the ideology of globalism. And when it is placed in opposition to it, stressing differences, it becomes 'post-modernism'. However, even if post-war developmentalism has ended, the underlying problem has hardly changed, since capitalist development always goes together with regional inequality. Capitalism is a historical reality that always generates 'development' problems, including spatial inequality and strife. If, following Hart (2001), this is called 'development in small letters', the end of 'development in capital letters' leads to deeper problems of 'development in small letters' as capitalism evolves.

Globalization, inequality and diversity of development

Going back to Beck, globalization must be clearly distinguished from globalism. According to Beck (1999), globalization is 'the process through which transnational actors with various possibilities in power, orientation, identity and networks move among sovereign nation-states and undermine the basis of sovereign nation-states'. Therefore, globalization creates a transnational social space, but is also a process with multiple dimensions which is not made unitary by the movement of the world market. Globalization promotes re-evaluation of regional cultures and development of a third culture which is neither local nor that of a nation state. The multiple dimensions discussed by Beck refer to the logic of globalization that works in various forms and independently in the fields of economics, politics, culture, civil society, ecology, and so on. Even in the field of economics, globalization does not bring unification within a homogeneous world of

the market. Pressures towards assimilation certainly exist but economic globalization follows a complex course due to the effect of local systems, control mechanisms, customs, and so on. This is easy to comprehend as multi-national corporations move among nation-states and face different management practices in the economic field, thus being forced to generate a third culture of management different from both the host countries and the countries of origin.

Whether the capitalist world tends to reach a homogeneous market order as a result of its self-unfolding development is a very important issue in understanding the nature of capitalism and its history. Concerning this issue, not all Western mainstream economists believe in the simple convergence model of globalism. An early example was Alfred Marshal who discussed industrial accumulation and concentration in specific areas on the basis of the concept of increasing returns due to external economies. In his discussion, it is possible to recognize the theoretical expectation that regional capitalist development does not always proceed evenly. Krugman (1991) developed this view and indicated that the dynamics of regional specification of industries and core-periphery differentiation were endogenously generated through industrial concentration and demand concentration in specific locations. This model of uneven regional development claims that a company that seeks maximum profit should not disperse production sites but move from industry-heavy sites to dispersed consumption sites so that the returns due to external economics prove sufficient for industrial accumulation even including transport cost. Thus, it is noteworthy that mainstream economics has also made some attempt to recognize uneven development, usually discussed by the non-mainstream theories of development economics and economic geography.

Formation of the global network made possible by the information technology revolution has brought dramatic savings in the cost of physical movement as well as time.[3] Thus, geographical and spatial differences eventually lose their meaning and the view is often mentioned that uniform global development has become reality. According to Krugman's model, however, it is more profitable not to disperse production locations, but to concentrate on specific areas in the manufacturing sector with strong external economies as transport cost decreases. In other words, globalization has a tendency to promote regional centralization and polarization of industrial centres and peripheries, instead of decentralization of the manufacturing sector.[4] Yet, the factors which spontaneously cause geographically uneven development are not limited to the relations between external economies and transport cost. Krugman's analytical framework, based on neo-classical equilibrium analysis, is very narrow. As Harvey (1982, 1998) has suggested, the emergence of geographically uneven development is not the result of a corporation's choice of spatial equilibrium which achieves maximum profit. Geographically uneven development emerges as crises of capital accumulation are solved by forces that push

the spatial economy toward perpetual disequilibrium. In other words, as a corporation faces difficulties of capital accumulation within some specific regions, it not only tries to take advantage of existing geographical differences but also tries to create geographical differences so that it generates opportunities to gain new profit. Harvey emphasizes labour relations as a factor which restricts capital accumulation and shows that geographical restructuring of production sites could be a powerful means of restructuring labour relations.

Harvey's argument is useful in order to grasp the dynamics of contemporary geographically uneven development. The manufacturing capital of developed countries flows out not only because developing countries open their borders to foreign direct investment, but also because it tries to extract new profit by the use of low wage labour in the developing countries, thus avoiding the restrictions of labour relations and the burden of high wages in developed countries. The movement of labour from developing countries to developed countries is restricted. However, the outflow of productive capital, or the threat of outflow, forces developed countries' workers, who were protected under developed welfare states, to face competition from developing countries' workers (Noguchi 2000). Thus, contemporary geographically uneven development involves the deindustrialization of developed countries and the concentration of industrial locations in some newly emerging markets, instead of simply representing the movement toward increasing profit through industrial accumulation. It is rather the restructuring of space which reinforces the power of manufacturing capital relative to workers.

Nevertheless, the factors which stimulate geographically uneven development are not limited to labour relations in a narrow sense. There are manifold differences of social relations, institutions and cultures in the world, which afford corporations various possibilities to extract profit. According to Martin (1999), the process of regionally uneven development is that of perpetual progress not only with regard to quantitative changes, but also regarding great qualitative changes. Moreover, it is critical for the understanding of spatial economy to explain why uneven development emerges in the geographical location of institutions. When corporations with different national origins move among different nation-states, they face various spatial differences including among institutions and customs. These differences are not only those of legal restrictions, but also those of historical and cultural background, such as inter-corporation networks, intra-corporation organization, labour customs at work, rules of the labour market, relations between corporations and financial institutions as well as between corporations and the state. These differences could favour a corporation's profitability in some cases but not in others. Capital may positively utilize institutional differences when they offer advantages, such as low-wage labour, and conversely, may work on reforming institutions or altogether with-

draw when they offer disadvantages, such as institutions and social customs that are barriers to entry.

Thus, as capital globalizes in the contemporary age, a corporation creates various relationships with other corporations as well as with workers, financial institutions and the state in the national economies that it enters. There are complicated dynamics of institutional and cultural dissimilation and assimilation at work. It is not enough to observe the flow of goods to understand the effect of foreign investment on the local economy. Neither is it enough merely to consider technology or knowledge. When corporations with different origins move among national economies, new problems are created regarding, for instance, what kind of institutional system and what kind of spatial location a corporation chooses to adopt in its production system, what kind of adjustment mechanism is created between foreign capital and the national economic system, and so on. Friction can be caused by conflicts between different systems and cultures. Inter-state cooperative relations may be required among nation-states in order to extract the positive effect of industrial accumulation and to restrain the regional differentiation brought about by industrial concentration. It follows that globalization is neither a unified movement towards a homogeneous market world nor the road towards the death of nation-states. Instead, globalization requires perpetual redefinition of the meaning of system and borders of nation-states. Consequently, one increasingly important role for a nation-state is to prepare the institutional framework and to facilitate the restructuring of spatial economy.

The same holds with the relations between the financial market and the national economy. Because of the rapid progress of financial liberation and the revolution in the information network which involves developing countries, the financial markets of the world have become integrated and speculative funds instantaneously move across the world searching for profit and capital gains. Especially with regard to the capital market, newly emerging markets have developed in a remarkable way and made it possible for investors to invest in various kinds of bonds. Yet, it is interesting to note that the formation of the global financial network has brought about concentration of financial transactions rather than decentralization (Sassen 1999a). The creation of a global financial market does not imply the homogeneous development of the financial market.

As Sassen pointed out, financial centres such as New York and London are concentrated due to highly advanced information technology as well as due to the presence of market players with advanced knowledge who undertake complicated information analysis and risk management in international financial transactions. The information accumulation accompanied by the concentration of financial transactions produces an increasing volume of high-level financial services and more professional players are attracted to the financial centres. This cumulative process is similar to the profit-increasing mechanism of industrial accumulation which promotes

concentration of industrial sites as mentioned above. The creation of the global financial market does not always bring financial development that is appropriate for the economy of a newly emerging country, as Sassen also pointed out. Mass inflow of speculative funds might inhibit supply of long-term development funds and restrain financial development in developing countries.

However, it is noteworthy that the power of the global financial centres cannot eliminate the financial needs of the regional economy, and cannot exclude the possibility of variable development patterns in the regional financial markets. Uneven financial development makes it necessary for a national economy, especially for a developing economy, to consider what kind of institutional framework is required to reconcile the global financial market and the regional financial system. It is only nation-states that can take the lead in solving this problem.

Globalists and 'post-modernists' think that the historical role of developmentalism finished at the end of the Cold War with the accelerating globalization of production and finance. However, once again according to Hart (2001), 'development in capital letters' passed away but 'development in small letters' will survive. In so far as the development of capitalism is accompanied by geographical unevenness or spatial differences, development problems, which can only be confronted by states, are perpetually generated.

The state as intra-system coordinator

Did the developmental state reach its end when 'development in capital letters' exhausted its historical role? This problem is quite complicated. Today, the issues facing states in developing countries are on three levels. First, a sovereign state is by definition, a state with exclusive authority within its borders in international relations, following the Treaty of Westphalia. Contemporary globalization affects nation-state sovereignty and legitimacy in both developed and developing countries. Second, developing countries must confront the economic differences opened by geographically uneven development, albeit under the pressure of the global system which strongly restricts the autonomy of the nation-state. Third, relations between state and society are different between developing and developed countries. Developing countries must confront underdevelopment under a state system which is not necessarily separated from civil society.

The issue on the first level arises because nation-states are charged with the role of protecting the global activity of private capital, as Sassen (1999b) pointed out. Nation-states are required to protect private rights as international accounting standards, international commercial arbitration regulation, WTO rules, health and safety regulation, quality standards, and so on, emerge in the course of globalization. Accordingly, states are

called on to devise compromises between global capital demands and domestic institutions under the pressure of necessity. The design of these compromises often follows Anglo-American rules, thus making globalist convergence theory appear realistic.

However, this is only one side of the matter. With differing historical and cultural backgrounds as well as geographically different conditions, nation-states contain many economic sectors which cannot be left to global capital activities. Thus, introduction of rules which are regarded as international standards always present problems of coordination entailing friction and confrontations with the domestic system.

In particular, the role of inter-system coordination is important for developing countries. For instance, a developing country which enters the WTO regime will be subjected to pressures to compete on the same stage as developed countries, including prohibition of local content regulation (obligation of local supply of parts) and protection of intellectual property rights. Therefore, developing countries invariably face the problem of being unable to close the big economic gaps that separate them from the developed countries, if they accept the regulations of the global system. Thus, considering the second level problem of geographically uneven development, the leading role of the state is important to designing an institutional coordination framework and enforcing this framework in developing countries.

Moreover, states in developing countries have to face the third level problem of seeking a way of building internal relations with various actors, and thus acting as inter-institution coordinators. It is the political and economic task of a developing country that seeks to close the economic gap to set up a network around society to mobilize people in the development process and to coordinate different interests of various social strata, especially interests caused by complicated stratification within the agricultural sector (Evans 1995).[5]

The main component of post-war developmentalism was industrial policy and those responsible for it were bureaucrats. It was the same for Johnson's developmental state theory, which provided a basis for Japanese revisionists, as well as for the earlier Latin American developmental state theory. It is clearly true that developmental policy is incompatible with further liberalization of the movement of capital. Even when developing countries use foreign capital, protection policy to promote industry cannot be effective without capital controls. Industrial policy for development is designed to change the international division of labour since developing countries cannot accept the division forced on them by international capital competition. Thus, industrial policy should contain some restriction of capital competition as a pre-condition, whether policy is import-substituting or export-oriented. Globalization, in contrast, eliminates border barriers which prevent capital movement and seems increasingly to restrain industrial policy and technocratic–bureaucratic activities.

It certainly seems difficult for an individual developing country to regulate global capital activities. Moreover, neo-liberals severely criticize the very notion of industrial policy. Apparently, regulation promotes unproductive activities caused by rent-seeking and produces waste. Since the government and bureaucrats do not have more knowledge than the private sector, it is unlikely that state intervention will guide the private sector correctly. Today, this kind of view about state intervention is not only an ideology, but also a political regime in itself.

However, no one has tried precisely to compare what a developing country loses by leaving everything to the market with what it wastes through state regulation. Indeed, there is no difference between the government and the private sector as neither can know all about the future. What is critical is not what both commonly know but the perspective from which they assess what they commonly know. In the process of development, a state is required to take on the role of a coordinator that could make decisions with long-term and social aims, while the perspective of the private sector is to seek short-term private benefits (Chang and Rowthorn 1995). The private actor that seeks immediate profit might drive a developing country into a vicious circle of underdevelopment.

Although global competition could limit the scope of state power to act as coordinator, the way to break the vicious circle of underdevelopment depends on building an institutional framework of inter-state corporations transcending nation-states. Thus, while old-style industrial policy based on capital controls at the level of each state might have limited prospects, the potential of industrial policy in a broad sense is much greater within the international framework that includes regional corporations. In this sense, the death of developmentalism did not bring the death of the developmental state, but its transformation.

Contents of this book

This book, based on an examination of the huge historical change which has affected developmentalism and developmental states, shows that the advance of globalism, in opposition to the claims of the globalists, has not eliminated the possibility of diverse development paths and diverse economic systems. The book is divided into four parts comprising contributions from economists from the USA, Europe, Asia and Latin America, who have serious doubts about the approach of mainstream economics. All the papers focus either on the potential instability or the conflicts within a market economy development process that are typically ignored by mainstream economics. The papers are part of an international joint effort that seeks to explore the new possibilities of development in the age of globalization.

This effort has shown that even under a neo-liberal policy regime or under a strong spillover effect from the Anglo-American capitalist system, developing countries never trace the same developmental path, but can

have diverse options. Although scope has been limited to the East Asian and Latin American regions, the discussions developed in the book can be applied to other regions or developing countries, including those which have been left out of the global financial flows.

The first part prises out the problems of mainstream analysis, which implicitly idealizes an Anglo-American type of economy, and presents a new analytical framework for an alternative development course. While reviewing the debate regarding the developmental state, Fine proposes a radical political economic direction which clarifies the development problem of modern capitalism. This is an alternative approach to the mainstream new development economics that studies the systems and practices of developing countries based on the methods of rational choice. Noguchi then shows that analysis of the East Asian crisis that is based on mainstream economics and the post-crisis structural reforms has brought about a warped understanding of the development process. By focusing on Asian corporate governance, the paper stresses the indispensability of an analytical framework that accounts for factions and adjustments between different institutions.

The second part discusses the processes through which instability, conflicts and unbalanced development were inflicted on the economies of developing countries through globalization promoted by international institutions, such as the IMF, World Bank and WTO, which disregard economic diversity and press for rules and systems that are mainly Anglo-American in inspiration. The Frenkel paper criticizes the role of the IMF which was very influential in the introduction and maintenance of the Argentine currency convertibility system. It gives an overview of 'another lost decade' of the Argentine economy which suffered economic instability and international fragility under an unsustainable foreign exchange system, eventually leading to the collapse of the convertibility system. The Kim paper asserts that Korea's future remains uncertain, although as a result of accepting IMF conditionality after the Asian currency crisis the country carried out severe restructuring of corporations, finance, labour and the public sector as well as shifting towards an Anglo-American free-market economy. The Aboites and Cimoli paper shows that the protection of intellectual property rights under the World Trade Organization regime has supported patent applications of multinational firms, but has also killed the incentive for Mexicans to apply for patent rights, thus leading to decline of indigenous technological creation.

The third part shows that while the advance of globalization has created a tendency toward instability and inequality, it has not necessarily led to convergence of economic development paths. The Jomo paper rejects the convergence hypothesis, stressing that even though neo-liberal globalization will continue to reduce institutional differences, an eclectic mix of the remaining differences will lead to a diversified system. The Marukawa paper suggests that the reason for the contrasting development paths

between the market transition economies of China, Russia and Eastern Europe lies in the difference between, on the one hand, a market policy without private ownership and, on the other, a policy of abrupt commencement of private ownership which is also evident in the peculiar evolution of public enterprises. The Sano paper cautions that the reversal of the 'Brazilian Miracle' from the end of the 1960s to the 1970s may be re-enacted in Asia, particularly China, which has achieved a seemingly miraculous development of the market economy under globalization. The paper also stresses the necessity of a 'Third Path' in Asia's development.

The fourth part considers strategies focusing on the financial field, to counter the neo-liberal policy regime that led to the Asian crisis. The Grabel paper proposes restriction of short-term capital flows in order to prevent financial crisis in the emerging market economies, while also showing that financial crises will occur frequently under a neo-liberal policy regime. Tracing the history of financial economic thought, the Lapavitsas paper shows that a bank-based system rather than a market-based system is more appropriate for the economic development of developing countries. The Hirakawa paper, finally, explores East Asian regional cooperation which is emerging in the fields of currency, finance and trade. It considers the possibility of East Asia achieving a stable economic development that precludes the re-occurrence of crisis and is independent of American hegemony.

The book seeks to provide a direction for political economy of development that opposes globalism. It presents new theoretical frameworks, alternative analytical methods of the development process, and counter-strategies that stress the possibility of diversification and coexistence of economic systems in developing economies.

Notes

1 In Japan, Murakami (1992) offered a unique interpretation that generalizes 'developmentalism' as one of two categories of industrialization along with classical liberalism, but the origin of his interpretation is also the definition by Johnson (1982).

2 This ambiguity shows that Cardoso and the others are essentially influenced by the developmentalism of Latin American structuralists with a strategy of 'redistribution compatible with growth' (Kay 1989).

3 The transformation of people's mode of interaction brought by the internet is evidently due to the dramatic expansion of the ability to communicate and deal with others without physical movement of the body or physical objects.

4 Krugman's model assumes that capital and labour move freely. In contrast to capital movement liberalization, the regulation of labour movement across national borders is still strong despite contemporary globalization (Noguchi 2000). Krugman's model concludes that regional uneven development would develop further as population would concentrate in the industrial accumulation locations, if the movement of labour was freed. Krugman's model suggests that when the development pattern is controlled by historical contingency, called 'channel-dependence', there are important implications for concentration of

production in specific locations, as in the situation referred to as 'lock-in' by Arthur (1994).

5 While Evans (1995) and others contend that a mechanism to embed state autonomy in society is a key to success of the developmental state, Corbridge (2001), in the tradition of cultural anthropology, puts forth a notion of the state which interprets regional cultural variety through its institutions and actions. These views are also necessary in order to examine relations between various societies and states.

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Part I

Theoretical framework

1 Beyond the developmental state

Towards a political economy of development

Ben Fine

Introduction

The state has always been at the centre of the study of development. This is not just because of its overwhelming importance but also because the way in which the state is understood is part and parcel of how the economy and development are conceived. Crudely simplified, development in the post-war period was first understood through modernisation, Keynesianism and welfarism, with socialist planning and Marxism as the alternative. This gave way to the neo-liberal Washington consensus in the 1980s, a developmental agenda of market versus the state, with the idea of the developmental state in opposition to the pro-market ideology of the World Bank and IMF.[1] The turn of the millennium has witnessed something of a reaction against the Washington consensus as it has been superseded, at least in rhetoric, by the post-Washington consensus. Meanwhile, far from progressing, the idea of the developmental state has also gone into decline following the Asian crisis of 1997.

The result is to open up the issue of development to more radical thinking, as is argued in the closing section of this paper, for matters are not so simple as suggested in the previous paragraph. In the next section, selectively drawing predominantly upon the most recent literature, it is argued that the developmental state literature can be divided into two schools, the political and the economic. Each of these was declining *prior* to the crisis of 1997. The political school had been forced to recognise the presence, for it the emergence, of powerful class interests. Its response has been to delimit the life of the developmental state to historically contingent opportunities for state autonomy. The economic school, on the other hand, as is argued in Section 3, has been analytically outflanked by the post-Washington consensus. The latter, too, suggests a limited life for the developmental state but for different reasons than for the political school. Development is about handling market, especially informational, imperfections through efficacy of the financial system and institutions such as the state. Consequently, the developmental state is limited to latecomer catch-up after which market imperfections are less

pervasive and intervention, as opposed to market regulation, less necessary.

The demise of the political school and the capture of the economic school by the post-Washington consensus will leave dissatisfied many of those who study development. As argued in the closing section, questions concerning the nature of contemporary capitalism as a system, and the role of classes and of conflict, appear to evaporate as market and non-market phenomena are reduced to the rationality of responses to market imperfections. As a result, there are bright prospects for radical political economy to contest the emerging orthodoxy.

The political and economic schools

In earlier work, literature on the development state has been interpreted through the prism of two distinct approaches or schools, the political and the economic (Fine and Stoneman (1996) and Fine and Rustomjee (1997, Chapter 2)). For the political school, focus has been concentrated on the nature and capacity of the state. In a nutshell, what is it that enables the state to adopt developmental policies *whatever they might be*? Kohli (1999, p. 94) recognises the mission of the political school in terms of the 'the prior question of *why* the South Korean state was able to do what it did'. Such is one way of interpreting Johnson's (1982) founding contribution to the literature, his classic study of Japanese late development. His implicit attachment to the political school is confirmed by his recent retrospective in which the decisive factor is perceived to be the relationship between the state and the private sector (Johnson 1999).[2] He reluctantly furnishes a model with four elements:[3] a small, elite top quality management within the state to select and promote industries, and to supervise competition; a political system which enables this; market-conforming methods of intervention; and an organisation such as MITI to effect implementation. Further, Johnson explicitly praises Castells's (1992, pp. 56–7) account of the developmental state, his definition having been widely cited by others:

> *A state is developmental when it establishes as its principle of legitimacy its ability to promote and sustain development, understanding by development the combination of steady high rates of growth and structural change in the productive system, both domestically and in its relationship to the international economy* . . . Thus, ultimately for the developmental state, economic development is not a goal but a means.

So the developmental state concerns political legitimacy with the economy as a sideshow.

For the political school, the passage from Johnson to the present has been marked, as in his initiating work, by identifying decisive *characteristics* of the state and/or the *mechanisms* by which it becomes develop-

mental. As previously argued in Fine and Stoneman (1996) and Fine and Rustomjee (1997), these factors have expanded to accommodate a widening range of empirical case studies, successes or failures that have not otherwise fitted comfortably within the narrower set of characteristics/mechanisms. Starting with its autonomy, it was found that the state could either be developmental or parasitical. Accordingly, it also needed, somewhat inconsistently, to be embedded. But then we enter a universe of qualifications and extensions – (relatively) autonomous and embedded in what ways and with whom? Thus, in pursuit of the democratic developmental state, White (1998) ranges over the following factors: consensus, institutions, political participation, authoritarianism, inclusion and exclusion, international environment, and social structure comprising class, gender, ethnicity, culture and religion.

Similarly, Chan *et al.* (1998a, pp. 1–4) add bureaucratic cohesion, depoliticisation, weakness and strength, efficacy, adaptability, networks and politics in all its forms (leadership choice, regime maintenance and interaction between economic performance and coalition formation). In the context of Japanese agriculture and national food supply, Francks (1998 and 2000) emphasises the importance of a dedicated bureaucracy, giving rise to a bureaucratic developmental state. For Koh (1997), Singapore's developmental state is attached to a mission-oriented bureaucracy. Drawing upon South Korean experience, Chibber (1999) insists that such a bureaucracy be of high quality and selective in its targeting. But ideology is also crucial for such bureaucracies, as is more general opinion formation in Marsh's (1999) account of Asian developmental states, with Williams (1997) arguing that the failure of developmental discourse to reach beyond an elite is crucial in explaining the failure of the Indian developmental state. Grabowski (2000) points to the importance of national identity. Indeed, p. 274 states:[4]

> The developmental state is not rooted solely in the existing economic and social structure, but also in the future social and economic structure. This has generally involved the building or rebuilding of the national economic identity.

The same issue is approached differently in terms of corporatism and consensus, central to Riain's (2000) and O'Hearn's (2000) debate over the Irish (flexible) developmental state in an era of globalisation. Xia (2000) perceives China as a *dual* developmental state, supported by both legislative and local political institutions, with structures at both central and local levels. Emphasis is placed on networks, with heavy analytical reliance on the transaction costs approach to the firm for understanding political hierarchy – 'although transaction costs analysis is a theory of the firm, it has utilities for our understanding of politics, international affairs, sociology, and law' (p. 9).

In short, the political school focuses on the politics of economic policy with little or no interest in economics as such. In contrast, the economic school is almost exclusively concerned with the necessity for economic policy at the expense of the political conditions that allow it to be identified and adopted. It is an approach to the developmental state that is inspired both by the notion of market imperfections and by an antipathy to neo-liberalism. It is aptly summed up in the catch-phrase associated with Alice Amsden of 'getting the prices wrong', although this is symbolic of a more general commitment to state interventionism, especially in industrial and trade policy and state control of finance. Although Amsden (1989) and Wade (1990) are best known as leading representatives of the economic school, the most prolific and wide-ranging contributor in this vein has been Ha-Joon Chang, not least because he has addressed both theoretical and empirical issues, especially as regards South Korea for the latter. Starting with Chang (1994), his work has covered most aspects of industrial policy, finance and 'cronyism'. For each, a clear case is made for the pervasive presence of market imperfections, the need for the state to intervene and correct or temper them, for the inappropriate perspective offered by the neo-liberal Washington consensus, and the latter's lack of correspondence to empirical realities.[5]

Ultimately, Chang has been drawn into emphasising the institutional preconditions for a successful developmental state as part of a more general theory or political economy of development itself (Chang 2000b; Chang and Evans 2000). This, however, merely pushes back the issue of political capacity one step. For, in part, the political school is concerned with what makes developmental institutions possible. The economic school begins where the political school ends. This confirms the division of the literature between the two schools, as has been neatly summarised by Cumings's (1999) simile of economic analysis as a spider without a web and of political analysis as a web without a spider. This opens the option of each school complementing the other. But, to belabour the metaphor, how do we know we have put the right spider in with the right web? The two schools only offer a neat fit in the vacuous sense of occupying analytical terrains that do not overlap. Each has progressed within the confines of its own territory: the political school by refinement with an expanding range of case studies and evidence, the economic school by widening the scope of what constitutes market imperfections and how they have or have not been appropriately handled.

The division between the two different approaches has, if anything, been accentuated by the Asian crisis of 1997. First, consider the political school. Because it tends to stand aloof from economic analysis as such, it is confronted most sharply by the analytical problem posed by the crisis – how is it that a developmental state has proven incapable of safeguarding itself against crisis, certainly of 1997 proportions? The school has offered a particularly ingenious answer, one that was already in place prior to the

crisis itself.[6] This is to argue that the developmental state is, by its nature, of limited duration. Specifically, it is confined to catch-up by latecomer industrialisers. As Moon (1999, p. 220) puts it:[7]

> The developmental state is a transitional phenomenon. It worked well in the earlier stage of economic development and industrialization. As national economies become more mature and sophisticated, the state becomes a liability rather than an asset.

The most significant factor in cutting off the life of the developmental state is that its success undermines its own conditions of existence. More specifically, most notably for Korea, the 'relative' 'autonomy' enjoyed by the state in its developmental phase gives rise to large-scale conglomerates, the chaebol, which eventually become too powerful to be subordinate to the state. From the created instrument of the state, large-scale capital comes into conflict with it (Lee 1997; Kim 1999). More generally, the developmental state induces other interests and demands upon itself as development raises the prospect of modernisation in a Western image.[8] As White (1998, p. 44) puts it, in the context of prospective democratic developmental states:[9]

> It is defined in terms which are potentially contradictory and difficult to achieve: autonomy *and* accountability; growth *and* redistribution; consensus *and* inclusiveness.

In addition, continuing or aspiring developmental states are, in token deference to intellectual fashions, taken to be subject to the constraints imposed by 'globalization' (Gereffi 1998; O'Hearn 2000), although Lee (1997) argues that there are limits on response due to weaknesses in internal financial and ownership structures of East Asian economies.

Thus, the political school views the developmental state to be limited by its own internal dynamic and by increasing external pressure (to liberalise). Such limits on its life are complemented by those surrounding its birth. The emergence of a developmental state is perceived to be dependent upon the now analytically eponymous 'initial conditions', those that allow the state to act both developmentally and, consequently, independently of special interests. Thus, for Aoki *et al.* (1998a, pp. 25–7):[10]

> Northeast Asian economies seem to have a unique initial condition of economic development: the absence of a dominant economic class . . . Before the postwar development process took off in those economies, there were no individual capitalists who had amassed enormous assets and controlled the supply of financial and industrial capital . . . Furthermore, political leaders and bureaucrats in these economies had no incentive to distribute political rents in favor of any particular

> economic class, because if that class were to become sufficiently powerful in the future, the favored class might thereby be able to threaten these leaders' autonomy someday in the future. Thus the 'shared growth' phenomenon in Northeast Asia seems to be a profoundly path-dependent phenomenon that evolved from the unique historical conditions prevailing immediately after the Pacific War. It was not something intrinsic to a Confucian tradition of the East Asian bureaucracy. Because of its apparent autonomy, the permanent bureaucracy in the East Asian state is sometimes characterised as 'strong'. Paradoxically, however, it may be also regarded as 'weak'. Both strength and weakness arise from the same source – the absence of a dominant economic class.

With the life-span of the developmental state hedged between fortuitous initial conditions and mounting internal and external pressures, the political school accommodates the crisis of 1997 by interpreting it as signifying the death throes of the developmental state as it undertakes transition to new state forms. What these are is rarely specified, but some sort of idealised Western democracy is never far from sight. In this light, the developmental state is a temporary but beneficial aberration in the phase of catch-up as if the 'catchees' were themselves free of state intervention, the exact opposite of the truth as far as the developed world is concerned.[11] Inevitably, given the dramatic form taken by the crisis, the political school emphasises how financial liberalisation has been damaging, appropriately weakening state control over finance but without putting alternative forms of regulation in place.

From developmental state to post-Washington consensus

Not surprisingly, this is a rare entry point, shared in common with the economic school. More generally, it has also needed to address the miracle or crisis syndrome – how could one become the other? It, however, has a richer tapestry of explanations that fall into two types. One is to view the miracle and the crisis as entirely independent of one another, with the crisis explained by a fragile financial system, both created and destabilised by inappropriate financial liberalisation and neo-liberal macroeconomic policy. Such a stance is best represented in extreme form in the work of Krugman, not least because he has also been at the forefront in denying the miracle in the first place – with East Asian growth explained by growth of factor inputs. In short, he merely needs to explain the crisis independently of longer-term economic performance.

This is admirably illustrated by his 'Analytical afterthoughts on the Asian crisis' (1999). Essentially, his argument is that aggregate demand in an economy might not increase monotonically with a fall in the exchange rate since the latter may lead to loss of confidence in foreign investors and

loss of net worth and investment by domestic firms: 'a loss of confidence by foreign investors can be self-justifying, because capital flight leads to a plunge in the currency, and the balance-sheet effects of this plunge lead to a collapse in domestic investment'. Krugman formalises the model and discusses its implications. Analytically, the central property is the presence of two stable equilibria, one at a high (normal) and one at a low (crisis) exchange rate. Remarkably, considering the nature of the Asian crisis itself, both equilibria share the same level of real output.[12] But the details of the model need not detain us, although this is indicative of the extent to which Krugman's approach is purely orthodox/macroeconomic confined to the financial. As a result, Krugman's primary concern is to redesign or reform international 'financial architecture'. In his model, neo-liberal policies at best reduce the level of equilibrium output rather than address the problem of exchange rate confidence (for which he advises rapid support to balance of payments, not least through controls on international capital flows).

Although they might hold to a different understanding of how the real economy works (see later), Krugman's approach is not too different from the approach to the crisis adopted by the economic school, for which emphasis is placed upon the deleterious impact of financial liberalisation (Wade 1998; Wade and Veneroso 1998). A more sophisticated approach within mainstream economics, however, is to relate the financial crisis to the unfolding of the miracle underlying the real economy. This has been done through drawing upon the new development economics whose leading representative has been Joe Stigltiz, erstwhile Chief Economist at the World Bank, where he launched the post-Washington consensus as an explicit critique of the neo-liberal Washington consensus (Stiglitz 1998a).[13]

Unlike the Washington consensus, the post-Washington consensus is based on the idea that markets are imperfect, especially in the light of informational imperfections and asymmetries. As a result, government intervention is justified as long as its own imperfections do not outweigh those of the market it is designed to remedy. Analytically, the new information-theoretic economics, upon which the post-Washington consensus draws, explains both market *and* non-market outcomes as the rational response to market imperfections. As a result, it is a special case of what has been termed 'economics imperialism' or 'the colonisation of other social sciences by economics'.[14] Unlike earlier versions of economic imperialism, in which the non-economic was treated as if it were (and were to be made as far as possible) market-like – as in the new household economics for example – the new economics imperialism reduces all economic and social phenomena to the incidence and effect of, and response to, market imperfections. On this basis, it purports to explain, despite a continuing commitment to methodological individualism, institutions, customs, collective action and economic and social structures. It also allows for history to matter in the form of path dependence, multiple equilibria and complex dynamics.

In this light, the post-Washington consensus understands the difference between the developed and the developing world in two complementary ways – by composition of output (with developing skewed towards primary) and by institutional sophistication (with developing more primitive and more pervasive in response to higher incidence of market imperfections). Thus, Aoki *et al.* (1998a, p. 1) suggest the 'developmental-state view regards market failures as more pervasive for developing economies . . . and thus looks to government intervention as a substitute mechanism for the resolution of these'. Consequently, extensive state intervention is warranted for those economies seeking to catch up. But the process of catching up does itself render redundant the institutions that have enabled it. The Asian crisis is, then, explained as the end of the miracle and the need to undergo a transition to more modern market forms of regulation in correspondence to the more sophisticated level of economic performance (J. Lee 1999).

Such an account is supported by Stiglitz's (1998b) discussion of the Asian crisis. His main preoccupation is with the informational content of the domestic and international financial systems. There is suddenly 'the need for greater transparency and more information'. Related to this is the increasingly inappropriate allocation of finance by the state, a particular form of 'crony capitalism'. In this vein, Stiglitz raises the issue of the balance between the positive and negative impact of state intervention:

> Business–government interaction in the region . . . always included the danger that the fine line between consensus building and collusion, between partnership and political cronyism, would be crossed.

Not surprisingly, then, the new development economics is drawn to understand the Asian crisis on the basis of three features – by finance and by cronyism, with both indicative of the impact of imperfect information and the structure of incentives, and through analytical generalisation across countries, reading off selective empirical evidence in terms of the preordained analytical framework.

The lead in this regard is taken up by Crafts (1999a, b).[15] He perceives economic performance as dependent upon factor inputs and 'social capability', 'Catching-up is not automatic, therefore, and absence of social capability may be a crucial obstacle to growth and development' (Crafts 1999b, p. 112). He also stresses the role of imperfect information and financial systems. On the basis of highly questionable total factor productivity and other empirical work, he concludes, 'this analysis tends to reinforce the conclusion that the Asian developmental state has been much more successful in promoting high levels of investment than in achieving exceptional productivity performance'.[16] Thus, 'present problems are a result of earlier success which propelled the leading Tigers to a point at which more emphasis needed to be placed on strong productivity

performance, and reform of the developmental state model seemed appropriate' (Crafts 1999b, p. 120).[17] Consequently, Crafts (1999a, pp. 156–7) concludes:

> Initially backward countries have an opportunity for rapid catch-up if they take radical measures to promote development through institutional innovations and controlled capital markets . . . this would tend to leave a legacy of institutions different from the standard US model and . . . especially in the longer term, there were a number of downside risks of this type of strategy . . . A clear risk . . . is that it is perverted into opportunities for rent-seeking and corruption that ultimately undermine economic growth . . . A second danger . . . is that it spawns government policies that serve the interests of special interest groups and actually inhibit economic growth by inducing misallocation of resources, for example, through so-called 'industrial policy'.

Crafts's explanatory reliance upon industrial policy, financial regulation and cronyism has been effectively demolished by Chang (2000a) on simple empirical grounds. There is no evidence that these factors were sufficient or sufficiently different than in the past or from other countries to have generated the crisis. Across his own work, Chang seeks an explanation for the crisis, not in the persistence but in the dismantling of the core elements of the developmental state across industry and finance, not least through the partial acceptance of the dictates of neo-liberalism. As Chang *et al.* (1998, p. 735) argue:

> The crisis resulted from uncoordinated and excessive investments by the private sector, financed by imprudent amounts of short-term foreign debt, which in turn had been made possible by rapid and ill-designed financial liberalisation (especially capital account liberalisation) and a serious weakening of industrial policy . . . While it has some important shortcomings, Korea's supposedly pathological corporate governance system was neither the main source of the current crisis, nor something that has to be radically restructured if Korea is to regain its growth momentum, as many observers outside and inside Korea currently believe.

But it would be a mistake, from a methodological perspective, to exaggerate the differences between Crafts and Chang, as leading representatives of new post-Washington consensus and old developmental state theory of the economic school. For, whilst the latter is considerably richer and deeper in theoretical and empirical scope, there is *convergence* of analytical frameworks. Crafts (1999b), for example, perceives himself as incorporating the insights of Gerschenkron, Rodrik, Amsden and Wade. Chang (1999), on the other hand, is readily interpreted in one of the latest collec-

tions on the developmental state in the following terms (Woo-Cumings 1999a, pp. 3–4):

> The developmental state paradigm is often thought to be at loggerheads with both neoclassical economics and its cross-dressed version in political science, rational choice theory. The two chapters by economists working in England and Sweden show that this need not be so. Both Ha-Joon Chang and Juhana Vartiainen explain how some of the more recent ideas in economics – for example, the new institutional economics, evolutionary economics, the economics of increasing returns, and transactions theory – can be used to explain the rationality and efficiency of industrial policy.

Thus, for Crafts at least, the developmental state has a limited life, just as for the political school. From an intellectual point of view, however, the post-Washington consensus has the potential to appropriate the economic school on its own terms. Given its origins in taking the Washington consensus as its point of departure, it is hardly surprising that its initial stance should remain cautious and guarded as far as the extent of market imperfections is concerned.[18] Further, as argued elsewhere, in becoming more state- and user-friendly, at least rhetorically, the World Bank and, to a lesser extent, the IMF is keen to occupy the analytical ground previously secured by the economic school (Fine 1999).[19] They do so, however, without confronting its extensive theoretical and empirical work. Hence arises the process of diminishing the scope contained under the umbrella of the developmental state, whilst retaining the term as for Crafts, or its being displaced altogether by generalised reference to market imperfections. At best, the economic school survives and is distinguished only by its more radical stance on the extent of market imperfections and interventionism.

Towards an alternative

So far, I have sought to explain the demise of literature on the developmental state from both schools in terms of their own intellectual content and the intellectual environment as opposed to its being an inevitable response to the Asian crisis. What alternative approaches are there? A starting point can be made by rejecting the basis for the developmental state approach, the dichotomy between market and state. Rather, both market and state are the consequence of, or form taken by, underlying economics and political relations and interests. Significantly, the political school suspends the (strength of) presence of such interests in creating a limited space for the developmental state. But, whilst the school is correct to point to the changing nature of class relations as development proceeds, the state always reflects the balance of class forces and not their absence, as emphasised for South Korea by Koo and Kim (1992).

Second, however, the representation of class interests through the state must always give rise to a specific system of accumulation – sectoral composition and levels of investment, financed and coordinated through private and public institutions. Such a system of accumulation, whilst not independent of external or international factors, is liable to be specific to each country, reflecting its history and dynamic as well as its evolving class structure.[20] In the case of South Korea, for example, real accumulation has primarily been undertaken by the chaebol which have expanded and competed by diversification and conglomeration across sectors. State industrial policy has monitored performance, partially directed finance, and tempered competition within sectors (Park 1999). Ultimately, the competition between chaebol has led them to press for deregulation in general and of (external) finance in particular, conforming to the dictates of neo-liberalism (Kim and Cho n.d.; K. Lee 1999). The system of accumulation prior to the crisis could no longer be sustained as it depended upon excessive competitive penetration of chaebol across one another's sectors of operation. Neo-liberal policies have only intensified that competitive process by weakening the constraints on the funding of intra-sectoral competition, whilst fuelling speculative investment and reliance upon foreign borrowing. This also explains the form taken by the crisis – as seemingly unwise, unmonitored and even corrupt use of finance to support long-standing patterns of accumulation that were previously understood as 'miraculous'.

The purpose here, however, is not to provide an alternative account of the South Korean or Asian crisis more generally.[21] Rather, it is to demonstrate that there are alternatives both to the expiring developmental-state approach and to the post-Washington consensus as its putative, less radical, successor. The latter is a response to the intellectual, political and rhetorical despair surrounding the Washington consensus, the developmental agenda of market versus the state whichever side is preferred, and the methodological reductionism associated with mainstream economics. In other words, neo-liberalism is on the retreat but economics imperialism is to the fore in development studies as well as more generally. In this, it is also potentially assisted by two other factors. First, the excesses of post-modernism are also on the wane, with renewed commitment to confront material – including economic – realities as opposed to being exclusively preoccupied with discourse and subjectivity. Second, mainstream economics remains marked within its own internal development as a discipline by the most esoteric theoretical and statistical methods that falter under even the most casual external scrutiny. Whilst the result of its technical virtuosity is to intimidate and exclude all but a limited number of vanguard practitioners, the translation of its axiomatic models to other social sciences is inevitably subject to informalisation and transformation via the appropriation of ideas and concepts that are traditional to the colonised discipline. Thus is the new development economics/studies enabled to deal with institutions, structures, customs, social norms and so on.

Yet, properly examined and seductive though it may be, there is no escaping how alien to other social sciences is mainstream economics in itself and in its colonising designs on other disciplines.[22] As a result, the prospect is one of controversy over the appropriate political economy with which to understand contemporary capitalism in general and development in particular. The debate over the developmental state has, at times, unwittingly brought the following problems to the fore:

- What is the relationship between classes and the state and how do they resolve and sustain a system of accumulation?
- What is the relationship between the financial and industrial systems in the process of accumulation?
- What are national differences in systems of accumulation?
- Why are apparently miraculous and sustained periods of economic growth punctuated by crises?
- What is the relationship between economic and political systems and how can they be addressed by a genuinely interdisciplinary approach?
- How do the new world order, US hegemony, and the factors associated with 'globalisation' impact upon the prospects for development?

These issues have long been addressed and debated by radical political economy. In the light of the prospective intellectual environment outlined above, it is an opportune moment to place the theory of capital and of capitalism on the developmental agenda and to pursue an alternative to the all embracing post-Washington consensus with courage and conviction.

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Notes

1 Thus, Henderson and Appelbaum (1992a) argue that dependency was displaced by the developmental state as alternative to the mainstream.
2 See also Johnson (1995, p. 99), 'the economists are unable to analyse the Japan problem because at root it is actually not an economic problem, but a matter of differing political institutions'.
3 Johnson reports his reluctance in terms of his wish to retain Japanese specificity and not to generalise unduly.
4 Note that Woo-Cumings (1999a) emphasises nationalism as crucial to Johnson's account of the Japanese developmental state, and the desire to break with both US and Soviet models of development.
5 In the case of destructive, duplicative competition, Carlile and Tilton (1998a, p. 5) offer analysis typical of Chang:

Private ownership is preferred over ownership by the state, but whereas Anglo-American liberalism views intense competition as a beneficial process that allows more efficient producers to replace less efficient ones, Japanese developmentalism holds that markets are prone to 'excessive competition', in which investment is wasted as firms overinvest and underutilise capacity as they drive each other out of business. In light of this, developmentalist policies have sought to economise on national investment resources by using public, private, or mixed regulation to limit competition.

6 Thus, the death of the developmental state is anticipated in Chan *et al.* (1998a), with earlier versions of the collection appearing in *Governance* in 1994.
7 See also J. Lee (1999) for South Korea and Weyland (1998) for Brazil. For Singapore, Huff (1999, p. 234) concludes: 'The successful developmental state should obviate the need for its existence as the private sector, once nurtured by government, strengthens economically'.
8 See Sum (2000) for the developmental state literature as a form of orientalism.
9 Note that Cumings (1999) observes how such distinctions and oppositions are far from sharp.
10 See also Aoki (1998), Kim (1998), Woo-Cumings (1998) and Booth (1997). The roles of Japan as colonial power, followed by US aid, are important aspects of 'initial conditions'.
11 Yeung (2000) perceptively sees the Asian crisis as in part strengthening the role of the developmental state.
12 Presumably, however, future levels of investment would be lower in the crisis equilibrium.
13 For critical appraisal of the post-Washington consensus, see Fine *et al.* (2001).
14 See Fine (2001a) for an account and reference to the literature.
15 Crafts is a leading new economic historian – applying mainstream economics to historical problems – who has wandered into the field of development. For a critique of the new economic history in its latest phase of adopting the new information-theoretic economics, see Fine (2000) and Fine and Milonakis (2000).
16 As Stiglitz (1998b) comments, 'I do not believe, however, that East Asia has grown through investment alone. Any visitor to the cities and factories in East Asia comes away impressed by the enormous technological progress in the last decades.'
17 See also p. 124: 'the 1997/8 crisis reflects weaknesses in the institutional arrangements of the East Asian developmental state model in the age of financial liberalisation'.
18 By taking the new consensus to its logical policy conclusions in favour of extensive interventionism, Stiglitz was forced to resign from the World Bank.
19 Here it is argued that the new consensus would skirt around the literature critical of the Washington consensus by addressing the state through the notion of social capital, in its vertical or linking form, as in the work of Evans (1996a, b). In the event, as was subsequently elaborated in Fine (2001b), social capital has been used to continue to evade the issue of the state in the post-Washington consensus.
20 This approach was originally developed for South Africa in Fine and Rustomjee (1997). One implication, widely recognised in the literature, is that there is no single East Asian model. On this, in the context of the crisis and the developmental state, see Henderson (1999).
21 See Cabalu (1999) for an overview. But note that Matthews (1998, p. 747) correctly sees three agendas at work in the Korean crisis – 'a conventional IMF agenda, a US trade and investment opening agenda, as well as a Korean-imposed institutional reform agenda'.
22 But note that Johnson (1999) explains the initial negative reaction to his 1992

book and the misunderstanding of his notion of the developmental state as a consequence, respectively, of orthodox commitment to rational choice and of laissez-faire and Cold War ideology.

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2 Can Asia find its own path of development?

Corporate governance, system conflict and financial crisis

Makoto Noguchi

The memory of the financial crisis, which suddenly struck East Asia in 1997–8 and threw the Newly Industrializing Economies (NIEs) of this region into the depths of turmoil, is still vivid. It seems that this incident has brought to light the great risk hiding behind the apparently smooth development of the region. But what has caused East Asia, which has achieved 'miraculous' growth, to be suddenly confronted with this risk?

Although a lot of discussions on this theme have taken place, there are still circumstances that have not been thoroughly looked at. For example, the World Bank in a White Paper (World Bank 1998), which was first to put forth an analysis of the crisis and the prospects for resolving it, stated that there are three major causes leading to the crisis: excessive current balance deficits that were financed by short-run foreign capital inflows; liberalisation of financial markets without adequate regulation and surveillance; and heavy reliance on foreign borrowings in the context of underdeveloped bond and stock markets. The World Bank also suggested that, to get rid of the economic vulnerability that was the major cause of the financial crisis, it is necessary for the East Asian countries to restructure their business and financial sectors by setting up a corporate governance that provides prudential regulation, careful surveillance and transparency. However, it appears that this diagnosis and the ensuing prescription by the World Bank were based on implicit assumptions about corporate governance. To be specific, the World Bank strongly believed that if a strong framework for corporate governance were established that was able to withstand the risk of relying on capital markets, financial crises could be avoided even when financial liberalisation, which accelerates foreign capital flows, proved inevitable. However, it is possible that such a belief may have led to a mistaken diagnosis of and prescription for the crisis.

It is easy to believe that the bad loans and investments that triggered the crisis could be avoided if transparency of capital transactions were maintained and surveillance or appropriate control of corporate managers were properly conducted. The problem is that there is no single answer to

the questions regarding what transparency is and what is its purpose, or for whom and for what is managerial discipline. Mainstream economists believe that, under a reliable capital market, firms will be made completely to disclose information to stockholders, and this would supposedly discipline managers to maximize stockholder value. This paper aims to provide a different view, which is in contrast to the diagnosis and prescription that treated the lack of regulation and transparency in financial transactions as the cause of the economic crisis. In fact, it is precisely by being free of the biases of mainstream economists regarding transparency and discipline that we are able to take into account the historical and institutional factors which determined the sources of the crisis, and to suggest a path toward the development of institutions that will accelerate the recovery of the Asian economy.

