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Policies for structural transformation: An analysis of the Asia-Pacific experience

C.P. Chandrasekhar and Jayati Ghosh



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WP/13/01

MPDD Working Papers
Macroeconomic Policy and Development Division

Policies for structural transformation: An analysis of the Asia-Pacific experience

by C.P. Chandrasekhar¹ and Jayati Ghosh²

April 2013

Abstract

The views expressed in this Working Paper are those of the author(s) and should not necessarily be considered as reflecting the views or carrying the endorsement of the United Nations. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate. This publication has been issued without formal editing.

Remarkable growth and structural transformation in a number of developing Asian countries in the period after World War II have earned them the reputation for being “models” of successful development. Among the factors that contributed to their success were macroeconomic and regulatory policies that permitted them to finance that transformation without experiencing high inflation or balance of payments difficulties and ensure that growth was accompanied by human development advance. This article identifies a set of key policies that contributed to that success, examines the ways in which they did so, and assesses the degree to which they can inform policy in other Asian contexts in a period when much has changed in the national and international economic environment.

JEL Classification Numbers: E2; E3; O11; O14; O19; O24; O25.

Keywords: Structural transformation, macroeconomic policy, sources of growth, public investment, capital controls, financial policy, wage-goods constraint

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Policies for structural transformation: An analysis of the Asia-Pacific experience

C.P. Chandrasekhar and Jayati Ghosh

I. INTRODUCTION

In the discussion on means to development in underdeveloped countries in the period immediately after World War II, the focus was on the appropriate macroeconomic policies needed to raise investment, accelerate productivity growth and raise per capita incomes. It was in the 1970s that the influence of marginalist economics resulted in an emphasis on improving the “efficiency” of investment and, therefore, in microeconomic policies involving a reduced role for regulation and a greater role for unfettered market forces. In particular, with global relative prices (taken as given) determining the allocation of investment, use of the comparative advantage principle was seen as generating growth without unemployment, inflation or balance of payments difficulties. Since the rise to prominence of such theorising coincided with the success of Asian developing countries such as the Republic of Korea and Taiwan Province of China, in terms of both income and export growth, their experience was initially wrongly interpreted as being the result of such microeconomic policies.

However, closer analysis makes it clear that the remarkable post-War success of countries in the Asia-Pacific region was marked, *inter alia*, by four noteworthy features:

(1) the dramatic structural transformation of their economies leading to high shares of GDP and employment in manufacturing;

(2) the ability to use that transformation to exploit the benefits of the expansion of world trade associated with the "Golden Age" of post-War capitalism;

(3) the ability of the state to adopt a set of "macroeconomic and regulatory policies" broadly defined, which allowed these nations to finance their transformation in ways that were sustainable for a reasonable period of time; and

(4) significant progress with respect to indicators of social development, despite substantial dependence on market-mediated investment for growth.

Needless to say the timing and extent to which these processes applied varied across countries, and so did the relative role of domestic and foreign markets. But there was enough experience here with successful state intervention to provide some points of departure for innovative macroeconomic strategies in other countries of the region (and elsewhere). Of course, much has changed since the "model" countries found their way to success, including changes in the international environment, enhanced cross-border capital flows and opportunities for growth based on trade. Moreover, even in the successful countries (such as China today), at some point a large role for exports becomes an impediment to rather than a stimulus to growth.

Keeping this changed environment in mind, the paper will examine some successful Asian experiences and consider their similarities and differences, so as to:

(i) identify some key features of the macroeconomic stance (broadly defined) that underpinned the combination of successful structural transformation, sustainability and inclusiveness;

(ii) discuss specific fiscal, monetary, exchange rate, trade, financial, and private sector regulatory policies that defined this stance;

(iii) examine how some of these policies worked and transmitted their effects to the real economy to realise the 'success' of these economies;

(iv) discuss how the changed global and national environments limit the ability of countries to adopt a similar stance so that policies may have to be tweaked to suit the current context, and how the focus may therefore need shift, for example, from exports to the domestic market; and

(v) assess how regional cooperation can help leverage past success for the benefit of more or all countries in the region.