The recovery of Asia can be achieved through fostering development dynamism by drawing on Asia's intrinsic heterogeneity. For this, Asia needs to ensure a symbiotic development path: taking a positive slant on corporate and finance globalization trends and, consistent with this, providing several types of corporate governance systems varying by region.

The Asian financial crisis as institutional friction

The chain-reaction-like financial crisis in East Asia, triggered by the devaluation of the Thai baht, was a crisis that was closely connected with the steep swing toward financial liberalisation worldwide. During the last decade prior to the crisis in Asia, many crises set off by financial liberalisation can be observed in both developing and developed countries. Financial liberalisation, which prompts the abolition of regulations on capital transactions and interest rates, is likely to weaken the financial structure and fuel economic instability. For many years post-Keynesian economists have analysed this tendency. Recently, however, there has been concern regarding the existence of a close correlation between adoption of a financial liberalisation policy and the incidence of financial crisis even on the part of the IMF and World Bank which actively encouraged the opening of financial markets in developing countries and NIEs (Rossi 1999).

Why would financial liberalisation cause fragility in the financial structure? The particular mechanism of the outbreak of a financial crisis can follow various patterns as a consequence of differences in economic structure prior to launching financial liberalisation policy, or differences in the surrounding economic environment. However, it can be said that in most cases, with the development of the capital market, there is a growing trend towards the removal of border constraints on capital movement, and elimination of boundaries between capital and money markets. As a result, the banking system of a country previously protected within a regime of financial repression would be exposed to sudden flows of funds from the money

market to the capital market. Under conditions such that the monetary base remains invariable, funds draining away from the money market would not only cause money market interest rates to soar, but also deprive banks of established credit customers and aggravate credit market competition. Desperate credit competition is likely to induce bad loans and poor investment, since it foments a pattern of banks' behavior dictated by survival priorities instead of risk considerations and the prospect of returns (Noguchi 2002; Grabel 1995).

Within the Asian countries that entered financial crisis, prior to the crisis outbreak there already existed in the domestic financial sector an established mechanism for unrestricted fund-raising from capital markets directly connected with the global market. For international investors, the East Asian financial market brimming with expectations of high growth became a much sought-after place to invest. Floating portfolio investments poured in large amounts first into Thailand, which triggered the crisis, and then into the other NIEs. Thus, as a result of rapid globalization of financial markets in the 1990s Asian countries, which were expected to become growth centers, came under sudden pressure to raise domestic interest rates and faced intensified loan market competition. The Asian crisis has several distinctive features compared with the crisis that broke out in the 1980s in Latin America, which was a sort of proving ground for financial liberalisation. In Latin America, the currency and finance crisis was triggered by high debt service ratio (external debt repayments ratio against gross exports) and cumulative government deficit. In contrast, in the case of the Asian financial crisis, massive short-term capital outflow suddenly struck Asia and ignited severe crisis of finance and currency despite no observed deterioration in the two indicators at the time (Noguchi 1999). Behind this difference in the mechanisms of crisis outbreak lies the difference between Latin America, which suffered from inflationary spiral, and Asia, which maintained regular growth, in terms of economic structures and corresponding policy framework.

Demirguc-Kunt and Detragiache (1998) found some intriguing empirical evidence. In the case of financial liberalisation in countries that practised financial repression with negative real interest rates, the beneficial effect of financial expansion exceeded the detrimental effect of banking crisis; however, in the case of financial liberalisation in economies practising financial restraint policies that kept minimal real interest rates, the authors could not identify a large financial expansion effect that compensated for the negative impact of banking crisis. The extent of the positive effect of financial expansion in the case of financial liberalisation in Latin America that previously employed financial repression is, perhaps, an issue for further discussion. As the structuralists point out, the plunging of the Latin American economies into a vicious cycle of stagflation was the outcome of the failure of financial liberalisation to direct funds accumulated as an inflation hedge into real investment. Instead, the informal

credit market was divested of funds and growth was halted. However, the Asian financial crisis turned superior macro-performing countries into bankrupt countries overnight – in this sense, in Asia the negative effect of the crisis was far greater.

A financial repression regime is said to have encouraged growth in Asia, including Japan. The East Asian economic system, having been severely affected by globalization of financial markets, is now suffering from major financial reverses and crisis repercussions. Such a dramatic turn-around in macro-performance indicates the incompatibility of a high savings regime with the institutional framework required for financial liberalization. Moreover, it indicates the highly frictional effect that financial globalization can have on formal finance. Liberalisation and globalization of finance undermines the foundations of a financial repression regime that depends on banks in at least two ways: first, the formal credit system is under pressure from a capital market that drains out funds; and second, migrant portfolio investment brings about a destabilization effect. However, given that in Japan and other East Asian countries the solidity of capital accumulation and the degree of credit system sophistication differ greatly, East Asia cannot be treated uniformly. In particular, the macro-performance of the NIEs is strongly affected by the flux of foreign capital inflows and outflows because of the fragility of NIE capital accumulation base. In East Asia's NIEs, capital accumulation comprises family-owned businesses. Corporate fund shortages are covered through an indirect finance system that is closely tied up with family companies. The financial liberalisation of the 1990s made it possible for firms and banks interconnected in this way to access the global financial market with its alien mechanisms. Here lies an explanation of the conundrum of the outbreak of the Asian financial crisis and its reverberations.

When financial crisis hindered East Asia's growth, the opacity of Asian corporate management and finance based on family relationships immediately became an object of ridicule, being associated with cronyism. Many mainstream economists take the standpoint that cronyism became a hotbed of executive anarchy and corrupt finance and that this led to crisis. In comparison to impersonal transactions within fluid international financial markets, East Asian market institutions appear to be far more opaque because of their stronger family connections and lower transparency. East Asian firms and financial institutions normally conduct transactions that rely on family connections as the cornerstone of trust. If, in the course of financial liberalisation, they gained the opportunity to borrow from international market creditors, then creditors and borrowers would assume distinct behavior patterns that followed different risk assessments within the bounds of different systems. Analysis of the creditor–borrower relationship within the mainstream economic framework of information asymmetry would suggest that East Asian borrowers, being laxer towards risk assessment, were tempted to indulge in unsound investments that went

unnoticed by international market creditors, who are more rigorous about risks. Such a one-sided account of the borrower's responsibility easily leads to a panacea-like conviction that, if one successfully replaced family connections with highly transparent market relationships, then borrowers and creditors would face equally strict requirements for risk assessment, and thus information asymmetry would be corrected. What actually happened, however, was the opposite. East Asian borrowers managed to attract enormous amounts of capital 'in spite of all those notorious conditions of Asian capitalism' (Radelet and Sachs 1998, p. 30). International creditors, although aware enough of East Asian borrowers' investment behaviour that stemmed from lax risk assessment, included loans for East Asia into their investment portfolio as a high-risk high-return financial asset (Noguchi 2001a).

The devastating storm of restructuring – structural reforms and evolution of economic system

At first the IMF provided support to crisis-hit Asia using an almost traditional method. The crisis spread to Thailand, Indonesia and Korea, and the IMF decided to provide three years stand-by accommodation to those three countries. As for the other conventional IMF programmes, the adjustment programme that was imposed on the three countries as a condition for crisis finance required the adoption of monetary and financial retrenchment policies aimed at regaining credibility with the market through reduction of the current account deficit, recovery of foreign currency reserves, and curbing inflation. However, this conventional adjustment programme could not break the vicious cycle of crisis triggered by capital flight; rather, it caused apprehension that such austerity policies could fuel a vicious circle. There was growing criticism that the adjustment programme was making the crisis even worse. Taking into consideration the new historical characteristics of the Asian crisis, which differs from previous debt crises in developing countries, these criticisms were worth listening to.[1] Large capital flight from the Asian NIEs caused foreign exchange rates to plummet, inflating foreign currency liabilities. As a result, the Asian NIEs found themselves in a vicious circle where the financial situation of both the corporate and the banking sectors immediately became worse and this, in turn, induced further flight of foreign capital. In the midst of such a crisis the implementation of austerity policies that focused on contracting the financial deficit was not only powerless to liquidate the enormous stock of liabilities of firms and banks, but even depressed their output level and increased liability burdens, thus leading the economy into a negative spiral that hindered investment.

Fearful that the situation would not get any better, the IMF, in the process of conducting its quarterly review of the adjustment programme, was forced to change its policy direction. In the amended programme,

austerity policies were relaxed and some measures to strengthen the social safety net were introduced, while measures to stabilise the economy from the demand side were given a certain degree of consideration. However, at the same time, structural reform, aimed at strengthening the financial sector and encouraging corporate restructuring, became a matter of priority. Combining their efforts with the IMF coordination programme to foster reconstruction of the financial and corporate sectors, the World Bank and the Asian Development Bank provided not only financial support but also technology and policy assistance. The IMF and the World Bank did not stop at simply assisting in the creation of a plan to deal with bad loans and bank restructuring in the three countries that were hit by the crisis: they were also deeply involved in creating a legal and institutional framework aimed at overcoming the causes of the crisis, which they understood to be the structural weakness of the financial and corporate sectors towards market risk.

Although the structural reforms introduced by the IMF and the World Bank in those three countries differed in several particulars, they shared the ultimate goal of eliminating regulations and institutions that had worsened market risk and replacing them with a new system congruent with market discipline. Structural reform in the financial sector pursued the following goals: strengthening the regulations for sound management and monitoring along the lines of the capital standards set by the Basle Committee; providing a deposit insurance system that could effectively restrain moral hazard; reforming banking legislation, including limitation of cross-holding of shares between banks and corporations; and facilitating the development of capital markets through fostering the growth of institutional investors. In the corporate sector, debt disposal was pursued through the so-called London approach, whereby voluntary agreement between creditor and debtor is reached without law court involvement. A system of mortgage repayments and bankruptcy procedures was introduced as supportive legislation. Corporate sector restructuring was not limited to corporate debt disposal. In order to enhance corporate governance effectiveness and encourage competition, a wide range of measures were taken: tightening accounting principles, imposing information disclosure, making boards of directors perform functions independently and achieving clarity of responsibilities, accelerating privatisation, and eliminating opaque ties between government, financial institutions and corporations. In Korea, for example, there was an attempt to introduce an Anglo-American type of corporate governance based on capital markets – a range of policies were pushed that aimed at endowing minority shareholders with more rights and power, limiting cross-shareholding, preventing government interference in corporate reorganization, and dissolving the chaebol (conglomerate) network (Lane *et al.* 1999; World Bank 1998).

The implementation of the adjustment programme had an extremely drastic effect regarding the disposal of bad loans in the financial sector.

This is particularly true in the cases of Korea and Thailand. In Korea, out of the 14 merchant banks that stopped operations in December in 1997, ten were closed down by January 1998. In Thailand, out of the 58 finance companies that stopped operations in June–August 1997, 56 had been closed down by December of the same year (Lane *et al.* 1999, p. 69). This was just the start of financial restructuring, and, though not purporting to diminish the significance of the financial assistance provided by the IMF and the World Bank, if we compare this kind of quick and intensive liquidation of bankrupt financial institutions with the hesitant disposal of bad loans in Japan, we can observe a dramatic difference. One can accept that the relatively swift settlement of the financial insolvency problem had some positive effect on the investment environment and could compensate to a certain extent at the macro-level for the destabilizing influence of the intervention initiated by the IMF and World Bank, as well as at the micro-level for the large negative effect of frictions attendant on structural reform.

However, it remains highly questionable whether the three crisis-hit countries have accelerated their evolution toward an Anglo-American system of corporate governance following the prescriptions of the IMF and World Bank. Economic micro-structures cannot undergo changes absolutely independently of their historical and institutional background conditions inherited from the past, and separately from the overall dynamics produced by those conditions. Especially for those three countries, which are deeply embedded in the activities of globalizing capitalism, the economic system cannot be a matter of choice unconstrained by those global activities. Japanese firms advancing into Thailand and Indonesia, for instance, would not be very happy about the prevalence of Anglo-American corporate governance in those countries. Even for Western firms advancing into Asia it might be more beneficial to take advantage of specific structural factors of local economies, such as family-owned businesses and a low-wage workforce, when constructing their profit generation schemes. Western institutional investors, finally, would not necessarily be pleased with the rise of strong competitors in Asia. To sum up, in the modern capitalist world with ongoing globalization of capital markets and activities of firms, there is no predetermined tendency toward convergence of corporate governance systems (Noguchi 2000).

In fact, in Korea, ravaged by a storm of restructuring during the chaebol reforms, reconstruction of giant conglomerates took place through the so-called Big Deal corporate exchange. Nevertheless, no clear perspective can still be ascertained regarding the direction of relationships between government, financial institutions and corporations. Besides, it is evident that remoulding the Korean market economy according to the design of the IMF and World Bank would be an extremely difficult task. It is worth noting that, in the process of restructuring the financial and corporate sectors, the Korean government exploited the power of the

banks, helped with official funds, against the chaebol. Using the power of the banks, the government urged the chaebol to restructure (Mo 2000). As a result, state power over banks was retained and, in this sense, the aspirations of the IMF and World Bank to eliminate government intervention were not realized. Moreover, the ability of the chaebol to resist should not be underrated. After all, the audacious Big Deal policies have the aspect of intensifying chaebol resistance to structural reform, while making it possible for the chaebol to survive. One can even observe the inclination of the government, fearful that such resistance will be politically exploited, to abandon chaebol reform and assist in the quick recovery of the economy (see Chapter 6 in this book). Whatever kind of governance system is going to be adopted by Korean chaebol from now on, and whatever transformations will take place in the relations between Korean government, financial institutions and corporations, the outcome matters critically for the challenge facing Korea in retaining its position as a globally competitive manufacturing base. The appropriate corporate system to meet this challenge cannot be identical to the Anglo-American one, which exists in a context of significant domestic de-industrialization where firms depend on the competitiveness of the service and financial sectors.

From a similar perspective, several question marks hang over the outcome of the adjustment policies in Indonesia and Thailand. Intervention by the IMF and World Bank in Indonesia resulted in intensified political and social anxieties and, in contrast to the other two countries, the implementation of the adjustment programme was extremely delayed. The contractionary policies imposed by the IMF and World Bank required frequent modifications and as a consequence inflation became uncontrollable and emerged as an acute social problem. There was also substantial resistance to implementation of a structural reform programme that necessitated deregulation and privatisation. With the liberalization of agricultural products, some actions were taken to break the monopoly of the National Logistics Agency (BULOG, Badan Urusan Logistic) in import and distribution of food. However, protection policies with regard to rice crops remained impervious to change; the planned privatisation of state-managed corporations also lagged behind schedule. Recently, national protests have grown against selling off state-managed corporations to foreign capital. The resistance of holders of vested interests due to regulation and monopolies cannot be seen as the sole cause of time delay and changes of direction in the course of structural reform. Taking into consideration the characteristics of Indonesian social structure and the constraints of the international environment encompassing its economy, it is essential to think through the appropriate 'good governance' with regard to Indonesia. Glossing over this subject and blindly implementing an Anglo-American governance system as a model of structural reform may result in aggravating systems friction, and fanning the flames of turmoil and agitation in the economic and social system.

Even in Thailand, which eluded the social and political upheavals that befell Indonesia, the structural reform initiated by the IMF and World Bank seems to have produced outcomes inconsistent with the original intentions. Although Thailand established a legal foundation for bankruptcy procedures in compliance with the guidelines of the IMF and World Bank, at the implementation stage of rehabilitation plans for bankrupt corporations the original executives of family-managed firms were not removed, leaving open the way to perpetuation of the system. This was the consequence of replicating US bankruptcy law, which permits participation of former management even after a rehabilitation plan has been applied (Suehiro and Yamakage 2001, Part 1, Ch. 5). This reveals an intriguing process of system evolution whereby a particular law administered in a different managerial climate produces unexpected social effects compared to its original purposes and concepts. It is conceivable that the central issue for the future development of the economy of Thailand, which witnessed a sharp increase in the proportion of manufacturing exports, is to establish an extensive and strong industrial network. Whether family networks rehabilitated through bankruptcy liquidation procedures can grow into a system capable of coping with this problem is an issue that will have far-reaching implications as Thailand's economy experiments with assimilating an Anglo-American corporate style. In addition, restoring the mechanism for the mobilization of national savings to finance domestic investments is also a matter of great urgency. Before the crisis, Thailand could sustain high growth rates by virtue of a flexible financial network where domestic banks mediated the passage of huge savings from the agricultural sector to family-owned firms' investments. With bank bankruptcies in the course of the financial crisis this network almost collapsed (Phongpaichit and Baker 2001). It is unlikely that an Anglo-American corporate and financial system could fulfill the function of mobilizing farm savings and deploying them in domestic investments adequately in Thailand, where farm labour share remains high.

Toward harmonious production, finance and governance

According to the diagnosis of the IMF and the World Bank, corporate finance biased toward bank loans was one of the major causes of the Asian financial crisis, and in order to prevent recurrence of the crisis, it is necessary to reduce the ratio of liabilities to capital. However, through dependence on bank borrowings, East Asian corporations achieved steady high growth by mobilizing financial resources for industrialization, including funds from the agricultural sector. This system became the cause of the fragility of financial structure when global change linked the East Asian corporate and financial sectors with international markets. In fact, before the outbreak of the crisis such global expansion of capital markets had already advanced and deeply involved Asia. From the mid-1980s till the

early 1990s, the aggregate spot price of stock markets in emerging economies continued to rise at a speed greater than that of developed countries. According to UNCTAD (1997), in the period 1986–95 aggregate spot price of stock markets in emerging market economies grew tenfold, and its share in the world's aggregate spot stock price increased from 4 to 11 percent. Moreover, in 1995, Asia absorbed 53 percent of the net inflow of foreign stock investments in the emerging market economies. In this way, the Asian emerging economies increased their dependence on the capital market before the crisis. Singh (1995), who early on focused on this trend, raised the issue of why modern emerging market economies had come to depend on high-risk capital for their fund-raising. This phenomenon apparently contradicts the pecking order hypothesis proposed in orthodox economics textbooks. Under this hypothesis, fund raising by means of stock issuing must be dearer in terms of capital costs than bank borrowing.

There is little doubt that several concrete factors can be identified that led to deep involvement of emerging market countries in the globalization process.[2] However, the most crucial role was played by the underlying historical factor of the great transformation of the relationship between corporations and finance in the international financial centers of the UK and the USA. In the 1980s, the share of stockholdings of institutional investors, such as pension funds, insurance companies and trust investors, increased in the UK and the USA. Institutional investors, which hold huge volumes of shares and have the power to manipulate stock prices, came to participate in corporate governance, which led Anglo-American management to operate in compliance with shareholders' interests. Meanwhile, institutional investors set up strongholds in Anglo-American international financial centers, and diversified asset investment in capital markets around the world through the global network. Thus, through institutional investors, a large amount of savings accumulated in pension and insurance funds was invested into promising stocks of various corporations, including governance-conscious Anglo-American corporations mindful of shareholders' interests, as well as family-managed firms in emerging economies (Noguchi 2000). National differences in corporate governance and its supporting economic system is assessed within the portfolio of institutional investors as the difference between risk and its corresponding profit potential. Asia, having shown remarkable growth, became part of the portfolio of institutional investors as an asset investment site through the anticipation of high profits substantial enough to cover high risks, including governance ambiguities. This is the reason that led to fund-raising in the Asian emerging market economies that invalidated the pecking order hypothesis.

Therefore, the Asian financial crisis was not the result of an excessively high liability-to-capital ratio, but the consequence of Asia's precocious involvement in portfolio investment. The dramatic expansion of the

capital market helped drain funds out of the money market, which had supported Asia's rapid industrialization, thus escalating credit competition among financial institutions. Misjudging the causes of crisis may also have led to damaging prescriptions. Trying to transplant Anglo-American corporate governance practices into Asian emerging market economies, the IMF and World Bank put in great efforts to create an appropriate legal framework including shareholders' interest protection and assignment of directors from outside the company. It is evident from the experience of transition economies that the provision of laws is not necessarily conducive to successful establishment of stock markets. In Russia and Eastern Europe the experiment with Big-Bang-type market creation was conducted in full awareness of the fact that systematic enforcement of law cannot overcome bad law (La Porta *et al.* 1997). However, the reality was the opposite – even good law failed to overcome poor enforcement of law (Pistor *et al.* 2000). The stock market, which is believed to enforce managers' discipline as a market for corporate control, cannot be established by simply providing a legal framework. The market for corporate control is brought into existence only upon the creation of systemic relations necessary for such a market.

Thus, weighing up the pros and cons of the corporate governance system in terms of evolutionary adaptability, we can say that the Anglo-American governance system's applicability to Asian economies as the world's manufacturing base is not self-evident. From the beginning, the argument that the takeover threat from the stock market could control the behavior of corporate managers and maximize shareholders' value was disputed. Even the proponents of the legal protection of shareholders' rights have recognized several problems, including the escalation of buy-out costs because of shareholders' resistance to selling shares, as well as executives from the buying side being motivated by private interest of corporate control and giving low priority to shareholders' wealth (Shleifer and Vishny 1997, p. 756). In fact, even in the USA the number of successful hostile corporate takeovers is not so large (Osano 2001). However, for Asia, which is getting back on track after recovering from crisis, structural reform that is modelled on the Anglo-American governance system is fraught with even more problems when compared with the UK and USA. In contrast to Anglo-American incorporated companies with decentralized stock ownership, in Asia the family-firm owner-executive generally holds the controlling bloc of shares. When trying hastily to transform this company system into the Anglo-American type, there is a tendency to believe that the crucial task of reform is to protect minority shareholders' rights from infringement by owner-executives. This view is certainly too narrow. Corporate system reform must confront such enormous issues as the settlement of conflicts of interest between various stakeholders, including employees, creditors, financial institutions, business partners and customers as well as shareholders and top management; this amounts to

creation of a system that corresponds to contemporary requirements and local peculiarities. Moreover, one particularly important issue for Asian economic development is boosting the growth of non-stock medium and small companies, which cannot be resolved by simply addressing the agency framework in corporate governance.

In order for Asia to move toward the development of an intra-regional economy that takes advantage of its status as a manufacturing base for de-industrializing advanced countries, it is necessary to create a mechanism for industrial development through which extensive skill accumulation lays the foundation for technological progress. This point is relevant both before and after the crisis. The corporate governance system that it was attempted to introduce in Asia after the crisis deals solely with enforcing discipline on executives as representatives of investors' interests. However, the agency problem does not only exist between management and finance. The agency problem between management and workers remains to be resolved. To achieve systematic productivity growth in manufacturing, a governance system properly treating the latter agency problem is also required. How should top management design a labour process in conformity with this framework? The issue is not limited to devising a scheme of providing incentives to workers. Creating a base for the enhancement of abundant skills and promoting workers' participation in organizational learning will guarantee sustainable economic growth (Lazonick and O'Sullivan 2002). Can this kind of governance, attaching great importance to the skills base, be consistent with the Anglo-American governance system that gives priority to investors' profit?[3]

Generally speaking, the more rigorous the control exerted over top-management by investors, the greater the likelihood that the firm will be fettered by pursuit of short-term profit and will tend to neglect continuous and cumulative creation of skills. Thus, if Asian emerging economies accept an Anglo-American governance system without any adjustment, the seeds of institutional friction will be planted again. However, as long as Asia needs access to the international capital market, the corporate governance system that prioritizes investor interests must be given due regard. Here lies the dilemma of post-crisis Asia. Whether Asia resolves the dilemma and regains a balance between production and finance, depends on its ability to create a governance framework that can sustain proper regulation of inward and outward portfolio investment, and at the same time embed portfolio investment in a process of enlargement of the Asian region's skills base.

Conclusion: Developmentalism and neo-liberalism at the crossroads

Following a liberalisation policy that welcomed foreign direct investment, East Asia made progress as an export-oriented region. In this sense, East

Asia's development can be viewed as a phenomenon that occurred under pervasive influence of the so-called neo-liberal regime policies that spread across the world in the 1980s. Nevertheless, East Asia's growth has also been analysed in the context of development theory. This is because government intervention and a corresponding regulatory network played an important role in coordinating foreign direct investment to encourage domestic industrialization. In particular the important external framework that restricted capital account transactions and pegged the domestic currency to the US dollar assured the viability of East Asian developmentalism. But now, at least in the crisis-hit Asian countries, this external framework has faded away. Capital liberalisation triggered a currency and finance crisis and the dollar-peg system was ruined by the crisis. Moreover, after the outbreak of the crisis, attempts made by the IMF and World Bank to transplant an Anglo-American governance system that prioritizes investors' interests undermined even the internal framework of developmentalism. The impression is unavoidable that East Asia's deeper involvement with the neo-liberal regime is only a matter of time.

However, even a seemingly uniform financial market in practice must have various institutional characteristics reflecting historical and cultural peculiarities of each region's industrial development. Asia is confronted with economic issues different from those faced by advanced post-industrial capitalist countries, i.e. a sizeable agricultural sector, the prevalent role of medium and small companies, and skill creation in manufacture. Thus, the higher a nation's expectations about economic development, the more pressing is the need to manage market risk and create a finance-mediating network that satisfies diverse financial needs, rather than aiming at immunity from market risk. This trend cannot be reversed even by proposing corporate governance that prioritizes investors. Even then, for East Asia successfully to introduce into its multi-dimensional cultural domain its own financial system modified for each country, it is indispensable that East Asia should also construct a new reliable framework for regulation of capital transactions and stabilization of currency exchange. Will East Asia, currently at the crossroads of failure of both neo-liberalism and developmentalism, find a new way that overcomes conventional developmentalism? For the present the answer is not clear.

Notes

1 A conventional adjustment programme was not altogether effective when treating monetary crises in developing countries caused by extreme financial deficits. Structuralists provide a remarkable analysis of this issue (Taylor 1988).

2 Singh (1995) points out the following four factors: (1) Government in emerging countries played a major supportive role in stock market development, (2) As a result of stock prices rising, stock capital costs significantly declined relatively to liabilities, (3) Securities in developing countries were supplied elastically, (4) There were factors, domestic and international, that gave a boost to stock revenue growth.

3 According to Lazonick and O'Sullivan (2002), in the USA the 1980s and 1990s, governance trapped in the ideology of maximizing shareholders' value led to biased innovation that narrowed the base for skill creation (Ch. 3). This is a hint of what kind of governance system is appropriate for Asian economic development.

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Part II

Results of globalization

3 Argentina

A decade of the convertibility regime[1]

Roberto Frenkel

Macroeconomic performance, employment and income distribution[2]

On 1 December 2001 Domingo Cavallo, Minister of the Economy, announced, among other measures, the decision to establish controls and restrictions on transactions in the foreign-exchange market. He thus put an official end to the monetary regime that he himself had launched slightly more than ten years before. Economic breakdown and a wave of social turmoil and political turbulence brought President De la Rua's Administration to a dramatic end well before the completion of its constitutional term, which had begun at the end of 1999.

The macroeconomic regime of the 1990s, including convertibility of the peso at a one-to-one rate with the US dollar, is now consigned to history. An entire decade passed from the glowing initial success of hard pegging the exchange rate in April 1991 to the scheme's abandonment following a protracted recession that persisted for more than three years. This was another 'lost decade' in many respects, with lasting consequences that have not yet developed fully and are yet to be understood. At present, the Argentine economy is struggling to emerge from the many uncertainties that arose from the downfall of the former set of economic rules and from the difficulties that had to be faced to establish an alternative setting. It faces the challenge of recovering its basic macroeconomic balance in an unfavourable international context.

Argentina made a comprehensive economic reform effort at the beginning of the 1990s. In addition to convertibility, this included massive privatisation of public utilities, broad trade and financial opening, equal treatment of local and foreign capital, and deregulation of domestic markets. At first, drastic disinflation and fast economic growth seemed to prove this combination right. Other reforms, like the independence of the Central Bank and the reorganization of the pension system, were later implemented as additional measures to consolidate the institutional framework of the new macroeconomic setting.

Some negative signals could already be perceived during the initial

expansionary phase that preceded the Tequila episode of late 1994 in Mexico. This is not only true regarding rising financial vulnerability to sudden stops or reversions of capital inflows. Well before the impact of the spillover of the Mexican crisis, some labour-market indicators began to deteriorate. In particular, the lack of dynamism in employment creation became evident as a kind of anomaly in a period of fast economic growth. Moreover, income distribution indicators such as the incidence of indigence among both households and individuals, were also showing an early worsening. In the second half of the 1990s, a much weaker macroeconomic performance lay behind a generalized deterioration of labour-market and income-distribution indices. This phase led to a deep crisis and the breakdown of the regime in December 2001.

The launching of the convertibility regime was a landmark for Argentina in the 1990s. The programme finally collapsed ten years later at the end of 2001. Thus, the decade witnessed the establishment of a macroeconomic regime that was based on a redefinition of the public and private spheres of economic activity (through an intense privatisation process of publicly-owned firms), trade and financial opening and, at a more general level, a clear market-friendly orientation of policy. From a macroeconomic standpoint, two neat cycles can be observed during the period. The outstanding and early success of price stabilization came together with a lengthy four-year expansion and a subsequent short recession in 1995. A brief recovery followed, and then the current recession began in mid-1998, characterized by an unusually long contractionary period. It is a true depression, accompanied by a slightly declining trend in nominal prices. This phase led to the final crisis of the monetary regime of the 1990s.

Capital flows had a crucial role in the short-run macroeconomic dynamics of the period through their impact on interest rates, internal liquidity and aggregate expenditure. In the early 1990s, the net capital inflows exceeded the current account deficit, thus allowing for a significant accumulation of foreign reserves while feeding domestic credit creation and economic recovery. In this way, they made for the achievement of a double target: price stabilization and output growth. In contrast, significant capital outflows would later trigger the recession of the mid-1990s. Renewed inflows (following the same pattern as in the initial period) provided the impulse for the next recovery. A worsening of the international context after the crises of Southeast Asia in 1997 and Russia in 1998 would stop the economic expansion and trigger the second recession of the decade. Later, the closing of access to foreign credit would bring about the collapse of the regime.

Under the convertibility framework there was a close relationship between fluctuations in capital flows and the domestic cycle of economic activity. In this institutional context, changes in the international conditions regarding liquidity and credit availability have an immediate impact on the domestic interest rates, on the supply of money and credit

and, thus, on short-run macroeconomic performance. This is a particularly disadvantageous feature, taking into account the evident volatility of international capital movements.

The two aforementioned cycles had their counterparts in the labour market. They also impacted on income distribution indicators and on poverty and indigence levels. In effect, exchange-rate based stabilization processes similar to the Argentine one in the early 1990s – which also involve simultaneous trade opening, privatization and fiscal adjustment – tend to generate characteristic dynamics that can also be observed in other national economies. In the labour market it is possible to see, typically, the development of a cycle in employment and distribution. In the early 1990s, both the employment level and the average real income initially grew. However, in the ensuing contractionary phase, those initial effects weakened and a number of negative factors became dominant. We refer to the persistent consequences of the combination of trade opening and exchange-rate appreciation; later on, the reversion of the aggregate expenditure's rising trend acted in the same direction.

Thus, the ratio of full-time employment to population after having increased from 1991 to 1992, started to fall to a new low in 1996, well below its 1990 level. Note that the ratio of the number of employed individuals to the total population began to decline (and the unemployment rate to rise) well before the turning point of the economic expansion at the beginning of the decade.

The average earnings and the employment rate rose again in the second cycle of the 1990s, to decline once more from mid-1998, but falling short of the levels attained at the preceding peak. By the end of the period, for instance, the average real income of employed individuals was almost 11 percent below the 1994 level. The full-time employment ratio was about 2.7 p.p. (percentage points) lower in 2000 than the 1992 peak. Meanwhile, the unemployment rate increased by 3.87 p.p. in the same period (according to Greater Buenos Aires figures).

The contractionary adjustment of employment in the 1990s can be understood as a gradual adaptation to the conditions (of trade opening and relative prices, in particular) set at the beginning of the decade. Increased competition from imported goods, on the one hand, and a strong upswing in the ratio between average wages and the cost of capital goods (as reflected by the average wage measured in US dollars, which rose abruptly in 1990–1), on the other hand, explain the significant drop in labour demand by firms. The estimated coefficient of structural adjustment of full-time employment would explain, in fact, a fall in this ratio equivalent to 10 p.p. between 1990 and 1996 (about 1.44 p.p. a year), though this effect was partially offset by the increase in labour demand caused by GDP growth.

Although both the privatisation process and fiscal adjustment had some negative impact on employment, the dominant negative effects came from

the restructuring and concentration of economic activity in the tradable goods sector, particularly in manufactures, as was also observed in the cases of Brazil and Mexico. Even in expansionary periods, the increases in the demand for manufactured goods could not offset a number of negative effects. These resulted from the direct displacement of domestic production for imported goods and from the reduction in the number of jobs per unit of output in the surviving firms, as an adaptation to the new set of relative prices. Furthermore, many small and medium-sized firms found serious difficulties in continuing operations. Their closure was an important cause of employment contraction.

In spite of the decline in the full-time employment ratio, total employment, including the underemployed, rose by 1.09 p.p. between the extremes of the period. This reflects the fact that involuntary underemployment (which showed a counter-cyclical behavior as well as a rising trend in the 1990s) increased by more than 3 p.p. during the decade.

The average real income of employed individuals rose during the expansionary phase of 1991–4, as did the active population's average earnings. But the increase was lower for the latter, reflecting the impact of unemployment rates that started to rise in this period in spite of a still growing output. Income distribution indicators estimated for both households and employed individuals improved slightly in this initial period. The incidence of poverty showed an important fall from the record levels related to the hyperinflationary phase of 1989–90. However, the behaviour of indigence was different: after an initial reduction, it started to climb while the economy was still in the middle of an economic expansion.

This picture seriously worsened after 1994. Average real income of both employed workers and the active population fell strongly, in particular for the latter (as a consequence of the simultaneous impact of lowered wages and a higher unemployment rate). The income-distribution indicators suffered generalized and significant deterioration in the mid-1990s. The household's Gini coefficient, for instance, recorded significant increases, as also happened in the case of employed workers and, even more intensely, of the active population.

The rising unemployment rate is the main factor explaining the deterioration in these income-distribution indices. Unemployment affects income distribution in a number of ways. One is direct, by diminishing the number of income recipients among active persons. As the contraction in the number of jobs hits the lowest-income households more intensely, unemployment was not neutral with regard to income distribution among households. Meanwhile, unemployment affected more heavily the less-educated workers, who represent a high proportion of the lowest-income households.

But the rise in unemployment also has an indirect impact on labour earnings and distribution. It causes a decline in the hourly earnings of both full-time and underemployed workers. The elasticity of both hourly and

total real earnings of employed workers to unemployment is negative and statistically significant. The unemployment rate also has a negative effect on the number of hours worked by the underemployed. Furthermore, the unemployment-elasticity of income is higher for the underemployed than for full-time workers. As the incidence of underemployment is higher in the lowest-income households, these effects had negative consequences on income distribution.

The estimated unemployment elasticities of workers' earnings are very close to their values for the United States and for other developed economies. This suggests that the observed increase in unemployment and underemployment cannot be attributed to a particularly strong downward inflexibility of wages. From 1998, for instance, average earnings fell somewhat, in the context of a slight negative trend in nominal prices, without any significant positive effect on the employment levels. On the contrary, it is possible that these factors generated greater excess supply in the goods markets, thus reinforcing the depressed condition of the labour market. On the one hand, lower earnings have a negative impact on aggregate demand. On the other, price deflation increases the level of debt in real terms, and this can also have a negative effect on aggregate expenditures, through its impact on debtors' spending propensity (investment projects, fall in future expected cash-flows, etc.).

An intermittent procyclical fiscal policy (not always confirmed by *ex post* figures) has added to these depressive factors in recent years, and particularly from late 1999 when public sector access to foreign credit became increasingly difficult. The economic malaise found another manifestation in the lack of policy instruments to help the economy to emerge from the quagmire of depression and price deflation.

After a deterioration in the mid-1990s, the estimated income-distribution indicators recorded a moderate improvement during the ensuing expansion between 1996 and 1998. But they never reached the levels they had attained before the Tequila episode in 1994. During this phase the average income of both employed workers and active individuals rose, but without reaching the preceding peak. After 1998, and following the spillover of the Russian crisis, the macroeconomic performance clearly worsened.

Even if it were true that the effects of exchange-rate appreciation (combined with trade opening) had been a crucial determinant of the behaviour of labour indicators at the beginning of the 1990s, other factors assumed a dominant role in the second half of the decade. They were also a result, in part, of the exchange-rate appreciation. We refer in particular to the negative effects that result from the accumulation of foreign debt, which was, in turn, a consequence of the sustained deficits in the current account of the balance of payments in the 1990s.

The debt overhang is another constraint to growth that reinforces the negative effect of the low profitability of firms in the tradable goods sector.

The combination of higher financial fragility with an unfavourable shift in international economic conditions led to a significant decline in private capital inflows from 1998. The accumulation of foreign reserves stopped, thus negatively impacting on domestic liquidity and pushing up interest rates. A new economic contraction followed, as well as a decline in average real earnings of both employed workers and the active population. Indigence and poverty indicators also resumed their rising trend in 1998–2000. Thus, poverty almost completed its return to 1991 levels, while indigence rose between the beginning and the end of the decade.

The end-of-period picture could also be observed prior to the outbreak of the crisis, whose consequences will certainly include an additional worsening of labour conditions and income distribution indicators. The overall situation can be summarized using the following figures that compare the end of the convertibility period with its beginning. The full-time employment rate (for the urban population) fell by 1.8 p.p., basically due to the behaviour of the manufacturing sector and, in particular, a lower proportion of male and head-of-household workers in manufacturing jobs. However, the proportion of involuntarily underemployed persons rose strongly (by more than 3 p.p.). As a consequence, the employment rate (including the underemployed) increased by slightly more than 1 p.p. of the population. The only sector to generate a relatively significant number of full-time jobs was financial services.

The proportion of active individuals in the total population followed a sustained upward trend. This ratio increased by about 1 p.p. every three years in the 1990s, mainly as a result of the behaviour of female participation rates. Weak employment creation, together with the rising trend in the number of active individuals, explains the important upward shift in the unemployment rate. It rose from 6.3 percent of the active population at the beginning of 1991 to 14.7 percent by late 2000. On the other hand, the per capita real income of the employed was almost 9 percent higher by the end of the period. But it was almost the same for the active population (only 1 percent higher). This is because of the aforementioned upward shift in the participation rates, which largely surpassed the increase in the rate of total employment.

Although the average earnings of employed workers rose (by less than 10 percent), their distribution worsened considerably according to several indicators. This is due in part to the distributive effects of the rise in the unemployment rate. When different categories of workers are considered, a decline in full-time jobs can be observed (in particular for wage earners), and an important increase in involuntary underemployment results as a counterpart. The participation of female workers in the labour force also rose, as happened with those with a tertiary-level education. The same can be said of workers with secondary-level education, but in lower proportion, while those with only primary-level education lost ground. These trends in employment figures closely followed the changes in the

educational levels of the total population. An important increase in the returns of education can also be observed in the period.

Distribution indicators like the households' Gini coefficient, as well as those for poverty and indigence, showed markedly rising trends in all cases (beyond a cyclical behaviour that resembles that of output). We could note, as an example of the results of these trends, that the income of the richest decile of households was 40.3 percent of total income in 2000, while it had been only 35.3 percent in 1991. This income was equivalent to 23.6 times the total earnings of the lowest-income decile of households in 1991, but had jumped to 38 times in 2000. Surprising as this may appear to an outsider, note that the dramatic change in labour indicators and in income distribution was not the result of the final crisis of the macroeconomic regime of the 1990s in Argentina, but preceded it.

Why has the regime lasted for so long? Why have the negative social effects been so acute? Why has the financial crisis been so deep and complex?

In this section I consider six possible answers to these questions. First, the story told in the first section attributes the causality of the process almost exclusively to macroeconomic factors. We appeal to Ockham's razor in order to focus the analysis on the macroeconomic factors that have led Argentina to the present situation. This focus does not mean that other aspects of the 'model' should be disregarded. For instance, some of the reforms – such as the privatisation of natural monopolies without adequate regulation and the privatisation of pension funds – had direct negative effects on fiscal accounts and on income distribution. Nor do we disregard the importance of political corruption and the opportunistic behaviour of most political leaders. But, if a hierarchy of political errors could be determined according to their relative importance, we think that the Menem and De la Rua administrations should be blamed mainly for setting up and supporting the convertibility regime.

The same should be said about the IMF, because this institution supported the Argentine administration's sacred doctrine with financial resources, by giving its seal of approval to unsustainable programmes and by providing arguments in defense of the currency board. Before abandoning the boat, just as it was sinking, the IMF encouraged policy measures that deepened the recession and pushed the economy further into a vicious circle of sales and activity contraction, which reduced tax collection and caused a further deterioration in the fiscal accounts. Both the authorities and the IMF followed this line, disregarding sensible analyses, international experience and the overwhelming evidence of the persistent worsening of the country's economic and social situation.

Second, as of 1991, the Argentine macroeconomic setting comprised trade and financial opening, a currency board regime determining the

exchange rate and monetary policies, partial but increasing dollarization of the banking system, and a strongly appreciated exchange rate. The story that can be told starting from that date is not unique. For instance, the stylized facts of Argentine performance are essentially the same as were observed in Argentina and Chile in the late 1970s and early 1980s and, more recently in Mexico, between 1988 and 1994, and in Brazil, between 1994 and 1998.

In all the above-mentioned cases a cycle developed, with an initial expansionary phase followed by a period of stagnation or recession, increasing external and financial fragility and a final financial and exchange rate crisis. Decline in the number of workers in the tradables and formal sectors, rise in unemployment and/or employment in the informal sector and deterioration in income distribution were also common features of the above-mentioned cases. Argentina experienced this cycle twice in the decade, because the convertibility regime survived the 1995 Tequila effect crisis. After 1995 the economy underwent another short expansionary phase backed by a new surge in capital flows that lasted until the Asian crisis. As a consequence of the first cycle, high external debt ratios and a high unemployment rate were part of the initial conditions of the second cycle.

Third, the appreciated exchange rate and the partial dollarization of the local banking system are not necessary ingredients of a currency board regime. They arose from specific local circumstances, but both constituted basic characteristics of the convertibility regime and significantly influenced its performance.

The appreciated exchange rate is a crucial factor. The exchange rate was greatly appreciated when it was pegged to the dollar in 1991. Coming from a highly depreciated level, reached in early 1990 in the context of hyperinflation, the exchange rate significantly appreciated during the rest of that year. The appreciation was accentuated in the first half of the 1990s and there was a slight depreciation in the late 1990s, but these changes did not significantly alter the appreciated level, which persisted throughout the whole period. There was an important rise in manufacturing-sector labour productivity, but the average unit labour cost in constant dollars did not fall because the prices of non-tradable goods and services and nominal wages rose in the first half of the 1990s. Fluctuations in the multilateral real exchange rate around the trend were mainly caused by exchange rate fluctuations in trade partners, particularly in Brazil.

The partial dollarization of the domestic financial system is also an important factor, and explains both the persistence of the regime and the complexity of the present financial crisis. The Convertibility Law sanctioned the validity of monetary contracts denominated in any currency. The measure was originally intended to encourage the repatriation of Argentine capital, allowing its owners to make deposits in dollars in the domestic banks. Despite the high credibility enjoyed by the exchange rate

commitment (as measured by the interest rate differentials), private-sector savers have showed preference for dollar-denominated deposits while banks hedged (or so they thought) balance sheets against exchange rate risk by offering dollar-denominated credits. Consequently, as from the early stages of the convertibility regime there was a persistent trend towards a growing proportion of dollar-denominated assets and liabilities in the local banking system.

The dollarization of local savings and credits played an important role in agents' perceptions and behaviour. The dollarization of private-sector assets was perceived both by the public and the banks as a hedge against the risk of devaluation (wrongly, because both disregarded the existence of a systemic exchange risk) and so contributed to stabilizing local portfolios. On the other hand, the exchange risk burden rested not only on foreign investors, and banks and big firms indebted abroad, but also on numerous local bank debtors with peso-denominated incomes. This feature strongly amplified the wealth effects of devaluation and forced the authorities to implement a massive intervention in private financial contracts.

Fourth, as was mentioned above, the Argentine experience is not unique since it resembles other cases of trade and financial opening accompanied by exchange rate appreciation. On the other hand, owing to some specific characteristics, it might be said that the negative consequences of financial globalisation were in Argentina more accentuated than in other countries.

The convertibility regime was an extremely rigid setting. The rigidity did not follow exclusively from the legal rules but also from the actual behaviour of markets. For instance, the flexibility of the real exchange rate *vis-à-vis* negative external shocks would have required a significant downward flexibility of domestic non-tradable-good prices (according to macroeconomic textbooks). Actually, no significant nominal deflation took place either in the 1995 recession or in 1998–2001, in spite of significant flexibility of wages. Labour market legislation plays, at most, a minor role in this regard. As mentioned above, the wages–unemployment elasticity in Argentina is significant and similar to the unemployment elasticity estimated in the USA and other developed countries.

The convertibility regime determined two features of the macroeconomic performance. The first feature was a growing external gap. The combination of trade opening with an appreciated exchange rate has resulted in a chronic trade balance deficit. The trade balance reached equilibrium or surplus only under conditions of deep recession. On the other hand, there was a growing structural deficit in the factor services account, caused by debt accumulation and foreign capital investment. Consequently, the regime generated a rising current-account deficit. This means that the economy required substantial net capital inflows to reach a positive rate of growth. Moreover, the economy required increasing external capital inflows to sustain any positive rate of growth.

The second feature of the macroeconomic performance was that the volatility of the international financial conditions facing the country was mechanically transmitted to domestic activity and employment levels. The correlation between national performance and the behavior of international capital markets is a common characteristic of the emerging market economies, as was dramatically illustrated in the second half of the 1990s. In the Argentine case the correlation was accentuated by the convertibility regime because it lacked any significant monetary and nominal flexibility. In the first half of the 1990s there was a booming domestic demand, led by capital inflows and consumption. After the Mexican devaluation the Argentine economy was hard hit by the Tequila effect and faced the second deepest regional recession (after Mexico). A second surge in capital inflows led to an acceleration of growth in 1996–7. The external impulse slowed down after October 1997, together with the rate of growth. There was again a turnaround in economic activity in the third quarter of 1998, after the Russian–Brazilian crisis (but well before Brazilian devaluation in January 1999). In 1999, when the international financial conditions confronted by the country were still similar to those of Brazil (as indicated by the country-risk premium) the Argentine economy suffered one of the deepest recessions in the region (only Ecuador and Venezuela ranked below Argentina).

Fifth, the currency board regime played to some extent its intended role as an automatic stabilizer of the external accounts. Balance-of-payments deficit caused an automatic contraction in money and credit, a fall in aggregate demand and a consequent contraction in imports. But under the convertibility regime, the deep recessions left the current account with a substantial deficit and a very high unemployment rate. These features weighed on the negative side of international investors' perceptions and tended to offset the positive side. The Argentine version of the currency board was far from moderating the risk of default.

The investor community had to express opinions and bet on the risk of default and on the permanence of the convertibility regime. Default and the abandonment of the convertibility regime was one of the potential outcomes in the Argentine case. This characteristic put the economy in a situation of multiple equilibria, vulnerable to self-fulfilling prophecies.

Multiple equilibria situations and self-fulfilling prophecies are not unusual in the present setting of international financial markets. One difference between the Argentine game and other emerging market games was the reduced relevance of domestic economic factors in the Argentine case. Given the above mentioned features of macroeconomic performance, what counted most for sustainability were external factors. These factors included, for instance, the main external circumstances affecting the prospects of the trade balance: export commodity prices and Brazilian demand for Argentine imports. But fundamentals contributed only partially to the formation of the players' conjectures. Given that the bulk of

the financial needs originated in sources of high inertia (debt rollover and the deficit in the factor services account), each individual player had to focus on the future behavior of the international financial market with respect to the country, that is on the behaviour of other players. The signals about the prospects of the trade balance – like any other signals – were valued mainly for their expected influence on the financial market's future behaviour.

Because the convertibility regime left little room for correcting policies, the government's 'economic policy' was restricted to delivering signals. Government economic measures counted mainly for their presumed signalling value. Fiscal adjustment and fiscal equilibrium commitments, for example, were credibility signals of certain value, despite their negative impact on aggregate demand. For instance, an agreement with the IMF mattered more as a signal to the market than due to the amount of resources committed through it.

Sixth, it has already been mentioned that an acute dependence on external capital inflows is the original sin of the convertibility regime. Sustainability and growth expectations fluctuated throughout the 1990s driven by good and bad news. Contagion from the Mexican crisis disappointed the initial expectations of persistently high capital inflows and revealed their volatility. But, at the same time, booming commodity prices and the Brazilian *real* plan represented good news. Helped by the positive *real* shock and an 11-billion-dollar rescue package, the convertibility regime survived the Tequila effect. The combination of both a favourable external environment and the very success of the rescue operation gave strength to unfoundedly optimistic expectations and a new surge in private capital inflows. This lasted until the Asian crisis. From then on optimism receded, capital inflows declined and the country risk premium rose persistently with relatively high peaks marked by the Russian–Brazilian crisis and the Brazilian devaluation. In 1998–9, while the general financial conditions of the emerging markets reflected the lasting effects of the crisis initiated in Asia, the main external factors of the Argentine economy – including the bilateral real exchange rate *vis-à-vis* Brazil – all took a turn for the worse. Without the compensating effect of external good news, the low competitiveness of the Argentine economy regained prominence in the opinions of analysts. The last wave of moderate optimism was motivated by the support package agreed with the IMF in October 2000. This lasted for only a month.

On no occasion throughout this turbulent history was an eventual withdrawal of the convertibility regime given serious public discussion. Although some criticism was expressed from time to time, no significant political or social representative has taken an open position in favour of a change of regime. Similarly, few economists criticized or even focused their analysis of Argentina's problems on the difficulties represented by the regime. In the public arena the convertibility regime was taken as a

given and unalterable state of nature. It became a sacred doctrine, not to be discussed in rational terms. Critics carried the burden of being labelled 'devaluationists' and were doomed to intellectual and political isolation.

On the other hand, some influential economists strongly supported the regime. Their arguments did not disregard negative evidence but emphasized the virtue of the discipline imposed on government and society. With time that virtue was expected to bear fruit in competitiveness, higher exports and sustainable growth. Sectoral interests also help explain the situation. Banks, large firms indebted abroad, foreign-owned companies and financial intermediaries were strongly interested in continuity. Domestic credit dollarization vastly benefitted these economic actors. Analyses and opinions were not immune from such influences.

Leaving aside faith and interests, it is fair to say that a change in the convertibility regime would have been a very difficult and risky policy move in any case. The acceleration of inflation was a real threat. The fear of inflation constituted the main source of popular adherence to the fixed exchange rate to such an extent that 'convertibility' and 'price stability' were almost interchangeable terms in the public arena. Change appeared to be no less difficult and risky for the local financial system.

On top of the technical complexities, the change of regime would have entailed a risky political operation. The authorities in office at the time would have surely carried the full burden of responsibility and would have been blamed by popular opinion for the short-run disruption and negative consequences. Thus, it could be said that most of the public attitudes, opinions and lack of candour were driven more by fear than by conviction. Finally, as in most similar situations, a crisis, rather than a political or economic decision, put an end to the convertibility regime.

Notes

1 Paper prepared for the conference 'Economic Management and Political Collapse in Argentina: Interpreting the Past to Build for the Future', organized by the Graduate Program in International Affairs, The New School, New York, 8–9 April 2002.

2 This section presents a synthesis of the conclusions of the book: M. Damill, R. Frenkel and R. Maurizio, *Argentina: A Decade of Currency Board. An analysis of Growth, Employment and Income Distribution* International Labor Office, Geneva, 2002.

4 State and development in Korea after the Asian crisis

Dae-Hwan Kim

Introduction

The four years following the 1997 crisis have been among the most turbulent in Korea's modern economic history. It has been said that this financial crisis was the severest national crisis since the Korean War. During this period, the country has witnessed not only severe financial turmoil and ensuing economic stagnation but also a very rapid recovery from the crisis. After sharply declining, economic activity and employment are on the rise and GDP has returned to its pre-crisis level. Financial markets and general financial conditions also improved, but are now becoming unstable again. After entering free fall during the financial crisis, the foreign exchange rate has strengthened considerably, although it still remains significantly depreciated compared to before the crisis.

It is a really dramatic story that Korea went from OECD member to being the recipient of the single largest financial bailout in the history of multilateral lending in a single year. Observing such an abrupt downfall, many authors have tried to explain the causes of the crisis. Most have now reached agreement that the crisis was 'home-grown', i.e. due to 'market failure' in the Korean economy causing macroeconomic weakness and financial vulnerability. Closely connected to this, the crisis is also attributed to the 'policy failure' of the former Korean government. These diagnoses are hard to refute, since the external contradictions facing the Korean economy have indeed realised themselves through internal ones.

This does not mean, however, that the external factors of the crisis can be ignored. Given the home-grown causes, whether market or policy failure, their leading to a crisis was not self-fulfilling (through the action of domestic factors alone) but occurred through interaction with globalization factors, including through the action of international financial capital.

The sudden and contagious nature of the Korean crisis in 1997 is thought to have stemmed from globalization of the economy in general and of international speculative financial capital in particular. In the same vein, IMF control of the Korean economy following the bailout has effectively strengthened the logic of globalization by taming the Korean 'tiger',

probably the fiercest among the Asian four (Taiwan, Singapore, Hong Kong and Korea). The economic and social consequences are very closely connected to ongoing globalization as the prospects for the Korean economy have become more dependent on the future of globalization.

In the process of adjusting to the crisis, Korea has endeavoured to meet IMF conditionality by restructuring four key sectors: financial, corporate, public and labour. Along with this, the government has had to build and expand a social safety net, in particular to protect the increased unemployed population as a result of bankruptcy and restructuring since the crisis. The Korean state still seems to take the driver's seat, as it did during the previous three decades of rapid economic growth preceding the crisis. But its position in the development process has considerably changed since the crisis, not only economically but also politically, as neo-liberal restructuring advanced. It is thought that the concept of the developmental state no longer applies to Korea, although a neo-liberal market-oriented paradigm has not yet become dominant in its economy and society.

The Asian crisis in the context of globalization

Crisis-ridden globalization

Globalization is understood as a new accumulation regime emerging in response to the end of the golden age of capitalist accumulation. While dismantling the Keynesian welfare state and organised labour, globalization has successfully pursued a widening of markets across national borders and an intensification of 'free' competition in the market (Kim 1998a). In this process, globalization has also intensified economic crises in developing countries and emerging markets.

The debt crisis of Latin America in the 1980s was the responsibility of international capital, not to mention the military regimes that held power in most of the region in the 1970s. The 1970s was a period when the international banks were flush with funds due to the surge of oil money in the world financial system, and the central banks of the advanced capitalist countries were willing to pump funds into the banking system. There was an abundance of banking funds, and Latin America, which was rich in resources and had demonstrated a capacity for economic growth, became a major target for the international banks to invest their funds.

A significant portion of the international capital lent in the 1970s went to expand agricultural and mineral production. The Latin Americans were simply following the rules and logic of the capitalist market in that they sought to expand their exports in order to repay the loans as well as accumulate profits and capital for their own economic growth and development (Burbach 1992, p. 244). Virtually all developing countries followed the same economic logic. As a result, in the early 1980s the prices of raw

materials and agricultural products, the mainstays of the Latin American export market, dropped sharply. In contrast, the prices of manufacturing and industrial goods, the major exports of the advanced countries, continued to rise. Thus, the Latin American countries became unable to repay their huge foreign debt, which jumped from $25 billion in 1970 to $318 billion in the region (ECLAC 1986, p. 53), leading to debt crisis in the 1980s.

Following the logic of globalization, the Reagan administration in the USA and the international financial institutions insisted that what was needed to resolve the crisis was not coordinated international efforts to regulate overproduction or a moratorium on debt payments, but rather the free market bringing an end to any type of national regulation and control. This is what became known as the 'Washington consensus' (Williamson 1990). The Washington consensus, now the powerful carrier of globalization, forces governments to reform their policies, and in particular: (a) pursue macroeconomic stability by controlling inflation and reducing fiscal deficits; (b) open their economies to the rest of the world through trade and capital account liberalisation; and (c) liberalise domestic product and factor markets through privatisation and deregulation (Gore 2000, pp. 789–90).

Actually, as the 1980s wore on, most Latin American countries bowed to the dictates of the Washington consensus, under the pressure of the IMF and the World Bank. These institutions gave financial support to carry out adjustments from the mid-1980s: lifting tariff barriers, selling off state-owned enterprises and, most importantly, throwing national economies open to foreign capital. Along with this, after the debt crisis and currency collapse in 1982, foreign capital was attracted by low wages. This led to the 'Tequila boom' and the real appreciation of the Mexican peso, which in turn increased external current account deficits and weakened the banking system following its privatisation in the early 1990s.

Throughout the middle and late 1980s capital was sucked out of Latin America by the international banks which recognised that there is little profit to be made by financing or investing in the region because of the 'debt overhang', the capital flight and the protracted nature of economic reforms. The banking crisis developed with the balance of payments crisis, resulting in outflows of foreign capital and leading to the Mexican crisis in 1994 (Kalter and Ribas 1999). Combined with domestic causes, the effects of contagion spread the banking crisis across the region (Garcia-Herrero 1997).

The Washington consensus and the Asian crisis

If the Latin American crisis in the 1980s is a debt crisis, the recent Asian crisis is a financial crisis. The banking crisis of the 1990s in Latin America bridges the two. This implies that the Washington consensus has carried

and promoted crisis-ridden globalization, increasingly targeting the financial sector, and liberalising the external capital account of developing countries.

Much has been said regarding the causes of the Asian crisis, and most of the explanations have focused on macroeconomic weakness and financial vulnerability: over valuation of currencies, high or growing current account deficits, relative price distortions against exports and tradables, inconsistent macro policies, lack of prudential regulation and monitoring, moral hazard, adverse incentives (government guarantees and expected government bailouts of banks and other financial institutions), lack of transparency, and so on.[1]

Admitting these 'home-grown' causes of the crisis, it should be noted that the list is far from comprehensive. Macroeconomic weakness and financial vulnerability are in fact the products of opening national economies to foreign capital, particularly to short-term financial capital. The vulnerability as well as the weakness itself are not solely home-grown but also guided by globalization. Deep within these much-discussed causes there is the fundamental cause of the crisis: opening up to short-term foreign capital flows.[2]

One author has described this as opening Pandora's box (Lim 1999, p. 442). But there are differences. The evil spirits inside the box came out ready-made when Pandora opened it; however, opening up to volatile international financial flows made things worse and eventually converted the situation into a crisis. More importantly, Pandora opened the box to satisfy her own curiosity despite a warning never to do so, while the Asian countries were pressed to open their national economies to short-term capital by the Washington consensus. The bomb of globalization was dropped on the box, to produce the explosion of a crisis.

The doctrine of the Washington consensus has been applied by the institution of the WTO across the world and by the ASEAN (Association of South East Asian Nations), Asian Free Trade Area (AFTA) and the APEC (Asia–Pacific Economic Cooperation) to Asia. These organisations institutionalised trade liberalisation, and, together with the IMF, encouraged capital account liberalisation as a sequel to the process of trade liberalisation. The IMF was in the process of amending its Articles of Agreement to make the liberalisation of capital account one of the purposes of the Fund, requiring member governments to assume 'consistently applied obligations' with regard to capital account liberalisation. Behind these players, there was a directing body of interests called 'Wall St.–Treasury' (Bhagwati)[3] or 'Wall St.–US Treasury–US Congress–City of London–UK Treasury' complex (Wade 1998).

North America's protracted recession at the beginning of the 1990s pressured fund managers to 'discover' higher-yielding investment opportunities in 'emerging markets'. Pressed to adopt globalization and motivated by the desire to 'get rich quick', the most rapidly growing

economies in the 1990s gullibly and enthusiastically opened their external capital accounts. Flows to Korea, Indonesia, Malaysia, Thailand and the Philippines rose from $47 billion in 1994 to $93 billion in 1996. An 'East Asian boom' was created, the currencies were over valued, and current account deficits increased.

In the process of opening, the distinction between long-term and short-term debt was ignored. As of 1996, the short-term debt of these five countries snowballed to $189 billion, far above their foreign exchange reserves (except Malaysia).[4] 'It was like an initially healthy person becoming unable to distinguish his intake of good and bad cholesterol. Over many years, one can safely predict the state of his health. Unfortunately for the East Asian countries, the "bad cholesterol" dominated the flows' (Lim 1999, p. 437). As was documented by Berg (1999), this swiftly led to the Asian financial crisis, which was sparked by the depreciation of the Thai baht in July 1997 and spread to Indonesia, the Philippines, Malaysia, and eventually to Korea.

Not having been anticipated, the Asian crisis can be understood as a 'crisis of success' caused by a boom of international lending followed by a sudden withdrawal of funds. But it has been the sharpest economic crisis to hit developing countries since the 1982 debt crisis in Latin America, leading to the largest financial bailout in history.

The Korean crisis and IMF conditionality

The crisis of 1997

For the recent economic crises, particularly the Asian financial crisis of the 1990s, the blame seems to be shared between national governments and the international players pushing for globalization. But it must fall disproportionately on the IMF which for several years now has been pushing aggressively for the opening of the capital account of developing countries (Wade 1998). Ultimately, however, the responsibility of the IMF originates in the 'Wall St.–Treasury' complex. This is particularly so in the case of the Korean crisis because its outbreak was the result of contagion rather than of home-grown causes.

The outbreak of foreign exchange turmoil in November 1997 was so sudden that no one could predict it, nor take action to prevent it. There were few signs of impending crisis, such as rising interest rates in the G-7 countries or a sudden suspension of capital flows to developing countries, even after the Thai baht devaluation. In June 1997, the Japan Center for International Finance, the Japanese government's *de facto* credit rating agency, gave Korea one of its highest credit ratings for any developing country (Yoshitomi and Ohno 1999); and the World Economic Forum rated Korea the fifth best investment site in the world. The IMF and World Bank lavished praise on the Korean government throughout 1997.

Even three months before the crisis, the IMF annual report stated that, 'Directors welcome Korea's continued impressive macroeconomic performance ... [and] praised the authorities for their enviable fiscal record'. The report called for financial sector reform in general terms, giving no hint of alarm, and made no mention of breaking up the chaebol or allowing foreign ownership of banks or strengthening banking supervision, issues that are now central to the IMF programme for Korea.

Some authors argue that the problem was not lack of capability to address market failures, and go further to say that foreign financial flows subverted the healthy coordination between the state, financial institutions and corporations in East Asian countries in general and Korea in particular (Wade 1998; Wade and Veneroso 1998). Bhagwati (1998), Radelet and Sachs (1998a, 1999), Rodrik (1998) and Stiglitz (1998a, 1998b) are also reluctant to admit macroeconomic weaknesses. All these authors insist that financial vulnerability was the result of opening to international financial flows.

Given that macroeconomic weakness and financial vulnerability had been embedded in the Korean economy and were much aggravated in the years before the crisis (Kim 1995, 1998b, 1998c, 1999), their exacerbation was due to over-lending as well as over-borrowing. By 1996, when Korea recorded huge current deficits[5] and Japanese interest rates were the world's lowest, Korea's fledgling merchant banks and finance companies began borrowing prodigious amounts of money from Japanese banks and the Japanese branches of US and European banks. These transactions, no longer scrutinised by the government, featured poor maturity structures, with more than 70 per cent having less than one year's maturity and more than half with a maturity of 90 days. Thus, on the eve of the crisis, foreign debts mounted to more than $150 billion (as it became known later) and more than 60 per cent were short-term debts.

When the Korean government refused to allow a major chaebol (Kia Motors) to go bankrupt, the bond rating agency Standard & Poors downgraded the country's creditworthiness. Shortly after this, hedge funds, 'fresh from their killing in Southeast Asia' (Bernard 1999, p. 198), moved in to attack the Korean won. Over the ensuing few weeks the primary holders of Korean debt, the foreign banks, insisted on calling roughly 75 per cent of the loans due, precipitating a run on the Korean won, and as much as $1 billion a day flowed out of the country. This dried up foreign exchange reserves and pushed Korea into financial crisis.[6]

It is thought that the crisis could have been avoided if Korea had liberalised its financial system more slowly or if there had been coordinated efforts to stabilise the international financial system. Then the domestic lending excess and vulnerability to outflows of hot money would have been curbed and the rush to crisis may have been checked. In reality, however, Korea had no capability of resisting the Washington consensus pressure radically to free its capital account, while the international

financial market became more volatile than ever. Korea's financial crisis is as much a manifestation of the cul-de-sac represented by dependent capitalist development as it is a debt roll-over crisis.

IMF conditionality

Facing imminent bankruptcy, Korea, with its capital account free and floating exchange rates in place, hurriedly asked for an IMF bailout that was essential to solving its problems. The IMF finally committed emergency official liquidity support of $58 billion (IMF $21.1 billion, World Bank and Asian Development Bank (ADB) $14.2 billion, and bilateral support of $23.1 billion) to cushion the blow of the rapid capital outflow which characterised the crisis.[7] It was the greatest financial bailout offered to a single country in the history of multilateral lending, if not enough to cover all potential debt service over the near term. Korea relied on the assumption of some roll-over of maturing foreign debt to close the financing gap generated by 'herd' outflows. The IMF bailout was needed to convince at least some investors that they should remain.

The IMF programme announced on 4 December 1997 left doubts remaining about the size of the support package as well as serious concerns of default, so the roll-over rates were very low. After the programme was strengthened by late December, the situation turned around. Korea was relieved in April 1998 when agreement was finally reached to roll over and restructure $32 billion of short-term debt into medium-term loans, at higher interest rates than the original and with government guarantees for repayment. Bernard (1999, p. 199) blames the IMF for acting as a collection agency for bankers who profited greatly from imprudent lending.[8]

While providing external finance, the IMF imposed on the Korean economy its conditionality consisting not only of tight monetary–fiscal policy and structural reforms but also unlimited opening of domestic markets. Contraction in monetary and fiscal policy is a typical shock treatment delivered by the IMF. By raising interest rates and cutting public expenditure, it aims at currency stability and softening inflationary pressures. There were criticisms that monetary and fiscal austerity measures, uniformly imposed on all affected Asian economies, actually deepened and prolonged Korea's crisis. Before the controversy cooled down, however, austerity was relaxed. Behind this relaxation, it has been argued, the USA exerted its interests.[9] It was further alleged that most of the urgent short-term remedies prescribed were 'Made in America' (Dale 1998).

The structural reforms, prescribed for economic stability and sustained growth, cover all sectors of the Korean economy: restructuring the financial and corporate sectors, privatising public enterprises, making the labour market flexible, and even reforming the close relations between government, financial institutions and businesses. As a key component of the effort to restore growth and persuade investors to stay, the undertaking

of financial reform included (a) the closure of insolvent banks and non-bank financial institutions, (b) the recapitalization of the bank system, (c) an injection of public capital, and (d) measures to strengthen regulation and supervision, capital adequacy requirements, loan provision and classification rules. This was what the creditor banks involved in roll-over negotiations with the Korean authorities demanded strongly as a condition for their participation in the debt restructuring agreement (Berg 1999, p. 26).

Restructuring of the corporate sector stressed, among other measures, the effective dissolution of the chaebol regime. It included not only the big deals among chaebol and the 'workouts' (restructuring) of affiliated firms, but also management transparency and improvement in corporate governance. Together with financial reform, it went further to demand getting rid of the 'bad practices' between government, financial institutions and businesses. This actually aimed at prevention of corruption and, in particular, the eradication of the so-called power–money nexus. Although these measures were welcomed by many Korean economists, it is possible to raise the criticism that focusing on these issues is inappropriate for the IMF.[10]

What is clear is that IMF conditionality imposed on Korea was based not only on neo-liberal market-friendly philosophy but also on a radical 'big-bang' approach which had been adopted by the IMF in the transitional economies of Eastern Europe. This also applies to the reforms of the public sector and the labour market, in addition to financial and corporate restructuring. The public-sector reform put emphasis on, among other things, privatisation including selling assets to foreign investors, while the labour-sector reform brought flexibility by institutionalising layoffs, temporary workers and flexible working time. Admitting the need for privatisation and flexibility, it is problematic to apply a 'one-size-fits-all' neo-liberal programme to the public sector and the labour market. The result could be to sacrifice public and workers' welfare for private profits, while the efficiency effects would be questionable in theory and practice.

There is no doubt that the IMF and the World Bank have made loans conditional upon the creation of a certain environment attractive to foreign investors, including not only tariff reduction but also currency realignment. This 'forced liberalisation' has in fact served the interests of ongoing globalisation to the detriment of developing economies and people's welfare.

After the crisis: restructuring, social safety net and industrial relations

Restructuring[11]

The Korean government has made every effort to meet IMF conditionality based on the Washington consensus. Restructuring the economy as a

whole, that is the four key sectors (finance, corporate, public and labour), has been given the greatest policy emphasis. This section covers the first three, leaving the fourth for the next.

The financial sector

In the face of the 1997 crisis evoked by financial turmoil, the government tried to make financial markets stable by restructuring financial institutions. From the crisis to April 2001, 572 'ill-managed' financial institutions (27.2 per cent of all, as of 1997) have been liquidated or merged: 11 banks, 27 merchant banks, 7 securities firms, 10 investment and trust banks, 15 insurance companies, 10 lease companies and 492 small savings institutions (Ministry of Finance and Economy 2001). For this restructuring, a huge volume of public capital (137 trillion won in two tranches) has been poured into the 'surviving' financial institutions, still bedevilled by heavy non-performing loans, to rescue them from bankruptcy. Four banks and a merchant bank have recently been turned into a financial holding company to 'clean' them by pouring in public capital. These actions have created bigger institutions based on the 'big-is-competitive' belief.

Along with this process, the government has strengthened its monitoring role of the financial institutions to prevent moral hazard, while emphasising their autonomy of management. In 1998, the Financial Supervisory Commission was established as a government body and measures related to restructuring of the financial sector were legalised. In 1999, several monitoring institutions were integrated into the existing Financial Supervisory Service and the international standards of FLC (Forward-Looking Criteria) was introduced. At the same time, the government announced non-intervention in the management of financial institutions and handed over the right to the election of the CEOs to a 'neutral' independent committee in each institution. It is still doubtful, however, that the old legacy of government-controlled finance in Korea will promptly disappear.[12]

In practice, restructuring of the financial sector was soon compromised. Because of past mistakes involving weak prudential regulation and arbitrary intervention, the government was less than strict in applying the principle of accountability to investors who had made their decisions under past regimes. Concerns about systemic risk also played a part. In fact, the resolution of the Daewoo crisis in 1999 was delayed because of these concerns. In the end, the government decided to err on the side of safety, and used taxpayers' money (public funds) to bail out individual investors rather generously, allowing them to redeem up to 95 per cent of the face value of Daewoo corporate bonds.[13] Many critics argue that the government carried the 'path-dependence' logic[14] too far and failed to take advantage of a golden opportunity to address the problem of moral hazard and establish the principle of accountability.

The financial sector partly achieved 'hardware reforms' by closing and

recapitalising banks and non-bank financial institutions, largely ignoring such 'software reforms' as risk analysis and credit rating. The banks that were effectively nationalised through injections of public capital have simply augmented the restructuring tasks of (re)privatisation instead of being properly restructured (IMF 2000, p. 80). Despite 'hardware' restructuring, it is hard to believe that 'software' restructuring has been carried out effectively enough to make the Korean financial institutions competitive at the global level.

The corporate sector

Restructuring of the corporate sector has focused on the 'workout' of ill-managed firms and the reform of the chaebol, the Korean conglomerates.

In July 1998 the government classified 104 firms as needing 'workout', of which about a third had been indefinitely suspended by the time of writing. The reason why progress has been so slow is that concern over charges of revived interventionism as well as possible litigation a few years down the line led bureaucrats to minimise their involvement in corporate restructuring in the immediate post-crisis period. Instead, they opted for bank-led corporate restructuring. This is hard to understand in light of the fact that the commercial banks in Korea were controlled by the government and were in no position to give a lead. As they had done before the crisis, the bankers looked to the government for guidance on how to deal with distressed firms. More often than not, bankruptcy suspension was the result, as the banks rescheduled just enough debt to keep the firms going and the government, *de facto* the controlling shareholder of these banks, provided little guidance. A number of 'workout' firms have been allowed to prolong their existence in a state of limbo (Lim 2001).

With the authority of the chaebol bosses greatly weakened by the crisis, the government announced five guidelines for chaebol restructuring: (a) enhancing transparency in corporate management; (b) eliminating cross-debt guarantees; (c) improving financial structures; (d) improving corporate governance; and (e) streamlining business activities.[15] Among these, (a) and (d) were designed to address the problem of arbitrary imperial rule by the chaebol bosses, most of whom exercised complete control over their firms, even though not legally registered as chief executives at that time. The intention of (b), (c) and (e) appeared to be to break up the 'fleet-style' management structure of the chaebol.

At an early stage, a series of policy measures designed to improve corporate governance and protect the property rights of minority shareholders were also implemented. All publicly listed firms were required to have at least one outside member on the board of directors. Institutional investors were no longer required to follow a system of shadow voting, in which they had to cast their votes in proportion to other votes cast instead of exercising their full voting rights. Minimum shareholding requirements

were significantly reduced for shareholders' right to file derivative lawsuits against company executives for mismanagement. These were thought to be greater achievements than could have been expected.[16]

After a V-shaped recovery in 1999, however, and given a general election in April 2000, the government became increasingly reluctant to go further down the path of fundamental reform of the chaebol. The reform of the chaebol has not reached yet the heart of the matter, i.e. corporate governance and the ownership structure, as observed in the Hyundai case.[17] The separation of banking and commerce has not been seriously considered. On the contrary, the government is taking action to raise the ceiling on the total amount of equity investment (25 per cent of net worth) which is an effective safeguard against cross-shareholding and debt guarantees for affiliated corporations of the chaebol (Lee 2001, p. 10). The ceiling of chaebol shareholding in banks is to be allowed to rise to ten from the previous four per cent. Although this is allegedly to encourage investment, a retreat of the state from the reform of chaebol can be clearly recognised.

The public sector

Restructuring of the public sector has set its focus on managerial innovation and privatisation of public enterprises. The government announced two successive plans in July and August 1998 to privatise 11 public enterprises and restructure 55 subsidiary companies, for the purpose of enhancing efficiency and competitiveness. Among the subsidiaries, 35 were immediately (by the end of 1999) or gradually (by 2000–2) to be privatised, while six were to be merged among those having similar functions. Though the rest would remain in the public sector, the government was still supposed to undertake a wide range of restructuring. In addition, the government announced a plan to reduce employment in public enterprises. The target of reduction has been revised upward several times and was set at about 30 per cent of the total (41,269 employees) until 2001 (Kim 2000b).

The 1998 plans have two related distinguishing characteristics: full-scale privatisation and a positive attitude toward selling public assets to foreign investors. As they were finalised when the Korean economy was in a severe crisis originating in the foreign exchange turmoil and thus under the control of the IMF, policy priority was assigned to obtaining dollars by selling public enterprises to foreign investors. This pushed the policy makers to choose full-scale, not partial, privatisation, so that IMF conditionality of thorough restructuring could also be met in the public sector. The seemingly strong will of the government to adopt full-scale privatisation as well as its keenness to sell assets abroad was in fact defined by these conditions.

Up to now, it is thought that the restructuring plans have worked fairly

well. Among the eleven public enterprises falling within the remit of privatisation, six have been completely privatised. Korea Comprehensive Chemistry (September 1998, and liquidated later), National Textbook Co. (November 1998), Korea Comprehensive Technology Banking (January 1999) and their subsidiaries were sold off as planned. Korea Transmission Pipe Co. (April 2000), POSCO (October 2000) and Korea Heavy Industry (December 2000) were also privatised after some delay.[18] Some subsidiaries of the remaining public enterprises have already been privatised. International depositary receipts for Korea Telecom (about 2.5 billion dollars) and Korea Electric Power Corp. (750 million dollars) were well received; some shares of Korea Telecom, Korea Tobacco & Ginseng Corp. and Korea Gas Corp. enjoyed good sales in the domestic market; and Korea Regional Heating Corp. is also under privatisation.

Despite the government's strong intention to speed-up privatisation and restructuring, however, opposition to selling assets abroad has recently been organised among public sector workers and some NGOs. Their attempts to stop privatisation and restructuring, have moved the issue high on the agenda of politics as well as economics.[19]

Social safety net

Allegedly due to industrial restructuring, a very rapid recovery from the crisis was evidenced by the return of GDP to its pre-crisis level, which brought decreased unemployment, increased foreign exchange reserves and an early stabilisation of the foreign exchange rate (see Table 4.1). Faster recovery than in other crisis-hit Asian countries entitled the Korean economy to be considered a distinguished pupil of the IMF. Proudly, the Korean government received a 'shining certificate of graduation' from IMF control.

Is this a happy ending to a one-act drama? Sadly, the curtain is not

Table 4.1 Major economic indicators

	1996	*1997*	*1998*	*1999*	*2000*
Real GDP growth (%)	6.8	5.0	−5.8	10.7	8.8[c]
Per capita GNI (current $)	11380	10307	6723	8551	9628[c]
Unemployment rate[a] (%)	2.0	2.6	8.4	4.8	4.1
Balance of current account ($ billion)	−23.0	−8.2	40.2	25.2	11.4
Usable FX reserves[b] ($ billion)	29.4	8.9	8.5	74.1	95.9
FX rate[b] (won per $)	844	1415	1208	1145	1260

Source: Ministry of Finance and Economy, Korean Government (http://www.mofe.go.kr).

Notes
a Seasonally adjusted, at the end of the year.
b As of the end of the year.
c Preliminary.

down yet and the tragedies born of the crisis are still around. Restructuring of the financial, corporate and public sectors with the help of labour market flexibility brought about mass layoffs, as is seen in Figure 4.1. Although employment rose, its return to the pre-crisis level is unlikely because of the more recent economic recession. The unemployed are still suffering from long-term unemployment,[20] with their savings being used up. Their financial crisis is certainly not over. Even for the employed, job stability has been heavily reduced. The proportion of non-standard (temporary and daily) workers among employees has increased exceeding that of the standard: from 41.9 per cent in 1997 to 53.7 per cent in 2000. About 90 per cent of new jobs since the last quarter of 1999 have reportedly been filled with non-standard workers, and this trend continues.

Closely related to this, inequality in the distribution of income among urban workers has seen a remarkable increase. The ratio of the top 20 per cent to the bottom 20 per cent of incomes jumped to 5.6 in 1999 from 4.5 in 1997, while the Gini coefficient rose to 0.320 from 0.228, as is shown in Table 4.2. More serious is the fact that the problem of absolute poverty re-emerged during the period. According to a survey carried out by the United Nations Development Programme (UNDP) and People's Solidarity for Participatory Democracy (PSPD), the population whose incomes were below the minimum subsistence expenditures increased from 7.7 million in the first quarter of 1996 to 10.1 million in that of 1999.[21]

With massive layoffs following the crisis and the ensuing restructuring, poverty among the jobless and low-income families emerged as an important

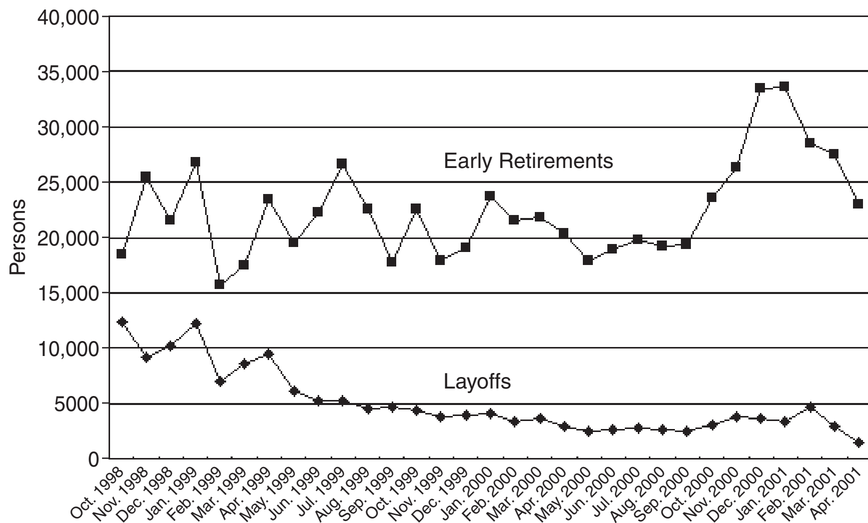

Figure 4.1 Trend of monthly layoffs (source: Ministry of Labour, Monthly Labour Statistics, various issues).

Table 4.2 Trend of income distribution

	1997	1998	1999			
			I	II	III	IV
Top 20%/Bottom 20%	4.49	5.41	5.85	5.24	5.29	5.57
Gini coefficient	0.228	0.316	0.333	0.311	0.310	0.320

Source: Same as for Table 4.1.

social issue that needed to be immediately addressed. The increase in absolute as well as relative poverty is not simply due to economic stagnation but is a result of restructuring and other policies implemented to meet IMF conditionality. Therefore, it is not expected that the problem will be easily solved with simple economic recovery. Considering that restructuring is to be continued, the seriousness of the problem will not be reduced. Among other things, poverty provides Korean society with the material for social conflict which in turn erodes the base of sustainable economic development.

To remedy this situation, the Korean government has made efforts to build and expand the social safety net, particularly for the jobless. Among the various policy measures adopted by the government are: (a) social care for the jobless and the poor, (b) job retention, (c) job creation, (d) training for re-employment, and (e) public employment services and a labour market information system. The first of these is considered in the rest of this section. Measures for social care have been implemented in two directions. First, the employment insurance system has been extended to take care of as many of the unemployed as possible. Second, the low-income jobless have been given income or credit support and other public aid benefits.

Unemployment benefits

The employment insurance system was put in place in July 1995, before the crisis. Its three components are traditional unemployment insurance, job training, and subsidies to maintain and increase employment.

When the system was first introduced, the coverage of unemployment insurance was limited to workers employed by firms with more than 30 employees. Faced with increasing unemployment as well as low-wage earners at small firms with a high probability of becoming unemployed, the extension of coverage was deemed critical to widening and strengthening the social protection of the unemployed. Thus, the Korean government rapidly extended the coverage of unemployment insurance within a short period of time: to firms with more than ten employees (January 1998), to firms with more than five employees (July 1998), and then to all firms with

at least one employee (October 1998). After the three consecutive amendments of the Employment Insurance Law in 1998, only those part-time workers working more than 80 hours a month and day workers employed less than a month remain legitimately excluded from receiving unemployment benefits.

Extending the coverage of the employment insurance system was not enough because it did not also confer eligibility for unemployment benefits. Before the crisis, to qualify for the benefits a worker had to be involuntarily dismissed from the covered firms after working (or contributing premia) for more than a year out of the last 18 months. Temporary workers and other unstably employed workers working at small firms found it hard to satisfy this condition. Better to protect marginal workers and newly insured employees, the government continued to relax qualification conditions for unemployment insurance benefits, which includes relaxing the minimum contribution requirements from 12 out of 18 months to 6 out of 12 months.

The duration of unemployment benefit varies depending on the insured employment period and the age of the claimant. It used to range between a minimum of 60 days and a maximum of 210 days. However, since Korea's employment insurance system was implemented on 1 July 1995, the insured period of employees could not exceed five years and thus the actual duration of unemployment insurance benefit could not exceed 150 days during the period until 30 June 2000. Given the limited benefit duration, extended benefit rule was put into operation from July 1998 so that the qualified unemployed could receive up to 60 days longer than the number of days designated by the benefit duration matrix. The unemployment benefit duration matrix, ranging from 60 to 210 days, was modified to one ranging from 90 to 240 days. In this way, average duration of unemployment benefit increased to 126 days in 1999, whereas it was 85 days in 1997 and 91 days in 1998.

Due to coverage and duration extension, the beneficiaries and the volume of unemployment insurance increased rapidly after the crisis. However the V-shaped economic recovery lowered both, as is shown in Table 4.3. Nevertheless, despite all the efforts of the government to improve unemployment insurance, there still remain important problems. Even after the extension of coverage, the actual number of insured employees fell far short of the number of employees expected to be covered. As of June 2000, the compliance rate was 70.6 per cent and only 55.6 per cent of the total of wage workers were registered – that is, there was a large gap between coverage *de jure* and coverage *de facto*. Many temporary and daily workers are not registered yet and remain without protection.

Even with the extension of coverage, relaxation of eligibility criteria and lengthening of benefit period, the percentage of beneficiaries among the unemployed is too small for the unemployment insurance benefit to be the primary safety net for the unemployed. As of March 2000, the percentage

Table 4.3 Unemployment insurance benefits

Period	*Beneficiaries (persons)*	*Amount (million won)*
2nd half 1996	8186	10464
1st half 1997	21076	30036
2nd half 1997	29761	48696
1st half 1998	191446	270867
2nd half 1998	230730	522080
1st half 1999	188782	551403
2nd half 1999	140830	384782

Source: Employment insurance DB (http://www.kli.re.kr).

was about 9.8, which is considerably lower than that of other OECD countries.[22] For this, four reasons can be adduced. Wage workers account for only 61.1 per cent of total employment, while Korea's unemployment insurance system cannot protect non-wage workers against unemployment. The number of *de facto* registered employees does not exceed 70.6 per cent of those to be covered legitimately, and most temporary and day employees are still excluded from receiving unemployment benefit. Actual benefit duration is limited because of its rules and the short history of Korea's employment insurance system. Finally, the criteria to judge whether a claimant is involuntarily unemployed are still strict (Hur 2000, pp. 14–15).

Livelihood protection for the poor

As unemployment benefits cannot protect a large part of the jobless in the face of massive unemployment, poverty among the jobless and low-income families has to be addressed with different measures.

The pre-existing livelihood protection programme, based on the Livelihood Protection Act (1961), provided income support to the poor whose incomes were below a certain level (230000 won per month per person). In 1997, about 1.2 million people were protected under the programme. However, cash living allowances were paid only to those who were not able to work (disabled, sick or too old) and had no income. For all others who had the ability to work, the government subsidised only living, educational, medical, maternity and funeral expenses. In fact, less than half of the 1.2 million could receive cash living allowances.

With the advent of the 1997 crisis, the Korean government expanded the programme and introduced the Temporary Livelihood Protection programme in March 1998 in order to protect the livelihood of the poor unemployed who were not qualified for unemployment insurance benefits. This temporary programme also provided low-interest long-term loans for daily living, support for housing, medical and educational costs, and low-interest loans for the self-employed (Phang 1999).

The Temporary Livelihood Protection programme relaxed the wealth

criterion of the pre-existing Livelihood Protection programme. Those who possessed property worth less than 44 million won, instead of 29 million won, could qualify for the programme. In 1998, about 311000 unemployed people benefited from this programme. The Temporary Livelihood Protection programme, however, was still too restrictive in its coverage and limited in its generosity to be a substitute for unemployment benefits. For example, a household of four members could only receive 250000 won per month under the programme, while the minimum living expenses of the same-sized family were estimated to be 880000 won at that time. Although the Korean government developed various social safety nets for the unemployed after the crisis, the absolute level of social protection was judged to be low in the light of basic living standards.

Thus, the government revised the Livelihood Protection Act turning it into the National Basic Livelihood Security Law in 1999 that intended to guarantee a national minimum standard of living for all people regardless of their working capacity. This law became effective on 1 October 2000 covering 1.5 million people, and providing an allowance of 940000 won to a household of four family members in accordance with the minimum living expenses in urban areas (see Table 4.4). Based on the principle of 'productive welfare', the allowance to those with ability to work is conditional on their participation in the self-reliance programme.

Although the new system has yet to be evaluated,[23] it already represents remarkable progress in the history of the Korean welfare system given its wide coverage and reasonable allowances and considering that the country had a low base of social security (Kim 1995). However, there is a fundamental problem of combining the system's emphasis on 'productive welfare' with its smooth implementation. Though it is still early, it can be pointed out that the self-reliance programmes within the system have until now been inefficient, and cannot easily be expected to improve in the near future.

Industrial relations

Restructuring of the labour sector has focused on the flexibility of labour markets, and that has been much more a matter of numbers than functions,

Table 4.4 Minimum living expenses by household in 2000, in won

Area	*Number of family members*					
	1	*2*	*3*	*4*	*5*	*6*
Metropolitan	344243	570122	784164	986370	1121503	1265513
Urban	324011	536614	738076	928398	1055588	1191134
Rural	278907	461915	635333	799161	908646	1025314

Source: Ministry of Health and Welfare, Korean Government (http://www.mohw.go.kr).

as many authors agree (Kim 2000a; Lee 2000; Choi 2001). The revision of labour-related laws in early 1998 legalised the system of layoffs to deal with managerial difficulties of firms, flexible working hours, and temporary-help workers. Massive layoffs followed and an increase of non-standard workers, as was seen above. To this worsening employment instability were added wage cuts.

At least for the first year after the crisis, however, industrial disputes did not happen. Shocked by the crisis, workers and trade unions cooperated with the government in the effort to restructure the four key sectors, including labour market flexibility. Korea was able to enjoy 'quiet' industrial relations with the establishment of the Tripartite Commission in early 1998. Through the '9 February Agreement' at the Commission, the government in fact achieved revision of labour laws to institutionalise important measures increasing the flexibility of labour markets. This gave a great boost to restructuring, and workers even refrained from demanding wage increases and better working conditions. But this sort of 'industrial peace' did not last long.

Industrial conflict

The labour policies of the government after the crisis can be characterised by a limited subsumption of labour to capital (Kim 2000a). Compared to the repression in the past and considering the situation of economic crisis, this was progress. At the national level, the government tried to use the Tripartite Commission as a vehicle for industrial peace, while arbitrating industrial disputes at the major companies. Thus, industrial relations in post-crisis Korea became more government–labour than labour–management relations.

With restructuring a top priority, however, the government firmly believed that the most fundamental labour reform was to enhance labour market flexibility, which would in turn invite increases in both efficiency and employment. This approach naturally made the 'limited subsumption' unstable, and led to intensified industrial conflict. Workers and unions argued that restructuring was not only 'one-sided' but also biased toward numerical flexibility, that is layoffs. This brought an end to the cooperative mood.

The symptoms of conflict were seen in the public sector. The government began to accelerate restructuring of the public sector from around the end of June 1998, aiming to induce restructuring of other sectors. In the process of restructuring the public sector, the government in practice aimed at layoffs and completely ignored consultation with unions. Almost the same process was witnessed in the financial sector. The unions vehemently protested and boycotted the Tripartite Commission. Although the boycott was withdrawn after the government's arbitration of the Hyundai Motor disputes in August,[24] the government crushed the strikes at Mando Machinery a month later.

Table 4.5 Trends of industrial disputes

	1996	*1997*	*1998*	*1999*	*2000*
Number of strikes	85	78	129	198	250
Working days lost	893000	444000	1452000	1366000	1894000

Source: Ministry of Labour.

As the government moved towards 'law and order' and away from consultation and arbitration, also pushing restructuring, the workers and the unions began to resist from around the end of 1998, organising strikes and campaigns against the government's 'neo-liberal policies'. From 1998, industrial disputes started to be recorded more frequently than before the crisis, as is seen in Table 4.5. The strikes at the Seoul Metropolitan Subway in 1999 and of the Korea Financial Industry Union in 2000 were typical examples. Arrests followed and social conflict manifested itself strongly in labour issues. This led the unions to boycott the Tripartite Commission in 1999 and since then the Commission has lost ground (as is discussed below).

Crisis management by the government has placed government–labour relations ahead of those between labour and management. This has in turn brought more conflict than cooperation between the government and the unions, which seems unavoidable given that the government is promoting restructuring ahead of providing a social safety net. The unions have become increasingly politicised and are now directly opposing government policies of restructuring including privatisation. With restructuring not yet completed, the government is pushing ahead, while the unions are trying to block layoffs and demanding better wages and welfare benefits. This confrontation is not going to be easy to resolve because it depends not only on the prospects of economic recovery but also on the political environment.

The Tripartite Commission

The pivotal political problem of economic reform is that restructuring involves significant transitional costs. This problem becomes deeper when sudden economic downturns accompany intensive reform efforts. As a result, it is necessary to coordinate conflicting interests and diverging views between major producer groups (Lee 2000, p. 17). For this purpose, President-elect Kim established the tripartite body in January 1998.[25]

After releasing the Tripartite Joint Statement on Fair Burden-sharing in the Process of Overcoming the Economic Crisis on 20 January 1998, the Commission forged a detailed social pact on 9 February 1998. Its foremost concern was to advance labour market flexibility, for which cooperation of

the unions was vital. The Commission agreed on the revision of the Labour Standards Act to ease the procedures for laying off workers when there are urgent managerial reasons, and introduced a draft act for employment of dispatched temporary-help workers to replace vacancies. In return for measures that severely threatened employment security, the labour side earned a promise to strengthen the social safety net with improvements in trade union rights. Freedom of association and political activities of trade unions were more thoroughly guaranteed.

The second Tripartite Commission was launched in June 1998, with four committees specialising in the areas of economic reform, employment, industrial relations and social welfare. To the third Tripartite Commission, inaugurated in September 1999, four further committees were added, dealing with public-sector restructuring, financial-sector restructuring, unfair labour practices and working-hour reduction. The social pact provided a temporary accord between labour and management, creating channels through which workers could influence some of the allocation choices that bear on them directly. The existence of consensus politics certainly facilitated the implementation of structural reforms. However, this precarious balance broke down when massive layoffs and wage cuts began to aggravate workers' discontent. Actually, some of the KCTU's (Korean Confederation of Trade Unions) more militant rank-and-file members rejected the leadership's decision to reach an agreement with the employers' associations, and the leadership subsequently resigned. Since then, the KCTU has been firmly against the government's unilateral restructuring programme. Demanding a suspension of layoffs and revival of company payments for full-time union staff, the labour side boycotted the Commission in early 1999.

Shortly after the government accepted labour's key demands business representatives quit the Commission. Although the FKTU (Federation of Korean Trade Unionsand business representatives returned to the Commission in April 2000, the tripartite system in Korea is still crippled by the absence of the KCTU. Here is one of the reasons why the issue of cutting working hours to 40 hours in a week is still far from being settled. Instead of joining discussions at the Commission, the KCTU is calling for the downfall of the present regime.

This points to the fact that the effort to achieve social agreement in Korea has not been successful. The fundamental reason why the Tripartite Commission is currently ineffectual lies in that Korea lacks institutional preconditions for neo-corporatist policy-making. No labour confederation acted an all-encompassing organisation with direct decision- making power over its members. The institutional setting for the necessary reciprocity and trust to develop was not available due to a long history of confrontational industrial relations. The time horizon of workers as a result is very short, with a high degree of uncertainty about the future state of the Korean economy and society. In such a situation, expectations

about labour's voluntary cooperation are not likely to materialise. Instead, scepticism about the tripartite system prevails in Korea.

Conclusion: a tiger turned into a pussy cat?

The fundamental effect of IMF control over the Korean economy after the outbreak of the financial crisis is the economy's radical move towards an Anglo-Saxon form of free-market competition, which globalization enforces worldwide by dismantling the nation-state's leverage over the economy. Characterising the crisis as 'financial', the IMF has in practice demanded comprehensive restructuring and opening up of domestic markets. It has enforced uniform neo-liberal programmes, while paying lip-service to country-specific conditions.

Confronting the crisis, the Korean government without doubt followed the IMF prescription. Thus, a tiger economy has been turned into a pussy cat. Without ever thinking of opposing globalization, the government has nestled in the arms of the Wall Street–Treasury complex, preferring to undertake apparently sophisticated measures of increasing the country's international openness. Although the IMF has forced restructuring in every sector of the economy, it is premature to conclude that the measures are capable of providing a stable platform to strengthen the country's economic competitiveness and enhance its economic soundness. More opening up of markets may increase economic vulnerability to global forces.