II. DEVELOPMENT SUCCESS IN ASIA

A much-noted feature of the Asia-Pacific growth successes was their ability to sustain high rates of investment, savings and growth for relatively long periods of time without running into balance of payments difficulties or experiencing high rates of inflation. Consider the 1970s. During those years nominal per capita GDP in dollar terms increased by six times in the Republic of Korea and Indonesia, 4.5 to 5 times in Malaysia and 3.5 times in Thailand. Crucial to this transition was an increase in the investment ratio. The rate of capital formation (as per cent of GDP) rose from the low 20s to the low 30s in South Korea and from the low 30s to low 40s in the case of Singapore.

Given the fact that these economies experienced a rather quick transition from low to relatively high levels of per capita income (which even allowed the Republic of Korea to join the OECD) based on high rates of investment, their experiences became “models” of the opportunities available to developing countries. When their transition started, these economies were predominantly agrarian or primary producing economies. Accelerating growth required relying on imported technology and equipment in order to realize the structural changes that facilitate that process. In addition, limited industrialization prior to World War II meant that the increased demand for manufactured consumption goods associated with growth had to be partly met with imports. For these reasons the propensity to import tends to be high. Thus, assessing growth success requires understanding how these countries managed the foreign exchange costs associated with the transition. Finally, poor economies are inevitably characterised by a number of structural bottlenecks that imply supply-constraints that are not easily relaxed. Any acceleration of growth in the sectors that are not constrained from the supply side, could lead to specific demand-supply imbalances (in agricultural wage goods, for example) that trigger and aggravate inflation. If that happens, growth is unlikely to be sustained. Hence, understanding the macroeconomic stance that helped realize the Asian growth successes requires an analysis of how these economies managed (i) to significantly raise their rates of investment; (ii) to garner the foreign exchange needed to avoid balance of payments difficulties; and (iii) to relax the specific supply constraints they faced in order ensure non-inflationary growth or growth with relatively low inflation.

There can be little disagreement on the proximate determinants of the pace of economic growth in the Asia-Pacific. The simple arithmetic of growth equates it to the product of the incremental output-capital ratio and the rate of investment (I/Y). This identity captures in rudimentary form the divide that characterises development economics. On one side of the divide are those who emphasise the role of the investment rate in raising the rate of growth, a tradition that goes back to the classical economists. This was the approach adopted by the immediate post-World War II consensus on measures to be adopted to ensure the development of the less developed countries. On the other side are those who focus on raising the incremental income yielded by a unit of investment. This improvement in the “efficiency” of investment was

to be garnered by allowing market signals to determine the volume of savings (that are seen as ‘determining’ investment), the allocation of those savings across sectors and the technical form in which such investment is embodied in each sector.

This paper does not go into that debate but is premised on the empirically verifiable view that higher growth has typically been associated with higher rates of investment. As The Growth Report prepared by the Commission on Growth and Development (Commission on Growth and Development, 2008: 34) has put it in its analysis of the experience of high growth economies: “Strong, enduring growth requires high rates of investment. By investing resources, rather than consuming them, economies make a trade-off between present and future standards of living.

That trade-off is quite steep. If the sustained, high-growth cases are any guide, it appears that overall investment rates of 25 per cent of GDP or above are needed, counting both public and private expenditures. They often invested at least another 7–8 per cent of GDP in education, training, and health (also counting public and private spending), although this is not treated as investment in the national accounts.”

III. INVESTMENT, EXPORTS AND GROWTH

High investment rates seem to matter even in countries that have grown largely on the basis of exports. This comes through from cross-country correlations of investment ratios, output growth rates and export growth rates. An analysis (Patnaik & Chandrasekhar, 1996) based on twenty years (1968-88) data for 25 developing countries showed a close correlation between output growth and the investment rate (or the ratio of investment to income). Similarly there was an extremely close relationship between output growth and export growth. If it is investment that drives output growth, then the high correlation between output growth and export growth must make itself visible in terms of a high correlation between the investment ratio and export growth, which it does. The results of a similar analysis for a more recent period (1996-2005), for a larger group of 48 similarly placed developing countries, are provided in Table 1. That analysis too corroborates the existence of the same kind of relationships between investment, output and exports.

	Coefficient	Intercept	R-squared
GDP growth vs Average I/Y	0.18	0.36	0.22
Goods export growth vs Average I/Y	0.34	2.69	0.08
GDP growth vs Goods export growth	0.17	2.60	0.31

Source: Calculations based on data from World Bank, *World Development Indicators Online*.