The thorniest problem in implementing the IMF programme is that restructuring has been accompanied by great social costs, which have not been evenly distributed among different socioeconomic groups. The neo-liberal market-oriented reforms have led the state away from intervention in income distribution. The crucial policy problem here is that it is extremely difficult for a country like Korea, having only recently constructed a basic welfare state, simultaneously to attain flexibility in labour markets and social protection for workers. Naturally, conflicts and confrontations have dominated industrial relations soon after the crisis, and the Korean state is no longer dominant in dealing with industrial disputes. Despite some cases in which the government suppressed industrial strikes, the government has gradually lost its leverage over socio-economic groups within the country.

The crisis marks the end of the export-oriented development of the Korean economy. The situation brought about by the crisis does not permit 'a return to the developmental state.' The Korean state is being pushed towards a new direction, as are the other crisis-hit Asian states, though it is not clear where.

Notes

1 IMF (1998) and World Bank (1998) take the 'mainstream' view of macroeconomic weakness and financial vulnerability, while McKinnon and Pill (1998) see the afflicted countries immediately before the crisis as having basically sound macroeconomic fundamentals but suffering from financial weakness. On the other hand, Radelet and Sachs (1998a, 1998b) emphasise the effects of contagion on the basis of 'multiple equilibria' theory: with one stable and 'good' equilibrium during times of high confidence and another 'bad' equilibrium marked by panic-induced bank runs, and the unfolding of crisis during times of low and deteriorating confidence in the system. Berg (1999) divides the interpretations into two categories as above.

2 Bhagwati (1998), Wade (1998) and Wade and Veneroso (1998) share this view, while Krugman (1998a, 1998b), Rodrik (1998) and Stiglitz (1998a, 1998b) only partly admit it.

3 Interview in *The Times of India*, 31 December 1997. Re-cited from Wade (1998).

4 The figures are from the IMF and the World Bank staff estimates.

5 Trade and current account balances were in surplus during the period 1986–9 due to the high yen. Partly due to the sharp appreciation of the won in the late 1980s, the trade balance turned into deficit throughout the 1990s.

6 The chronology of the main events is well documented in Kochhar *et al.* (2000), especially p. 8.

7 The disbursed amount was $28.7 billion: the IMF $19.0 billion, the World Bank and the ADB $9.7 billion, and no bilateral disbursement.

8 Concerning the role of the IMF in the Asian crisis in general, Radelet and Sachs (1998a) criticise it for not immediately taking action on roll-over and workout arrangements between the debtors and their foreign creditors.

9 'The threat of meltdown was very real during the period between June and September 1998. This forced the US Federal Bank to reduce interest rates in the last quarter of 1998, and persuaded the IMF to relax its stringent fiscal and monetary policies in the East Asian countries to allow them to reflate their economies' (Lim 1999, pp. 428–9).

10 Feldstein (1998) and Radelet and Sachs (1998a, 1998b, 1999) go further to argue that their inclusion in IMF programmes has reduced confidence by emphasising weaknesses that are inherently hard to correct and not a fundamental part of the current problem.

11 This section relies largely on the author's previous papers (Kim 2000a, 2000c).

12 Despite the government's claim of their autonomy, it is alleged that the financial institutions are still not free in important decisions including the disposal of the debtor chaebol-affiliated firms.

13 To the government's credit, it did allow the Daewoo Group to go bankrupt in 1999 after vainly trying to come up with a solution that would have had a smaller adverse impact on the financial system.

14 This emphasises the importance of initial conditions and subsequent development as a system evolves, with historical accidents having a significant effect upon the eventual outcome (David 1985).

15 These were originally announced in early 1998 by the President-elect Kim Dae-Jung just before his inauguration and have continued to be the guidelines of the government policy for restructuring the chaebol.

16 The contribution of NGOs, particularly the PSPD (People's Solidarity for Participatory Democracy) is notable.

17 Encountering a liquidity crisis, Hyundai promised to change its governance to an expert managerial system. Note that it was just a promise in response to the crisis, and the ownership structure is still untouched.

18 The details are on http://www.reform.go.kr.
19 For more details on this, see Kim (2001).
20 Those who had been unemployed for more than a year were 10.6 per cent of the unemployed in 1998 and their number sharply increased to 17.6 per cent in 1999 (Ministry of Labour 2000, p. 5).
21 The details are on http://www.pspd.org.kr.
22 Compare to Germany (43.5 per cent in 1990), the USA (36.0 per cent in 1993) and Japan (27.8 per cent in 1992). For more details, see Hur (2000, p. 14: Table 10).
23 An evaluation committee, to which the author belongs, established in July 2000, is carrying out surveys and preparing a report, which will be submitted to the Ministry of Health and Welfare in due time.
24 For details, see Lee (2000).
25 The Tripartite Commission, *Nosajung Wiwonhoe*, born as a presidential advisory body, is in principle composed of representatives from the government, the two trade union confederations, the Federation of Korean Trade Unions (FKTU) and the Korean Confederation of Trade Unions (KCTU), and the two national-level employers' associations, the Korean Federation of Industries (FKI) and the Korean Employers Federation (KEF). It is worth noting that since 1990 the Korean state has made great efforts to establish a tripartite body which could bring about wage restraint and industrial peace. The National Economic and Social Council set up in April 1990, in which the author participated as a member of the public, was the first attempt at this sort of neo-corporatist policy-making. For this and other attempts, see Choi *et al.* (1999) and Lee and Lee (1999).

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5 Intellectual property rights and national innovation systems

Lessons from Mexico and Korea

Jaime Aboites and Mario Cimoli

During the second half of the 1980s important changes took place in the regulatory framework of intellectual property rights (IPR) in both the industrialized and the less developed countries. The reasons behind these changes were, on the one hand, the growing acceptance by governments and firms of the importance of knowledge assets in international trade; and, on the other pressure by the US government during the GATT negotiations – the Uruguay Round – to harmonize institutional norms regarding intellectual property rights. Underlying the harmonization proposal was support by most developed economies for the idea that the heterogeneity of IPR in GATT member countries produces serious distortions in world trade, and particularly that it discourages foreign direct investment. The debate concluded with an international proposal that was called *Trade Related Aspects of Intellectual Property Rights* (TRIPs). This initiative was passed in 1993, when GATT/WTO member countries approved TRIPs during the Marrakesh Conference. Mexico has accepted this regulatory framework and introduced changes in the domestic law that regulates IPRs.

This new norm has been introduced together with the consolidation of trade reform which began during the second half of the 1980s and concluded with the signing of NAFTA and Mexico's membership of the OECD. Mexico is a country that has implemented important economic reforms such as trade liberalisation, privatisation of state companies and economic integration with the USA and Canada (NAFTA). Since it was recognized as an engine of economic growth in the 1940s, the Mexican manufacturing industry had grown under a regime of intensive protection. Its orientation had a strong inward bias, at least until the 1982 financial crisis. In contrast, the more recent period has seen a major shift in economic outlook: the nation faced a 'radical shock' involving new economic reforms, in which the primary objective was to generate conditions for faster economic growth and a new pattern of economic development. This shock intended to provide an effective way of reshaping economic activities by combining a favourable environment of relative prices with improvements in the incentives for technology upgrades. Since the beginning of this liberalisation period, and combined with the further

privatisation of services, Mexican industry has experienced a profound structural transformation. A major consequence has been a steady internationalization process that is based on an external performance which the nation had never experienced before.

The main contention of this paper is that these economic changes and the impact of the new IPR framework cannot be understood outside the behavioural patterns and linkages that characterize the Mexican innovation system. Thus, the analysis of the new IPR framework refers to a collection of different agents – residents, non-residents, transnational companies, local firms, universities, research centres and sectors – and the interactive linkages between them. In such a context, this paper argues, on the basis of the experience of the new intellectual property law, that the use of patents is a weak incentive for local creation and diffusion of technology. The reason is that it does not favour local efforts on R&D – both by local firms and through foreign direct investment (FDI) by transnational companies – and nor does it facilitate relationships linking the agents of the innovation system.

In general, it is shown that the new IPR framework and the economic reforms do not provide incentives for the upgrading of technological capabilities in the Mexican economic system. Both sets of influences interact with each other and reinforce adverse mechanisms for the diffusion of innovation within the system. Section 1 presents a definition of national innovation systems (NIS) and relates this to the institutional framework promoted by the homogenization of the IPR regime. Section 2 describes the differences in patent systems considering the following categories of flows: (i) applications for patents from *residents* (domestic); (ii) applications for patents from *non-residents* (usually transnational foreign companies); and (iii) *external* applications for patents (local companies or any other agents that might request a patent abroad). The first two kinds are registered inside each country's borders, while external patents are registered in a wide set of other countries the size of which depends on the country in question and the time period. According to the above taxonomy, in this section we also describe how different innovation systems explain differences in performance of patent systems. In the following three sections, our analysis focuses on the incentives promoted by the IPR regime introduced in Mexico and its impact on the innovation system. Here, a broad comparative analysis between the innovative performance of patenting systems in Mexico and Korea is presented. Section 6 is a brief conclusion.

1 Innovation systems and intellectual property rights

In modern innovation theory, the firm's strategic behaviour and alliances as well as the interactions between firms, research institutes, universities and other institutions are at the heart of analysis of the innovation process. More specifically, for the concept of a national innovation system, as

introduced by Freeman (1987) and as further developed by Nelson (1993), Lundvall (1993), Metcalfe (1995), Edquist (1997), Cimoli and Della Giusta (2000), innovation is considered to be an interactive process in which the above-mentioned features are captured. In general terms, most of the contributions cited above support the idea that the main building blocks in a national innovation system are articulated by a collection of different agents and their interactions.

Following the concepts introduced in Freeman (1987) and Nelson (1993) and remaining within national boundaries, analysis is carried out on a set of actors (firms and particularly other institutions, such as universities and research organizations) as well as on the links between these actors in the innovation and diffusion processes. Metcalfe (1995) provides the following policy-oriented definition of a national innovation system (NIS): a 'set of institutions which jointly and individually contribute to the development and diffusion of new technologies and which provide the framework within which governments form and implement policies to influence the innovation process'. He argues that the nature of each NIS is fundamentally shaped by the division of labour and the peculiarities of information, which cause non-market means to predominate in the coordination process. The institutions that form this set (private firms, universities, other educational institutions, public sector research laboratories, private consultants, professional societies and industrial research associations) 'make complementary contributions, but they differ significantly with respect to motivation and in commitment to the dissemination of the knowledge they create'.

The evolutionary analysis which accounts for the characteristics of national systems of production and innovation draws on the idea that firms are repositories of knowledge, nested in networks of linkages with other firms and also with non-profit organizations (networks which enhance the opportunities facing each firm to improve its problem-solving capabilities). Finally, it rests on a broader notion (at a wider level of aggregation) of embeddedness of microeconomic behaviour into a set of social relationships, rules and political constraints (Cimoli and Dosi 1995). Thus, in general, nations are seen as *receptacles of variable microeconomic behaviours* characterized by particular modes of institutional governance that to a certain extent make them diverse self-reproducing entities. Indeed, nationality, which is provided by shared language and culture and the national focus of policies, laws and regulations, conditions the innovative environment (Metcalfe 1995). Together these elements contribute to the shaping of the organizational and technological context within which economic activity takes place. In a sense, they set the opportunities and constraints facing each individual process of production and innovation – including the availability of complementary skills, information on intermediate inputs and capital goods and demand stimuli to improve particular products.

Even more, at a system level, the interpretation presented here is consistent with, and indeed is a complement to, institutional approaches that

build on the observation that markets do not operate apart from the rules and institutions that establish them, and that 'the institutional structure of the economy creates a distinct pattern of constraints and incentives', which defines the interests of the actors, as well as shaping and channelling their behaviour (Zysman 1994, pp. 1–2).

The IPR regime should be viewed as an institutional change that impacts on most innovative activities. Most of the promoters of the homogenization of the IPR regime argue that the incentives contained in this process will stimulate the creation of a market for knowledge, where the intrinsically uncertain investment in R&D can be paid back (Foray 1993; David 1992).

In setting up an IPR regime to protect innovation and promote its homogenization across countries, more incentives to increase firms' R&D expenditure and knowledge activities should materialize. Some general conjectures support this expectation: (i) homogenization of IPR is the basis for the development of a market for knowledge whose instruments are patents; (ii) a system of IPR that protects innovation will better stimulate public welfare in the world economy and; (iii) such a pattern of incentives will stimulate risk-sharing in R&D activities. Most of these points support the argument that protection is the appropriate incentive framework to promote innovation. Indeed, such an institutional design of incentives fits very well with innovation systems in developed economies, where most R&D activities and technological efforts in practice occur.

A first point to be raised is that countries do not start from the same place but have differences in their innovation systems (Cimoli and Dosi 1995). The advantages that characterize a developed country in comparison with a developing one are: (1) higher R&D expenditures (public and private); (2) more resources and well-established institutions dedicated to training people, including universities; (3) higher articulation of networks that interlink institutions and production systems; (4) higher concentration of innovation leaders at the world level. Under such conditions, an IPR regime that gives incentives to protect innovators and their activities leads to improvement of welfare in terms of the benefit that society draws from the introduction of new goods and production processes.

The case of developing countries is substantially different.[1] Recent literature on these themes confirms that the impact of the IPR reforms on developing countries can produce adverse effects on the promotion of innovation and growth (Combe and Pfister 2000), particularly when the incentives promoted by the IPR regime are superimposed on market-driven reforms. Thus, on the one hand, developing countries have adopted an IPR regime that encourages the protection of innovative activities; and, on the other, they have also adopted liberalisation policies to allow greater freedom of trade and capital movement. Some general results can be summarized as follows:

i If a large number of high-knowledge-content products are produced in developed countries, this specialization pattern will produce a deterioration of the terms of trade of developing countries affecting their possibilities for growth. The static welfare effect is negative for developing economies.

ii The relation between IPR protection and Foreign Direct Investment (FDI) is ambiguous. On the one hand, FDI could increase if the protective IPR regime were adopted but, on the other, there is no guarantee that FDI would diffuse innovations locally.

iii The relation between IPR and technological effort seems to be very weak. Most developing economies have not increased their technological efforts after adoption of the IPR regime.

iv The superimposition of free trade and IPR regimes reinforces adverse incentives for the upgrading of local technological capabilities.

In particular, this last finding is confirmed by Latin American countries. These have changed most of the elements and interactions that configure their innovation systems, namely the role played by multinational companies and large domestic conglomerates, the presence of the state in the economy, and the regulatory mechanisms in services (Cimoli 2001). Thus, in a world of increasing returns to scale in production of knowledge at the level of the firm, and of synergies and interdependencies between firms and other repository institutions involved in the 'production' of a skilled workforce and technology (such as universities, public R&D laboratories, and so forth), the conditions are given for the globalization process to induce a dual worldwide pattern of production organisation. In such a dual pattern, R&D and engineering activities will tend increasingly to concentrate in developed countries, while developing economies will remain 'locked-in' the production of low-value-added industrial 'commodities' as well as in Mexican border maquila-type activities. In many cases this has involved the transfer abroad of many 'in-house' R&D and engineering efforts. Local operations have turned more into assembly activities, strongly based on imported parts and components as well as on externally supplied technological and engineering services. This process is likely to induce increasing isolation of peripheral countries from the world of technology generation.

2 Asymmetries in patent systems (PS)

Table 5.1, compiled from WIPO (World Intellectual Property Organization) data, confirms that patent applications in Latin American countries are equal to nearly a third of the flow of US applications for patents. Mexico's situation is noteworthy in that its volume of applications relative to the USA (15.2 per cent) is higher than Brazil's (13.5 per cent). Patenting data from Japan and Korea indicate that these economies maintain a strong performance (Aboites 2001).

Table 5.1 Patent applications

Country	*1997*	*As % of US applications*
North America		
USA	236692	100.0
Canada	54446	23.0
Latin America		
Mexico	35932	15.2
Brazil	31983	13.5
Argentina	6683	2.8
Europe		
Germany	175595	74.2
UK	148209	62.6
France	112631	47.6
Spain	113767	48.1
Portugal	106687	45.1
Greece	82443	34.8
Southeast Asia		
Japan	417974	176.6
Korea	129982	54.9

Sources: Intellectual Property Statistics, World Intellectual Property Organization, 1988; Indicadores tecnologicos de AL, Organization of American States, 1999.

The patent systems of these countries display highly contrasting behaviours under the effect of institutional homogenization brought by the IPR regulatory framework. Although the changes in the regulatory framework agreed upon by the WTO (World Trade Organization) – i.e. TRIPs, Trade Related Intellectual Property Rights – took place in 1993 (Marrakesh), it is a fact that from the late 1980s to the early 1990s similar changes were already under way in the majority of the countries studied. Mexico, for example, approved such changes in 1991. This is why for the purpose of studying the evolution in the flow of applications for patents the period from 1981 to 1997 was divided in two: the first (1981–9) covers the years before the TRIPs reforms; the second (1990–7) covers the years after the changes took place.

The variations registered in the basic flows of applications for patents during the two periods merited particular consideration (Aboites 2001; Aboites and Soria 1999). They were examined in order to determine the possible existence of a degree of continuity or, on the contrary, of significant discontinuity in the flows of patents. For this purpose two aspects of the PS were considered: internal (applications for patents from residents and non-residents) and external (applications for patents from abroad). Internal flows were analysed with information from WIPO, while external flows, i.e. patents granted abroad for each economy, were analysed with data from USPTO, the US Patent and Trademark Office, as is shown in the next section. Three types of behaviour were defined based on the evolution of the flow of residents' patents, non-residents' patents and external

patents (Aboites 2001). These were: (i) *stable* PS (France and the UK), (ii) *converging* PS (USA, Canada, Germany, Japan and Korea) and (iii) *diverging* PS (Mexico, Brazil, Argentina and Spain). Each was characterized as follows.

Stable patents system

This is a PS whose basic internal flows (applications for patents from residents and non-residents) do not indicate any significant modification from one period to the next. They preserve – within a certain range – the previous trend. This internal continuity shows that the changes in the regulatory frame (implementation of the TRIPs of the WTO) did not alter domestic trends registered in the first time period. On the other hand, there has been a significant increase in the external flow of patents between one time period and the next. This shows that in a country with a *stable* PS there were no significant changes in internal trends despite changes in the external trends. In other words, such countries maintained the dynamism they displayed before the amendments to the regulations that took place in the 1980s and after the changes in the TRIPs during the 1990s.

Converging patents system

The internal and external flows of applications for patents exhibit similar trends and this tendency is clear during the second time period. However, in most of these countries, applications from residents show an increase in their relative share. In addition, the external flow of patents presents a significant increase when passing from one time period to the next. In quantitative terms, the flows of internal applications (residents' and non-residents') have registered increases on average; a positive and significant change was also registered between the two time periods.

Diverging patents system

Here internal and external flows of applications for patents show a discontinuity when passing from the first to the second time period. Such behaviour is due, on the one hand, to the increase of the flow of applications from non-residents. On the other, there is stagnation or contraction of the flow of applications from residents. The fact that neither the applications from residents nor the external applications are sensitive to institutional changes implies that this PS does not contribute to stimulation of inventive activity. It seems that the new incentives aimed at protecting innovation have instead inhibited it for such PS.

The general trend indicates that the harmonizing of IPR has produced an unprecedented increase in patenting around the world. This trend is led by the industrialized countries and the globalization of world economy.

Latin America, notably Mexico, has not taken part as originator of patents, but as an ever-growing recipient of flows of technology coded in patents. This is another profound difference between a *diverging* PS (Latin America) and a *converging* PS. This is also valid for *stable* PS. It should be kept in mind that *stable* PS like *converging* PS and unlike *diverging* PS have been characterized by an increase in external applications for patents after the international change of IPR.

Patenting in USPTO

The great centre of patenting is the US Patent and Trademark Office (USPTO) where the majority of technology-related transactions take place. Three areas (Europe, the USA and Southeast Asia) are the most important in the world, representing more than 90 per cent of the total patenting registered. Dosi *et al.* (1990) have called this group the *Innovative Countries Club*. Moreover, this select group is actually generating state-of-the-art technologies related to information and communications, biotechnology, new materials and so on. The analysis of patents granted in the USPTO, carried out on countries and sectors between 1980 and 1999, displays the following main trends.

First, from the analysis of patents granted to non-residents in USPTO (Table 5.2) we observe that in recent decades there has occurred a rise of Japan and a decline of Europe. From the late 1980s, and associated with the changes in the regulatory framework of the TRIPs, developing economies in Southeast Asia registered a rapid increase in incidence in the USPTO.

Second, the evidence suggests that there is a replacement of mechanical by electrical and electronic (E-E) technologies due to the growth of the latter and the considerable reduction of the former. Mechanical technologies were at the core of innovations during the first three postwar decades through their association with capital goods in the automotive, steel, glass and other industries. This trend, therefore, is associated with the emergence of a new technological paradigm based on E-E technologies. Latin America maintained a low patenting activity in the USPTO, which can be interpreted as lack of integration with that part of the world that produces knowledge.

Third, from the perspective of the PS, this analysis also suggests the existence of a trend towards technological specialization: Europe for chemical, Southeast Asia for E-E innovations. The USA also favours E-E innovations systems but is also characterized by multiple technological activities with a high degree of specialization in various fields.

The study of the patents system suggests that E-E technologies dominate and permeate other technologies. Thus, innovations tend to gravitate towards E-E technologies associated with digital technologies in information and communications. This is true of the USA and Southeast Asia, the

Table 5.2 Patents granted in the USA by foreign country, 1950–99 (shares)

	1950	*1958*	*1965*	*1973*	*1979*	*1986*	*1995*	*1997*	*1998*	*1999*
Australia	1.54	0.60	0.94	0.92	1.12	1.14	1.00	0.95	1.07	1.02
Austria	0.48	1.12	1.16	1.02	1.19	1.09	0.74	0.75	0.58	0.69
Belgium	1.07	1.14	1.50	1.23	0.98	0.74	0.87	1.02	1.03	0.93
Canada	11.16	7.99	7.00	6.20	4.56	4.01	4.61	4.73	4.42	4.64
Denmark	1.36	0.74	0.74	0.70	0.56	0.56	0.44	0.66	0.58	0.70
France	15.54	10.36	10.90	9.38	8.46	7.22	6.18	5.88	5.46	5.49
Germany	0.57	25.60	26.40	24.25	23.87	20.80	14.45	13.94	13.53	13.42
Italy	0.86	3.02	3.38	3.39	3.14	3.05	2.36	2.46	2.35	2.14
Japan	0.03	1.93	7.43	22.10	27.69	40.35	47.64	46.10	45.88	44.70
The Netherlands	8.10	5.71	4.15	3.03	2.80	2.20	1.75	1.61	1.82	1.79
Norway	0.95	0.61	0.42	0.42	0.43	0.25	0.28	0.28	0.29	0.32
Sweden	6.67	4.64	4.50	3.40	3.02	2.70	1.76	1.72	1.82	2.01
Switzerland	9.73	8.80	6.97	5.79	5.40	3.70	2.31	2.17	1.90	1.84
United Kingdom	36.00	23.45	20.62	12.56	10.07	7.37	5.42	5.33	5.15	5.13
Total NICs	1.41	1.31	1.71	1.36	1.45	1.50	7.53	9.55	11.26	12.23
Mexico	–	–	–	–	0.19	0.11	0.09	0.09	0.08	0.11
Argentina	–	–	–	–	0.13	0.05	0.07	0.07	0.06	0.06
Brazil	–	–	–	–	0.10	0.08	0.14	0.12	0.11	0.13
Korea	–	–	–	–	0.03	0.14	2.54	3.76	4.85	5.12
Taiwan	–	–	–	–	0.20	0.64	3.55	4.09	4.61	5.31
Other NICS	–	–	–	–	0.80	0.48	1.14	1.41	1.54	1.50

Source: Aboites (2001).

Table 5.3 Patents granted in the USPTO by sector and country

	United States	*Canada*	*Mexico*	*Argentina*	*Brazil*	*Germany*	*United Kingdom*	*France*	*Spain*	*Japan*	*Korea*
1986–92											
Chemical	27.7	23.1	42.4	16.9	19.3	33.0	31.9	31.4	25.5	27.2	19.1
Electrical and electronic	22.1	16.9	8.6	13.7	11.2	16.2	24.9	22.5	8.7	38.5	48.3
Mechanical	50.2	60.0	49.1	69.4	69.5	50.8	43.2	46.1	65.8	34.3	32.6
1993–9											
Chemical	27.9	27.4	41.9	21.8	24.0	35.8	36.3	37.3	33.3	26.6	21.2
Electrical and electronic	28.2	20.6	8.1	8.8	10.0	17.3	28.1	23.5	11.2	45.5	55.3
Mechanical	43.9	51.9	50.0	69.5	66.0	47.0	35.5	39.2	55.5	27.9	23.5

two regions most successful economically during the 1990s. On the other hand, European countries have focused on the area of chemicals, traditionally their field of expertise. Among the regions studied, Latin America is the only one where the importance of mechanical technology as an innovative activity is still very strong. This is especially true for Mexico. In other words, Latin America has stuck to the technological pattern developed in the import substitution period.

The absence of Latin America from the technological frontier is more noticeable when compared to the small countries of Southeast Asia. It can also be said that the low activity regarding patenting expresses the limited technological skills of the countries of the region. Besides, although a more precise discussion is necessary, it can be said that the niches where Latin America is successful reflect segments of production sectors where technological skills are already in existence.

Thus, the performance of PS in Latin America cannot be understood without considering the learning efforts during the import-substitution phase. During the subsequent period, firms developed necessary economies of scale to enable them to compete in the international market after the opening of the economy. This has implied the adoption of plans, blueprints and designs in the domestic market, as well as efforts to improve organization and increase productive capacity. Take, for example, the case of large groups in the chemical, brewery and glass containers sectors which have not only developed increased productive capacity, but focused their R&D activities on supporting the knowledge base acquired during the import-substitution phase. Most of the patents granted in mechanical technologies reflect this process.

Today most Latin American economies have specialized on the basis of their abundant factor endowments: natural resources and labour. The sectors where Latin America has specialized after the economic reforms are characterized by low technological opportunities (Breschi and Malerba 1997; Cimoli 2000). Technological opportunities are differentiated across sectors demonstrating that the likelihood of innovation in any given field is associated with different sources. In some sectors, these sources are related to scientific linkage with universities and other research institutions; for others, the main sources are internal technological efforts based on R&D and the acquisition of equipment. Opportunities in yet other sectors are mainly generated through consumer–producer relationships.

Existing specialization shows different patterns in two areas: the Mexican Gulf and the Southern Cone (Cimoli 2000; Katz 2000). The Southern Cone countries (such as Argentina, Brazil, Chile and Uruguay) have intensified their specialization towards natural resources and standardized commodities. These are now highly capital-intensive industries with low domestic value added. Firms producing for local markets – the labour-intensive and the engineering-intensive – are those that suffered the most as a result of trade liberalization and market deregulation efforts.

Conversely, countries such as Mexico and the Central American nations have greatly globalized their manufacturing and assembly activities based on cheap labour, and leading to a new pattern of specialization in the global production chain. The Mexican case is an important example in the region. In recent years, a new pattern of sectors and production lines has been created, and economic activities are mainly coordinated and integrated across geographical borders. For example, Capdevielle *et al.* (1997) argue that the in-bond (maquiladora) industry is a leading factor in the emergence of new Mexican competitiveness. Beginning in 1988, the importance of the maquiladora industries increased steadily in terms of number of plants and workers employed. The maquiladora phenomenon poses an interesting problem considering its effects on the dynamics of local industry.

Patenting systems: Effort and performance

In Table 5.4, we observe a set of indicators showing not only the level of economic activity but also other aspects that reflect innovative activity. The countries with *converging* PS have a per capita GDP above the OECD average, while the level of expenditure in R&D ranges between 2.3 and 2.9 per cent of GDP. *Stable* PS present a close-to-average GDP per capita, while the level of expenditure in R&D falls in the range of 1.5–2.2 per cent of the GDP. Finally, countries with *diverging* PS are characterized by GDP per capita less than half the average of the OCED. As regards their expenditure on R&D, this is under 1 per cent as proportion of the GDP for all *diverging* countries.

In the Latin American region, expenditure on R&D as fraction of the GDP is relatively low (below unity). As we have seen, these countries have *diverging* PS; the same holds true for low-income European countries (Portugal and Greece). This contrasts with North America and Southeast Asia whose level of R&D expenditure is close to 3 per cent of GDP. Europe, it has been pointed out, is divided into two groups: those with relatively high R&D expenditure and similar to the USA, and those with a low income per capita that show a relatively low expenditure on R&D, typically below unity. In countries with low R&D expenditure, this is due specifically to the low contribution by the private sector. At this juncture, we can state that R&D efforts tend to reflect also the production specialization of each country and its industrial structure. Here, again, the Latin American countries specialize in natural resources and cheap labour.

The same asymmetry is shown in columns three and four of the table, giving the number of researchers in the workforce by region and country and the number of scientific and technical articles published. Both display a low contribution to R&D activities by researchers with training in these kinds of tasks. The last two columns of Table 5.4 show the degree of government contribution and technological intensity, and the same

Table 5.4 Technological effort and performance (1999): countries and technological indicators

	A	*B*	*C*	*D*	*E*	*F*	*G*
US	152	2.77	74	20	0.9	34.6	10.4
Canada	116	1.61	53	25	0.6	33.7	3.3
Mexico	36	0.34	6	2	0.2	66.2	0.0
Argentina	–	0.38	–	–	–	–	–
Brazil	–	0.76	–	–	–	–	–
Germany	106	2.32	58	21	0.8	37	5.0
UK	100	1.87	52	29	0.7	33.3	3.2
France	98	2.24	60	20	1.0	42.3	2.7
Spain	81	0.88	30	16	0.4	43.6	0.2
Portugal	74	0.65	24	7	0.4	65.2	0.0
Turkey	28	0.49	7	4	0.2	64.5	–
Greece	66	0.50	20	16	0.2	46.9	–
Japan	110	2.91	83	15	0.6	20.9	10.6
Korea	71	2.89	48	5	–	19.0	0.7

(A) GDP per capita (OECD average = 100), (B) R&D expenditures as share of GDP, (C) Number of researchers in every 10,000 of the economically active population, (D) Scientific papers per unit of GDP, (E) Government R&D expenditures in total GDP, (F) Government expenditure share in R&D, (G) Index of technological intensity of patents.

asymmetries appear: high values for industrialized countries with *converging* PS and low values in countries with *diverging* PS, like Mexico.

Table 5.5 relates the performance of PS to our taxonomy developed above as well as the main features of the innovation system in the different countries, with particular attention paid to Mexico. Here, we introduce a broad view of the linkages that exist between the functioning of NIS institutions and their legal framework as far as improving the performance of their innovation systems is concerned.

Converging PS countries (the USA, Japan, Korea, Taiwan and Germany) display strong innovative activity, especially – although by no means exclusively – in E-E technologies. These PS are linked to solid NIS (high R&D expenditure, adequate human resources and a growing participation of the private sector) creating a dynamic presence in the USPTO and supporting the drive toward a more articulated system to promote innovative activities. *Stable* PS countries (European countries with high income levels – except Germany – and Canada) show considerable innovative activity in chemicals and are less dynamic in E-E. These PS are linked to solid NIS that are nonetheless technologically dated *vis-à-vis* the emergence of the new paradigm based on E-E (although there are some areas in chemicals, like pharmaceuticals, that utilize state-of-the-art technology). *Diverging* PS countries (Spain, Mexico, Brazil, Argentina, Portugal and Greece) display low domestic innovative activity. Their inventive activity is especially, but not exclusively, associated with mechanical technologies and in some cases chemicals. These PS are linked to still unsound NIS

Table 5.5 Innovation systems and patenting patterns

Patent system	*Aspects of innovation system*	*Penetration in the USPTO*
Convergent: US, Canada, Germany, Japan, Korea	Higher expenditures in R&D. High share of firms' expenditures in R&D. Surplus in the technological balance. A well-developed system to support human resources. Virtuous networks between firms and institutions. Export oriented towards products with high technological content.	Increasing. Increasing E-E technologies. Chemicals stable. Mechanical technologies decreasing.
Stable: France, UK	Higher expenditures in R&D. High share of firms' expenditures in R&D. Deficit in technological balance. A well-developed system to support human resources. Exports oriented towards products with medium technological content.	Decreasing Increasing E-E technologies Chemicals stable. Mechanical technologies decreasing.
Divergent: Mexico, Brazil, Venezuela, Spain	Lower expenditures in R&D. Lower share of firms' expenditures in R&D. Deficit in the technological balance. A weak institutional system to support human resources. Weak networks between firms and institutions. Exports oriented towards products with low technological content.	Not important. Non-significance of E-E technologies. Stable mechanical technologies. Increasing in chemicals.

Source: Aboites (2001).

(low expenditure level in R&D, unskilled human resources and low participation of the private sector). Their penetration in the USPTO has been very low in the last three decades and there was no new impact made on the regulatory framework. In short, the way an NIS with a low degree of integration is linked to a *diverging* PS is through the transfer of technology from abroad. The Mexican economy is some kind of paradox: while sharing several macroeconomic features with Korea (dynamism in exports with a high technological content, economic growth, etc.), its innovative performance is weak. This is the subject of the following section.

3 Incentives to patenting in the Mexican innovation system

Mexico has accepted the TRIPs–WTO norms, together with the consolidation of the trade reform which began during the second half of the 1980s,

and which was concluded with the signing of NAFTA and Mexico's membership of the OECD. The IPR that correspond to the previous industrial property law (1976) have changed radically. The new law incorporated most of the reforms carried out between 1987 and 1997 in such important areas as: (a) a breeder's rights; (b) an integrated circuit's layout design; (c) industrial secrecy; (d) computer programmes; and (e) industrial design. Under these circumstances and considering the characterization of the core patent cycle as 'granting protection and use' (Doern 1999), we can briefly describe the main institutional changes. The changes in the granting of patents (1991) included new areas of patenting (pharmaceuticals, biotechnology and chemical products), as well as the acceptance of the novelty test from the Patent Cooperation Treaty (PCT). The changes in protection were based on the duration of the period of patent protection: this period was ten years in 1976 and was extended to 20 years in 1991. As for use, the importing of a patented product was again incorporated in 1991. This right to exploit patents was the centre of a controversy during the 1970s, given that it would permit transnational companies to import patented products without having to produce them locally.

Comparing the evolution of patenting activities in two periods, i.e. before trade liberalisation (1982–7) and during the process itself (1988–99), we can state that: (a) before trade liberalisation, patent applications by residents and non-residents decreased; (b) during the process of liberalisation, non-resident applications grew considerably, while resident patenting continued to decrease. As a result, there was strong growth of patenting by non-residents, compared to total patenting. The United States is the country that has increased its participation the most (60 per cent) despite a decrease during the 1995 crisis. Europe and Japan follow. In this context, two important trends can be observed: (a) the flow of total and non-resident patent applications is closely linked to domestic and foreign direct investment during the 1978–96 period; and (b) there is no significant relation between resident patenting activities and the evolution of total private sector investment.

Launched in 1994, NAFTA (the North America Free Trade Agreement) exerted decisive influence on the behaviour of residents' and non-residents' patents flows in Mexico (Aboites and Soria 1999). For residents, the average annual rate of increase of applications flow during the first period (1981–9) was 3.6 per cent while during the second period (1990–7) the decrease was considerable (−7.7 per cent). Clearly, there was an important fall regarding patenting activity among Mexico residents. The flows for non-residents increased by only 2.2 per cent during the first time period, while during the second period the applications by these external agents increased at the unprecedented rate for the Mexican economy of 34 per cent. External applications for patents did not register any significant changes in Mexico. During the first time period the flow went up by 3.3 per cent, while during the second time

period it increased by 4.9 per cent. This confirms our categorization of the Mexican PS as a *diverging* one.[2]

Growing pre-eminence of the non-residents' applications is noticeable. Moreover, a large part of the problem can be related to the role played by the transnational companies that use patents to block competition and protect their markets (Aboites and Soria 1999; Aboites 2001). This trend was markedly accentuated after the first year of negotiations of NAFTA and with the changes in the legislation of intellectual property rights (1990 and 1991 respectively). Thus, in 1983 non-residents' applications represented 84 per cent of the total, while by 1999 they would reach 96 per cent. Moreover, it could be said that during the negotiations and launching of NAFTA, a strong flow of non-residents' patents and a constant drop of activity from individual inventors and businesses characterized the Mexican PS. However, this situation does not seem to bear any relation to NAFTA.

During the 1991–4 period, there was growth of applications by all patent-holders, whereas in the 1994–6 period there was a substantial decrease in three types of patent-holders (Aboites 2001). Between 1991 and 1994, the most important growth in patent applications was from firms, universities and research institutes. Individual persons showed the lowest growth. Between 1994 and 1996, there was an overall decrease, universities and research institutes being the most affected. It is important to point out that firms are the main patent-holders, since eight out of ten patents belong to firms, especially transnational companies

Chemicals, metal products, machinery and equipment are the sectors in which 88 per cent of patent applications are concentrated. They are also the most active sectors regarding the number of patent applications during the 1991–4 period. In the chemical sector, the growth of patent applications is linked to PEMEX, the government-owned petroleum monopoly, as well as to the important petrochemical industry that has developed around this state-run company. The rest of the manufacturing sectors, specifically the traditional ones (food and beverages, textile, leather, etc.) are less important and show less activity in patent applications. During the 1995 economic crisis, the manufacturing sectors registered reductions; R&D-intensive sectors with a predominance of multinational firms (pharmaceuticals, biotechnology and others) were noteworthy because of their dynamism in patent applications.

Innovation has to be considered and defined as an interactive process since firms almost never innovate in isolation (in this context, strategic alliances and interactions between firms, research institutes, universities and other institutions are at the heart of the analysis). Some new technologies are being patented in the Mexican patenting system. Nonetheless, this non-resident patenting, for example in pharmaceuticals and other sectors, does not show a spillover effect influencing domestic innovative activity. This fact appears to show that growth of non-resident patenting does not

Table 5.6 Patents granted in Mexico to multinational corporations (1980–92)

Sectors	*1980–2*	*1983–6*	*1987–9*	*1990–2*
1 Chemical	1393	1240	1106	1679
2 Electrical and electronic	1009	631	466	414
3 Non-electrical machines	851	672	632	993
4 Transport	170	134	124	176
5 Other technology	183	141	137	243
Total	3606	2818	2465	3505

Source: Aboites and Soria (1999).

generate an upgrade in local innovative activity, or in the creation of networks that contribute to the strengthening of the nation's technological capability (Arvanitis and Villavicencio 2000; Gonsen and Jasso 2000). For example, this is particularly true for the pharmaceutical industry, where there is no incentive for R&D spending and for linkages between universities and domestic companies related to the generation of new molecules that would constitute a national discovery. Another characteristic that distinguishes the system of patents registered is that applications for patents in electronic technology are relatively few. In effect, despite the boom in electronic exports, there has not been a significant increase in patenting activity and R&D efforts.

4 Asymmetries between Korea and Mexico

Korea is an interesting case to compare with Mexico, particularly since Korea was on the 'watch list' of the US trade representative for a long time. It is mainly argued that Korea's intellectual property rights law does not meet the standards set out by the WTO Agreement on TRIPs. Most notably, Korea does not provide for TRIPs-consistent protection for pre-existing work and sound recordings. The USA has also raised concerns about the level of patent protection for pharmaceuticals and the protection of data in Korea, as well as about Korea's market access restrictions on pharmaceutical products and on motion picture and cable TV programming (Combe and Pfister 2000). In other words, the Korean PS is characterized by a set of incentives that support the diffusion of innovation and protect the technological capabilities achieved during the industrialization period.

In the case of Korea only the second time period (1990–7) is analysed below due to lack of any further information from the OECD. The trends registered in this time period are striking: applications from residents have increased at an average annual rate of 51 per cent, the highest in any of the countries studied. Dynamism from non-residents is also considerable: an increase of 12 per cent. It may be observed that at the beginning of the

period under study, residents submitted fewer applications for patents than foreigners, but at the end (1997) they greatly surpassed them. Undoubtedly, Korea's patents system is *converging* and is the most dynamic of the decade. Add to this the impressive flow of external applications in this country (a rise of 43 per cent) which, as we shall see later, are spread over many industrialized countries, particularly the USA, where the number of patents granted to Korea is comparable to that to the United Kingdom. Moreover, the Korean PS has succedded in increasing considerably the number of patents granted in the USPTO (see Table 5.4).

The previous section suggests that in countries with *converging* PS exporting is strongly associated with the innovative activity reflected in patents. Mexico is renowned for strong dynamism in exporting manufactured goods, comparable to Korea's. Nevertheless the correlation of patents with exports of manufactured goods shows pronounced differences. In fact, the proportion of residents' patents to exports of manufactured goods is 0.47 for Mexico, as was mentioned earlier, while for Korea it is 66 (USA 22; Japan, 84). Besides, Mexico is strongly deficient in its technological balance (Aboites and Soria 1999). This suggests that while in Korea exporting is associated with innovative activity, the same does not hold true of Mexico.

This set of contrasts between Mexico and Korea should be considered while bearing in mind that Korea is an economy with a *converging* PS and an NIS that has consolidated its upgrade of technological capabilities in recent decades. A factor that explains the differences between the two countries is selective dynamic intervention. For example, one of the keys to success by interventionists has been the ability to programme the level and composition of non-competitive intermediate and capital goods. In the case of South Korea, quotas, directed credits and targeting were used in order to select those industries that were to provide foreign exchange through exports. The industries whose exports were promoted were those in which the country possessed a static comparative advantage whereas the industries which enjoyed protective policy were expected to develop a dynamic comparative advantage. At the aggregate level, it was also possible to obtain a balanced portfolio in terms of sources and uses of foreign exchange. Within the industries expected to develop dynamic comparative advantages, it seems that the major actors in technological learning have been the large business groups – the chaebol – which have been able at a very early stage of development to internalize the skills of selecting among technologies acquired from abroad, efficiently using and adapting them, and soon developing impressive engineering capabilities (Kim 1993). This process has been further supported by a set of institutions and networks dedicated to improving and upgrading human recourses (Amsden 1989).

5 Performance of the Mexican innovation system

Since the trade reform, Mexico has substantially increased its participation in the world arena in terms of exports as well as imports. Most of the surviving and efficient firms (both MNC and large domestic firms) have increased their exports (components for automobiles, chemicals, plastic products, glass, beer, electronics, steel, cement, etc.) and imports of intermediate and capital goods. Mexico is a country in which production activities are highly globalized and a new specialization in the global chain of production is emerging (Capdevielle *et al.* 2000; Unger and Oloriz 2000). Nonetheless, all types of firms have some degree of integration with the countries that lead in international trade and technological innovation, thus becoming dependent on imported technology especially of the most technologically dynamic products and intermediates. In a similar context, the majority of the transnational companies' patents is to trade and protect their products locally. More generally, the following factors in the Mexican NIS can explain the impact of the superimposed incentives provided by the new trade and IPR regimes (Cimoli 2000).

R&D effort

Mexico's R&D effort is rather poor in comparison to those countries at the technological frontier. Moreover, R&D is highly concentrated in the export sectors (automobiles, glass, cement, office machinery and computers, electronic equipment, etc.). R&D effort is principally focused on addressing the modernization of production processes as well as improving production organization and product quality. As for sources of new technological knowledge, the vast majority of firms rely almost exclusively on internal sources. Regardless of the sectors in which firms operate, they have not developed cooperative R&D efforts with other firms and institutions. Furthermore, in none of the technological sectors have there been significant expenditures on R&D by firms, except for those that are export-oriented and these firms have principally invested in improving processes, organization or quality. The pattern of R&D effort – which has been limited and scattered – as well as other modes of technology transfer have been dominated by increasing penetration of imported inputs in most competitive sectors (Capdevielle *et al.* 2000).

FDI and local technological effort

Foreign direct investment (FDI) refers to activities and decisions taken by multinational companies (MNC). These activities and decisions, developed in relation to international production, exert a strong influence on the direction, scale and content of trade flows as well as on the trade specialization, competitiveness and foreign trade balance of both the host and the home

country. This is certainly true for a host country such as Mexico. In large part, the Mexican pattern of trade specialization and performance can be analysed as the outcome of processes that result from MNC decisions on localization and quality of FDI. In this context, regional integration through NAFTA has played a crucial role as an institutional regime or framework that supported incentives for MNC. Today, technological developments occur mainly in the home bases of MNC and only a small portion is transferred to countries such as Mexico. This process implies, on the one hand, that Mexico participates actively in the globalization of production and, on the other, that its participation in the globalization of scientific and technological activities is very poor. As companies transfer only some of their R&D activities to Mexico, we can expect that the present concentration of corporate R&D will, by and large, lead to an even stronger international divergence of technological development. Internationalization of R&D proceeds within developed economies and regions with revealed technological advantages. Technological cooperation between firms seems in practice to exclude firms that do not already have an established reputation within the developed economies. This view is supported by results obtained from empirical research on the organization of research activities in multinational firms; here we note that even multinational companies perform most of their innovative activities in their home country (Pavitt and Patel 1991; Cantwell 1989, 1997; Chesnais 1988; Unger and Oloriz 2000).

Most production activities in Mexico have increased their demand for knowledge and technology provided by foreign sources. Evidence indicates that firms have modernized their exporting plants, which suggests that industrial adjustment has occurred through process innovation, such as improvement of production organization, skills and adaptation of machinery and equipment. It has not happened through the renewing of fixed capital, which would permit the MNC and large domestic groups to achieve higher competitiveness. Moreover, there are reasons why the dynamics of inter-industry flows simply do not improve R&D effort and linkages within the local institutional framework. For example, maquiladora operations dominate the production of science-based components, thus allowing for very limited links and flows to other domestic suppliers of intermediate goods. In particular, in recent years, maquila industry has become one of the leading actors of industrial modernization. The diffusion of this type of industry supplies only very weak connections with domestic productive firms and institutions (Unger and Oloriz 2000). The 'maquila innovation system' mainly supports and stimulates the networking activities of foreign firms and institutions, thus reinforcing knowledge and technological advantages in developed economies.

The pattern of innovative activity contrasts with the orientation of production among different kinds of businesses. In Mexico, companies whose production is basically geared toward exporting do not carry on either innovative or patenting activities. When comparing the behaviour of

patents systems among technological sectors, a widening gap is observed between the electrical and electronic sectors and the rest. This is important because a very significant part of the exporting maquiladora industry is related to electronic accessories or automotive parts closely related to this type of technology. Chemicals are the fastest growing technological patents sector in Mexico, while in the USA their share is low and they exhibit moderate growth. This is a result of the exporting industry (maquiladora) whose outstanding feature is a weak link between production and innovation. Thus, its technological externalities do not appear to have contributed in any way to developing technological skills or strengthening the NIS.

Specialization in assembly activities

There are several pointers showing the links between the export activity of maquiladora-manufactured goods and the rest of the economy. We will present only two. First, during the last decade approximately 95 per cent of the raw materials required by this sector were imported. This clearly shows the lack of connection between the manufactured-goods exporting sector and the Mexican production system. Second, the resource most utilized by the manufactured-goods exporting sector is labour. The low salaries paid to workers in maquiladoras (in 1998 the established salaries paid in the Mexican maquiladora industry were equivalent to 9 per cent of those paid in the USA and to 14 per cent those is paid in France) reflect the low technological complexity of the labour tasks as well as the workers' low level of qualifications. In other words, when reviewing these links with the national production sector it is clear, as several authors (Capdevielle *et al.* 2000) have explained, that the strongest link established by the maquiladora industry is with the least qualified and lowest salary segments of the country's labour market. It is important to bear in mind that the vitality of the maquiladora industry does not depend on the internal market but on the integration of the plants installed within national borders with production processes abroad, especially in the US. Finally, it should be stressed that during the last decade approximately 25 per cent of the FDI was associated with this industry. In short, the maquiladora industry contributes decisively to the exporting of manufactured goods without significantly associating itself with the national production sector; but it is tightly associated with that sector of the labour market that is characterized by low qualifications and salaries. (Capdevielle *et al.* 2000).

Substitution of local technological sources

Imported equipment used throughout the industrial system replaces the capability that could accumulate in specialized domestic suppliers of equipment in a well-integrated industrial system. The process can be

observed in the links of sectors and types of firms (foreign and non-foreign) with foreign production networks and sources of technology. In particular, the pattern of R&D effort and technology transfer has mainly been substituted by greater reliance on imported inputs, stronger linkages with foreign engineering services and institutions (such as universities and other research institutes) as far as the most successful exporting sectors are concerned. Their direct contribution to R&D and technology transfer is not significant.

The personnel employed in R&D activities, quality control and local adaptation of design mainly interact with others within the multinational firms where they work. Furthermore, those firms are characterized by reduced linkages with the domestic higher-education institutions, local research centres and laboratories. In this context, universities still show an increasing effort to improve and create linkages with the production system, but their efforts are inhibited by two principal factors. The first is the bureaucratic organization of most public universities and the second a lack of demand from the industrial sector – modernized and more science-based – which tends to demand 'knowledge' from institutions and research centres abroad. In the long term, these trends are consistent with a reduction of competencies of local human capital and adverse incentives to develop linkages with local research centres.

Inhibition of local networks

The interaction between firms and local institutions that produce knowledge is very poor – a fact that is most keenly felt by those companies belonging to the science-based sector. The results show that domestic firms consider internal sources of knowledge as more important for their innovative activities than external sources. Within the production system the activities of engineers, technicians and the experience of the labour force constitute the most relevant sources of knowledge, particularly for firms within the scale-intensive and science-based sectors. According to firms, users are also an important source of technological knowledge, especially in the specialized supplier and supplier-dominated sectors. Public-sector or university research centres are not a relevant source of information for Mexican firms. This is a rather remarkable fact in the case of firms within the science-based sector, since this sector is strongly linked with such centres in the more developed countries. This process is reinforced by the protection incentives introduced by the homogenization of the IPR regime.

A substantial and widespread perception is that networks are a powerful engine for innovation systems. Regarding recent parables of globalization and liberalisation, it could be conjectured that the benefits generated by knowledge-intensive networks are not equally distributed. Moreover, the specialization of production supports a system of networks where the

demand for knowledge and innovation is continuously directed towards advanced economies. This increases their ability to capture benefits and advantages. Thus, at first sight there appears to be a contradiction between theoretical support for the idea that countries can capture the benefits of globalization and empirical evidence on the increasing gaps in the ability to capture the benefit of networks and innovative activities (Cimoli 2000).

In addition analysis of the effectiveness of the linkages supporting knowledge flows and innovation processes, is complicated by the presence of informal relationships between organizations and institutions that in the standard literature fall under the heading of 'externalities'. Clearly, further investigation is required in order to provide a more solid basis for inclusion in our analysis. Nonetheless, such analysis would be helpful in understanding the mechanisms by which networks determine the success or failure of innovation. Recent advances in the economics of innovation have highlighted the powerful role of externalities in the generation of new technologies and adoption of a beneficial development path.

The conclusion to be drawn from this section is that the effects of the stimuli generated by the openness of the economy are starting to wear out and, furthermore, local networking activities do not have sufficient support in terms of linkages between the different agents throughout the innovation system of Mexico. In others words, the production system has successfully modernized a small part of the economy, due to the effects derived from opening up to global competition. However, this process has not been accompanied by an increased effort to stimulate the creation of local networks, such as non-market linkages, business culture and institutions that enable firms to interact with each other. Moreover, the new IPR system does not stimulate local innovative activities; on the contrary, it inhibits them.

6 Conclusions

The incentives from the IPR do not suit well developing economies, particularly those that have adopted liberalisation policies and market-oriented reforms. Countries do not start from the same place. The advantages of IPR homogenization are asymmetrical: only developed economies benefit from both static and dynamic advantages.

This asymmetry reinforces the prevailing gap between domestic and external technological capabilities, the latter benefiting further from the globalization process. The interactions between the incentives promoted by economic reforms and the IPR regime are responsible for the occurrence of what has been called 'lock-in by historical events' and 'self-reinforcing process' (Arthur 1989; David 1994). Liberalisation and globalization of markets together with the homogenization of the IPR regime can eventually reinforce the technology gap between nations, if the

'destruction' of local capabilities is not compensated by the diffusion of knowledge transferred (or diffused) by globalized firms.

In developed economies, the IPR regime promotes R&D effort and linkages between different types of components of the innovation system. Thus, the main difference between developed and developing economies lies in the effect that IPR has on innovative activities. In Mexico, there has been a reduction in domestic patenting. Thus, despite the increase in non-resident patents, there is inadequate local diffusion of the technological knowledge that arrives in Mexico from abroad. This suggests that the existing networks are not stimulated to diffuse this type of technological information towards the national agents, this being a distinguishing characteristic of the Mexican innovation system. This leads us to conclude that there are two factors that block the diffusion of technology codified in patents, preventing it from reaching the domestic productive system: (a) the majority of the transnational companies' patenting is for trading purposes (importing patented products or blocking competition); and (b) transnational companies support their R&D effort at home and develop networks with institutions and high-technology firms in developed economies. An important conclusion from the previous statement is that NAFTA might have met expectations of increasing foreign direct investment, but the same is not true for local diffusion of technology flows. In other words, transnational companies mostly gain patents to trade, thus favouring the creation of networks abroad. We can affirm that changes in intellectual property rights in Mexico have strengthened the transnational companies' ability to diffuse their innovations through trade, instead of through the creation of local innovation and technological networks.

Notes

1 See among others: Braga and Willmore (1991), Diwan and Rodrik (1991), Bertin and Wyatt (1988), Vaitsos (1972).

2 The number of applications from residents was characterized by a permanent and slow decline, a trend that does not display any modifications due to the great changes in the economic incentives, the negotiations of NAFTA or the actual launching of the Agreement. In 1983 applications from residents represented 16 per cent of the total, by 1994 they amounted to only 4 per cent. The average annual rate of increase for residents was of –3.1 per cent and the corresponding one for non-residents was 13.2 per cent.

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Part III

Converging and diverging paths of economic development

6 What remains of the East Asian model?

K. Sundaram Jomo

There is considerable debate about the implications of the recent crises for economic development, particularly over whether the East Asian experience of the last three decades offered different lessons and prescriptions for development from those advocated by the 'counter-revolution' against development economics. As is now well known, this neo-liberal reaction has maintained that development economics and its prescriptions constituted bad economics, based on distortions of neo-classical welfare economics, which exaggerated the extent and implications of 'market failure' and underestimated the likelihood of 'state failure' and its consequences.

Influential economists at the United States Treasury, the IMF, the World Bank and elsewhere have cited the East Asian financial crisis to criticize the Bank's 1993 *East Asian Miracle* volume as flawed. In particular, the critics denounce the study's acknowledgement of the success of 'directed credit' and what has come to be known as 'financial restraint', authored by Joseph Stiglitz, who later publicly dissented on the appropriateness of IMF prescriptions for the East Asian crises, while serving as Chief Economist and Senior Vice-President of the World Bank until late 1999.

The crisis from mid-1997 started not long after Krugman's (1994) claims that East Asian growth was not sustainable because it was based primarily on factor accumulation – eventually subject to diminishing returns, rather than productivity growth ('perspiration rather than inspiration'). Many critics, from across the intellectual spectrum, initially saw the East Asian currency and financial crises as vindication of Krugman's argument, or of some variation thereof. Often, there was more than a touch of neo-liberal triumphalism in hasty pronouncements of the end of the Asian miracle, or in word plays of 'miracle or *débâcle*', 'tigers or fat cats' and the like.

International reform for the better?

For the first year after the East Asian crises began in mid-1997, there was limited interest in the West with respect to growing calls from East Asia and elsewhere for reforms to the international monetary and financial

systems. An initiative by the Japanese government in the third quarter of 1997 to set up a regional monetary facility with US$100 billion to deal with the crisis was opposed by the IMF. The opposition was endorsed by the Western powers as well as by China, which was suspicious of Japanese intentions to take advantage of the crisis to secure regional leadership.

However, as noted earlier, the situation changed dramatically a year later as the East Asian crisis seemed to be spreading to the West, via the Russian Federation and Brazil. In the United States, there was a scare on Wall Street after the collapse of the Long-Term Capital Management (LTCM) hedge fund, subsequently rescued thanks to an initiative by the United States Federal Reserve Bank. The second half of 1998 saw much greater Western concern about the international financial system, and the possible damage that might be caused by its vulnerability. Various government leaders began a briefly animated international discussion concerning the need for a new international financial architecture, leading to some initiatives to promote greater international financial stability.

The new challenges at the international level are formidable, considering the powerful vested interests involved, particularly in Europe, Japan and the United States. There have been many misgivings elsewhere about the nature and volatility of the international financial system, renewed and enhanced by each new crisis, especially the recent East Asian crisis, not least because of its new characteristics. Nevertheless, the voice of the developing countries has continued to weaken after the debt crisis of the 1980s began to reverse the gains of the 1970s, associated with the New International Economic Order and related initiatives.

The conditionalities imposed in the aftermath of the debt crisis, the broad range of reforms associated with the World Trade Organization (WTO), and changing transnational economic and political alliances have advanced economic liberalisation. Meanwhile, international political developments following the end of the Cold War as well as the new constraints on state initiatives have further undermined the capacity for effective collective action by the governments of developing countries. Hence, it seems unlikely that much goodwill came out of the traumatic *débâcle* of 1997/8.

Contrary to the claim that 'the market' will exact swift and painful punishment on governments and economies which do not have their macroeconomic houses in order, the timing, nature and consequences of the 1997/8 financial crises in East Asia underline the imperfect nature of financial markets. This was reflected in the long delay in 'rectification'. For example, although current account deficits were more serious in 1995 compared to 1997, there was no rectification then, let alone 'punishment' of the culprits – that is, the current account deficits in Malaysia and Thailand reached all time highs, without any commensurate adverse effect.[1]

Incredibly, at the September 1997 annual meetings of the IMF and the World Bank in Hong Kong (China), the IMF policy-making Interim Com-

mittee – which represents all 181 IMF member countries via 24 ministers – gave the Fund a mandate to alter its Articles of Association. The IMF would eventually have 'jurisdiction' over the capital account, in addition to the current account of member countries' balance of payments, which it has had for many decades.[2] In December 1997, the WTO also concluded its financial services agreement, which basically commits member countries to a schedule of accelerated liberalisation of trade in financial services. Even the *Wall Street Journal* noted that the agreement would primarily benefit the United States and Europe, since it was most unlikely that the South would be in a position to export financial services to the North.

It is therefore likely that countries of the South will face even greater problems with their balance of payments as their services, and hence current account deficits, worsen. Much of the nascent financial services that have emerged under protection in these countries are unlikely to survive international competition from transnational giants enjoying economies of scale and other advantages.

Macroeconomic recovery

As noted earlier, before the East Asian crisis, there were no clear macroeconomic warnings of imminent crisis. The countries of the region sustained high growth with low inflation. Their public finances were sound, and both the external debt and the current account deficit were manageable. Thus, East Asian government officials kept reiterating 'healthy fundamentals' up to the outbreak of the full-scale crisis. Many attempts have since been made to explain the causes and consequences of the crisis, but there has been relatively little attention paid to the recovery.

With the possible exception of Indonesia – largely owing to its complicated political transition – the East Asian economies are now clearly on a path of recovery from financial crisis, the pace of which is far quicker than anticipated by most early forecasts, including those by the IMF. Hence, the speed of the recovery has been as surprising as the earlier spread and deepening of the crisis (see the official IMF publications during the period 1997–2000). Initial IMF predictions were that growth would be stagnant for at least three to four years following the crisis (a U-shaped recovery). In late 1997 and early 1998, the IMF failed to anticipate the sharp downturns of 1998. Then, once deep recession was evident, it anticipated continued recession in 1999 and very modest recovery from 2000. Instead, the economies of Malaysia, the Republic of Korea and, arguably, Thailand have quickly recovered after some sharp drops in 1998 (a V-shaped recovery).

The turnaround in economic performance can mainly be attributed to Keynesian[3] macroeconomic measures. Both the Malaysian and Korean economies recovered as a result of reflationary macroeconomic policies. Also, among financial reform measures, the swift recapitalization of commercial banks from mid-1998 in both Malaysia and the Republic of

Korea is now acknowledged as having been crucial for their recovery.[4] However, the restoration of bank liquidity through such measures is not what is usually meant by the structural reforms desired by the IMF. In fact, such measures have been much criticized as likely to perpetuate, if not exacerbate, the problem of moral hazard in the economy. After all, as Shin (2000) notes, 'the injection of public money is necessary to revive its financial sector whether a government is committed to reform or not'.

Interest rates were reduced drastically – almost in defiance of IMF prescriptions – to boost corporate recovery. The IMF's initial macroeconomic policy emphasis involved retrenchment. By insisting on sharply higher interest rates, corporate failures were made to soar, making voluntary corporate reforms even more difficult. Figure 6.1 shows interest rates peaking in Thailand in September 1997, in the Republic of Korea in January 1998, in Malaysia in April 1998, and in Indonesia in August 1998. Of the East Asian four, rates had risen least in Malaysia, by less than 3 percentage points. Although capital controls, introduced in September 1998, succeeded in consolidating the downward trend in interest rates, Thai rates soon fell below Malaysia's from their much higher earlier levels. Interest rates fell throughout the region in the second half of 1998; this was helped by changed monetary policies in the West, and it is not clear whether Malaysia's capital controls were really necessary for bringing down interest rates by the third quarter of 1998.

The depreciation of the region's currencies caused by the crisis (see Table 6.1 and Figure 6.2) may also have helped corporate recovery and

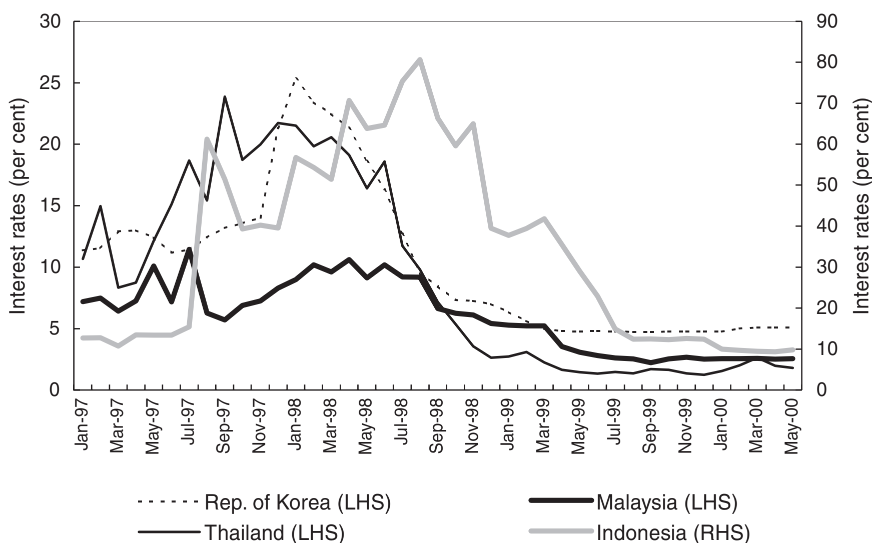

Figure 6.1 East Asian four: monthly foreign exchange rates, January 1997–May 2000

Table 6.1 East Asian four: exchange rates and depreciation against US dollar, 1997–2000

	Exchange rate (monthly average)				*Depreciation (per cent)*		
Currency	*Jan. 1997*	*Jan. 1998*	*July 1998*	*July 2000*	*Jan. 1997– Jan. 1998*	*Jan. 1997– July 1998*	*Jan. 1997– July 2000*
Indonesia: rupiah	2369.00	9767	14,233	8249	312.2	500.7	248.2
Malaysia: ringgit	2491.00	4363	4151	3800	75.2	66.7	52.6
Rep. of Korea: won	850.60	1700	1294	1119	99.9	51.1	31.5
Thailand: baht	25.72	53.12	41.22	39.29	106.5	60.3	52.8

Source: Computed from *Financial Times*, Extel data.

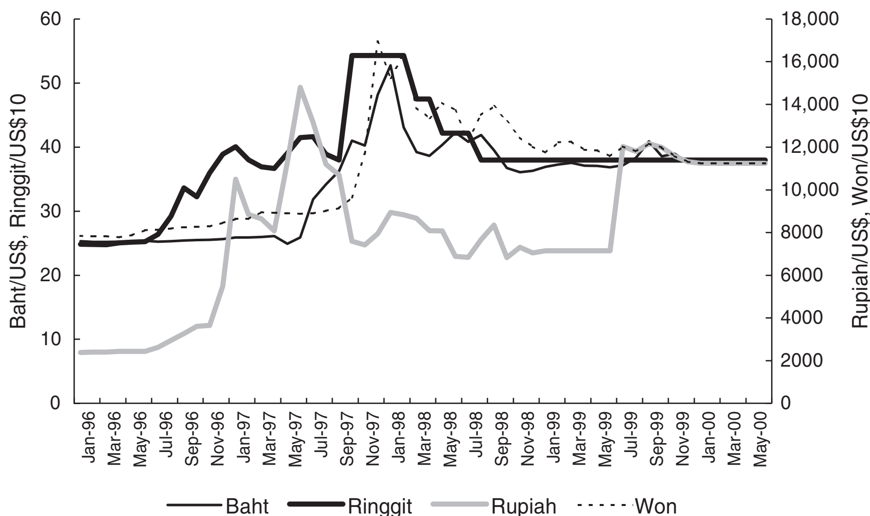

Figure 6.2 East Asian four: monthly foreign exchange rates, January 1996–June 2000

contributed to improved trade balances as well as foreign reserves among the four economies. Figure 6.2 also shows that exchange rate volatility declined significantly after mid-1998, except in Indonesia where there was political instability. Interest rates were highest when exchange rates were lowest, indicating that all four governments responded similarly by raising interest rates in response to the contagion of spreading currency crises and falling foreign exchange rates. The self-fulfilling nature of the crisis suggests that little else could be done in the face of such capital flight with open capital accounts. It is also difficult to determine how futile these initial monetary policy responses actually were.

The currency depreciations generally more than compensated for the declining export prices because of global price deflation of both primary and manufactured commodities associated with international trade liberalisation. The Malaysian ringgit was fixed to the US dollar from early September 1998 in an effort originally intended to strengthen its value. Fortuitously lower US interest rates in the aftermath of the Russian, Brazilian, LTCM and Wall Street crises of August 1998 served to strengthen other East Asian currencies, causing the ringgit to be undervalued instead from late 1998. In the Republic of Korea, the authorities intervened in the foreign exchange market to slow down the pace of won appreciation from late 1998 to ensure exchange rate competitiveness.

As Figures 6.3a and b show, budget deficits substantially increased in 1998, especially in the second half of the year. While government revenues were probably adversely affected by the economic slowdown, government

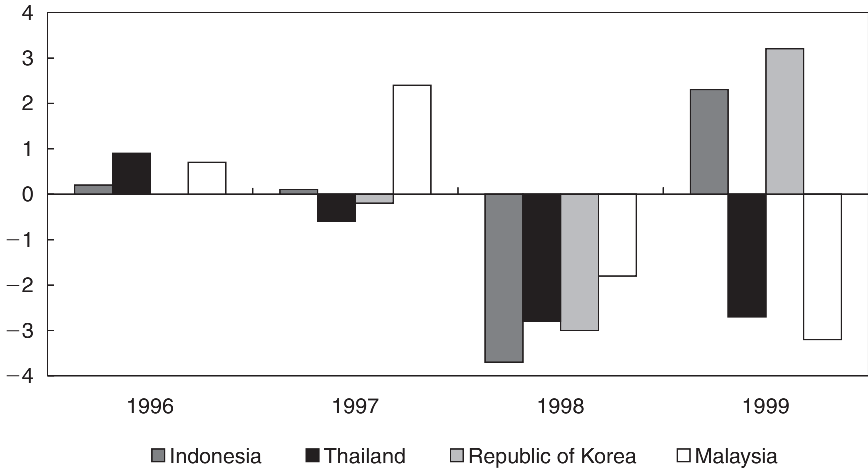

Figure 6.3a Indonesia, Malaysia, Republic of Korea, Thailand: annual budget balances, 1996–9 (per cent of GDP)

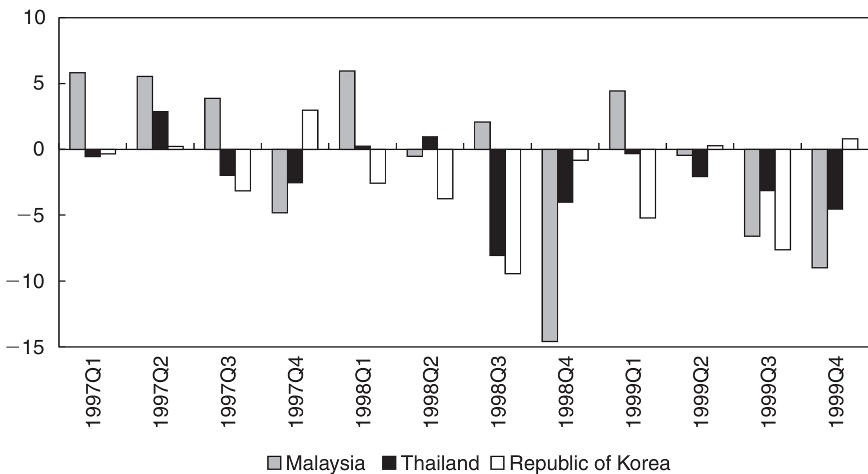

Figure 6.3b Malaysia, Republic of Korea, Thailand: quarterly budget balances, 1997Q1–1999Q4 (per cent of GDP)

expenditure rose with efforts to reflate the economy from around mid-1998. Government funds went to recapitalize financial institutions and for increased spending, especially for public works and to provide the 'social safety nets' advocated by the Fund and the Bank. The recapitalization of financial institutions[5] was crucial for recovery by taking out inherited systemic risk from the banking system, thus restoring liquidity. The modest

budget surpluses during the early and mid-1990s before the crisis were replaced by significant budgetary deficits to finance counter-cyclical measures. Thus, the balanced budgets of the pre-crisis period were crucial to helping overcome the crisis. It should be emphasized that such Keynesian policies were not part of IMF programmes.

In the absence of capital controls, the East Asian economies could not reverse monetary policy without further adverse effects due to international exposure. Hence, monetary policy remained cautious until mid-1998. Thus, regional macroeconomic policies could only be changed after conducive changes in the international economic environment. Interest rates could only be lowered after the G-7 took concerted action to lower interest rates and increase money supply to avoid financial turmoil after the Russian crisis led to the collapse of the LTCM hedge fund. In other words, East Asian Keynesian policies were made possible by international responses to the fear of global financial collapse from the third quarter of 1998. Ironically, this only became possible over a year after the East Asian crisis began, when it seemed to threaten the rest of the world, especially Wall Street.

Reform of corporate governance[6]

Many institutional arrangements in the most affected economies probably contributed significantly to 'catching up' and, while many features may no longer be desirable or appropriate, corporate reform advocates usually fail even to acknowledge that they were at least once conducive to rapid accumulation and growth. This is largely due to ideological presumptions about what constitutes good corporate governance, usually inspired by what has often been termed 'the Anglo-American model of capitalism'. From this perspective, pre-crisis economic institutions were undesirable for various reasons, especially insofar as they departed from such a model. Worse still, with minimal evidence and faulty reasoning, the 1997/8 crises in the region have been blamed on these institutions, as if they were crises just waiting to happen. Not surprisingly then, from this perspective, thorough going reforms should be the top priority and the pre-crisis systems need to be abandoned altogether.

The IMF pushed for radical corporate reforms, claiming that corporate structure was at the root of the crisis, with some reform-minded East Asian governments agreeing. However, it is doubtful that corporate structure was a major cause of the crisis, although there were some symptoms of corporate distress in all the crisis-affected economies before the crisis. First, corporate profitability was deteriorating, most rapidly in Thailand but also elsewhere in East Asia. Second, indices of investment efficiency, such as the incremental capital output ratio (ICOR), were rapidly deteriorating. Some of the economies (especially those of the Republic of Korea and Thailand) began to experience corporate failures from early 1997.

After Indonesia, the Republic of Korea and Thailand went to the IMF for emergency credit facilities, the Fund kept emphasizing microeconomic reform as central to its recovery programme, especially for the last two countries (Lane *et al.* 1999). The newly elected reformist governments of Thailand and the Republic of Korea, led by Chuan Leekpai and Kim Dae Jung respectively, agreed with the IMF's insistence on the urgency of comprehensive corporate reforms, although there was some dissent over the Fund's punitive macroeconomic policies. These reforms generally sought to transform existing corporate structures, regarded as having caused overinvestment and other ills, in line with ostensibly 'global' Anglo-American standards. Shin (2000) describes how Korean corporate reforms sought to remould its corporate structure along more American lines.

From recent East Asian experiences, it was clearly better first to improve the macroeconomic environment and remove systemic risks in the financial system. There is no evidence whatsoever that the simultaneous attempts at radical corporate reforms helped recovery in any decisive way. The agenda for corporate reform needs to be determined after careful consideration of existing weaknesses, rather than by presumptions about what may be best according to some ideological or policy-driven agenda. An economy's corporate structure is inevitably the consequence of evolutionary developments, including cultural heritage and colonial inheritance. Most economies accommodate a diversity of corporate structures. Inappropriate arrangements would have perished unless propped up by patrons such as the state. Others may have become dysfunctional owing to changing circumstances, but there is no universally optimal corporate structure.

The East Asian experiences also suggest that the IMF programmes were generally not conducive to corporate reforms; they tended to exacerbate corporate failures sharply, and made corporate as well as financial adjustments more difficult. The East Asian experiences, particularly those of Malaysia and the Republic of Korea, suggest that improvements in macroeconomic conditions, especially interest rate reductions and appropriate increases in government spending, were necessary to facilitate adjustments and reforms. New stock issues, asset sales and foreign capital investments, all necessary for corporate restructuring, only became possible with the more buoyant economic conditions of 1999.

It has also been argued that in all the East Asian cases, corporate reform efforts thus far have hardly succeeded in achieving their objective of correcting the structure of high debt and low profitability, but have instead imposed large costs on the economy. This is seen as self-evident in the case of Malaysia, in view of the regime's approach, and for Indonesia owing to the political uncertainties since the crisis, but is also held to be true, albeit to lesser degrees, for the Republic of Korea (Shin 2000) and Thailand (Phongpaichit and Baker 2000).

Enterprises in any country that are otherwise well managed and

profitable may find themselves in serious financial distress because of developments beyond their control. During the East Asian crisis, sudden and steep currency devaluations increased firms' import costs and unhedged external liabilities denominated in foreign currencies, usually the US dollar. As these devaluations were accompanied by financial crises, limited access to emergency finance threatened the very survival of firms in the affected countries, especially small and medium-sized enterprises; they faced insolvency or being taken over at 'bargain basement' or 'fire sale' prices, usually by foreign interests unaffected by the crisis. For a variety of microeconomic reasons, such takeovers were unlikely to result in superior management. Such elimination of otherwise viable enterprises would most certainly have undermined the processes of capacity- and capability-building deemed essential for catching-up development.

Shin (2000) argues for building a second-stage catching-up system for the Republic of Korea, instead of IMF and other proposed transitions on ostensibly Anglo-American lines. Other similar arguments from elsewhere in the region acknowledge that there were considerable abuses of the pre-crisis system by politically powerful *rentiers*, and these should, of course, be eliminated (Gomez and Jomo 1999). Nevertheless, the other crisis-affected Southeast Asian economies still need reforms to ensure more appropriate developmental regimes in line with changing circumstances and challenges. States need to develop a new range of institutions for more effective selective intervention to accelerate the development of new industrial, technological, organizational and managerial capacities to face the various new challenges associated with accelerated globalization in the past decade and a half.

There are also grave doubts as to whether the reforms have improved corporate resilience in the long run. Shin (2000) argues that foreign capital returned to the Republic of Korea because the economy began picking up from November 1998, after uncertainties had been substantially reduced, rather than the return of foreign investment having led the recovery, as hoped for by the IMF. The recovery has been mainly driven by typically Keynesian policies and certainly not by reforms in corporate governance.

In light of the basis for, and nature of, the recent recovery, the earlier and ongoing emphasis on the urgency of corporate reform was clearly ill-informed and ill-advised. Corporate profitability has undoubtedly improved. But there is no clear evidence that corporate reform was the key to bringing about this recovery. In fact, it has been noted that many corporate reform measures have been intended to prevent future crises, even at the cost of short-term economic recovery. With their earlier predictions of imminent 'doom without corporate reform' unrealized, those insisting on such reforms as a prerequisite for recovery have now switched to warning of a second downturn for countries like Malaysia, where resistance to reform has been officially articulated.

New international financial architecture[7]

As noted earlier, recent trends in the IMF and the WTO following the East Asian crises are unlikely to make prevention of future crises any easier. Keeping open the capital account and allowing freedom for trans-border movement of funds makes it difficult not only to introduce measures to prevent financial crises, but also to introduce effective financial safety nets at the national level. Past IMF consultations with various governments have been unable to prevent major financial turmoil, with the frequency of currency and financial crises increasing, rather than decreasing in the course of financial liberalisation in the last two decades. Despite its grudging acceptance of the efficacy of capital controls in Chile, Colombia and elsewhere, the Fund has been reluctant to urge countries to control short-term inflows before a crisis occurs.

Too little attention has been paid to the policies of the developed countries, especially the major economic powers, despite their impact on exchange rates in the rest of the world, above all, in developing countries. Akyüz (2000a) has noted that all the emerging-market crises of the past two decades have been associated with large changes in the exchange rates of the major industrial economies. Developing countries seem generally incapable of maintaining exchange rate stability, while the major currencies experience big fluctuations. Hence, currency coordination between Europe, Japan and the United States is desperately needed for the stability of their own currencies as well as others in the world today. Despite frequent G-7 meetings, existing arrangements leave much to be desired. Consequently, there may be fluctuations of up to 20 per cent within a week. The effects of such huge swings on smaller open economies are not well understood, although such economies are expected simply to adjust to these changes.

Since the East Asian crisis, the international discussion on international financial reform to prevent future crises has emphasized questions of transparency and greater supply of information. However, there is no evidence that having more information will be enough to prevent crises. Also, efforts seem to be directed mainly to obtaining more information from governments, especially of the developing countries. Little is done to get information on the various financial markets, especially the most volatile and vulnerable ones, such as those involving highly leveraged institutions and offshore markets.

A global system of prudential controls should accommodate the existing diversity of national conditions as well as regional arrangements. However, the currently favoured approach to prudential regulation is to formulate international standards for countries to implement and enforce. In the recent past, such standards have usually been set by the Bank for International Settlements (BIS), which serves banks in the OECD economies. There are several problems with this approach (Akyüz 2000a,

2000b). First, such standards do not specifically take into account the risks associated with international lending. Currently, credit rating agencies are relied upon to fill the vacuum, but they have a tendency to be pro-cyclical, thus exacerbating, rather than checking, fluctuations. Second, the standards have mainly been designed to protect creditors, not debtors and the countries they belong to. A similar level of exposure may imply different risks to different creditors as well as debtors. Third, the one-size-fits-all approach implicit in setting standards tends to gloss over important variations, thus undermining the efficacy of this approach. Although there is currently general agreement that the IMF should not set standards, the Fund is likely to be involved in policing the enforcement of such standards, which would raise similar concerns.

After the East Asian crises, there seemed to be agreement that short-term capital flows required regulation. But while developing countries currently have the right to control short-term capital flows, the lack of international endorsement of such measures serves as a major deterrent for those considering their introduction.

Developing countries are currently being encouraged either to fix (through a currency board system or even dollarization) or freely float their currencies, but are being discouraged from considering intermediate alternatives. However, studies have shown that a floating system is associated with the same degree of volatility as a fixed one (Akyüz 2000a, b), with the principal difference between the two being how external shocks work themselves out. It is important that countries should be allowed to choose their own exchange rate regime, which should not be imposed as IMF conditionality.

In managing crises, the recent East Asian experiences highlight the crucial importance of ensuring international liquidity by quickly providing foreign funds to economies experiencing crisis. Currently, such international liquidity provision is being frustrated by the following conditions:

- i Multilateral institutions generally do not have the necessary finances readily at their disposal. Although the IMF nominally has the requisite facilities, it lacks the required funds, which have to be raised with the approval and active support of its principal shareholders. This *de facto* requirement subjects the process to undue political influence, as was clear in the international financial community's changing responses to the East Asian crises as it unfolded from mid-1997.
- ii IMF-imposed policy conditionalities accompanying the provision of such emergency liquidity have also been onerous. The East Asian experiences suggest that these conditionalities actually exacerbated the macroeconomic crises.
- iii Such funds should be used to support a currency against speculation, but instead, currencies were allowed to collapse first, with the emergency funds going to pay off creditors.

Recent experiences underline the importance of facilitating fair and orderly debt workouts to restructure debt payments due. Existing arrangements tend to treat debtor countries as if they were bankrupt without providing the protection and facilities of normal bankruptcy procedures. With such a procedure, a debtor would have certain rights, including getting a temporary standstill on debt payments, continued financing for ongoing operations, and orderly debt restructuring. While the IMF's Articles of Agreement allow for such temporary standstills, the latter have not actually occurred.

Despite the IMF's Articles of Agreement providing for a temporary standstill, for instance, in the recent case of the Republic of Korea the creditors got together and struck an agreement with the government, raising three problems:

- i the government was coerced into taking over responsibility for private debt;
- ii the creditors got better debt restructuring terms, whereas debtors would be more likely to get better terms in a bankruptcy court;
- iii the new finance went to the creditors, instead of supporting the debtors.

Globalization and the likelihood of convergence

Finally, to return to the key question of growth prospects for the region after the 1997/8 crisis, the following can be stated.

Although there was no single development model for the eight HPAEs (High-Performance Asian Economies) all experienced rapid growth due to high savings and investment rates as well as labour utilization and human resource development. Exports were also important in all these economies, although most were far from being open economies. It is now generally agreed that international financial liberalisation was the principal cause of the crisis, though those in favour of such liberalisation would argue that the problems involved improper sequencing and/or inadequate prudential supervision rather than liberalisation *per se*. Such international financial liberalisation generally began in the region from around the late 1980s, and certainly cannot be considered part and parcel of the development strategies responsible for rapid growth, industrialization and structural changes in the preceding period.

Returning to the various institutional features that made possible the East Asian 'miracle' in the past is no longer an option for several reasons. The international economic environment has changed quite radically in the past fifteen years. International economic governance profoundly altered with the IMF's stabilization programmes and the World Bank's structural adjustment packages in the wake of the debt crises of the 1980s. New conditionalities have been imposed in the region by the Bretton

Woods institutions, together with the emergency credit facilities provided to Indonesia, the Republic of Korea and Thailand during the 1997/8 crises. It is increasingly recognized that economic liberalisation and such conditionalities have had adverse consequences for growth, as well as distribution. International economic liberalisation has been further advanced by other institutions and processes, most notably the conclusion of the Uruguay Round of international trade negotiations with the advent of the WTO in the mid-1990s.

Furthermore, the needs and requirements of the HPAEs have changed over time; given their variety, there is no single universal set of institutional reforms for all these economies. However, bank-based financial systems are still more likely to serve the developmental finance requirements of these economies. But the scope for directed credit (praised in World Bank 1993) and financial restraint has been considerably reduced by internal as well as international financial liberalisation. Instead, with the Financial Services Agreement under the General Agreement on Trade in Services (GATS) and the imminent broadening of the IMF's mandate also to cover the capital account, there is likely to be greater pressure to promote and open up capital markets in the region.

As with finance, there is little conclusive evidence of the superiority of Anglo-American corporate governance. Nevertheless, the Fund and the World Bank continue to press for corporate governance reforms and corresponding conditionalities imposed during the East Asian crises, insisting that such changes are necessary for economic recovery. However, the relatively stronger economic recoveries in Malaysia and the Republic of Korea have had little to do with such reforms and were primarily due to successful, Keynesian-style, counter-cyclical reflationary policies. East Asian business relations – once celebrated as synergistic social capital – have since come to be denounced as 'crony capitalism' ostensibly responsible for the crisis. The family firm, a feature of early capitalist development in much of the world, has also been targeted for reform as if it were responsible for the abuses associated with parasitic 'cronyism'.

Economic liberalisation more generally has greatly reduced the scope for industrial policy or selective government interventions. Yet, the World Bank's advocacy of poverty targeting – for example, in connection with its social safety net programmes – has underscored the legitimacy of such selectivity, besides implicitly acknowledging government capacity to do so reasonably well. Despite the recent push for trade liberalisation as well as abandonment of several GATT arrangements that acknowledged and sought to compensate for different national economic capabilities, UNCTAD's annual *Trade and Development Reports* have continued to affirm the remaining scope for trade-related industrial policy. Similarly, the work of Stiglitz and others has reiterated not only the need for but also the potential for finance-related industrial policy.

We have seen some recent developments in Southeast Asian invest-

ment regimes in line with industrial policy despite initiatives such as the Uruguay Round's trade-related investment measures (TRIMs), the OECD's aborted Multilateral Agreement on Investment and WTO's Multilateral Investment Agreement. The scope for corresponding technology policy has also been identified despite the strengthening of corporate intellectual property rights. Human resource development is probably the area for industrial policy initiatives least fettered by recent liberalisation trends, despite the World Bank's advocacy of non-subsidization of post-primary education and recent trends in education and health-care privatisation.

Ensuring a return to the high productive investment rates of the past is helped by the continued high domestic savings rates in the region in spite of the devastating social impact of the 1997/8 crises in the East Asian region. It is now generally acknowledged that much of the additional funding made available by foreign bank borrowings as well as portfolio investment inflows into the region helped fuel asset price bubbles, which later burst with such catastrophic consequences. Yet, financial liberalisation in the region has been furthered – rather than checked – in the aftermath of the crises, mainly due to the conditionalities imposed by the Fund as well as the urgent need for foreign funds to help economic recovery.

Some popular accounts of the East Asian miracle economies portrayed them as geese flying in the slipstream of the leading goose, Japan. Many went further to imply that they were Japanese clones or at least 'wannabes'. Even serious scholars of the region have written of a yen bloc, for instance, despite the fact that most Japanese corporations used the US dollar to denominate their internal transactions, and most monetary authorities in the region, including Japan, never sought the internationalization of their currencies. In short, the picture of East Asian homogeneity has long been grossly exaggerated.

In the unlikely event that the Europeans and the Japanese do not resist the continued promotion of the Anglo-American capitalist norm for the rest of the world, it is quite likely that we will witness a greater degree of conformity and uniformity in the formal rules and institutions of the economy. But such conformity may remain superficial, rather than become substantial or, as is perhaps more likely, the Anglo-American forms may take root unevenly in different situations depending on changing historical, economic, political, cultural, social and other environmental factors. In the same way that Islam once spread rapidly across North Africa, providing a common legal and cultural basis for long-distance trade, the English language and Anglo-American norms may well become universal in the forthcoming era. But just as the acceptance of Islam has resulted in a great variety of Muslim cultural expression and behavioural norms, a twenty-first-century Anglo-American global capitalism may still be quite diverse.

Neo-liberal globalization of Anglo-American capitalism seems likely to continue in the near future. These trends will probably be led by the two Bretton Woods institutions as well as the WTO. Nevertheless, there

continues to be some diversity of opinion within as well as among these institutions, which is likely to be reflected in policy prescriptions. The WTO's formal democracy provides some basis for reformist initiatives, while the Fund and the World Bank will continue to be under pressure to become more accountable, if not democratic.

As noted earlier, the aftermath of the debt crises of the early and mid-1980s saw stabilization programmes and structural adjustment packages begin the process of globalization, especially in the most heavily indebted economies which had to approach the Bretton Woods institutions for emergency credit facilities, and were therefore obliged to accept the accompanying conditionalities. The currency and financial crises of the 1990s have seen similar outcomes, with East Asian governments obliged to accept, implement and enforce conditionalities imposed by the Fund and the United States Treasury, as well as other foreign government agencies. But such circumstances for the extension of the neo-liberal globalization agenda underscore the constraints it is subject to. Not only is there growing resentment over such impositions within the countries concerned, but there is also growing international understanding and wariness of the underlying interests and agendas involved. In other words, every success also hardens resistance. This alone will ensure that the future of liberalisation is far from assured and likely to be neither smooth nor even.

Even in the improbable scenario that all developing countries are compelled to subject themselves to such conditionalities, the outcomes are unlikely to be the same. Initial conditions can account for many variations, as we have seen from our very limited sample of four East Asian economies. Different economies have developed different capacities and capabilities, and may therefore be affected rather differently by liberalisation and globalization.

Sequencing will also give rise to differences. There are at least several different sequencing issues; that of different aspects of domestic and external liberalisation may involve many different permutations. Policy makers for those economies that liberalise later are also in a position to learn from the experiences of those before them, and thus to anticipate and prepare themselves better.

The mixed consequences and experiences of liberalisation and globalization thus far have also greatly undermined the previously smug self-confidence of what has been termed 'the Washington consensus'. With the benefit of hindsight, Stiglitz's (1998) predictions of a post-Washington consensus may well have been premature. The circumstances of his departure from the World Bank and the more recent controversy over the contents of the *World Development Report* for the year 2000 on poverty are important reminders of the continued hegemony of the Washington consensus, albeit slightly chastened. Hence, it is not a self-confident, unchallenged and unproblematic consensus, but rather one that is increasingly vulnerable, not least because of developments in East Asia.

The earlier appreciation of the East Asian miracle posed an important challenge to the economic neo-liberalism underlying the stabilization programmes and structural adjustment packages of the 1980s and 1990s. While the East Asian *débâcle* of 1997/8 has been invoked to negate much of that earlier analytical challenge, it has also raised troubling questions about financial liberalisation. Much of the earlier criticism of liberalisation and economic globalization came from outside the mainstream of contemporary economic thinking. However, the recent debate and dissent over financial and capital account liberalisation, as well as the role of the Bretton Woods institutions, has involved orthodox economists, including many who have been strong advocates of liberalisation with regard to international trade, investment and other economic areas.

Though it is unlikely that imminent radical change will take place in the international financial architecture, as the threat posed by and the memory of the East Asian financial crises recede, it is also unlikely that there will be a simple return to the smug and simple-minded advocacy of economic liberalisation on all fronts. Much more nuanced and sophisticated understanding of economic liberalisation and its consequences may therefore have a greater intellectual and policy-making impact.

However, while the economic convergence promised by neo-liberal economic globalization is unlikely – not only because it is mythical, but also because the true level playing field promised by liberalisation can never exist – one cannot deny that even partial liberalisation has limited the range of options as well as the variety of possible economic arrangements. The changed institutional or systemic ecology permits fewer species to survive. But variety, albeit increasingly limited, can and will exist.

In these circumstances, it is increasingly probable that systemic differences will be less stark and obvious. But this will perhaps encourage closer attention to be given to the remaining variety as well as the remaining scope for diversity, which should in turn lead to more careful attention paid to detail and greater appreciation of the sources of efficacy of policy instruments. Hence, it seems likely that there will be less interest in alternative economic models or systems, but more consideration of the microeconomic basis for the viability of particular policies and institutions. This could, in turn, lead to a much more eclectic mixture of policies and institutions, and thus, to a greater variety of systems or models.

Notes

1 In a telling episode at the beginning of September 1997, IMF deputy head, Stanley Fischer, pointed out that although the current account deficits in Southeast Asia had emerged quite some years ago, markets had failed to adjust contrary to the predictions of conventional economic theory. (Instead of recognizing the failure of market mechanisms, US Federal Reserve Chair Alan Greenspan gently chided Fischer in response, as if expecting IMF to 'remind' Wall Street of

what it had forgotten.) Meanwhile, 'the market' had become so fixated with the current account deficit that this indicator, almost alone, has become the fetish of financial analysts, especially since the Mexican meltdown of early 1995. In earlier, different times, some economies sustained similar deficits for much longer, without comparable consequences. As noted in the immediate aftermath of the Mexican crisis of 1995, several Southeast Asian economies already had comparable current account deficits then despite, or rather because of, rapid economic growth. Yet, as Fischer observed, the currency markets had failed to adjust earlier on in Southeast Asia (Fischer 1997).

2 In the wake of the Mexican crisis in early 1995, the IMF had stepped back momentarily from its advocacy of virtually unfettered financial, liberalisation, including the capital account. Unfortunately, the short-termism of financial markets extends to human and institutional memories as well as to related policy-making and advocacy. (I am grateful to Anthony Rowley for confirming these details with Kunio Saito, director of the IMF Tokyo regional representative office, on 17 December 1997.)

3 As Keynes (1936: 322–3) argued, the remedy for crisis is lowering, rather than increasing, interest rates: 'The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.... [A] rate of interest, high enough to overcome the speculative excitement, would have checked, at the same time, every kind of reasonable new investment. Thus an increase in the rate of interest ... belongs to the species of remedy which cures the disease by killing the patient.'

4 However, a much lower share of recent Malaysian bank-lending is going to productive purposes, compared to the other three economies with their more bank-based financial systems.

5 For instance, the recapitalization of commercial banks in the Republic of Korea in September 1998 involved an injection of 64 trillion won. Similarly, the Malaysian effort involved over RM47 billion to take non-performing loans out of the banking system, and another RM5–7 billion to recapitalize the most distressed banks.

6 This section and the next draw heavily on Furman and Stiglitz (1998).

7 This section draws heavily on Akyüz (2000a, 2000b).

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7 Evolutionary privatisation in China

Tomo Marukawa

Market economy *without* private ownership?

Mainstream economics argues that competition and private ownership are indispensable to a well-functioning market economy. A mixture of state and private ownership will probably harm the economy. Therefore, in order to transform a planned economy into a market economy, it is crucial to move swiftly from state ownership to private ownership (Lipton and Sachs 1990; Boycko *et al.* 1995). Based on this doctrine, Russia, Poland and the Czech Republic engaged in a rapid privatisation programme of state-owned enterprises from the early 1990s. Following the advice of US-trained economists, these countries divided the property rights of the state-owned enterprises into small shares and distributed them to their people without requiring compensation.

In contrast, Hungary adopted a more gradual way of reform. State-owned enterprises were transferred to private hands through sale – not by giving them away – and at the same time start-ups of private and foreign-owned enterprises were encouraged (Mori 1999; Nishimura 1995).[1] In China, state ownership was never transferred to private owners except in very exceptional cases, for nearly twenty years after its economic reform began in 1978. Until 1997 China's enterprise reform only included giving autonomy to state-owned enterprise managers and encouraging start-ups of non-state-owned enterprises and foreign enterprises.

Since the former socialist countries adopted different reform strategies, the transformation turned out to be a historical experiment testing the effectiveness of various methods of creating a market economy out of a planned economy. The results show that those countries that were most faithful to mainstream economists' advice had the worst outcomes. Russia, the Czech Republic and Romania, which engaged in rapid privatisation, experienced severe economic shocks and contraction of the economy. Their GDP in 2000 was still less than that of 1989. Hungary also experienced economic shock at the beginning of the reform process, but the country registered higher growth in the late 1990s, and its GDP in 2000 was larger than that of 1989.[2] China, which did not at all follow the advice

of mainstream economists, had the best performance among the reforming economies, resulting in real GDP in 2000 2.7 times larger than that of 1989.

Since this 'experiment' was not conducted in a laboratory, we have to take into consideration the effect of external conditions on the performance of reforming countries. Still, it is ironic that Russia, which went ahead with its privatisation programme in the hope of creating a vibrant capitalist economy, ended up with 'an absurd, perverse and extremely unfair form of oligarchic capitalism'(Kornai 2001), while China succeeded in creating many promising enterprises and vastly expanding its production capacity without any particular privatisation programme. The contrasting results of this 'experiment' are a challenge to the mainstream economists' view of the market economy (Stiglitz 1999).

In the eyes of mainstream economists, the success of China's economic reform can only be regarded as an anomaly. As Table 7.1 indicates, the main force of China's industry has been public enterprises, including state-owned and collectively-owned enterprises. The public sector's share of industrial output was still over 60 per cent in 1999, even though the sector has been in decline. Although the growth rate of public enterprises has been lower than those of 'self-employed individuals' and 'other enterprises',[3] it was still positive even in the late 1990s. In Chinese agriculture the land is still owned collectively, though cultivated privately, and in tertiary industry the state still maintains a high ownership share.

Economists have been puzzled by the coexistence of a prospering market economy with the dominance of public ownership. Some have stressed the contribution of township and village enterprises, which are publicly owned but nonetheless face equally 'hard budget constraints' to private enterprises. Others have stressed the effect of decentralization, which induced local governments to develop their local economy in the hope of expanding their budgetary income (Qian 2000). There are also many empirical works showing that the expansion of managerial autonomy in state-owned enterprises led to the improvement of their efficiency (Groves *et al.* 1994).

Based on these experiences the Chinese government and the Communist Party came to believe that market economy and public ownership are compatible, and in 1993 decided to create a 'socialist market economy system', in which state-owned enterprises play a dominant role but the economy is run on market principles. This aim stimulated debates on the feasibility of 'market socialism' among Western socialists (Itoh 1996). But while Chinese authorities and Western scholars were busy interpreting the coexistence of public ownership and market economy in China, privatisation was taking place silently in inland China.

Table 7.1 Output growth and output share of various types of enterprises in Chinese industry

		1980	*1985*	*1990*	*1995*	*1999*
Output index 1980 = 100	Industry total	100	176	328	892	1453
	State-owned enterprises	100	148	210	313	362
	Collectively-owned enterprises	100	247	554	1698	2617
	Self-employed individuals	100	3467	20091	145627	264456
	Other enterprises	100	492	3530	40203	103559
Share in industry total	State-owned enterprises	76	65	55	34	28
	Collectively-owned enterprises	24	32	36	37	35
	Self-employed individuals	0	2	5	13	18
	Other enterprises	0	1	4	17	26

Source: Calculated from China Statistical Yearbook, 2000.

Note
Industry includes mining and quarrying, manufacturing, production and supply of power, gas and water.

Privatisation in China

Yibin county in Sichuan province was among the first in China to undertake privatisation of state-owned enterprises. Yibin county had 66 small state-owned enterprises under its jurisdiction,[4] but after 1989 the performance of these enterprises deteriorated, until in 1991 their losses became greater than the annual income of the county budget. Having no way of saving the ailing enterprises, the county government started to sell them off to their employees in 1991. In order to make the enterprises affordable to the poorer employees, the government sold the enterprises at the value of their 'net productive assets', that is total assets excluding non-productive assets, such as housing, minus total liabilities. All employees who wished to remain employed were required to buy a certain number of shares, but were also allowed to pay in three year installments. By selling the enterprises at large discount the county government incurred losses on assets, but the enterprises' performance improved after sale, and the county's budget benefited from increased tax income. Seeing this effect of privatisation, Yibin county sold off all 66 state-owned enterprises under its jurisdiction by 1996.

Fearing criticism from the public and interference from above, the Yibin county government maintained a low profile at the beginning of its privatisation programme. But the process was made public through press coverage in 1993. Fortunately, 1993 was the year when China decided to accelerate the move towards a market economy, and hence the programme of Yibin county was endorsed by the authorities. Sichuan province regarded Yibin's experience as a model for other counties in the province which also faced the problem of ailing local state-owned enterprises. In 1994, the provincial government summoned a meeting of county leaders in Yibin county and urged them to learn from the experience of Yibin. Every year after that Sichuan province held a meeting of county leaders to urge them to reform local state-owned enterprises. Some counties responded eagerly to the province's request, while other counties simply acted as if they were making progress because in practice they did not want to reform their enterprises. In Sichuan province as a whole, 60 per cent of small and medium-sized public enterprises had been privatized by 1999 (Marukawa 2000).

In order to remove the obstacles to the development of private enterprises, the Chinese Communist Party redefined the 'non-public economy', that is private enterprises, as 'one of the important components of the economy', replacing its former definition of them as 'a supplement of the economy', at the 15th Party Plenum in 1997. Some local governments regarded this as a signal from Communist Party leaders to allow the privatisation of public enterprises, and indeed started to privatise local public enterprises. As far as the author knows, Sichuan, Shandong, Jiangsu and Zhejiang provinces proceeded with a programme to privatise virtually all the state-owned and collectively-owned enterprises governed by the

counties as well as all the enterprises run by the townships and villages. When Yibin county started its careful privatisation in the early 1990s, the enterprises were reformed into labour-managed concerns in which all employees had an equal amount of shares, similar to enterprises in former Yugoslavia. But since 1998, local governments have started to favour an ownership structure whereby 30–40 per cent of the shares of a privatised enterprise are owned as a single bloc. The former managers were usually encouraged to hold the single bloc, and in order to enable managers to do so, shares of privatised enterprises were given to managers on condition that they bought a volume of other shares.

In Russia, state-owned enterprises were privatised in a planned and centralized manner, based on the list of 15,000 enterprises constructed by the central government. In contrast, China's privatisation, just like its economic reform, proceeded in a decentralized and unplanned manner. The central government even tried to slow down the pace of privatisation of small state-owned enterprises in 1998. The reason was that they thought that some local governments were so eager to get rid of state-owned enterprises that they were remiss at preserving the value of enterprises during the process of privatisation. Since the central government cast a sceptical eye on privatisation by local governments, the media have been reticent in reporting the achievements of privatisation, so it is difficult to acquire even basic information regarding the privatisation of local enterprises, such as the total number of enterprises privatised. A newspaper reported that among the country's 46,281 small state-owned enterprises, 76 per cent had been 'reorganized' by June 2000.[5]

While public enterprises were privatised, genuine private enterprises began to rise to the top ranks of various industries. The most famous is Huawei Technologies Ltd., a telephone switch producer in Shenzhen. This private company, established in 1988 by eight people with a capital of 2400 yuan (equivalent to 645 US dollars in that year), has grown into one of the leading manufacturers in China's telecommunication equipment industry, with 22,000 employees and an output of 25.5 billion yuan (3 billion US dollars) in 2001. The company competes with Cisco and Siemens in the Chinese market and exports its products to some developing countries. In the past the growth of private enterprises was hampered by the domestic banks' inclination to lend to state-owned enterprises rather than to private enterprises, regardless of the fact that some state-owned enterprises had little hope of repaying their debts. Since 1998, however, domestic banks began to lend increasingly on the basis of the performance and solvency of the borrower, rather than according to political importance. This change of the banks' lending attitude accelerated the rise of private firms and the decline of state-owned enterprises. As discrimination against private firms by financial institutions and the government decreased, private firms, which had disguised themselves as collectivelyowned enterprises in the past, started to shake off their disguise.

Large and medium-sized state-owned enterprises, on the other hand, have been reorganized into joint stock companies, with some proportion of shares held by the state. In short, the state's share in industry is shrinking gradually. It will not be surprising if the leading companies in China changed from state-owned enterprises to private enterprises within five years. China is no longer a 'market economy led by state-owned enterprises', and in the future it will not even be a 'market economy led by public enterprises'. China did succeed in shifting towards a market economy without privatisation, but the period of 'market economy led by public enterprises' appears to be at an end. China is heading towards 'a market economy led by private enterprises'.

The logic of evolutionary privatisation

Why is 'market economy led by public enterprises' coming to an end?

First, it must be made clear that, unlike Russia, it is not government opposition that brought the end of 'market economy led by public enterprises'. Since a 'socialist market economy' is the goal of economic reform, the government would rather maintain a 'market economy led by public enterprises' and avoid overt privatisation. Even in 2002, the word *'siyouhua'* (privatisation) was taboo among government officers and state-owned enterprise managers, who rendered 'privatisation' by such ambiguous words as *'gaizu'* (reorganization) and *'gaizhi'* (system reform).

Second, the question cannot be answered by pointing to the common problems of public enterprises, such as lack of autonomy and responsibility of managers. It is true that many public enterprises do suffer from such problems and have been privatised in order to enhance the autonomy and incentives available to managers. But the fact that public enterprises as a whole maintain positive productivity growth proves that it is not impossible to improve their efficiency without privatisation. It is, rather, when public enterprises succeed in improving their performance after expansion of managerial autonomy that the problems of public ownership become evident. In the following section, selected case studies show some of the pitfalls into which successful state-owned enterprises often fall.

Failure in a changing business domain

State-owned enterprise reform before the first half of the 1990s had been based on the following idea: let managers and workers acquire incentives to improve the performance of the enterprise by expanding managerial autonomy and by giving the right to the employees to retain a certain proportion of the profits. This type of reform did bear fruit in many state-owned enterprises, including the Capital Steel Corporation (Shougang),

which had been regarded as a model of reform. At Shougang, the contract responsibility system was adopted, according to which the amount of profit which the enterprise must pass to the government is fixed for several years and the residual profit is retained by the enterprise. Being the residual claimants, Shougang's managers had a strong incentive to strengthen internal management and improve productivity. As well as this incentive contract, Shougang enjoyed the privilege of selling a larger proportion of its products at market prices compared to other large state-owned steel mills. Having both this incentive and privilege, Shougang's profits and growth topped the steel industry during the 1980s. But after 1995 Shougang's profits shrank dramatically and the company was no longer a model.

The immediate reason for Shougang's sudden decline was the liberalisation of steel prices, which, together with the inflow of cheap Russian steel, deprived Shougang of its privilege. But this impact of market liberalization was probably anticipated by Chinese steel manufacturers. A more fundamental reason for Shougang's decline was that it failed to change its business domain according to the changes in the market environment, even though it had the capital to do so by retaining profits until 1994.

In a market economy an industry may prosper and decline according to technological progress and changes in demand. Thus, if enterprises want to survive they need to change their business domain. But changing the latter entails a large risk. In the course of the Chinese enterprise reform, various sorts of autonomy were given to managers, including the autonomy to undertake some diversification, but the managers were still not free to choose their business domain. Also, it was not proper to give the managers of state-owned enterprises such autonomy because that would have meant that managers were allowed to risk state-owned assets. This point shows that the management of state-owned enterprises, however reformed, cannot be the same as the management of private enterprises.

Shougang was originally a steel mill specializing in bar and shaped steel, which are rather low-value-added products in the steel industry. If the company wished to remain one of the top producers in the industry, it had to shift to sheet and pipe steel, for which the demand in China was certain to expand. Besides, the company also had to consider moving its plants to the coastal areas of China in order to minimize transportation costs, since Chinese steel production relied increasingly on imported iron ore and coke. But, as the company's name indicated ('Capital Steel Corporation') the government had already defined Shougang's location and business domain. The production goal for Shougang was determined by the government and the company was given an employment goal by local authorities until at least 1994. It would have been difficult to acquire production inputs (land, funds and materials) had the enterprise attempted to move outside the government-defined location and business domain. Such constraints have been relaxed recently but they remained strong until the

mid-1990s, when Shougang still had the funds to develop. Shougang ended up wasting its retained profits on halfway diversification, while also building an empire of employee welfare facilities. Shougang entered the shipping and shipbuilding industry because its managers thought that the shipping costs which Chinese shipping companies charged when Shougang bought steel manufacturing equipment from Belgium were too high. Subsequently, Shougang merged 13 ailing munition factories in order to produce and export steel manufacturing equipment. Shougang also went into semiconductor production, hotels, construction, banking and other areas (Kang and Marukawa 1996). It is apparent that this diversification was rather random and dispersed, and did not bear fruit for Shougang. Shougang also invested in fruit farms, bakeries, ham production, poultry farms, and pig farms, all for the consumption of its employees. Up to 40,000 employees worked in such welfare facilities.

The problem of 'contributing to the national interest'

Another pitfall into which successful state-owned enterprises often fall is to think more about contributing to the national interest than to their own development. Sichuan Changhong Electric Co. Ltd. (Changhong) is a colour television manufacturer that flourished after the price liberalisation of the early 1990s, and maintained its position as the top TV brand during the 1990s (Marukawa 2001). Unlike Shougang and many other state-owned enterprises, Changhong was a state-owned enterprise that took advantage of liberalisation, aggressively waging price wars against its rivals to expand its market share. In 1998, when Changhong was widely acclaimed as proof that state-owned enterprises could survive and win market competition, it declared that it aimed to control more than 50 per cent of the domestic colour television market. Changhong tried to achieve this goal by stifling its rivals through hoarding cathode ray tubes and waging price wars. But the rivals, which were also state-owned enterprises, resisted Changhong's attack by importing cathode ray tubes and reducing prices further. At the end of 1998, Changhong found itself with a huge stockpile of television sets and cathode ray tubes. The reason Changhong adopted such a reckless strategy was that the company felt that as a leader of Chinese industry it had to have the strength to compete with foreign electronics giants. In order to gain such strength the company had to get rid of cut-throat competition between domestic television makers as soon as possible. Changhong's strategy was a response to the Ministry of Electronics Industries' strategy of fostering 'national industry'. But the strategy cost the company dearly: after 1999, Changhong fell behind its rivals, such as Konka and TCL, which were also state-owned enterprises but were concerned only with their own survival.

Some successful state-owned enterprises also started to help other state-owned enterprises in the same industry or the same district. Handan

Steel Corporation (Handan) of Hebei Province became a new model of state-owned enterprise reform after Changhong because its managers succeeded in revitalizing an ailing enterprise by introducing market mechanisms into its internal management. As the media proclaimed the success of Handan, tens of thousands of visitors came to learn from the company every year, and Handan welcomed them by providing free meals. Handan also sent managers to three ailing steel companies in order to save them by injecting its own management methods. Hence Handan's managerial resources were dissipated by helping others and trying to contribute to the national interest.

It is not surprising, however, that successful state-owned enterprises have used their wealth and power not only for their own development but also to make contributions to the national interest. After all, state-owned enterprises are established partly to this purpose. But sometimes national interest and corporate interest conflict with each other. This is why the management of state-owned enterprises cannot operate the same way as that of private enterprises.

The success of state-owned enterprises that have received little support from the state

As the above shows, there have been several state-owned enterprises that were once very successful and became the models of reform, but whose success did not last long. Some failed to change business domain according to shifts in the market, and some wasted their wealth in trying to make contributions to the national interest. The state-owned enterprises that remain profitable today fall into two types. The first comprises state-monopolizers, such as petroleum and telecommunications. The second comprises enterprises that have received little support from the state. A typical example of the latter is Legend Group, which is now the top PC brand in the Chinese market. Legend Group was established in 1984 by eleven members of the Institute of Computation Technology at the Chinese Academy of Sciences. When the company was established, the Institute provided 200,000 yuan (85,000 US dollars). Since then, the company has expanded without receiving outside funds, and possesses assets of more than 5 billion yuan. The Institute, however, did not provide technology to the company. Legend was not a high-tech venture that utilized the research results of the Institute, but rather a company that allowed redundant researchers of the Institute to find new ways of making a living. Legend Group started operations by selling television sets, roller skates and personal computers. By recruiting one of the leading researchers of the Institute, Legend developed PC cards that facilitated the typing of Chinese into personal computers. The mainstay of Legend's business now is the production and sale of personal computers.

TCL, which ranks fifth in the Chinese electronics industry, has a similar

history. TCL was established in 1980 by separating the Electronics Division of the Machinery Bureau of the Huiyang district from the government. Being a former government division, TCL had no significant assets and relied on bank loans for its investment. To begin with, TCL produced cassette tapes under the brand 'TTK', a counterfeit of Japanese 'TDK'. Then it started producing telephone sets and even engaged in smuggling, but now the company has become a diverse electronics manufacturer, producing TV sets, refrigerators, washing machines, cellular phones and personal computers, to the value of more than 20 billion yuan annually. TCL, like Legend, was originally created in order to streamline the government machine and let redundant bureaucrats find a new way of living.

Both Legend and TCL are classified as state-owned enterprises because of their origin, but the managers are solely responsible for these companies' growth, while the state has contributed little to it.[6] They did not receive support from the government but also did not suffer interference, having to make their own way in the market from the outset. Hence, they did not fall into the same pitfalls as successful state-owned enterprises described in previous sections.

Legend and TCL are strong counterexamples to the assertion that state-owned enterprises cannot adapt to a market economy, but their success brought about new problems. Legend and TCL have built up their multi-billion-yuan net assets from a minimal initial investment by the state, but to whom should the incremental assets belong? According to US-inspired corporate governance theory, the company must be the property of the owner, and since nobody else but the state has ever invested in these companies, the state must be the sole owner.[7] But, because the state has only made a tiny initial contribution to the development of these enterprises, if the state were to insist upon its ownership rights, it would damage the morale of the managers, who are the real contributors to the enterprises' growth. If, moreover, the state insists on the management rights to which its ownership entitles it and tries to intervene in managing these enterprises, the state may ruin them.

In the Japanese tradition of corporate capitalism, the incremental assets would be retained within the company. But for Legend and TCL, where a small number of people established the companies from scratch and led them to success, the founders certainly made a special contribution, which is not the same as that of ordinary employees. Based on this idea, the ownership structure of enterprises like Legend and TCL has started to be reformed. In the case of Legend, which completed its ownership reform in 2001, 35 per cent of its capital was transferred to the founders, while 65 per cent remained in the hands of the state. The share of the state may seem large compared to its contribution, but this agreement did settle the hitherto ambiguous property rights of the firm and was a major departure from past practice in so far as the state conceded a substantial amount of net assets to the founders.

According to US-inspired corporate governance theory, this kind of *ex post* rearrangement of property rights among the state and the founders may constitute malpractice or misappropriation. The correct way may have been to arrange appropriate manager remuneration or stock options *ex ante*. But we have to take into consideration that *'ex ante'* arrangements were not available in China. Between *ex ante* and *ex post* the Chinese market economy and people's way of thinking have changed dramatically. In such a drastically changing environment, the *ex post* rearrangement is easy to understand.

The disposal of incremental assets is not only a problem for such extreme cases as Legend and TCL but for all state-owned enterprises pursuing profits with a certain degree of managerial autonomy. When managers succeed in generating profit by their own efforts, to whom should this profit belong? If the whole of the profit were taken away by the government or retained within the enterprise, the managers' incentives would be damaged. In order to retain and attract competent managers, a part of the profit must be given to managers, whether *ex ante* or *ex post*. Hence, as managers succeed in managing a state-owned enterprise and augment its net assets, the enterprise's net assets will be privatised bit by bit.

Is the 'market economy led by public enterprises' a necessary step in the transition?

The prescription of mainstream economists that privatisation of state-owned enterprises must precede the creation of a well-functioning market economy is obviously fallacious. Russia tried to create private enterprises from state-owned enterprises artificially but what emerged was a lot of 'mock private enterprises'. On the other hand, China's experience until the early 1990s tells us that a market economy can be created without privatising public enterprises, but by encouraging entry and giving autonomy and incentives to public enterprises.

China's experience also tells us, however, that the success of public enterprises in a market economy does not last long. After all, public enterprises cannot take too many risks and must consider the 'public interest'. These constraints handicap public enterprises in competition with private enterprises making it difficult for them to succeed for long.

Successful state-owned enterprises are either those that are state-monopolies or those that have received little support from the government, and hence were managed similarly to private enterprises. But the latter will sooner or later be privatised because, after all, the state has contributed little to their success. The process of privatisation of successful state-owned enterprises is similar to the process of the ownership diversification of Toyota and Matsushita in Japan, through which the share of the founder's family was reduced as the companies' assets were augmented.

The initial capital of the state-owned enterprise is provided by the state, but as several individuals make contributions during the course of development of the enterprise in the capacity of managers and investors, it is inevitable that the share of the state declines. Thus, 'market economy led by public enterprises' will not be able to last long.

However, the developmental step of 'market economy led by public enterprises' was not a redundant detour for China. When the township and village enterprises grew rapidly in the 1980s, the Chinese media described the phenomenon as 'the rise of irregular troops' (*yi jun tuqi*) claiming that reinforcements of national development appeared from an unexpected quarter. The leading state-owned enterprises in the 1990s, such as Changhong, Handan and TCL, were only inconspicuous enterprises during the 1980s, which nobody expected to become leading companies. In a sense these enterprises were also 'irregular troops'. Legend and Huawei emerged from a mass of similar small companies, and no one would have expected that such large enterprises would eventually be created.

During the course of China's economic reform, various types of enterprises have flourished and declined alternately. This can be interpreted as a process through which the enterprises that flourished were those that fitted best the economic environment of each transition stage, while the economic system shifted from planned economy to mixed economy and to market economy. In such a changing environment it is difficult to know which type of enterprise will prove to be the fittest *a priori*, so 'the rise of irregular troops' is bound to take place repeatedly. Privatised state-owned enterprises may not always be the fittest. In China, various types of enterprises, including state-owned enterprises, collectively-owned enterprises, township and village enterprises, self-employed individuals and foreign enterprises have existed from the outset of reform and competed for survival in the changing environment. The reason China succeeded in its systemic reform from planned economy to market economy does not lie in a particular type of enterprise, such as private enterprise or township enterprise, nor in a particular institution, such as decentralized government, but in the coexistence of various types of enterprises.

Notes

1 Kornai (2001) called Hungary's gradual strategy of privatisation 'the strategy of organic development', while Russia's way of rapid privatization was 'the strategy of accelerated privatisation', and claimed that the latter was 'inferior at best and expressly harmful at worst'.

2 Hungary's real GDP of 2000 was 4 per cent larger than that of 1989, while Russia's was 38 per cent smaller, Romania's was 23 per cent smaller, and the Czech Republic's was 3 per cent smaller. Poland registered the best performance among the former Soviet Union and Eastern European countries, but its growth was due to the entry of private and foreign enterprises rather than the privatisation of state-owned enterprises.

3 'Other enterprises' includes foreign enterprises, joint stock corporations and private enterprises other than 'self-employed individuals'. 'Self-employed individuals' refers to private enterprises with less than seven employees. Some foreign enterprises and joint stock corporations contain a state interest.
4 There are six strata in Chinese government, namely central, province (*sheng*), city (*shi*), county (*xian*) and district (*qu*), township (*xiang* and *zhen*), and village (*cun*). Each local government above the county and district levels runs state-owned enterprises of its own. Usually, state-owned enterprises run by counties and districts are small, employing 100 to 300 employees.
5 'Reorganize' is used as a synonym of 'privatise' when an author thinks that 'privatise' is too explicit. 'Reorganize' includes selling off enterprises to employees or private firms, leasing the enterprise to a manager, and bankrupting the enterprise.
6 Another leading electronics company, Haier, which is not state-owned but a collectively-owned company, was an insolvent refrigerator producer that also developed through the efforts of its manager.
7 However, Legend Group has listed two of its subsidiaries on the Hong Kong stock exchange, and TCL has established several joint ventures with foreign partners. In these subsidiaries, both private investors and foreign companies maintain interests.

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8 Is East Asia becoming 'Latin Asia'?

Lessons from the 'Brazilian miracle'

Makoto Sano

East Asia and Latin America have very different histories. Economic development has followed a different path in each region, with many variations within each. However, during the last two decades and even longer, a 'convergence' phenomenon has occurred between them. It is worth noting that East Asian countries, including Japan, have 'repeated' the past negative experience of Latin America, although in their specific institutional context. By comparing the phenomenon of East Asian 'Latinamericanization' with the experience of Latin America it is possible to get new insights and policy recommendations. From this perspective the author has elsewhere discussed the 'Argentinization' of Korea and Japan.[1] In this chapter the 'Brazilization' of China will be considered in some detail.

After liberalisation reforms and external opening in the late 1970s, the Chinese economy has experienced rapid growth with increasingly uneven distribution of income, whose prototype goes back to the 'Brazilian miracle' from the end of the 1960s to the 1970s. The consumer durable goods industry brought rapid economic growth to Brazil at that time, and demand to support this industry was created by a shift of income towards the middle and upper classes. Similar patterns of causation in relation to income distribution, changes in industrial structure and economic growth can be seen in post-reform contemporary China, although the similarity has not yet been clearly established in the literature. Moreover, the above-mentioned Brazilian policy of fast economic growth accompanied by rising inequality can be compared to Deng Xiao-ping's policy of *Xian Fu Lun*, which recognized worsening income distribution as a necessary evil of economic development. Following the 'miracle', Brazil has become a country with one of the most uneven income distributions in the world. Will China, in the name of 'socialist market economy', also follow the Brazilian *underdevelopment* path? This is going to be the main concern of this chapter.

In the first section, we will review the relationship between income distribution and economic growth. Reconsidering the reversed U-curve hypothesis of Simon Kuznets in the light of historical facts, we will confirm the absence of any deterministic relation between income distribution and

economic growth. In the second section, while formalizing the mechanism of the 'Brazilian miracle', we will also reconsider the development strategy disputes of the time. Similarities will be pointed out with contemporary China. In the third section, we will suggest some lessons from the 'Brazilian miracle' for China, which also apply to some extent to other 'Latin–Asian' countries with relatively uneven income distributions, such as the Philippines and Malaysia.

Income distribution and economic growth

A fundamental component of development economics is Kuznets's reversed U-curve hypothesis. According to the hypothesis, there is a reversed U-shape relationship between income per capita (on the horizontal axis) and the Gini coefficient (on the vertical axis). As is well-known, the Gini coefficient ranges from 0 to 1: the former indicates 'perfect' equality and the latter 'perfect' inequality. To put it simply, in the early stages of economic development, relative equality prevails in income distribution but it worsens in the middle stages, becoming even again in the final stages.

Although Kuznets extracted this trend from European and American economic history, he did not present it as a universally valid hypothesis. He rather discussed carefully the probable existence of deviations and reasons for their emergence (Kuznets 1955). Leading textbooks, after introducing the Kuznets hypothesis and verifying relevant facts on a worldwide basis, also show that it does not necessarily hold true (Todaro 1997, ch. 5). Nevertheless, this specific historical hypothesis is often regrettably considered as a natural law, and is taken as an implicit premise in explaining reality. It takes the form of the common excuse 'Distribution is unequal today but this is an unavoidable cost of economic development' and tends to justify unpleasant reality.

What emerges if we review historical facts? It is constructive to consider time series shifts in income distribution of households in Japan. It emerges that the Gini coefficient increased rapidly before the Second World War, reaching its worst level in recent history (approximately 0.55). However, soon after the war, it declined dramatically (standing at roughly 0.30 in the middle of the 1950s) and remained around this much lower level (from 0.30 to 0.35) revealing a moderately equalizing tendency in society from the 1960s to the 1970s (Minami 1996). As income per capita also grew during this period, these changes seem to support a bastardized version of Kuznets's hypothesis. However, needless to say, no mechanical law can explain this large shift in income distribution. Rather, it was clearly related to post-war progressive institutional reforms, such as the dismantling of *zaibatsu*, labour reform, the agricultural land reform, tax reform and, last but not least, the establishment of political democracy.

Second, after the war developed countries experienced a period of high

economic growth, often called 'the Golden Age of capitalism', and household income distribution in the United States and the UK tended to become equal at a moderate rate, as was also the case in Japan. However, since the middle of the 1970s, slower economic growth has prevailed and worsening income distribution has become a dominant trend in the aforementioned countries. At the same time, income per capita has grown in all of these countries, though at a slower pace than before. That is to say, on this occasion we can draw not a reversed but a regular U-curve.[2]

Thus, Kuznets' reversed U-curve cannot be considered a deterministic general proposition in theory. It is rather natural to assume that there can be diverse relations between income distribution and economic growth depending on period and country. If so, what specific relation between distribution and growth can we find in Brazil and China?

Prior to the liberalisation reforms China had adhered to a centralized socialist system based on a closed planned economy. In spite of some social and economic accomplishments following the revolution, by international standards China still belonged to the group of the poorest countries. On the other hand, it is known that income distribution at that time was very strongly even. In 1978 the Gini coefficient for incomes of people in urban areas was 0.16, an extremely low level (Nakagane 1999, p. 131).

It was exactly in that year that China adopted liberalisation reform and opening-up policies, thus making a major turn towards the 'socialist market economy', as it was later called. Thereafter, investment increased rapidly, induced by exports as well as demand for consumer durable goods,[3] leading to remarkably high rates of economic growth. However, almost side by side with this, the income gap between social strata as well as among regions and between industry and agriculture widened significantly (Nakagane 1999, ch. 4; for distribution among income strata see Figure 8.1).[4] In the course of this process the labour market also became clearly segmented (Minami and Xue 1999). Nevertheless, the Chinese government accepted worsening income distribution as a necessary evil of economic development as symbolized in Deng Xiao-ping's policy of *Xian Fu Lun*. Recently, however, political consideration has led to efforts to correct these excesses by such means as the Western Great Development Plan.

At first sight these changes might seem to fit the rising section of the previously mentioned reversed U-curve, if at some point in the future China were to enter the declining section. However, we have already seen that there is no deterministic relation between income distribution and economic growth. This relation in China is not decided *a priori* and its future direction remains open. Far from entering the declining section of the reversed U-curve, China might get stuck at the top and continue to shift horizontally. It is possible for a country to follow such a perverse economic evolutionary path, as is shown by the precedent of Brazil. In the next section, we shall revisit the southern part of the New World in the 1960s.

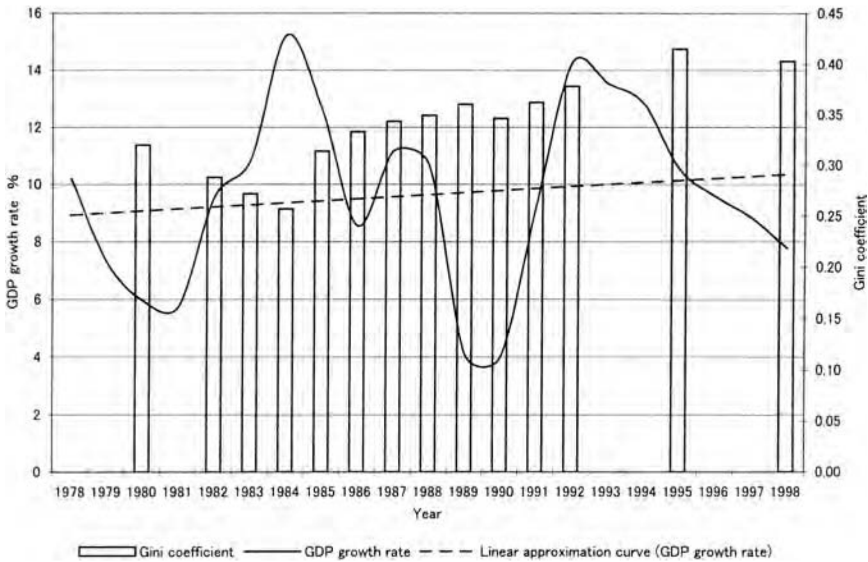

Figure 8.1 High economic growth with growing inequality: post-reform China (source: computed by the author from World Bank (1998, 2000)).

The 'Brazilian miracle': worsening distribution, structural change and high economic growth

Let us start by confirming some facts. As is shown in Figure 8.2, after recording a decline in growth in 1962 and 1963, the Brazilian economy entered a long recovery, particularly from 1967 to 1973. (Although it is not shown in the figure, following this period, Brazil enjoyed relatively high growth until 1980.) This is what was then called 'the Brazilian miracle'. It is worth noting, however, that during the same period the Gini coefficient increased rapidly. Income disparities between labour and capital also worsened during this time. Despite the fact that national productivity (GNP per capita) grew at a high rate, the real minimum wage (which affected the income of the bottom layer of workers) declined. Although real average wages did rise, their growth rate was still smaller than that of national productivity (Bresser Pereira 1986, p. 82, Table XI). In a little more detail, managers' salaries and skilled workers' wages increased rapidly but those of unskilled workers either stagnated or only rose moderately (Zurron Ocio 1986). Thus, the real content of the 'miracle' was high economic growth accompanied by rising inequality.

Brazil had in the past been integrated into the world economy through exporting primary products, such as sugar, gold and coffee. The country faced a slump in international markets during the Great Depression and

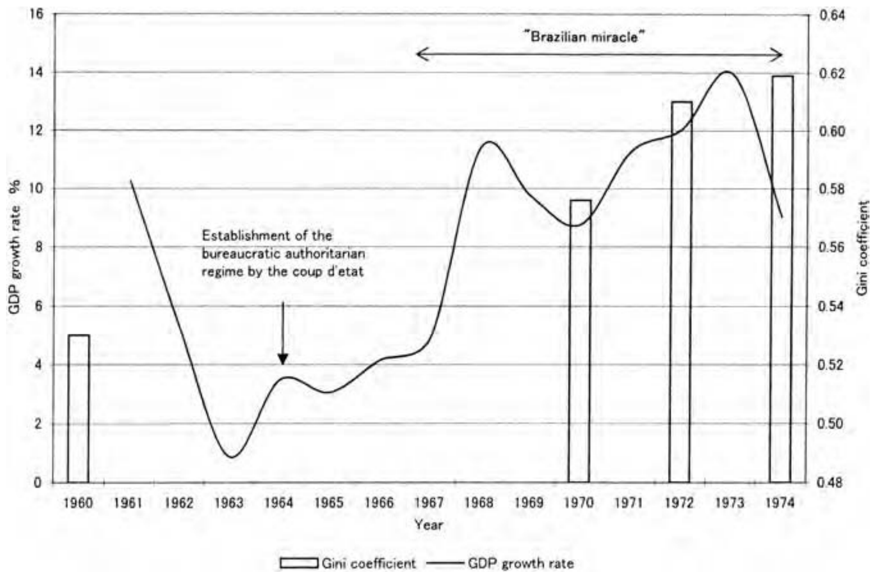

Figure 8.2 High economic growth with growing inequality: 'Brazilian miracle' (source: computed by the author from World Bank (1998, 2000)).

the world agricultural depression of the inter-war years, and turned to import-substituting industrialization. This was a process through which emerging forces comprising industrial capital, urban workers and the middle class, led by the state, challenged the interests of conventional primary products exporters. The balance of class forces moved in favour of the former group. Reflecting these social changes, policies and institutions were established that favoured import-substituting industrialization.

After a wave of import substitution based on light industries, there was further import substitution in the heavy and chemical industries (consumer durable goods, intermediate goods and capital goods) after the 1950s. At the heart of the second wave were the automobile and electrical appliance industries controlled by multinationals, as well as intermediate goods industries dominated by state enterprises. However, in Brazil at that time cars and electrical appliances were luxury goods which only a small group of the upper class could afford, and thus consumption demand was limited. In addition, due to historical factors originating in colonial times, such as slavery which had continued to the end of the nineteenth century, Brazil was already a society with a visible income gap even compared to other Latin American countries. Partly because of this 'underconsumption' structure, overinvestment appeared in the aforementioned new industries in the early 1960s and the economy slowed down, as was stated earlier (Bresser Pereira 1986, pp. 106–7).

The structural limits to Brazilian economic development in terms of demand and income distribution were recognized by the intellectuals of the time. Celso Furtado, a leading Latin American structuralist economist, proposed the following progressive reform plan in order to overcome these limits, along lines suggested earlier by Raúl Prebisch (Bresser Pereira 1984, pp. 144–5). If we classify income strata from the poorest to the richest as I, II, III and IV, the problem that Brazil faced was that the incomes of I and II were too low, while those of III and IV were too high. While the marginal propensity to consume of III was supposed to be equal to 1, that of IV was estimated to be about 0.8. Thus, if progressive income taxes were imposed on III and IV, and the government made large public investments in labour-intensive sectors using this tax revenue, employment of workers in I and II would increase, also raising their wages. If the income of these lower strata that had a high marginal propensity to consume grew, the demand for mass consumption goods (synonymous to consumption demand for labour-intensive industries) would also increase, thus making possible economic development with greater equality.

Furtado's plan, which was similar to Kaldor's (1959) economic reform plan for Chile, was well thought out but had little political feasibility, and faced the added difficulty that it could suppress the growth of newly emerging industries. In opposition to Furtado, Antonio Barros de Castro, another structuralist economist, offered a plan which he considered ethically undesirable but more realistic (Bresser Pereira 1984, pp. 145–6). According to this plan, in order for the Brazilian economy to enter a sustainable recovery by actively encouraging new industries, such as automobiles and electrical appliances, it was necessary to increase income concentration rather than bring about income redistribution. However, it was also crucial that income concentration should occur not only towards the richest class, IV, which already bought consumer durables, but also towards the middle classes, such as III and the upper layer of II, which could be potential demand sources for those goods.[5]

History shows that Brazil's 'miracle' developed as if Barros de Castro's proposal had been realized. That is to say, in practice, the consumer durable industry became the motor of growth. The production goods sector, having received a boost in demand, emerged as an auxiliary source of growth, thus leading to a regime of high economic growth with rising inequality. This mechanism can be clearly demonstrated through the following simplified model.[6]

Let us consider a closed economy consisting of three sectors and three classes. The three sectors are the production goods sector, J, the wage goods sector, B, and the luxury goods sector, V; the government is included in each sector among the producers. The three classes are capitalists, technocrats (employees of public and private bureaucratic organizations, such as managers, engineers, public officials and skilled workers),[7] and unskilled workers. Capitalists' income is profit, R, which is spent on

investment I and luxury goods consumption C_v in sectors J and V, respectively. Technocrats' income comprises salaries O, and is spent completely in sector V as C_v. Unskilled workers' income is wages W, the whole of which is spent in sector B as C_b. GDP can be expressed in terms of income Y_y, production Y_p, and expenditure Y_d as follows:

$$Y_y = R + O + W$$
$$Y_p = J + V + B$$
$$Y_d = I + C_v + C_b$$

Sectors J and V taken together form a monopolistic sector, M, and sector B comprises a competitive sector, T:

$$M = J + V$$
$$T = B$$

Static equilibrium in this model is reached if the following conditions are met in sectors M and T, respectively:

$$R + O = J + V = I + C_v$$
$$W = B = C_b$$

On the other hand, the relation shown in Figure 8.3 is necessary for capital accumulation and luxury goods consumption to take priority, income concentration to proceed, and thus dynamic equilibrium to be realized. Here L stands for employment, and E for economic surplus ($R + O$).

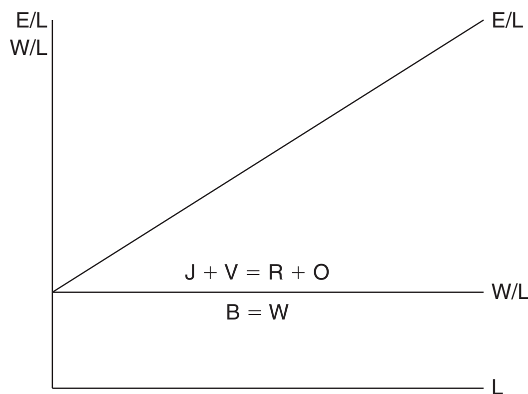

Figure 8.3 Stylized 'Brazilian miracle': dynamic equilibrium (source: from Bresser Pereira (1986, p. 73) with some modifications by the author).

To make this equilibrium possible two further conditions are necessary. First, unskilled workers do not succeed in raising their wages; second, unequal exchange remains between the monopolistic and the competitive sector, and *R* and *O* remain unchanged in the former sector.[8] These conditions were met through state corporatism under a bureaucratic authoritarian regime (military government).

As a result of the 'miracle', Brazil turned into what Edmar Bacha and his colleagues once called *Belindia*. This is a compound word consisting of *Bélgica* and *India* – the names for Belgium and India in Portuguese (Brazil's official language). It describes an imaginary country where an advanced industrial region on the scale of Belgium coexists with a huge poor region similar to the Indian rural sector (Bacha 1986, p. 11, note 1; Taylor and Bacha 1976, p. 198). In the case of Brazil, the megalopolis of São Paulo in the southern part corresponded to 'Belgium' and the north-eastern region of Nordeste was equivalent to 'India'.[9]

The 'miracle' happened principally in 'Belgium', and this increased the gap between the two areas. In fact, during this period, income per capita in the poorest region of Nordeste declined relative to the national average: 40.2 per cent in 1949, 45.6 percent in 1959, 38.3 per cent in 1970 and 35.1 per cent in 1978 (Bresser Pereira 1986, p. 85). This, together with the growing income gap between social strata within the industrial sector, is an economic evolution structure of the *underdevelopment* kind, which has been criticized consistently by Furtado (1999, pp. 24–6, pp. 73–6).

China: *Belindia* of East Asia?

The reason why 'Brazilization' was chosen as the keynote of this chapter is now clear. From the late 1960s until the early 1970s, Brazil witnessed rapid economic growth with the consumer durable goods industry as its mainstay, but this was linked to advancing income inequality between social strata and regions. From the end of the 1970s, China has also been experiencing fast economic growth. In China, the consumer durable industry also seems to have played an important role and, in parallel with this, a widening gap has occurred between social groups as well as among regions and between industry and agriculture. Moreover, in both Brazil and China discourses were prevalent which justified economic growth that led to inequality. The two countries are heterogeneous in many respects, but they share a 'repeated' phenomenon at different historical times, with regard to the above-mentioned points.

Mentioning this 'repetition' is not simply an academic endeavour. There is an important policy implication in this connection, which is none other than the *risk of stickiness in the income distribution structure*. In fact, income distribution in Brazil has been extremely uneven until now and Brazil, together with Chile, Colombia and Paraguay, is one of the countries with the most unequal distribution of income in the world.[10] On the

Table 8.1 Worsening Gini coefficient: Brazil and China

Brazil		*China*	
Year	*Gini c.*	*Year*	*Gini c.*
1960	0.53	1980	0.32
1970	0.58	1982	0.29
1972	0.61	1983	0.27
1974	0.62	1984	0.26
1976	0.60	1985	0.31
1979	0.59	1986	0.33
1980	0.58	1987	0.34
1981	0.55	1988	0.35
1982	0.54	1989	0.36
1983	0.57	1990	0.35
1985	0.62	1991	0.36
1986	0.55	1992	0.38
1987	0.56	1995	0.42
1989	0.60	1998	0.40
1995	0.60		
1996	0.60		

Sources: Compiled by the author from World Bank (1998, 1999, 2000).

other hand, as shown in Table 8.1, it was precisely in the 'miracle' period that income distribution in Brazil became heavily regressive. No structure, once established, changes easily. The social democratic programme pursued by the Cardoso government (1995–2002) brought some social results, but the income distribution structure barely changed.

This risk of stickiness in the income distribution structure is an important lesson for China as it aims to achieve the 'socialist market economy'. In the near future, the growth of the Chinese economy will depend increasingly on development of the consumer durables industry (automobiles, cellular phones, digital cameras, video recorders, etc.). If the engine of growth comprises income increases for the middle and the upper strata, as it was in Brazil in the past, the overall income distribution will worsen, even if the income of the lowest stratum rises in absolute terms due to a trickle-down effect.[11] It is probable that a *Belindia* outcome might then result. Once such a socioeconomic structure is formed, it is not easy to alter. In that case, it is possible that the 'socialism' part of the 'socialist market economy' will stop functioning as an ideology for national integration. For Chinese reform-minded economists, 'socialism' is no longer a system concept. Rather, it is only 'a sense of values against the disease of contemporary society', in other words, 'security of basic welfare of the public, and *realization of social justice and common wealth*' (Wu 1995, p. 6, italics added). Extreme income differentiation will contradict exactly this 'sense of values'.[12]

Table 8.2 Gini coefficient of some Asian countries

Hong Kong		*Singapore*		*Malaysia*		*Thailand*		*Philippines*	
Year	*Gini c.*	*Year*	*Gini c.*	*Year*	*Gini c.*	*Year*	*Gini c.*	*Year*	*Gini c.*
1971	40.9	1973	41.0	1970	50.0	1962	41.3	1957	46.1
1973	39.8	1978	37.0	1973	51.8	1969	42.6	1961	49.7
1976	40.9	1980	40.7	1976	53.0	1975	41.7	1965	51.3
1980	37.3	1983	42.0	1979	51.0	1981	43.1	1971	49.4
1981	45.2	1988	41.0	1984	48.0	1986	47.4	1985	46.1
1986	42.0	1989	39.0	1989	48.4	1988	47.4	1988	45.7
1991	45.0			1997	49.2	1990	48.8	1991	45.0
						1992	51.5		
						1998	41.4		

Source: Compiled by the author from World Bank (1998, 2002).

In this connection, it is worth noting that Cuba has also promoted a set of economic reforms since the middle of the 1990s (Sano 1997). Nevertheless, prior to taking that step, influential Cuban economists argued that 'The Chinese trial and error style of reforms is causing serious social problems and cannot be adopted in Cuba'.[13] Ironically economic reforms even in such a 'fundamentalist' country have led to worsening income distribution (Ferriol 2000). Even so, the above quote suggests that, from the Cuban point of view, China appears to have deviated significantly from socialism.

In any case, there are many significant differences between China and Brazil. A founding element of contemporary China was the egalitarianism of Mao Tse-tung's time, while Brazil before the 'miracle' had already been a society with great inequalities. In this sense, there may be still forces left which could make a restrained development strategy possible: neither egalitarianism nor *Belindia*, but 'a third way'. Can 21st-century China find such a path? Alternatively, will it regress to being East Asia's '*Belindia*'?

Conclusion

East Asia has been frequently praised in the past as a model for development due to combining a relatively equal income distribution with high economic growth. Nevertheless, even in the days of the 'East Asian miracle' income distribution in China, as well as in Hong Kong, Singapore, Malaysia, Thailand and the Philippines, could be considered unequal (Table 8.2). Similarly in Korea, persistent income differentiation proceeded at a faster rate than that estimated by the government (An 2000).

In spite of that, the attitude that we might call 'Asian Utopianism', which optimistically assesses the potential of East Asia, is still widespread. If Asian Utopians try to console themselves by thinking that, even at its worst, East Asia is not as bad as Latin America, let them think again of the tale of *Belindia*.

Notes

1 Since political democratisation in 1987, Korea has relived in a reduced and transformed manner a set of problems concerning post-Lewis-model-type wage-labour relations and financial liberalisation which Argentina had faced at a different historical time. This can be considered as at least one of the factors that led the country to a currency and financial crisis at the end of 1997 (Sano 2001b). At the same time, the Japanese economy's 'lost decade' of the 1990s and the subsequent socioeconomic degradation have resulted to some extent from neo-liberal policy since the 1980s, including financial liberalisation and a series of deregulations. The Asian malaise certainly differs in specific symptoms from the situation after the second half of the 1970s in Argentina, a typical 'advanced country' of neo-liberalism. In essence, however, both forms of malaise derived from the same virus (Sano 2001a).

2 This can be confirmed from the Gini coefficient time series data set published by the World Bank (1998).

3 Specialists on the Chinese economy point out, almost without exception, that consumption demand for durable goods may have played an important role in post-reform high economic growth. For example, 'following Deng Xiao-ping's strategy the ratio of heavy industrial output declined, but in the 1990s it started to rise slowly again. This could be partly due to continued emphasis on production goods from an industrial policy point of view, but it seems that it was much more the result of growing demand for production goods due to an increase in consumer goods production' (Nakagane 1999, p. 84). According to Kojima (1997, p. 145) consumer durable goods possessed on average for every 100 urban households grew rapidly in the period from 1982 to 1996: colour TVs from 1 to 64; washing machines from 17 to 90; refrigerators from 1 to 70; cameras from 6 to 32. Adding a word of confirmation, it is often said that the post-war high growth of the Japanese economy was realized following the route of 'investments calling investments'. However, investment itself was a response to increases in demand for consumer durable goods, and this was the major point of difference from the pre-war period (Yoshikawa 1992, pp. 83–6). It is also necessary to note that in the case of Japan the sources of demand for consumer durable goods spread across the nation due to the institutionalization of relatively equal income distribution by the post-war reforms.

4 If we look at the labour share in income distribution as a whole, using data from the census of industry, it appears that the wage share rose during 1985–95 (though it fell for 'foreign capital industries'). On the other hand, if we use input-output tables, the wage share decreased between 1981 and 1995. Furthermore, another indicator of wage share – (aggregate industrial workers' wages + xiang-zhen (village industries) companies' aggregate wages)/divided by secondary and tertiary industry GDP – also fell from 1980 to 1995 (Nakagane 1999, p. 147, p. 263, Table 7.5).

5 The relationship between income distribution and economic growth has been one of the traditional research topics for non-mainstream economists, such as post-Keynesians. For example, sophisticated theoretical research by Marglin and Bhaduri (1993) postulates the existence of a rapid growth regime stimulated from the supply side by an increasing profit share (worsening distribution) as well as the existence of a stagnationist regime driven from the demand side by an increasing wage share (equalizing distribution). This is an one-sector aggregate model, and does not treat the relation between changing industrial structure and economic growth. In contrast, Latin American structuralism studied the interrelations between income distribution, industrial structure, and economic growth. Interestingly enough, this approach has been rediscovered by a contemporary Japanese Keynesian author (Yoshikawa 2000, pp. 291–335).

6 The following account is due to Bresser Pereira (1986, ch. XII). Another simple conceptual model in Furtado (1973, pp. 68–75) is also worth referring to. For a somewhat more complicated mathematical model, see Taylor and Bacha (1976).

7 Bureaucratic organizations include large companies, schools, hospitals, labour unions, political parties, churches and government (Bresser Pereira 1986, p. 60).

8 This economic growth regime has some weaknesses. In the first place, it cannot be politically sustainable in the long run. Second, its dynamism may be limited because it is centered on the luxury goods sector. Moreover, although foreign trade is ignored in this model, in reality the 'miracle' regime was constrained by its reliance on the luxury goods sector that increased the tendency to import and often led to external disequilibrium (Bresser Pereira 1986, p. 74). The increasing foreign debt in the 1970s partially originated in this process. On the other hand, wage goods, which could not be absorbed domestically by wages or consumption demand, were redirected abroad through an export promotion policy.

9 There are features common to both India and Brazil, and hence socioeconomic comparison of the two countries is acknowledged as an established research field. India and China have also been objects of comparison as two major Asian countries (Itoh and Esho 1995, pp. 20–1). Therefore, comparing Brazil with China, as has been done in this chapter, is well established from the point of view of research history.

10 According to the World Bank (2000), countries with the highest Gini coefficient, except for Brazil, include the following: Central African Republic (0.613 in 1993), Chile (0.565 in 1994), Colombia (0.571 in 1996), Guatemala (0.596 in 1989), Guinea-Bissau (0.562 in 1991), Lesotho (0.560 in 1986–7), Paraguay (0.591 in 1995), Sierra-Leone (0.629 in 1989), South Africa (0.593 in 1993–4), Swaziland (0.609 in 1994), and Zimbabwe (0.568 in 1990–1). In Chile under the military government of the 1980s high economic growth with rising inequality also occurred although through a different mechanism.

11 It is indicative in this context that BMW began joint production in Shen Yang in the latter half of 2003. An expensive car market is definitely under formation in China.

12 A clear indication of this is peasant rebellions, which have occurred repeatedly in many parts of the country since the 1990s (Shimizu 2002).

13 From the author's May 1993 interview with J. L. Rodríguez, later appointed as Minister of Economy.

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Part IV

Finance and regionalism

9 Neo-liberal financial integration and financial crisis in emerging economies

Ilene Grabel

1 Introduction[1]

Much is at stake in the theoretical debate over the origins of the Asian financial crisis. Since the early 1980s, orthodox neoclassical theory has achieved increasing influence in the economics profession generally, and in development economics in particular. Neoclassical economists have come to play leading roles in multilateral financial institutions. Partly as a consequence, policymakers in emerging economies have been encouraged to pursue neo-liberal policies as the best means to promote economic efficiency and growth. A centerpiece of the neo-liberal agenda over this period is financial reform.

Under these circumstances, it is not surprising that the Asian financial crisis has precipitated such concern among advocates of the neo-liberal model of finance, and such furious attack from other quarters. Neoclassicals have taken great pains to demonstrate that the crisis did not result from any fundamental imperfections in the neo-liberal model. Heterodox economists, on the other hand, find in the crisis all too predictable evidence of the bankruptcy of this model, and the theory that defends it.[2] The Asian financial crisis reflects fundamental contradictions in policies of neo-liberal financial integration well understood by heterodox economics, particularly post-Keynesian theory (see Grabel 1996, 1999). It is therefore not surprising that the Asian crisis originated in and spread across those emerging economies that had most fully embraced the neo-liberal financial agenda, while sparing those countries that did not follow this path.

2 The risks of neo-liberal financial integration

The task before us now is analytically to establish the reasons why emerging economies that adopt policies of neo-liberal finance are prone to financial crises. I will examine five distinct, interrelated risks introduced by neo-liberal finance. These are *currency, flight, fragility, contagion* and *sovereignty risk*.

Currency risk

'Currency risk' refers to the possibility that a country's currency may experience a precipitous decline in value. This risk is an attribute of any type of exchange rate regime, provided the government maintains full currency convertibility.

Emerging economies confront the greatest currency risk for two reasons. First, governments in emerging economies are unlikely to hold sufficient reserves to protect the value of their currency should they confront a generalized investor exit. An initial exit from the currency is therefore likely to trigger a panic that deepens investors' concerns about reserve adequacy. An exception would be those cases where an emerging economy maintains a currency board (see Grabel 2000). Of course, the current situation in Argentina demonstrates that merely fixing the exchange rate through a currency board – in the absence of controls on international capital flows – does not insulate the domestic economy from currency flight, fragility or sovereignty risks. Second, emerging economy governments are rarely able to orchestrate multilateral currency rescues.

Flight risk

'Flight risk' refers to the likelihood that holders of liquid financial assets will sell their holdings *en masse* in the face of perceived difficulty. Flight creates a self-fulfilling prophecy that deflates asset and loan collateral values, induces bank distress and elevates ambient economic risk. Flight risk can interact with currency risk to render the economy vulnerable to financial crisis.

Emerging economies face acute flight risk because of the likelihood of investor herding. In this context investors face greater political and economic risks and are less confident about the integrity of the information they receive. Moreover, since investors often fail to differentiate among emerging economies, these countries are more vulnerable to generalized investor exits. Flight risk is most severe when governments fail to restrict the inflow of liquid, short-term capital flows that are subject to rapid reversal.

Fragility risk

'Fragility risk' refers to the vulnerability of an economy's private and public borrowers to internal or external shocks that jeopardize their ability to meet current obligations. Fragility risk arises in a number of ways. First, borrowers might finance long-term obligations with short-term credit, causing 'maturity mismatch' (or what Minsky called 'Ponzi financing'). This leaves borrowers vulnerable to changes in the supply of credit, and thereby exacerbates the ambient risk level in the economy. Second, borrowers might contract debts that are repayable in foreign currency,

causing 'locational mismatch'. This leaves borrowers vulnerable to currency depreciation or devaluation that may frustrate debt repayment. (Or, as in the case of Argentina, severe locational mismatch leaves the country essentially unable to devalue the currency because of the high costs of doing so.) Third, agents might finance private investment with capital that is highly subject to flight risk. This dependence renders collateral values more volatile, and thereby reduces the creditworthiness of borrowers just when they are most in need of funds.

Fragility risk is, to some extent, unavoidable. But the degree to which the decisions of economic actors can induce fragility risk depends very much on whether the institutional and regulatory climate allows the adoption of risky strategies. If regulatory bodies do not seek to coordinate the volume, allocation and/or prudence of lending and investing decisions, then there will exist no mechanisms to dampen maturity or locational mismatches, or the impulse to overborrow, overlend or overinvest. Financial integration magnifies the possibilities for over-exuberance (and introduces currency-induced fragility) by providing domestic agents with access to external sources of finance.

Contagion risk

'Contagion risk' refers to the threat that a country will fall victim to financial and macroeconomic instability that originates elsewhere. While financial openness is the carrier of contagion risk, its severity depends on the extent of currency, flight and fragility risk that characterize the economy. Countries can reduce their contagion risk by managing their degree of financial openness and by reducing their vulnerability to currency, flight and fragility risks.

Sovereignty risk

'Sovereignty risk' refers to the danger that a government will face constraints on its ability to pursue independent economic and social policies once it confronts a financial crisis. The constraint on policy autonomy can be introduced for numerous reasons.

First, governments may be forced to pursue contractionary economic policies during financial crises in order to slow investor flight. Moreover, following a crisis, a particularly contractionary policy regime may be necessary to induce investors to return to the country. While investors are not dictating policy *per se*, governments may find their ability to pursue expansionary policies severely constrained when they are seeking to reverse investor flight. Second, and more directly, emerging economies face constraints on their sovereignty when they receive external assistance. Assistance comes at the price of having critical domestic policy decisions vetted by the external actors that provide support.

Although sovereignty risk stems from the structural position of emerging economies in the world economy, this does not imply that this risk is unmanageable. The adoption of measures to constrain currency, flight, fragility and contagion risk all render the possibility of financial crisis less likely (or reduce its severity should it occur) and thereby buttress policy sovereignty.

Risk interactions

These distinct risks are deeply interrelated. The realization of currency risk can induce investor flight, and inaugurate a vicious cycle of further currency decline, flight and increased fragility. Should these circumstances develop into a fully-fledged crisis, policy sovereignty is compromised. In this context, other countries may face contagion. The severity of the contagion risk depends in turn on the degree of financial openness, the degree to which investors can and do herd out of emerging economies, and the extent to which countries have measures in place that constrain currency, flight and contagion risks.

These risk interactions capture well the dynamics of the Asian and the earlier Mexican crisis (Grabel 1996, 1999). I am not, however, proposing a strict temporal model of risk interaction. Analytically, the key point is that the construction of neo-liberal financial systems in emerging economies introduces the constellation of risks presented here. The precise triggering mechanism is ultimately unimportant and usually unpredictable. Similarly, the particular characteristics of an individual country (such as its political system and the degree of transparency) do not themselves induce a vulnerability to crisis. Vulnerability is created instead by the specific and interacting risks of the neo-liberal financial model.

3 Strategies for curtailing the risks of neo-liberal finance

We now turn our attention to prescriptive matters. In what follows we consider three strategies for curtailing the risks of neo-liberal finance. These are tripwires and speed-bumps, restrictions on currency convertibility, and the Chilean model.[3] We conclude, counterfactually, that implementation of any (or all) of these strategies would have reduced the severity of the Asian crisis and might even have prevented it entirely. Prospectively, we argue that these measures deserve serious consideration because of their potential to prevent the occurrence of financial crisis.

'Tripwires' and 'speed-bumps'

Tripwires are simple measures that warn policymakers and investors that a country is approaching high levels of currency risk, investor and lender flight risk, and fragility risk. When a tripwire indicates that a country is approaching trouble, policymakers could then immediately take steps to

prevent crisis by activating what we might think of as 'speed-bumps'. Speed-bumps would target the type of risk that is emerging with a graduated series of mitigation measures.

Emerging economies at the lowest, medium and highest levels of development might require distinct tripwire thresholds. Tripwires must be appropriately sensitive to subtle changes in the risk environment, and adjustable. Sensitive tripwires would allow policymakers to activate graduated speed-bumps at the earliest sign of heightened risk, well before conditions for investor panic had materialized (Neftci 1998; Taylor 1998).

Let us consider some possible tripwires. An indicator of currency risk is the ratio of official reserves to total short-term external obligations (the sum of accumulated foreign portfolio investment and short-term hard-currency-denominated foreign borrowing). Locational mismatch (which induces fragility risk) could be evidenced by the ratio of foreign-currency-denominated debt (with short-term obligations receiving a greater weight in the calculation) to domestic-currency-denominated debt. A proxy for maturity mismatch could be given by the ratio of short-term debt (with foreign-currency-denominated obligations receiving a greater weight in the calculation) to long-term debt. If this ratio and gross capital formation were both rising over time, that would indicate the emergence of maturity mismatch. An indicator of lender flight risk is the ratio of official reserves to private and public foreign-currency-denominated debt (with short-term obligations receiving a greater weight in the calculation). The vulnerability to portfolio investment flight risk could be measured by the ratio of total accumulated foreign portfolio investment to gross equity market capitalization or gross domestic capital formation.

Speed-bumps are measures that curb the accretion of particular risks (such as those induced by the prevalence of unsustainable financing strategies). Recent experience suggests that the slower short-term growth these speed-bumps *might* induce may be a worthwhile price to pay to avoid the vulnerabilities that often culminate in financial crisis. Speed-bumps can take many forms. Examples include measures that require borrowers to unwind positions involving locational or maturity mismatches, curb the pace of imports or foreign borrowing, limit the fluctuations or convertibility of the currency, or slow the exit and particularly the entry of portfolio investment. I emphasize the importance of speed-bumps governing *inflows* rather than outflows because measures that merely target outflows are more apt to trigger and exacerbate panic than to prevent it.

Note that the tripwire–speed-bump approach presumes with Keynes that better information is insufficient to prevent crisis. Given fundamental uncertainty and endogenous expectations, the same information might very well yield increasing investor confidence one day and a full-blown panic the next. From this perspective, warnings of potential danger must be *coupled with restrictions on investor behaviour* – otherwise, the warnings are apt to induce the very crisis that they are designed to prevent.

Effect on risks

Tripwires could indicate to policymakers and investors whether a country approached high levels of currency, fragility and flight risk. The speed-bump mechanism provides policymakers with a means to manage measurable risks, and in doing so reduces the possibility that policy sovereignty will be constrained by the imperatives of a financial crisis. Those countries that have tripwires and speed-bumps in place are also less vulnerable to contagion effects from crises that originate elsewhere. Hence, the combined effect of tripwires and speed-bumps is to reduce the likelihood that currency, flight, fragility or contagion risk sparks full-blown economic crisis.

It is certainly possible that activation of tripwires in one country could aggravate contagion risk in those countries that investors have reason to perceive as being vulnerable to similar difficulties. This risk could be mitigated through the use of 'contagion' tripwires. These would be activated (in 'country B') whenever speed-bumps are implemented in a country that investors have reason to view similarly ('country A'). In such circumstances, country B would then implement appropriate speed-bumps.

One important caveat bears mention. The risks introduced by off-balance-sheet activities, such as derivatives, cannot be revealed by tripwires (and hence cannot be curbed by speed-bumps) insofar as data on these activities are largely unavailable. If policymakers compelled actors to make these activities transparent, then tripwires and speed-bumps for them could be designed. In the absence of the will to enforce transparency, policymakers would be well advised to forbid domestic actors from engaging in off-balance-sheet activities.

Restrictions on currency convertibility

A convertible currency is a currency that holders may freely exchange for any other currency regardless of the purpose of conversion or the identity of the holder. A government can maintain currency convertibility for current account transactions but impose controls on capital account transactions. Moreover, a government can manage convertibility by requiring that investors apply for a foreign exchange license that entitles them to exchange currency for a particular reason. The latter approach allows the government to influence the pace of currency exchanges and distinguish among transactions based on the degree of currency risk associated with the transaction. The government can also suspend foreign exchange licensing (or convertibility, generally) as a type of speed-bump. The government can also control non-resident access to the domestic currency by restricting domestic bank lending to non-residents and/or by preventing non-residents from maintaining bank accounts in the country.

Today over 150 countries maintain fully convertible currencies. Emerg-

ing economies have been pressed to adopt full convertibility much earlier in their development than did Western Europe and Japan. Had the Asian crisis not intervened, the IMF was poised to modify its Articles of Agreement to make the maintenance of full convertibility and an open capital account preconditions for membership.

Effect on risks

Maintenance of unrestricted currency convertibility in emerging economies is highly problematic from the perspective of financial stability. Investors cannot move their money freely between countries unless they can easily convert capital from one currency into another. But the practice of currency conversion and the exit from assets denominated in the domestic currency places currencies under pressure to depreciate. For this reason, unrestricted convertibility introduces currency flight and currency-induced fragility risks.

Currencies that are not convertible cannot be placed under pressure to depreciate because there are substantial obstacles to investors' acquiring them in the first place. Moreover, to the extent that investors are able to acquire the currency (or assets denominated in it) their ability to liquidate these holdings is ultimately restricted. Thus, the likelihood of a currency collapse is trivial because the currency cannot be attacked. The greater are the restrictions on convertibility, the smaller is the scope for currency risk.

Restricting currency convertibility can curtail flight risk. Restricting convertibility can effectively discourage foreign investors from even buying the kinds of domestic assets that are most prone to flight risk because these holdings cannot be readily converted to their own national currency. To the extent that these restrictions do not discourage foreign investors from purchasing assets subject to flight risk, they nevertheless undermine their ability to liquidate these investments and take their proceeds out of the country. Convertibility restrictions also reduce the ability of domestic investors to engage in flight.

Convertibility restrictions also reduce currency-induced fragility risk. This measure decreases the possibility that currency depreciation will lead to an unexpected increase in debt-service costs. Restricting convertibility does not reduce the fragility risk induced by the adoption of risky financing strategies, such as those involving maturity mismatch.

By reducing the overall risk of financial crisis, currency convertibility restrictions can reduce sovereignty risk. This measure protects policy autonomy by slowing the rate of depletion of foreign exchange reserves, thereby giving the government time to implement changes in economic policy without being forced to do so by pressures against the currency (Eichengreen *et al.* 1995). Finally, convertibility restrictions can reduce a country's vulnerability to contagion by rendering the economy overall less vulnerable to financial crisis. Insofar as investors know that the economy is

less vulnerable to crisis, they are less likely to engage in actions that induce contagion via a 'guilt by association' effect.

Note that countries that did not maintain convertible currencies such as China,[4] India and Taiwan were largely unaffected by the crisis insofar as it was impossible for them to experience a currency collapse (and related currency-induced fragility risk) and the risk of investor flight was minimal. Investors had little reason to fear a collapse of currency and/or asset values in these countries, and they therefore behaved accordingly. These experiences suggest that had a greater number of countries taken steps to reduce currency and flight risks (by restricting convertibility or via other means), there may not have been so many ready sites for contagion.

Restrictions on currency convertibility alone did not inoculate China, India and Taiwan from the Asian crisis. The restrictions did, however, curtail the risks (and investor perceptions thereof) to which these economies were exposed. It is noteworthy that a recent study of capital account regimes by IMF staff concludes that despite the efficiency costs and some evasion of Chinese and Indian capital account restrictions, these restrictions are among the factors that can be credited with the performance of these economies during the Asian crisis (Ariyoshi *et al.* 2000, pp. 16–17, 31–4).

There are, of course, costs associated with maintaining convertibility restrictions (and indeed, any financial restrictions). These costs may be contained if convertibility restrictions are strengthened or activated only when tripwires reveal vulnerability to crisis. Speed-bumps notwithstanding, the potential costs of convertibility restrictions must be weighed against the actual, significant costs of crisis. Critics may also counter that convertibility restrictions reduce growth by raising capital costs. But the effects on capital costs and growth in any one country depend very much on whether other economies maintain such restrictions, and whether the hurdle rate is reduced by the reduction in the vulnerability to crisis (see Section 4).

The Chilean model

In the aftermath of the Asian crisis, a great deal of attention was focused on the 'Chilean model', a term that refers to a policy regime that Chilean and Colombian authorities began to implement in June 1991 and September 1993, respectively. As of this writing, the Chilean model has been dismantled. But the model (particularly, the effective variant actually applied in Chile) deserves careful examination in view of its record of success and its potential as a tool of crisis prevention.

Financial integration in Chile was regulated through a number of complementary measures. From June 1991 through to early 2000, the authorities maintained an exchange rate band that was gradually widened and modestly revalued several times. The monetary effects of the rapid

accumulation of international reserves were also largely sterilized. Central to the success of Chilean policies was a multi-faceted program of inflows management. First, foreign loans faced a tax of 1.2 percent per year. Second, FDI faced a one-year residence requirement. Third, from May 1992 to October 1998, the Chilean authorities imposed a non-interest-bearing reserve requirement of 30 percent on all types of external credits and all foreign financial investments in the country. The required reserves were held at the Central Bank for one year, regardless of the maturity of the obligation.

The Central Bank eliminated the management of inflows in several steps beginning in September 1998. This decision was taken because the country confronted a radical reduction in inflows in the post-Asian crisis environment. The Chilean authorities determined that the attraction of foreign capital was a regrettable necessity in light of declining copper prices and a rising current account deficit. Critics of the Chilean model heralded its demise as proof of its failure. But others viewed the dismantling of the model as evidence of its success insofar as the economy had outgrown the need for protection. In my view, the decision to terminate inflows management was imprudent given the substantial risks of unregulated short-term inflows and the risk that Chile could be destabilized by emergent crises in Argentina and Brazil. It would have been far more desirable to maintain the controls at a low level while addressing the current account deficit and the need to attract inflows through other means. Indeed, flexible deployment of the inflows policy was a hallmark of the Chilean model (consistent with tripwires and speed-bumps) and it is regrettable that the authorities abandoned this course.

Effect on risks

The Chilean model represents a highly effective means for managing all of the risks under consideration. The Chilean authorities managed currency risk via a crawling peg complemented by inflows management. Taken together, these measures greatly reduced the likelihood that the currency would appreciate to such a degree as to jeopardize the current account, and the policies made it difficult for investor flight to induce a currency collapse. Indeed, the appreciation of the Chilean currency and the current account deficit (as a share of GDP) were smaller than in other Latin American countries that were also recipients of large capital inflows (Agonsin 1998). Moreover, the currency never came under attack following the Mexican and Asian crises.

Chilean policies reduced the likelihood of a sudden exit of foreign investors by discouraging those inflows that introduce the highest degree of flight risk. The reserve requirement tax in Chile was designed to discourage such flows by raising the cost of these investments. The Chilean minimum stay policy governing FDI reinforced the strategy of encouraging longer-

term investments while also preventing short-term flows disguised as FDI. The reduction in (foreign investor) flight risk complemented efforts to reduce currency risk.

Chilean inflows management also mitigated fragility risk. The regime reduced the opportunity for maturity mismatch by demonstrating an effective bias against short-term, unstable capital inflows. Taxes on foreign borrowing were designed precisely to discourage the financing strategies that introduced so much fragility risk to the Asian economies and Mexico.

Numerous empirical studies find that inflows management in Chile played a constructive role in changing the composition and maturity structure (though not the volume) of net capital inflows, particularly after the controls were strengthened in 1994–5 (Ffrench-Davis and Reisen 1998; LeFort and Budenvich 1997; Palma 2000).[5] Following implementation of these policies, the maturity structure of foreign debt lengthened and external financing in general moved from debt to FDI.[6] Moreover, Chile received a larger supply of external finance (relative to GDP) than other countries in the region, and FDI became a much larger proportion of inflows than in many other emerging economies.

Some analysts challenge the sanguine assessment of the Chilean model. Edwards (1999) argues that the effectiveness of the model has been exaggerated. However, in a paper published a year later, De Gregorio *et al.* (2000) conclude that Chilean controls affected the composition and maturity of inflows, though not their volume. The De Gregorio *et al.* (2000) result is confirmed for Chile in other studies that claim to demonstrate the failure of the model, even though their reported results show just the opposite (Ariyoshi *et al.* 2000; Valdés-Prieto and Soto 1998).

Based on the empirical evidence, we conclude that Chilean policies reduced the likelihood of financial crisis by containing currency, fragility and foreign-investor flight risk. Policymakers were accordingly insulated from potential challenges to policy sovereignty via reduction in the risk of crisis. Furthermore, policymakers were able to implement growth-oriented policies because the risk of foreign investor flight was curtailed (LeFort and Budenvich 1997). The Chilean model also reduced the vulnerability to contagion by fostering macroeconomic stability. The transmission effects of the Asian crisis in Chile were quite mild compared to those in other Latin American countries (e.g. Brazil) let alone elsewhere. The decline in capital flows in Chile following the Mexican and Asian crises was rather orderly, and did not trigger currency, asset and investment collapse.

4 Lessons for policymakers

We are now in a position to look retrospectively and prospectively at policy implications. Our findings suggest the following policy lessons:

Lesson 1: The Asian crisis was preventable

As the discussion in Section 3 makes clear, policymakers could have taken steps to ensure that the economies involved in the crisis maintained access to private capital flows while reducing their vulnerability to particular risks.

Lesson 2: The mantra 'there is no alternative' to neo-liberal finance and the risks thereof is simply wrong[7]

This research suggests that it is the task of policymakers in emerging economies to select from among those tools that represent the most appropriate, desirable and feasible means to reduce the specific risks deemed most dangerous to their economy. This means, then, that there is neither a single policy inoculant nor a single policy package that should be applied uniformly.

Lesson 3: A programme of crisis prevention in emerging economies necessitates the implementation of a comprehensive and consistent set of complementary policies

This means that policymakers must pay attention to 'policy complements' because the independent implementation of certain risk-minimizing measures will have undesirable and even perverse effects. For example, as recent experience in Asia and Argentina demonstrates, efforts to manage currency risk must be complemented by inflows management. Additionally, efforts to reduce flight risk by restricting only gross capital outflows are likely to trigger investor panic if these policies are not accompanied by measures to manage gross inflows. Moreover, reliance on policy complements reduces the necessary severity of any single policy, and can magnify the effectiveness of the entire policy regime.

Lesson 4: We simply do not know whether implementation of the measures presented in Section 3 in one or a few emerging economies will increase or decrease the hurdle rate necessary to attract private capital flows

The hurdle rate necessary to attract foreign investment may increase if investors demand a premium in order to commit funds to an economy in which liquidity or exit options are compromised. But it is just as plausible to assume that the hurdle rate in such economies may be reduced by a policy regime that gives investors less reason to fear that capital losses will be incurred or growth will be sacrificed because of financial crisis. That foreign investors found Chile and Southeast Asian economies attractive when they had controls in place gives some credence to the latter view (as does investors' continued fascination with China).

Corollary to lesson 4: The hurdle rate for emerging economies as a whole would be lower in a world in which all or most emerging economies chose from among the policy options discussed here

It is, of course, true that emerging economies always face a higher hurdle rate than do wealthier economies because of investor concerns about informational adequacy and inflation and political risks. And, as discussed above, it is possible (*though not given*) that individual economies may face higher hurdle rates by implementing any of the policies considered here. But since there is no absolute hurdle rate for emerging economies (insofar as hurdle rates are always derived from a relative comparison of investment options) it is quite reasonable to conclude that emerging economies as a whole would find it easier and less costly to attract private capital flows if they reduced their vulnerability to crisis through collective implementation of the policies examined here.

Lesson 5: It is far from certain that efforts to reduce the risks of financial crisis will be frustrated by corruption, waste and evasion and will purchase stability at the cost of growth

Contra the claims of the new political economy, corruption, waste and evasion occur under both liberal and illiberal regimes. The policies considered here may well introduce *new* forms of corruption and waste. But it is by no means certain that the *volume* of these activities will be greater under an illiberal regime. The frequently invoked problem of policy evasion, too, is a red herring. Some actors will evade policy under any regime. Evasion, however, does not imply policy failure. The experiences of India, China, Chile and Columbia, for example, suggest that financial controls have been highly effective despite some evasion. It is nevertheless imperative that the particular controls adopted be consistent with national conditions, including state capacity (per lesson 2).

On the matter of economic growth, a tradeoff between stability and growth has not been established, though critics of financial controls often implicitly assume that it has. Certainly the experiences of Chile and China (and South Korea during the *dirigiste* era) cast strong doubt on the growth–stability tradeoff. More generally, if foreign investors value stability and predictability (especially in the post-Asian crisis environment) countries with well-functioning financial controls might have a comparative advantage in attracting capital inflows. Finally, it is important always to weigh the *actual* costs of instability and crisis against the *potential* costs of slower, sustainable growth (per lesson 5).

This paper has explored the link between neo-liberal financial reform and financial crisis in emerging economies. It has also exposed the fallacy of the argument that crises are an inherent feature of the financial landscape of emerging economies. With appropriate political will, policy-

makers can implement measures that effectively manage the challenges and opportunities of financial integration. Recent events in Asia have revealed the costs of poorly specified programs of neo-liberal reform. In the post-Asian crisis context, and in the context of growing scepticism (post-Seattle) about neo-liberal globalization, we might perhaps be cautiously optimistic about the prospects for serious discussion of the need to manage financial integration in emerging economies.

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Notes

1 This paper draws extensively on Grabel (2003)
2 Note that a few prominent neoclassical economists such as Bhagwati, Krugman and Stiglitz have also indicted neo-liberal financial reform in emerging economies. These critiques, however, do not imply that there has been a fundamental shift in the economics profession as concerns the desirability of neo-liberal financial reform.
3 See Grabel (2003) for a thorough assessment of these and other policies to prevent financial crisis. See also Crotty and Epstein (1996) for discussion of numerous types of capital controls.
4 The Chinese currency is not convertible for capital account transactions.
5 These studies also find that leakages from these regulations had no macroeconomic significance.
6 FDI is not unproblematic, however. It can, and has, introduced sovereignty risk (Grabel 1996).
7 Chang and Grabel (2004) present alternatives to neo-liberal policy in emerging economies in a range of policy domains.

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10 Bank-based and market-based financial systems

Insights from the history of economic thought

Costas Lapavitsas

1 Bank-based and market-based finance in contemporary capitalist development.[1]

The role of finance in capitalist development, especially the implications of the overall design of the financial system for the levels and efficiency of investment, have attracted strong interest in recent years. The old distinction between bank-based (indirect) and market-based (direct) finance has been widely employed in the literature.[2] Currently, the main source of industrial investment funds for companies across the developed world is found in retained profits, rather than external funds (either equity or borrowings) (Mayer 1987; Corbett and Jenkinson 1997). Nevertheless, in German–Japanese (bank-based) as opposed to Anglo-American (market-based) financial systems, banks are a far more important source of external funds than stock markets. Given the general performance of the German and Japanese economies in the post-war period, several economists have claimed that bank-based perform better than market-based systems. These claims are generally couched in terms of the scope provided by bank-based systems for superior monitoring of enterprises by banks, but also for monitoring of both banks and enterprises by the state (Stiglitz 1985, 1994; Wade and Veneroso 1998).

Despite the difficulty of drawing a clear dividing line between the two types of financial system in practice, casual observation indicates that Anglo-American systems have become more prevalent across the world in recent years. For Japan, in particular, it is widely accepted that a trend in that direction has existed for almost two decades. For the developing world, Glen and Pinto (1994) have shown that external financing of investment has become much more important in the 1990s. Similarly, Singh and Hamid (1992) and Singh (1995) found that corporate investment in developing countries in recent years has depended more heavily on external funds than on retained profits, particularly on new issues of shares rather than debt. The importance of stock-market-based finance in developing countries has led to the emergence of theoretical arguments in favour of

market-based financial systems as, for instance, in Demirguc-Kunt and Maksimovic (1996), Demirguc-Kunt and Levine (1999) and Levine and Zervos (1998). For these writers, stock markets complement banks by providing financial services supplementary to those of banks, such as allocation of risk and monitoring through shareholder action. Thus, it is claimed that, in well-developed financial systems, stock markets play a critically important role supplementing efficient banks.

The financing decisions of firms are of vital importance in this debate. The vast literature on corporate finance (the mixture of own capital, debt and equity through which investment is financed) has been dominated by the well-known theorem by Modigliani and Miller (1958) for much of the post-war period, even if largely as point of departure.[3] The theorem states that, in perfect capital markets which equalise returns without transactions costs and taxes, the stock market valuation of firms is not affected by the ratio of debt to equity ('capital structure'). Hence the theorem implies that corporate finance is irrelevant to the prospects of an enterprise. However, the economics of information asymmetry and transactions costs have wrought substantial change to this perspective, and capital structure is now considered vital to a firm's valuation (Stiglitz 1988).[4] The importance attached in the modern literature to information and its processing has led to closer examination of the full range of interactions (contractual and otherwise) between enterprises and financial institutions.

It is interesting to note that the advocates of both bank-based and market-based systems base their arguments on the monitoring properties of banks and stock markets. Those who favour bank-based systems often identify a 'relational' or 'commitment' aspect of banking in such systems, which is supposed to contribute to better performance of firms essentially through easing constraints posed by information asymmetries (Mayer 1987). Much of the emphasis on the monitoring advantages of banks derives from analysis of the Japanese financial system, in particular the 'main bank' relationship between banks and enterprises, and the relationship of both of these to the state (Aoki and Patrick 1994; Aoki *et al.* 1997). Consequently, there is general interest in identifying lending practices and state intervention in Japan and other Asian countries that might have promoted efficient investment by capitalist enterprises.

The recent explosion of interest in these issues should not obscure the fact that the debate has a long historical pedigree. Early exponents of bank-based and market-based finance can be found amongst mercantilists, classical political economists and Marxists. Important insights into the operation of bank-based systems, the financing decisions of enterprises and the practice of financial intermediaries can be gained by tracing the roots of bank-based finance in the writings of John Law and Sir James Steuart. Similarly, there is much to be gained by reconsidering the work of Adam Smith treated as exponent of market-based finance. For Marxist political economy, on the other hand, the provision of finance to capitalist

accumulation has always been considered an issue of the utmost importance. Analysis of the interaction of industry with financial intermediaries provided the theoretical foundation for Marxist theories of imperialism in the early years of the last century. Hilferding's (1910) work, relying on the bank-based character of the German and Austrian financial systems, remains the fullest and most important treatment of the issue from the standpoint of Marxist political economy. Despite its weaknesses, discussed below, it has much to offer in analysing contemporary phenomena and assessing mainstream literature. A distinctly Marxist position can be formulated that has much sympathy with bank-based finance but also recognises the spontaneous nature of market-based finance in a capitalist economy.

Section 2 of this essay compares and contrasts Law, Steuart and Smith on finance and banking in the course of capitalist development. The work of Law and Steuart has mercantilist aspects and leans towards bank-based finance. It also offers important analytical conclusions for the operations of (development) banks. In Smith's work, on the other hand, principles are laid out for the operation of commercial banks as independent capitalist enterprises in market-based financial systems. Commercial banking, for Smith, has its counterpart in enterprise finance regarding, in particular, the types of investment that ought to be financed through banks. Section 3 turns to Marxist theory of the financial system partly through a critical examination of Hilferding's work. It is shown that market-based finance can be seen as a spontaneous outcome of capitalist development, while bank-based finance represents an appropriate institutional rearrangement of the financial system for late developers who aim at 'catching up'. It follows that bank practices in late developing countries are consistent with state intervention in the sphere of finance. Section 4 briefly concludes.

2 Contrasting views on finance, banking and capitalist development in the history of economic thought

Steuart's analysis of banking and finance can be seen as the pinnacle of mercantilist thought on these issues, though his views rest explicitly on the prior work of Law. The treatment of banking and finance by both writers is closely related to their treatment of money. Both believed strongly that money could revitalise economic activity and transform society and Steuart, in particular, was a vehement opponent of the quantity theory of money.[5] Both also exhibited the characteristic mercantilist confusion between money and capital, as is shown below.[6]

Steuart, writing on the cusp of the Industrial Revolution and the capitalist transformation of Western Europe, is concerned with establishing principles that would be of help to policy-makers ('the statesman') in shaping economic and social policy. The underlying problem, according to Steuart, is to ensure 'a just proportion between the produce of industry

and the circulating equivalent available to purchase it' (Steuart 1995, ch. XXVIII, bk. II, p. 53). Too little of the latter would lead to stagnation of activity; too much of it would lead to 'prodigality' that would give rise to balance-of-trade deficits. It is clear, however, that he is mostly concerned with shortage rather than overabundance of money. Thus, 'the statesman' must be prepared to deploy appropriate policies that draw metallic money out of hoards, or supply 'symbolical' paper money. Specifically, a country's economic stagnation is considered by Steuart as tantamount to the inability of consumers to absorb the produce of industry because they lack 'circulating value' (money) and cannot obtain credit to effect purchases. Hence, the country needs a mechanism for 'liquidating' consumer assets, especially land they might hold, and providing them with the wherewithal for making purchases (Steuart, 1995, ch. XXVIII, bk. II, p. 59). Consequently, it is incumbent upon the policy-maker to provide mechanisms for making credit available to consumers. Such credit could create a 'circulating fund' of paper money for the country, which would allow purchase of the produce of industry and spur economic activity.

This analysis contains confusion between the money revenue of consumers and the money capital of industrialists (or between the supply of money and the available money capital). Money capital used to hire workers and purchase means of production is a very different economic category from the money income of individuals spent on means of consumption. The fundamental economic properties of the former are explained by the generation of money profit (accumulation), while those of the latter are explained by the simple need to acquire useful things. Thus, a country might not have sufficient money capital to sustain rapidly expanding accumulation, while possessing adequate money to circulate private income. What is of relevance for our purposes, however, is Steuart's perception of credit as a catalyst of development that could be consciously manipulated by policy-makers. Steuart's claim essentially is that, if economic development is lagging, the reason is that aggregate demand is continually weak due to a deficiency of money and credit. The 'statesman' should make good this deficiency, either through mobilisation of money hoards or through introduction of appropriate institutional changes in the economy that allow credit to be generated. As is shown below, these changes amount to creation of banks that facilitate consumer borrowing against their fixed assets, particularly land. Steuart fully understood that such institutional changes would contribute to dispossession of the landed aristocracy (the main group of 'consumers' short of cash but in possession of fixed assets) through sale of land or its use as collateral. For Steuart, credit contributes to development through social transformation.

John Law heavily influenced Steuart in this respect. Law's (1705, ch. VIII) best-known work on money and credit is explicitly concerned with the fact that Scotland lagged behind Holland in economic development. Scotland's weak development was due to poor trade performance, both

domestically and internationally, which Law attributed to lack of money in the country. The mercantilist confusion between money capital and money revenue is evident in Law's argument: 'Domestic Trade depends on the Money. A greater Quantity employs more people than a lesser Quantity' (1720, p. 11) and 'The first Branch of Foreign Trade, which is the Export and Import of Goods, depends on the Money' (1720, p. 12). The implications of money shortage for national development are stark:

> National Power and Wealth consists in Numbers of People, and Magazines of Home and Foreign Goods. These depend on Trade, and Trade depends on Money. So to be powerful and wealthy in Proportion to other Nations, we should have Money in Proportion with them; for the best Laws without Money cannot employ the People, improve the Product, or advance Manufacture and Trade
>
> (1720, p. 49)

To increase 'money', Law considers various methods of expanding metallic circulation, such as alloying existing coin or mobilising money hoards, but thinks that they are unlikely to have a sufficiently strong effect. His preferred method is to increase 'money' through credit. Nevertheless, Law (1720, ch. V) is adamant that credit based on promises to pay money in the future is insufficient for the purpose of spurring development, as there is not enough money in the country to support such credit and make it safe. Thus, he alights upon his preferred institutional transformation of the economy, far-sighted and notorious in equal measure, namely establishment of a land bank, that is a bank that would lend its own banknotes secured by land pledged against them. Law's proposal was rejected by the sober denizens of the Scottish parliament, and his subsequent disastrous attempt to put his ideas in practice in the New World are not of immediate relevance here. It is, however, worth noting that, similarly to Steuart, Law (1720, p. 10) understood that the expansion of credit and money would reduce the power of landed aristocracy.

Similarly to Law, Steuart's preferred method of expanding credit and money to achieve development is also the establishment of banks that hold pledges of land. However, his analysis of the operations of such banks is incomparably deeper and more detailed than that by Law. For Steuart (1995, bk. IV, pt. I, ch. I) there are three generic types of credit. First, 'private' credit, which is advanced against real or personal security (i.e. it either has a specific real asset as collateral, or is based on the entire personal wealth of the borrower). 'Private' credit is the most solid. Its broader social significance is that it converts ('melts down') solid property into money (1995, bk. IV, p. 196). The soundness of the 'melting down' operation depends on the ability of the collateral asset to maintain its value, with land being by far the best. Second, 'mercantile' credit, which is advanced against the creditworthiness of a borrower engaged in trade.

'Mercantile' credit is the most precarious of all, since it is advanced by traders to each other in the course of their business and has no solid backing. Third, 'public' credit, advanced by the state against its ability to command future income due to tax. Its solidity depends on historical and political circumstances.

For Steuart, when industry does not exist and trade is in its infancy, all credit will be scarce, thus preventing economic development (1995, bk. IV, p. 197). Under such conditions, Steuart argues that the statesman should promote establishment of 'banks of circulation upon mortgage', that is, banks that issue banknotes against securities backed by pledges of land. For Steuart, these are development banks that would normally lend for longer periods of time. He explicitly states that they would be unsuitable for developed countries, such as England, for which banks based on mercantile credit are more appropriate (1995, bk. IV, p. 197). The Bank of England is the model bank for developed countries, lending against trade bills rather than land, or making short-term loans to the government. Thus, Steuart clearly differentiates between his proposed banks and the early predecessor of modern commercial banking. For Steuart, necessary foundations for commercial banking are provided only by extensive and regular commercial transactions in developed countries, which are not present in developing countries.

The true measure of Steuart's originality in this connection, however, does not lie in simply differentiating between development banks and commercial banks operating in developed countries. More important, Steuart differentiated between the two in terms of their respective policies on capital and reserves, and his distinctions are directly relevant to the present-day literature on financial systems. The capital of 'banks upon mortgage' comprises any 'species of property' (metallic money, public securities, real estate and so on) that its owners put together in order to provide 'security' for the banknotes they have issued (1995, bk. IV, p. 201). The point bears restating in a slightly different way: the main purpose of the own capital of development banks is to ensure public confidence in their liabilities.[7] Clearly, if banknote liabilities are convertible into legal (metallic) money, banks must also secure a reserve of coin. But that is hardly a major concern, since their assets will be long-term and solid, other liabilities will be insignificant, and banknotes will be easily honoured as assets mature. For Steuart, the purpose of own capital for banks is to foster confidence amongst the public and to cover improper use of bank credit, for instance, when loans have been made against poor collateral or improperly to cover the bank's own expenses.

Thus, Steuart is deeply concerned with the solvency but not the liquidity of banks. The latter is unimportant, except in the subsidiary sense of providing a small reserve of coin for occasional requests to convert banknotes. His neglect of liquidity derives from the nature of the assets supposedly held by his development banks: the loans they would make would be

aimed at sustaining spending by otherwise illiquid social classes, not financing the short-term activities of merchants. Development bank liabilities would be short-term, but they would not be issued in relation to trade operations. Hence they would be unlikely suddenly to return to the banks in large volumes demanding conversion into reserves. Steuart (1995, bk. IV, p. 197) is fully aware of the fact that such sudden losses of reserves could easily occur if the country faced balance-of-trade deficits, so he advocates establishment of his banks in countries that have regular trade surpluses. His only genuine and persistent concern is of a run on the banks arising from loss of confidence in their solvency, which would deplete their reserves. Hence the importance of banks possessing solid and secure assets, and sufficient capital to provide solvency. For him, moreover, only land banks are able safely to issue very short-term (money-like) liabilities. Commercial banks that are based on mercantile credit tend to issue their banknotes against trade bills that are inherently less safe than land-backed assets. To ensure an adequate supply of mercantile credit, it is better to establish institutions that do not issue notes but borrow from land banks for the explicit purpose of engaging in discounting trade bills (1995, bk. IV, p. 208).

The contrast with Adam Smith, writing less than a decade later, is stark. Before elaborating, however, it is worth stressing that Smith's views on the determination of the quantity of money in circulation are not different from Steuart's. There is no mention of the quantity theory of money in Smith's work, something that sits very uneasily with the conventional view of the quantity theory as the standard 'classical' theory of money. On the contrary, Law, Steuart and Smith have a broadly similar, anti-quantity-theory approach regarding bank-created money.[8] Nevertheless, unlike Law and Steuart, development ('the wealth of nations') for Smith is the outcome of the division of labour and the accumulation of capital through saving. Money and credit play a secondary role in this process. Smith (1950, bk. II, ch. II) barely devoted a single chapter of his classic to the operations of banks. Smith's work, however, is largely free of the confusion between money revenue and money capital that stamped Law's and Steuart's. Hence, his discussion of the role of banks in supplying money to industry, and of the place of credit in the operations of capitalist enterprise, has strengths that are sorely absent from those of the other two.

The first point of note in comparing Smith's with Steuart's analysis of banking is that Smith is concerned precisely with those banks that Steuart had considered unimportant, namely commercial banks that lend to merchants by discounting bills of exchange.[9] Moreover, Smith analyses these banks as capitalist outfits subsisting independently amidst merchant and industrial enterprises, rather than as institutions set up by 'statesmen' in order to provide credit that would spur economic activity. Consequently, Smith's first and primary concern, in contrast to Steuart's, is to analyse the availability of liquidity for those banks, which essentially means determining

the volume and nature of their reserves. The solvency of these banks is not a major concern, and this has implications for Smith's analysis of their lending policy.

For Smith (1950, pp. 318–23), the proper lending business of commercial banks is to discount short-term bills that arise in the course of commercial transactions among capitalists of established reputation, that is, 'real bills'. To sustain this business, banks need either to keep reserves of gold or silver, or to be able rapidly to obtain such backing for their notes in the open market. Keeping reserves is costly because interest is forgone on metallic reserves, and it is expensive to procure additional reserves at the moment when pressing need arises. But if banks stick to 'real bills' lending, their reserves will be regularly maintained as assets mature, thus minimising the cost. Economic theory has known for a very long time that a real bills policy for banks is a fallacy on several scores, including purely monetary ones.[10] The fallacy of 'real bills', however, is not of critical importance here. The power of Smith's analysis of banking compared to Steuart's comes from his discussion of bank lending policy in relation to reserves, that is, from Smith's attempt to analyse banks as independent capitalist concerns. Regardless of what one thinks of 'real bills', Smith's view that the appropriate business of banks is short-term lending backed by adequate but minimal reserves remains the foundation of commercial banking in developed capitalism.

But it is not only in this respect that Smith's analysis of banks has a different focus and different concerns from Steuart's. For Smith (1950, pp. 323–4, 341–2) it is also important theoretically to ascertain which part of the capital of a functioning capitalist a bank can advance 'with propriety'. In this respect, Smith provides important insights into corporate finance. Thus, a bank should certainly not advance to capitalists the funds necessary for their fixed capital, as that is clearly long-term investment. Even more strongly, a bank should not supply the part of circulating capital (working capital) that is necessary for regular commercial payments, wages and so on. The appropriate source of these funds is own capital provided by the entrepreneur. Banks should appropriately supply to functioning capitalists the money that they would have kept idle in the normal course of their business, that is, banks should provide the money reserves necessary to functioning capitalists. If there are banks that lend against good bills or through overdrafts, capitalists need not hold the 'dead stock' of money reserves, but could convert it into active capital, investing it in materials, machinery and so on (1950, p. 340). Moreover, by exclusively discounting 'real bills', banks can ensure that they supply only this part of the capitalists' funds and no more.

To recapitulate, in contrast to Steuart, who examines (and advocates) development banks' supplying liabilities against pledges of land, Smith analyses commercial banks that supply liabilities in discount of bills of exchange. Moreover, Smith advocates a prescriptive policy for these

banks, namely short-term lending against 'real bills'. This policy would, presumably, maintain the necessary minimum of bank reserves (liquidity), while supplying capitalists with the money reserves required in their business, and no more. Here is an automatic mechanism ensuring the viability of banks as capitalist enterprises, as well as guaranteeing their creditworthiness. The size and uses of banks' own capital, especially in terms of providing solvency and sustaining their liabilities, were not important to Smith.

The same spirit is evident when Smith analyses the contribution that banking makes to the national economy as a whole, and draws conclusions about the banks' monetary role. After differentiating between gross and net money revenue, he focuses on the replenishment of fixed and circulating capital as deduction from gross revenue (1950, pp. 303–5). Smith is mistaken on the aggregate circulating capital of society, arguing erroneously that its replenishment does not represent a deduction from gross revenue because the goods that replenish it will actually be consumed by someone and hence they belong to net revenue (1950, p. 305).[11] But on money and aggregate revenue his analysis is revealing. The aggregate quantity of money, though part of circulating capital, he likens to fixed capital; 'the great wheel of circulation' possessed by society to facilitate its economic reproduction. Replenishing this quantity is a net deduction from gross revenue, as long as money is metallic, that is, has to be extracted from the bowels of the earth through labour. By providing a solid paper money, banks can save this expense, as well as allowing the metal to be exported for goods. But their credit certainly does not augment society's capital – that increases only through saving and accumulation. The most that banks can do, as we have already seen, is reduce the pressure on capitalists to hold money reserves, hence allowing conversion of reserves into active capital:

> That part of his capital which a dealer is obliged to keep by him unemployed, and in ready money for answering occasional demands, is so much dead stock, which so long as it remains in this situation, produces nothing either to him or to his country. The judicious operations of banking enable him to convert this dead stock into active and productive stock
>
> (1950, pp. 340–1)

Summing up this section, two opposing views on banking can be identified within the anti-quantity-theory tradition of monetary theory. The first is closely associated with Steuart and stresses the catalysing role of finance in capitalist development. Banks should provide fresh money instrumental to development, but to do so successfully they need to be of a particular type. Specifically, their assets should be long-term and backed by solid collateral while, on the liability side, they should possess substantial capital

that would guarantee their solvency and generate trust in bank-created money. Reserves are necessary but not of especial importance to these banks. The second view is associated with Smith and is much more circumspect regarding the contribution that banks can make to capitalist development. It shuns the mercantilist belief in the efficacy of credit as catalyst of development. Banks provide fresh money but not fresh capital and, hence, cannot significantly affect a country's development path. Banks' contribution derives from saving the costs of maintaining metallic money, and from ridding capitalists of much of the cost of holding money reserves. Smith treats banks as functioning capitalist enterprises, rather than as instruments available to the state for fostering development. For Smith, bank assets should be short-term and should represent 'real' transactions among capitalists. To sustain their assets, banks should possess liquidity, that is reserves, which are costly. Own capital and solvency are important but not critical issues for the operations of such commercial banks.

3 Marxist analysis of the spontaneous form of the capitalist financial system and its transformation

It is not clear whether a distinctive Marxist position on bank-based versus market-based systems exists. One thing that is certain is that Marxist monetary theory belongs firmly to the anti-quantity-theory tradition, thus bearing a strong affinity to both Steuart and Smith. However, as has been argued elsewhere (Lapavitsas 2000) Marxist monetary theory takes commodity money as the reference point for other forms of money, and so acknowledges a limited validity for the quantity theory on specific occasions. Thus, Marxist monetary theory recognises the explanatory power of the quantity theory in relation to state fiat money, or to bank money that (for institutional reasons) has become entirely unconnected with commodity money. In short, a characteristic and distinguishing feature of Marxist monetary theory is that, while it clearly belongs to the anti-quantity-theory tradition, it can also accord a limited validity to the quantity theory in certain closely specified conditions.

In this respect, an interesting analogy can be established for Marxist theory of banking and finance, especially by drawing on Hilferding (1910) who made the outstanding contribution by Marxist theorising in this field. In the preceding section it was established that Steuart viewed credit as a catalyst of development and advocated development banks that would lend for long-term investment, while Smith was more circumspect on the role of credit and analysed commercial banks that engaged in short-term lending. It is shown below that, by combining insights from Hilferding and from the analysis of capitalist finance in Itoh and Lapavitsas (1999), a distinctive Marxist position on capitalist financial systems could be formulated, which also takes its cue indirectly from both Steuart and Smith. This position accepts and further substantiates Steuart's claim that credit

catalyses capitalist development, but also acknowledges the validity of Smith's analysis of banks as independent capitalist enterprises.

It is possible to hold such a distinctive position because of two closely related theoretical postulates that distinguish Marxist theory of finance.[12] The first is that loanable money capital is a special form of capital, qualitatively different from industrial and commercial capital. The second is that the average rate of interest tends to be below the average rate of profit. Suffice it to state here that loanable money capital is created as idle money hoards are mobilised by financial institutions and then channelled back to accumulation. Thus, loanable money capital is not a functioning part of the total social capital directly engaged in production of surplus value, though it derives from the latter. Interest is generically a share of the profit generated by loanable money capital, when such capital becomes engaged in production. The rate of interest, on the other hand, is the price of loanable money capital, determined purely through demand and supply in the open markets of the financial system. It is trivially true that total interest accruing to lenders per period is normally less than total profit generated by industrial capital. More strongly, for Marxist theory of finance, the rate of interest on loanable money capital tends to be below the average rate of profit on capital engaged in production or circulation.[13] The reasons for this are complex and relate to the generation and mobilisation of loanable money capital as the total social capital goes through its motion.

The view of the role of banking and finance in development suggested below derives from analysis of the structure of the financial system based on these postulates. As has been shown elsewhere (Itoh and Lapavitsas 1999, ch. 4) the spontaneously emerging form of the capitalist financial system comprises a pyramid-like credit system that is supplemented by a stock market. The pyramid of the credit system represents a layering of credit relations, rising from the particular and individual to the general and social. The bottom layer comprises trade credit relations ('buy now, pay later') which are necessarily specific to enterprise, economic sector and geographical area, as is evidenced by the main instrument of such credit, the bill of exchange. The next layer up comprises banking credit, that is, the collection and advance of loanable money capital by banks. Banking credit arises in the discounting of trade bills and thus necessarily overcomes some of the particularities of trade credit. By collecting idle money from several sources and by discounting bills generated by many enterprises in different sectors of the economy, banks partly homogenise credit and begin to give it a less individual character.

The next layer of the credit system comprises the money market, a venue for the trading of loanable money capital among banks. In the money market the particularities of bills and spare money capital are completely disregarded, and credit emerges as a general relationship appropriate to the whole of the capitalist class. Through money market operations, loanable money capital is established as a social category and the rate of

interest is given a precise expression applicable across society. The apex of the pyramid of the credit system is the central bank, the leading bank of the money market, which gives to loanable money capital, and to credit in general, a partially conscious social aspect. Finally, the capitalist financial system is complete when a stock market is established that complements the credit system. In contrast to the latter, the stock market is a venue for mobilisation of idle money but on the basis of property (equity) rather than credit (debt). Nevertheless, the credit system is organically connected with the stock market, as both draw funds from the same pool of idle money, and as lending by the credit institutions sustains operations in the stock market. The connecting links between the credit system and the stock market are crystallised in the rate of interest, which for Marxist theory, as already stated, tends to be below the rate of profit.

Given the pyramid-like structure of the credit system, the analysis of banks as capitalist enterprises has similarities to Smith's discussion of banking. For Smith, as has been seen, appropriate lending by banks is short-term and replaces the money reserves that enterprises would have kept in the normal course of their business activities. It is certainly inappropriate for banks to lend to enterprises for purposes of investment in plant and equipment. As Hilferding (1910, ch. 5) has shown, for Marxist theory, the analogous theoretical distinction is between fixed capital, that is, capital invested in plant and equipment which lasts several turnovers, and circulating capital, that is, capital which meets short-term costs and lasts one turnover. For Hilferding, credit that meets the fixed capital needs of industrial enterprises and involves the advance of loanable money capital is 'capital or investment' credit. On the other hand, credit that finances the buying and selling of commodity capital is 'circulation' credit, which does not involve the advance of loanable money capital. Capitalist enterprises spontaneously create mechanisms for supplying 'circulation' credit to each other, via trade credit and bills of exchange. Banks make such credit more systematic through discounting and overdrafts, that is, by supplying banking credit that buttresses trade credit.

In line with Hilferding's view (and consistent with Smith's analysis) if banks were to operate as independent capitalist concerns, they would not be able regularly to provide 'capital or investment' credit. If they did so, the long-term nature of their loans would imperil their liquidity and lead to bankruptcy. Thus, the type of bank that can independently sustain itself as a profit-making capitalist concern is Smith-like in regard to lending and reserves. By the same token, within the pyramid-like credit system, banks specialise in the collection and advance of loanable money capital (as well as providing money services, such as managing accounts, transmitting funds and so on) and consequently earn the average rate of profit on their own capital. The spontaneously emerging banks of industrial capitalism are commercial banks that make short-term advances, typically related to

trade credit activities of enterprises and involving acquisition of bills. The levels of liquidity and reserves are prime concerns for such banks, and both are empirically ascertained. The original function of own capital for banks in this context is to provide the wherewithal of bank reserves.

At the same time, however, treating the credit system as a pyramid-like structure within a capitalist economy allows for conclusions regarding capitalist development that are reminiscent of Steuart's discussion of credit – though without the confusion between money capital and money revenue. The credit system mobilises the spare money of the capitalist class – and of society at large – hence increases the volume of capital that is actually engaged in accumulation. Moreover, it accelerates the turnover of capital by speeding payments and allowing liquid capital to return prior to output having been sold. Hence it increases the volume of profit generated by a given capital in any period of time. As mentioned above, banks are mediating cogs that allow the capitalist class to collect and share within itself society's money resources. However, banks can also independently accelerate accumulation by anticipating collection and repayment of loanable money capital through provision of their own credit to enterprises. The extent to which they can spur accumulation in this way depends on their own reserves and capital, but more importantly on the requirements of accumulation itself, which have historical, political and social dimensions.

Financing the fixed capital requirements of capitalist enterprises, on the other hand, poses more complex analytical problems than financing their circulating capital requirements, and shows even more strongly the relevance of Steuart's analysis. For Smith, as has already been discussed, it seems that the appropriate source of fixed capital funds is the individual capitalist's own capital. However, such a view corresponds with a relatively modest scale of fixed capital investment by enterprises. Projects with large fixed capital requirements require mobilisation of resources across society and cannot be financed in this way. One of the original functions of stock markets in a capitalist economy was precisely to provide funds for longer-term investment, but on the basis of equity rather than debt. Thus, a systematic difference in function between the two component parts of the capitalist financial system can be postulated: the pyramid-like credit system (above all, commercial banks) provides short-term credit to enterprises, while the stock market provides longer-term funds for fixed investment. In terms of the discussion above, it appears yet again that the spontaneously emerging form of the capitalist financial system has strong market-based characteristics.

If this is so, the question naturally arises: how and why do bank-based systems emerge, in which the role of stock markets is relatively unimportant and banks are able to lend long-term? Hilferding provides the fullest answer to this question within the Marxist tradition. However, his argument, despite offering powerful analytical insights, cannot withstand

sustained scrutiny. Hilferding's (1910, ch. 5) argument rests on his assumption that capitalist development exhibits an inherent structural tendency for banking credit to overtake trade credit, and for investment credit to overtake circulation credit. Thus, capitalist enterprises initially use their own capital for fixed investment, relying on banking credit for circulating capital. However, as the scale of production grows, also increasing fixed capital requirements, banking credit becomes necessary to sustain fixed investment. Consequently, banks become involved in supplying long-term funds to enterprises with the following two profound implications.

First, since bank funds are invested for long periods of time, banks necessarily become closely involved with borrowing enterprises, acquiring information about their prospects, and developing a close 'commitment' relationship. Second, banks also start to play a pivotal role in enterprises' acquiring funds in the stock market. Investment banking becomes an integral aspect of the banking firm, profits deriving from the management of security flotations in the stock market.[14] Moreover, since banks are able rapidly to recoup the money value of their assets by selling securities in the open markets, they can reallocate their capital much more fluidly than enterprises. This advantage, together with the monitoring role which they exercise over the funds lent, affords banks a controlling influence over enterprises. This is the foundation of Hilferding's celebrated concept of 'finance capital', that is, an amalgam of banking and industrial capital, with banks ascendant. For Hilferding, 'finance capital' is an inevitable outcome of capitalist development, the foundation stone of imperialism.

In short, Hilferding claims that capitalist development inexorably leads to increases in fixed capital requirements, which imply the gradual and spontaneous transformation of market-based systems into bank-based ones. As capitalism develops, banks inevitably begin to lend for fixed investment, thus becoming entangled in monitoring and running firms. However, Hilferding's view of the structural and historical tendencies of the capitalist financial system is not persuasive, since market-based systems have persisted and, if anything, appear to be on the ascendant at the end of the twentieth century. His claims are, in part, unwarranted generalisations from the early historical experience of the bank-based systems of Germany and Austria. Nevertheless, Hilferding's emphasis on fixed and circulating capital could afford important analytical insights, especially in the light of our discussion in Section 2. Steuart essentially claimed that, if late developing countries are to 'catch up', they must deploy finance as a spur to accumulation. This seems especially important if 'catching up' requires large fixed capital investments. But then there would be serious implications for the banks that would sustain 'catching up' finance.

To be more specific, if 'catching up' became state economic policy and brought a need for large-scale fixed investment in key sectors of the economy, finance would have to be actively mobilised by policy-makers to meet the requirements. In this connection, banks would probably be more

appropriate policy vehicles than stock markets. Banks have immediate access to idle money that is constantly generated amongst capitalist enterprises, partly because they intervene in trade credit operations. Intervention in trade credit transactions, moreover, affords banks knowledge of the prospects and performance of enterprises and entire industrial sectors. In contrast, stock markets rely on attracting idle money generated across society. Such ready savings are unlikely to be easily available at low levels of development, leading to thin and unreliable supplies of funds to the stock market. Moreover, information about enterprises and sectors of industry would not be immediately available to holders of money funds, and could only be ensured through creation of appropriate institutions that supplement the stock market. Creating such institutions, however, is a complex and uncertain process.

In the historical context of late development and under external pressure to 'catch up', bank-based systems are probably better able to serve the needs for large-scale fixed capital finance. But to make it possible for banks to operate in a manner appropriate to bank-based systems would necessarily involve strong government intervention (Steuart's 'statesman'). Thus, Hilferding was right to stress the advantages of bank-based finance in meeting fixed capital requirements, but wrong to posit its emergence as an inevitable outcome of capitalist development. Rather, bank-based finance should be seen as a historically specific form of the capitalist financial system suited to the needs of late developers. Countries that attempt to meet large fixed capital requirements in order to 'catch up' consciously form bank-based systems. Finance is peculiarly susceptible to such manipulation, despite the fact that it does have a spontaneously arising market-based form. The fluidity and flexibility of loanable money capital allows policy-makers to alter the operations of financial institutions in line with conscious policy. Bank-based finance is not an inevitable outcome of capitalist development, as Hilferding thought, but an institutional transformation imposed on the financial system to foster capitalist development.

The institutional changes that government intervention should bring about in this context are clearly demonstrated with respect to bank operations. As was discussed in Section 2 in relation to Steuart, for the capitalist financial system to acquire a bank-based character, the operations of banks have to change accordingly. For banks to be able to provide credit as a catalyst of capitalist development, the liability side of their balance sheets would have to become solid enough to sustain long-term lending, in the spirit of the original proposal of Steuart for his land banks. Banks have to be able to obtain sufficient long-term liabilities (own capital and borrowed funds) on terms compatible with their capitalist profit-making. This cannot happen spontaneously for the commercial banking firm, and must be secured through state intervention. Institutional change has to be instigated by the state, for instance enabling banks to issue long-term liabilities

(bonds or their own equity) on preferential terms compared to other enterprises. At the same time, bank reserves would also have to be guaranteed by policy-makers. Only if the solvency of banks were secured would banks be able to lend for long-term investment, thus sustaining the bank-based character of the financial system. The close relation that banks would inevitably acquire with enterprises in such a system (exhibiting 'commitment' and exercising 'monitoring') would rest on state policy that would sustain bank operations and actively determine the bank-based character of the financial system.

4 Conclusion

The current debate on bank-based and market-based financial systems and their role in economic development has interesting and important parallels in the history of economic thought. The current of bank-based finance shares some of the mercantilist belief that credit could play a catalysing role in fostering capitalist development. Moreover, as Steuart showed, banks which are to operate as catalysts of development (providing long-term investment funds to enterprises) must have appropriately altered liabilities. Above all, these banks have to possess adequate capital to guarantee their solvency. The current of market-based finance, on the other hand, exhibits some of the classical scepticism on whether banks that are purely operated as profit-making capitalist concerns could ever provide financial services requisite for long-term investment. For classical theory, as expressed by Smith, banks should only provide short-term loans related to commercial transactions. Long-term lending for productive investment would lead such banks to failure. In short, far from operating as development banks with substantial amounts of capital to guarantee their solvency, commercial banks should focus on liquidity and reserves.

A distinctive Marxist position was proposed in this article. It acknowledges the spontaneous nature of commercial banks operating along lines suggested by Smith, but also stresses that credit is a social and economic relationship that could promote capitalist development, as Steuart had argued. In the first instance, market-based finance is the spontaneous form of the capitalist financial system, in which commercial banks mostly provide short-term loans for circulating capital, while stock markets provide funds for long-term investment. Hilferding claimed that the spontaneously emerging financial system would inexorably acquire a bank-based character as investment requirements for fixed capital grew, leading to emergence of long-term bank lending to enterprises. This claim has not stood the test of time well. It is better to analyse bank-based finance as an institutional transformation of the spontaneous (market-based) form of the capitalist financial system. This transformation is brought about by policy-makers in order to mobilise finance for development, allowing late developers to meet their needs for large-scale fixed capital. State inter-

vention is also required in this context to allow banks that undertake long-term lending to meet their own needs for capital and sustain their solvency.

Notes

1 Thanks are due to Ben Fine, Alfredo Saad-Filho and Sedat Aybar for comments on an earlier draft. All errors are the author's responsibility.
2 For a review of the literature on the design of financial systems and identification of different currents within, see Aybar and Lapavitsas (2001).
3 For extensive reviews, see Harris and Raviv (1991) and Samuel (1996).
4 Myers (1984) has put forth an important argument on information-theoretic grounds, claiming that there is a 'pecking order' in corporate finance. Firms normally prefer to finance investment through retention of profits. However, new and rapidly growing firms often need external finance, which they choose according to risk attached, costs of issuance and the length of time for which finance is needed and available. Thus, a common preference ordering of external finance for firms would be trade credit, commercial paper, bank loans, bonds, convertible bonds and equity (the last three both private and public).
5 For discussion of Steuart's views on money, see Itoh and Lapavitsas (1999, ch. 1).
6 This is point is made clearly in Heckscher's exposition of mercantilism (1935, pt. IV, ch. II, sec. 5).
7 Redlich (1951) has emphasised the importance of this idea for the early development of US banking.
8 Mints (1945, ch. III) clearly notes the affinity between Steuart and Smith on the subject of banks and money, but finds that Smith played down the need of banks to hold reserves. That is not persuasive for reasons discussed below. Mints's commitment to mechanical fractional reserve analysis of banking is partly to blame for this assessment.
9 Smith (1950, pp. 337–8) was fully conversant with Law's writings, plans and failed experiments, though he pointedly refused to comment on them, positively or negatively. There can be little doubt that Steuart's work was also known to Smith.
10 See Itoh and Lapavitsas (1999, ch. 1) for further discussion of this point.
11 The confusion in Smith's discussion of gross and net revenue was noted by Marx (1969, pp. 97–103). There is no doubt, however, that the distinction between money revenue and money capital is fundamental to Smith's analysis, while Steuart certainly confuses the two.
12 Discussed in Itoh and Lapavitsas (1999, chs 4, 6).
13 The rate of profit on bank capital, on the other hand, tends to be equal to the rate of profit on industrial and commercial capital.
14 But also from the systematic difference between funds obtained in the stock market and funds invested in accumulation for a given project. The difference (promoter's profit) arises because the average rate of profit systematically exceeds the average rate of interest. Since the latter is used in the stock market for capitalisation of expected returns from a given project, flotations of stock necessarily generate more funds than are strictly necessary for the project (which would normally be capitalised at an expected rate of return equal to the average rate of profit).

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11 East Asia and the development of regionalism

Hitoshi Hirakawa

Introduction: Economics and regionalism

On the homepage of the World Trade Organization (WTO) there is an explanation of regionalism. It cites a definition of regionalism given in the *Dictionary of Trade Policy Terms* as 'the actions by governments to liberalise or facilitate trade on a regional basis'. In the context of the WTO, regionalism corresponds to regional trade agreements (RTA) such as free trade areas (FTA) or customs unions. These are more general concepts than those given in the dictionary, since they include agreements across regions. However, RTA are considered peculiar in that they have to be consistent with WTO terms. At the same time, the WTO also shows wariness: 'RTAs can complement the multilateral trading system, help to build and strengthen it. But by their very nature RTAs are discriminatory: they are a departure from the MFN (Most Favored Nation) principle, a cornerstone of the multilateral trading system.'[1] The discussion in this chapter will take a broad view of regionalism as regional cooperative action aimed at economic development.

Mainstream economics has adopted a negative view of efforts to strengthen regional economic integration and trade on the grounds that they are protectionist. Jagdish Bhagwati for example, points out the discriminatory aspects of FTA since, when two countries form an FTA, they divert trade from unallied countries to allied countries, and exclude the unallied country. He also refers to what he calls 'the spaghetti bowl effect': when the FTA is implemented between countries, there is a danger of creating major impediments to diversified trade liberalisation arising from the complicated mixing of norms, such as the arbitrary definition of producing countries (place of origin clause) (Bhagwati 2000, p. 243). As the movement towards tri-polar regional economic integration, i.e. Europe, America and Asia, strengthened in the early 1990s, Paul Krugman thought the formation of three blocs as the worst case scenario (Krugman 1991). Furthermore, C. Fred Bergsten also showed concern regarding the formation of three poles in the international economy (Bergsten 1996).

Nevertheless, from the second half of the 1980s diversified liberalisation

has been replaced by a dramatic increase of FTAs, and a growing trend towards regionalism. It has been claimed that this was caused not only by the pursuit of economies of scale, but also by political factors such as national security and enhancement of bargaining power (World Bank 2000). Even in East Asia after the end of the 1990s, regional cooperation has progressed rapidly, and attempts at economic integration have been initiated. Negative views can often be heard with regard to whether FTA will succeed in East Asia. What makes regional cooperation go forward? What are the particular problems of East Asian economic integration? In this paper, we will discuss the context of the development of regionalism and regional cooperation in East Asia after the 1990s, as well as assess its prospects.

The advance of regionalism after the mid-1980s and East Asia

The development of regionalism in Europe and the United States

Inaugurated in 1958, the European Common Market developed into the European Community (EC) then into the European Union (EU), eventually leading to adoption of a single currency. In the 1960s and 1970s, a movement towards regional integration in the developing regions could also be observed, but this was not comparable to the EU experience. However, there was a renewed surge of regional integration in the 1990s.

According to the material supplied by the Japan External Trade Organization (JETRO) the number of FTA registered with the WTO had reached 151 by May 2003, half being FTA among countries in Western Europe, the Near and Middle East, and the Mediterranean area. If the number of FTA concluded by countries in Middle and Central Europe, and the Commonwealth of Independent States were added to this, the resulting share would rise to more than 90 per cent of the total. It is worth noting that 123 FTA were registered after the 1990s (JETRO's WTO/FTA Column, No. 15, 30 July 2003). The creation of FTA spread from Europe to America and, as a response, FTA growth also occurred in Asia.

The direct impetus for the FTA boom in the 1990s may be the trend toward full European economic integration. Europe took a major step towards its integration in 1993 based on the 1985 paper entitled 'Completing the Internal Market'. The EU was formed through the conclusion of the Maastricht Treaty of 1992, and gave rise to the European single currency, the euro, in 1999. This was the birth of a gigantic economic zone of 380 million people and 8.5 trillion dollars of GDP. This European movement spread to the USA. The USA concluded a USA–Canada Free Trade Agreement in 1989 and, with the addition of Mexico in 1992, formed the North American Free Trade Agreement (NAFTA). This agreement

covers a population of 400 million with a combined GDP of 10.4 trillion dollars. Moreover, these two economic zones are showing tendencies toward further expansion. In Europe, there has been expansion towards Eastern Europe, while on the other side of the Atlantic following the 1994 Summit of the Americas, agreement has been reached to form the Free Trade Area of the Americas (FTAA) by 2005.

The running start in East Asian regionalism

The first response of East Asia to regionalism in Europe and the Americas was the proposal to form the East Asian Economic Group (EAEG) in December 1990 put forth by the Malaysian Prime Minister Mahathir bin Mohammed, who was sceptical towards the US-led APEC (see below). However, this proposal met with resistance from the USA and Australia, which were excluded from the group, and came under pressure to change its name to the East Asia Economic Caucus (EAEC). Thereafter, its importance was acknowledged in the fourth Association of South East Asian Nations (ASEAN) summit in Singapore in January 1992. But since it had not secured the participation of Japan, it never materialized. The EAEC proposal could not fend off criticism that it planned to create an isolated bloc and threatened to divide the Asia–Pacific Economic Cooperation (APEC) which had been inaugurated in 1989.

On the other hand, the 1992 ASEAN summit proposed the creation of the ASEAN Free Trade Area (AFTA) whereby tariffs would be eliminated within 15 years. In the next year, this was accelerated to ten years, and further shortened by another year in 1996, but there was no spread of this movement across the whole of the East Asian region until the end of the 1990s.

In practice, Japan, Korea, China, Taiwan and Hong Kong, the five nation states forming the Northeast Asian region, did not join in any FTA until the 1990s. According to JETRO, among the leading 30 nation states, it was only the five countries mentioned above which had not joined a regional trade agreement until the 1990s (JETRO 2000). The reason for the rarity of FTA in this region, as was officially stated for Japan was the region's fundamental support for a commercial policy that promotes a multilateral trade system, on the assumption that protectionism (creation of blocs) was one of the causes of the Second World War. Given Japan's history of Asian invasion, the Cold War made cooperation difficult in this region. Nonetheless, Northeast Asian countries achieved high growth through trade.

However, at the end of the 1990s a substantial change occurred: the currency crisis increased East Asia's awareness of economic globalization, since the region suddenly came to appreciate the importance of regional cooperation. Let us consider this further below.

The East Asian currency crisis and financial cooperation

The 'East Asian miracle' and the currency crisis

From the end of the 1980s to the first half of the 1990s, the East Asian region, as a whole, enjoyed high growth. As is shown in Figure 11.1, the Newly Industrializing Economies (Hong Kong, Korea, Singapore and Taiwan) up to 1997, and the ASEAN 4 (Indonesia, Malaysia, the Philippines and Thailand) up to 1996, maintained high growth rates, broadly between 6 and 8 per cent. In 1993, the World Bank published its *East Asian Miracle* report, and lauded the East Asian experience as a success story (World Bank 1993). At that time, because of the rapid spread of neoliberalism following the collapse of the Soviet Union and the dismantling of the socialist camp, confidence in East Asia's growth prospects significantly improved. The region attracted huge capital inflows encouraged by global finance liberalisation promoted mainly by the USA.

However, with the 1997 Thailand currency crisis, the NIE and ASEAN 4 economies fell into unprecedented slump, registering growth rates of minus 2.9 per cent and minus 9 per cent, respectively. The currencies of Thailand, Korea, Malaysia and the Philippines at the start of 1998 dropped by about 50 per cent, and in particular that of Indonesia fell by more than 80 per cent within the same year. Thailand, Indonesia and Korea accepted

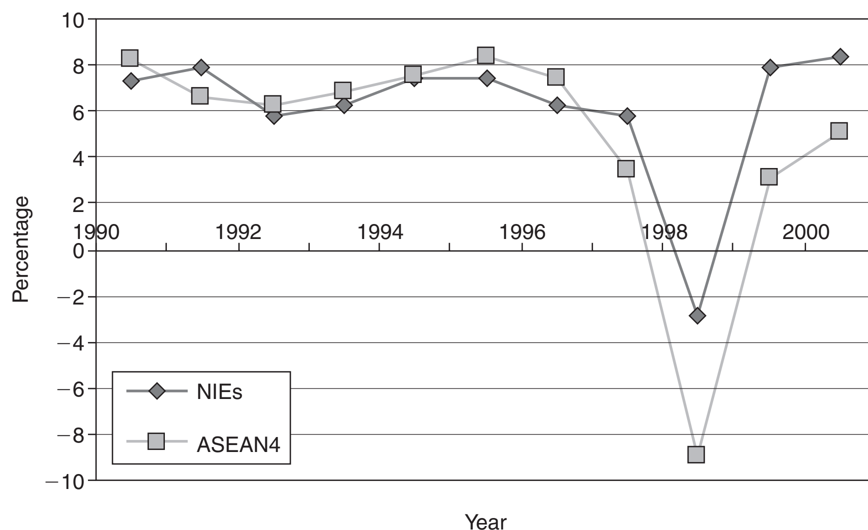

Figure 11.1 Annual growth rates in East Asia (source: Asian Development Bank (2001, Table III)).

Note: 'NIE' consists of Hong Kong, Korea, Taiwan and Singapore; 'ASEAN4' consists of Indonesia, Malaysia, the Philippines and Thailand

International Monetary Fund (IMF) conditionality in return for emergency financing. Owing to this, the three countries adopted liberalisation, as well as IMF-imposed contractionary policies, marked by high interest rates and fiscal austerity, and accepted structural reforms under the direction of the World Bank.[2] It cannot be denied that, from the standpoint of the IMF and the World Bank, the currency crisis was triggered to some extent by weaknesses in the financial system and lack of transparency in corporate governance of the East Asian countries. However, the most prominent features of the Asian currency crisis were 'contagion' and the dramatic outflow of short-term capital.

The evolution of East Asian financial cooperation

In August 1997, an emergency meeting for assistance to Thailand was held in Tokyo under the auspices of the IMF. The USA declined even to attend the meeting but, based on a request from Thailand, agreement was reached, including the following: the IMF and Japan pledged 4 billion dollars each, the World Bank 1.5 billion dollars, the Asian Development Bank 1.2 billion dollars, with further pledges from Australia, Hong Kong, Singapore, Malaysia, Indonesia, Korea and China resulting in a grand total of 17.2 billion dollars.

One of the reasons why this assistance became possible was the existence of the Executives' Meeting of East Asia/Pacific Central Banks and Monetary Authorities (EMEAP) initiated in February 1991 by the Bank of Japan, and in which eleven national and regional central banks participate. The objective of the EMEAP was the exchange of economic information among participating countries as well as analysis of G-7 discussions by the Bank of Japan, which was the only participating institution able to attend G-7 meetings. However, since 1996, general governors' meetings have been held every year, and joint projects were also initiated. In June 1997, two weeks before the eruption of the crisis in Thailand, the second EMEAP governors' meeting was held in Shanghai. A proposal was put forth to create an 'Asia Facility' which would complement the IMF in promoting each country's structural adjustment. It has been claimed that such information exchange, joint activities and networking secured the assistance of the majority of participating Asian countries at the Tokyo meeting (Yam 1997, p. 10). During the selling attack on the baht in May 1997, the central banks of Hong Kong, Singapore and Malaysia joined the Thai central bank in intervening in the market to defend the baht. Such experience also made possible intra-regional assistance.

The meeting in Tokyo to provide emergency assistance to Thailand provided foundations for a new policy on the part of Japan. Thailand's request for assistance was accepted by Japan, which proposed the setting up of an Asian Monetary Fund (AMF) on various occasions in 1997, such as the ASEM Finance Ministers meeting in Thailand, the informal

meeting of Finance Ministers Japan-ASEAN, the annual meeting of the IMF and World Bank, and the G-7 meeting held in Hong Kong. Japan's eventual aim was the creation of a 100 billion dollar AMF. The most important factor behind Japan's proposal was that planning to build such an instititution had already started in the fall of 1996 and by early 1997 a tentative broad consensus had been reached within the Japanese government.[3] However, despite the support of countries such as Malaysia, the AMF initiative was strongly rejected by the USA and the IMF, while it did not receive the approval of China and Korea. It was finally laid to rest at the meeting of Finance Ministers' and Central Bank Governors' proxies of 14 countries held in Manila in November of the same year. Instead, agreement was reached to strengthen the IMF and to install intra-regional surveillance in what came to be known as the Manila Framework. Deputy Treasury Secretary Laurence Summers later claimed with regard to the defunct AMF initiative that 'US economic leadership is crucial to avoid a descent into the kind of regionalism and protectionism that we saw in the period between the first and second world wars' (*Wall Street Journal*, 24 September 1998). Thus, the USA detected regionalism and protectionism in the movement towards strengthening cooperative relations in Asia along the lines of the Japanese initiative.

However, given the lack of support from APEC and the Asian Development Bank (ADB) as the currency crisis was aggravated in early 1998 (FEER 1999, p. 36) ASEAN countries became increasingly aware of the need for intra-regional cooperation. It is not that there was no system of financial cooperation within ASEAN. In 1977 an ASEAN swap arrangement was signed and in the 1980s standby credits were provided. These, however, were of a magnitude of only several hundreds of thousands of dollars (UNCTAD 1996, p. 111) and did not measure up to the 1997 currency crisis.

Confronted with this situation, Japan proposed the 'New Initiative to Overcome the Asian Currency Crisis' (the New Miyazawa Initiative) which was a 30 billion dollar assistance package consisting of 15 billion dollars worth of medium-to-long-term yen funds for economic recovery and 15 billion dollars worth of short-term yen funds needed for economic reforms. East Asian countries received the New Miyazawa Initiative favourably, and after December 1998 pledges were made of financial assistance to Thailand, the Philippines, Indonesia and Korea. By February 2000 total assistance amounted to yen funds equivalent to 21 billion dollars, focusing on medium-to-long-term financing. Needless to say, given the global spread of the crisis, the USA and the IMF had no choice but to accept Japan's cautious proposal. Under the New Miyazawa Initiative, Japan further contributed 367.5 billion yen (about 3.06 billion dollars at that time) to the Asian Development Bank, and inaugurated the Asia Currency Crisis Assistance Fund (ADB News Release No. 14/99, 23 March 1999).

One of the reasons for Japan's increasing financial assistance through

the New Miyazawa Initiative was the birth of the European common currency. On the day of the inauguration of the euro on 1 January 1999, Finance Minister Miyazawa made a proclamation welcoming the euro, while at the same time stressing the importance of the internationalization of the yen. In April of the same year, the Council on Foreign Exchange and Other Transactions of the Japanese Ministry of Finance submitted the document of the 'Internationalization of the Yen for the 21st century'. This reported that internationalization would contribute to currency stability in East Asia, and suggested a policy pact formed by the dollar, the yen and the euro. Relying on exports as the driving force of development, East Asian countries realized the importance of preventing the reoccurrence of currency crisis and of maintaining stable exchange rates. Starting with Malaysia and Thailand, the East Asian countries showed a favourable response to the internationalization of the yen. However, due to a very wary Chinese stance, the possibility does not exist at the moment of making the internationalization of the yen a common theme for East Asia. Still, the 'ASEAN + 3' summit meeting held in Manila in November 1999, proclaimed the importance of 'enhancing self-help and support mechanisms in East Asia' in monetary and financial cooperation, and even the AMF initiative became a topic of discussion.[4] In this manner, at the summit meeting held in Chiang Mai in May 2000, agreement was reached on the so-called Chiang Mai initiative, which is a mechanism for swaps between any two member countries, and can be considered a first step towards the future establishment of an AMF and a common currency. As of March 2003, swap mechanisms between Japan and the following countries have been set up, covering the dollar and their respective currencies: Korea for 7 billion dollars, Thailand for 3 billion dollars, Malaysia for 3.5 billion dollars, and China for 3 billion dollars (yen–yuan swap) (http://www.mof.go.jp/houhou/kokkin/pcmi.htm).

The development of East Asian regional cooperation

The formation and institutionalization of the 'ASEAN + 3' framework

Following Prime Minister Mahathir's declaration of the EAEC, the institutionalization of intra-regional dialogue started in full earnest in the 1990s. The Executives' Meeting of Asia-Pacific Central Banks (EMEAP) represents another such effort. The member countries of the EAEC, due strong resistance by the US, became the participating countries on the Asian side of the first Asia-Europe Meeting (ASEM) held in Bangkok in March 1996. This meeting was partly due to a proposal by Singapore's Prime Minister, Goh Chok Tong, and partly due to the steady efforts of the ASEAN minister participating in 'ASEAN + 3'.

In January 1997, the Japanese Prime Minister, Ryutaro Hashimoto, made a visit to Southeast Asia and proposed the 'ASEAN + 1 (Japan)'

regular summit meeting having as one of its objectives to allay the concerns of China and ASEAN regarding Japan's review of USA–Japan Defense Guidelines. While adopting a favourable stance towards the summit meeting, the ASEAN side revealed concern about Japan strengthening the Japan–USA security pact while simultaneously pursuing creation of an Asian regional framework in EAEC. Thus, at the second informal summit meeting at the 30th anniversary of the establishment of ASEAN, held in Kuala Lumpur in December 1997, the ASEAN side worked towards an 'ASEAN + 3' summit meeting by inviting the leaders of Japan, China and Korea (*Asahi Shimbun*, 20 January 1997; Oba 2001, p. 283; Hirakawa 2002, p. 385). It is worth noting that this meeting was held in the midst of the currency crisis. Quite naturally, the currency issue was raised and the necessity for regional cooperation was confirmed. At the second 'ASEAN + 3' summit meeting, held in Hanoi in December of 1998, it was agreed to hold regular 'ASEAN + 3' summit meetings together with ASEAN summit meetings.

However, a little more time was needed for this to materialize. The 'ASEAN + 3' framework essentially took form after the third informal summit meeting, held in Manila in November 1999. At that venue, the historically unprecedented 'Joint Statement on East Asia Cooperation' was issued, declaring the strengthening of regional cooperation in a wide range of fields such as East Asian politics, economics, culture and security. At that moment the 'ASEAN + 3' framework attracted close attention. Until then, East Asian countries had tried to build the framework of 'ASEAN + 3' carefully and quietly because of resistance from the USA, which believed that having meetings within such a framework amounted to pursuing exclusive regionalism. However, the Asian crisis and the birth of the euro in 1999 urged progress on regional cooperation on East Asian countries, especially Japan and China. They came to realize that without a framework of regional cooperation, they could not ensure a prosperous future in a world of globalization filled with uncertainties. Such awareness made possible the joint declaration of East Asian cooperation. In this sense, the 'ASEAN + 3' framework resulted from the aspirations of many East Asian countries, and was essentially established through the Japan–China decision of 1999.

At the fourth 'ASEAN + 3' summit meeting, held in Singapore in November 2000, the proposal was made to move toward a true East Asian summit, building on the existing practice of ASEAN to invite the three other countries. Moreover, Prime Minister Goh Chok Tong of Singapore, the country in the chair, proposed the formation of a free trade and investment area. Agreement was reached to set up a task force.

The proposal to set a free trade and investment area, the East Asian Economic Zone, was actually an initiative taken by Singapore's Goh Chok Tong to counter the proposal by Chinese Prime Minister Zhu Rhongji to set up a China–ASEAN free trade area that would have considerably

strengthened relations between China and ASEAN (*Nikkei Shimbun*, 26 November 2000). Nevertheless, China continued actively to promote FTA negotiations with ASEAN (*Reuters Business Briefing*, 23 August 2001). At a separate session of the fifth 'ASEAN + 3' summit meeting in Bandar Seri Begawan, Brunei, in November 2001, ASEAN and China agreed to institute an FTA over the next 10 years. However, according to a highly placed Thai official, Japan and Korea were not prepared to make a commitment (*Nation* [Thailand], 1 November 2001). In fact, Japanese newspapers published China's attacks on both Japan and Korea (*Asahi Shimbun*, 11 July 2001; *Nihon Keizai Shimbun*, 11 February 2001). On the other hand, Korea immediately formed a specialist group to research an FTA with ASEAN (*Nation*, 7 November 2001).

The fifth summit meeting had a heightened political character, having been influenced by the terrorist attacks in the USA on 11 September of the same year. Nevertheless, the report of the East Asia Vision Group, which was created in October 1999, based on an agreement at the second ASEAN + 3 summit in December 1998, was lauded by Korean President Kim Dae Jung as showing the desire to create a regional community, while confirming the possibility of constructing an East Asian FTA and creating an East Asian summit meeting. The co-operation of Japan, China and Korea with ASEAN was also declared.

In January 2002 Japan countered China's initiative, with Prime Minister Junichiro Koizumi proposing a comprehensive economic partnership with ASEAN countries. This seemed to promote agricultural liberalisation and was indecisive regarding deadlines for agreement, thus had a mixed reception. However, the proposal was comprehensive, covering a wide range of issues, such as security, trade, investment, scientific technology, human resource development and tourism. It should also be noted that this proposal entrenches the 'ASEAN + 3' framework, with ASEAN at the core, and is evidence of treating this region as an East Asian community.

During this period various meetings were institutionalized within the 'ASEAN + 3' framework. Finance ministers' meetings were held in April 1999 in Manila, in May 2000 in Chiang Mai, in September 2000 in Prague, and in May 2001 in Honolulu. Economic ministers' meetings were held in May 2000 in Yangon, in October 2000 in Chiang Mai, and in May 2001 in Cambodia. Foreign ministers' meetings were started in July 2000 in Bangkok, and labour ministers' meetings commenced in May of the next year in Kuala Lumpur. The fields of cooperation spanned a wide range, covering trade, investment, finance, information technology, e-commerce, assistance to small- and medium-scale enterprises, development of the Mekong Delta, and the environment.

Following the third 'ASEAN + 3' summit meeting, breakfast sessions of the Prime Ministers of Japan, China and Korea were initiated, and became institutional after the second time they met. This creates one more subregional body of cooperation between the Northeast Asian countries

(Japan, China and Korea) and the Southeast Asian countries (ASEAN), and may be the first step toward integration of the two regions.

The rush toward Free Trade Agreement proposals

The start of an East Asian FTA was probably President Kim Dae Jun Kim's proposal for the study of Japan–Korea economic collaboration which was made in October 1998 on the occasion of his visit to Japan. The following month, research was started in the respective countries' research institutions and in May 2000 a joint communiqué was issued (*Nikkei Keizai Shimbun*, evening edition, 22 March 2002). In addition, Korea finished negotiations with Chile in October 2002, and negotiations have also taken place with New Zealand and Singapore. The same path has been followed by Singapore, proposing an FTA with Japan in December 1999 and starting negotiations in January 2001. In January 2002, the first bilateral FTA within the 'ASEAN + 3' region was announced. Within this period, Singapore instituted an FTA with New Zealand in November 2000 and, in addition, negotiations were started with Chile in 1999 as well as with Canada, Mexico, the USA and Australia after 2000. The USA–Singapore FTA was signed in May 2003 and was approved by the House of Representatives and the Senate by August of the same year.

Japan's policy shift from stress on a multilateral trade system to FTA acceptance can be confirmed from the 'MITI White Paper' in 2000.[5] The White Paper argued that FTA led to market expansion, promotion of competition, and policy coordination, as well as that they are complementary with respect to the WTO multilateral trade system (Japanese Ministry of Trade and Industry (MITI) 2000, p. 123). In 2001, Thailand's new administration led by Thaksin Shinawatra started favourably to consider FTA, and in November proposed an FTA with Japan. Also, in May 2002 the Philippines proposed an FTA to Japan and the United States. Beyond these two bilateral FTA proposals, the Philippines also proposed the aforementioned regional ASEAN–China FTA and the East Asian FTA. There is a clear emphasis on generating a China–ASEAN FTA.

What is the reason for East Asian countries working towards FTA? Scollay and Gilbert state that the failure of the third WTO Ministerial Meeting in Seattle in December 1999 contributed to the trend toward an East Asia FTA, together with the failure of Early Voluntary Sectoral Liberalization (EVSL) which was confirmed at the ninth APEC ministerial meeting held in Vancouver at the end of 1998 (Scollay and Gilbert 2001, p. 7). However, it is not only the failure of the process of trade liberalisation led by the WTO and APEC that contributed to this process. An even stronger factor is reaction to regionalism in Europe and the Americas. The trend toward an East Asian FTA aims at dealing with the instability brought by economic globalization as well as strengthening the power of East Asian political expression.

The problems and the significance of East Asian regional cooperation

Needless to say, even though there is a surge of FTA proposals among East Asian countries, not every negotiating country is equally keen to promote them and not every member country is anxious unconditionally to conclude an FTA.

In the FTA treaty agreed with Singapore, Japan included a device 'unprecedented in an FTA' wherein 'tariffs were dismantled only in agricultural and marine product categories which actually have zero tariffs' owing to the resistance of agriculture and forest lobby groups within, for example, the Agriculture and Marine Trade Survey Group of the Liberal Democratic Party (*Asahi Shimbun*, 13 January 2002). Even in the comprehensive economic partnership proposed by Prime Minister Koizumi to ASEAN there is no serious consideration given to liberalisation of agriculture. China, which has constructed a comprehensive economic cooperation framework treaty with the ASEAN, provided for an 'early harvest'. This agreed to rapid liberalisation of agricultural goods in order to persuade ASEAN which was fearful of the impact on its domestic industries. China, which is worried about the effects of WTO accession on its domestic economy, faces considerable sacrifices due to this condition. On the other hand, until quite recently, Malaysia and Indonesia were wary of FTA being pushed by Singapore as a 'go-it-alone strategy' and becoming a 'backdoor' for extra-regional products entering the Asian Free Trade Area (AFTA) market. This represented a serious conflict of interest with Singapore (Rajan *et al.* 2001, p. 77; *Straits Times*, 3 and 10 May 2001). Even Thailand, which is strongly in favor of FTA, is not without concerns about FTA promotion (*Nation*, 2 and 7 November 2001). These kinds of concerns about FTA by regional countries are never to be taken lightly.

The advance of East Asian regional cooperation is also important because it threatens a revision of the international order, especially the Asia strategy of the USA. On this point, Japan's position is very unclear. The Chiang Mai Initiative might be thought of as the first step towards East Asian financial integration, but in order to employ more than 10 per cent of its funds it needs IMF approval, hence it cannot be used against the wishes of the IMF. Thus, Japan, while being the biggest promoter of regionalism, is also its greatest obstacle (Dieter 2001, p. 29). After the terrorist attacks on the USA on 11 September 2001, Japanese politics has again leaned towards unconditional support for the USA. However, after the currency crisis, East Asia began to realize the need to construct a self-help mechanism for prosperity. Asia's attainment of such capability is in itself a challenge to US hegemony. Asia has to be an equal partner with the rest of the world, particularly with the USA, which controls the IMF.

East Asian regionalism, catalysed by the currency crisis, is a movement that was born out of the need to protect economic development and

strengthen regional society. Currency and financial cooperation is its most important pillar given the trend toward globalization. However, such cooperation also poses new problems. Indispensable to its success is mutual understanding and trust among the countries of the region. In the course of its economic integration, Europe first attempted to create fixed exchange rates, and recently abolished individual currencies. It was able to do so because of a will to build a peaceful Europe, transcending historical hatred and distrust. Currency coordination requires effective adjustment of the macroeconomic policies of each country. The vast effort needed for this is supported by the political and social will to build a united Europe. It would not be easy to overcome such problems in East Asia, where mutual distrust remains strong. However, policy coordination for economic prosperity can be promoted if there is also a will to pursue an East Asia community at the same time.

East Asia has entered the challenging era of building cooperative relationships by citizens, NGO and autonomous groups transcending national boundaries, as well as creating a common entity, or economic zone, rich in diversity. East Asia faces the problem of removing mutual distrust among countries and ethnic groups through regional cooperation. In this sense, regional cooperation should not be negatively interpreted as mere protectionism. Japan further needs to appreciate the distrust that was caused by its historic invasion of East Asia, which has been allowed to fester for a long time. Finally, China and Japan will carry the burden of responsibility for the success or failure of East Asia's economic cooperation.

Notes

1 In this chapter, we shall follow current general usage. Instead of the RTA used by the WTO, we shall consider FTA.
2 From the outset, there were criticisms regarding the application of IMF prescriptions containing contractionary policies to the countries stricken by the Asian currency crisis. It is now the general view that such policies actually aggravated the crisis. The structural reforms pushed by the World Bank focused on the reform of the financial system and corporate governance. For details see Suehiro (2000) and Hirakawa (2002).
3 This was precipitated by the proposal from the Australian Central Bank Governor B. W. Fraser in the spring of 1996 for an 'Asian version of the BIS', which was met with resistance from European countries. But in the autumn of 1996 the proposal led to profound deliberations within the Japanese Government. According to Shinohara, the Japanese government's thinking was that, should a financial crisis similar to Mexico in 1999 break out, Asian countries could not expect support from the USA and the IMF. At the same time, Asian countries had enough reserves and could successfully manage a crisis (Shinohara 1999, p. 6).
4 At the press meeting after the ASEAN Ministerial Meeting, Japan reacted strongly to a statement of Minister Espiritu of the Philippines in favour of the multilateral institutionalization of the Miyazawa initiative. The *Asahi Shimbun* newspaper commented as follows: 'Underlying this strong reaction of Japan, there is an irritation towards the Philippine government for attempting to

institutionalize the "Miyazawa Initiative" without consultation with the Japanese government. The Asian Monetary Fund (AMF) initiative, which was proposed by Japan, was derailed by strong US resistance. High officials around the Prime Minister argued that there is no gain in further argument, even though Asian countries are asking Japan to do so' (*Asahi Shimbun*, 29 November 1999). The Japanese government's inconsistency on East Asian policy is evident: Japan cannot reconcile its political and economic initiatives between the USA and East Asian countries.

5 However, the Japanese government does not officially admit that this is a policy shift.

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