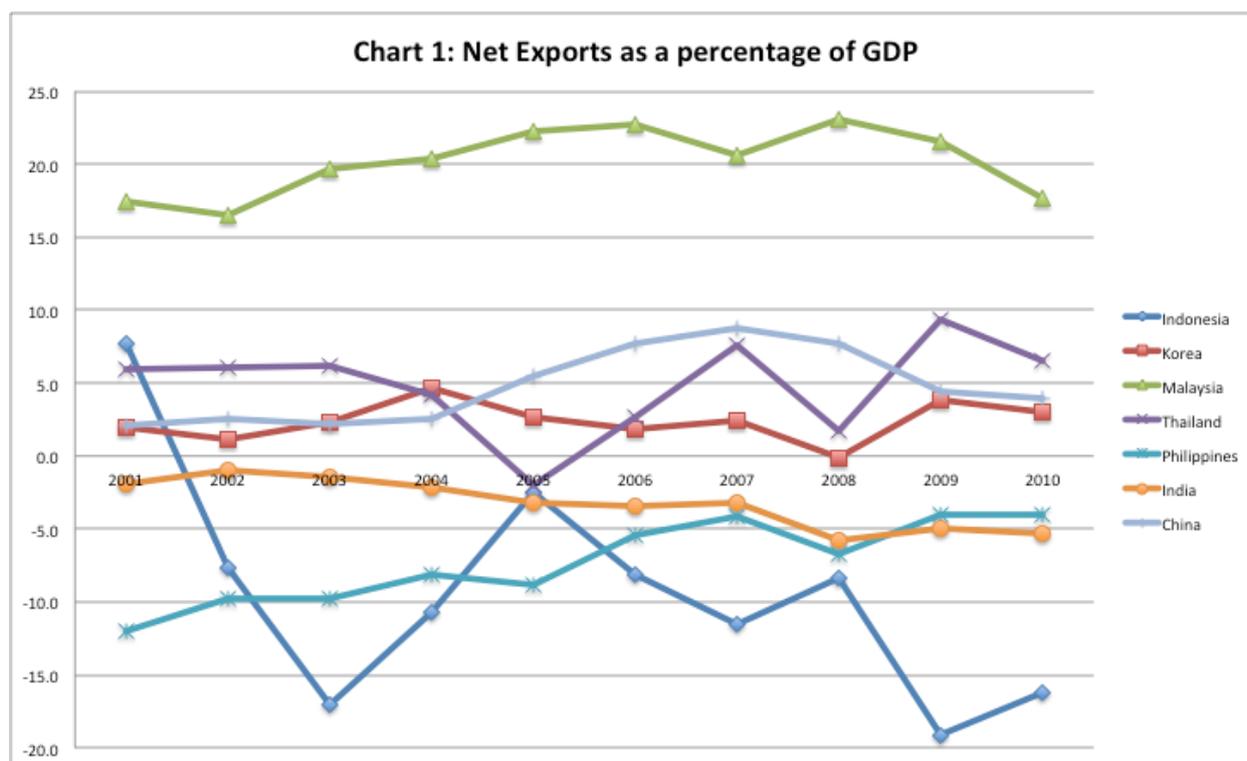
There are good theoretical reasons why a high investment ratio *ceteris paribus* should give rise to a strong export growth performance. International trade in different commodities grows, over any period, at different rates. Given these growth rates in world trade, the rate at which a particular underdeveloped country's exports grow would depend to a very significant extent upon its production structure and the rate at which that structure is changing. In particular since the underdeveloped countries were, by and large, saddled with production-structures specializing in commodities with relatively stagnant world trade, success on the export front depends crucially upon the ability to transform the production-structure rapidly in the direction of commodities where world trade grows faster. And the rapidity of this transformation is linked to the investment ratio: the higher the investment ratio, the faster the transformation of the

production-structure and hence the greater the ability to participate in the faster-growing segments of the world trade, i.e. the greater the rate of export growth.

Access to export earning by permitting transformation through trade does relax a range of supply constraints that can limit growth. In this sense export success, attributed to a mercantilist strategy, has feedback effects that facilitate the realisation of high growth rates based on high investment rates. Export growth was seen as the key to the success of the East Asian economies in the late eighties and the first half of the 1990s. Export growth in the region was very high in the pre-crisis years before 1997, with these countries showing among the most rapid rates of export expansion in the world, between 10 and 20 per cent per year in US dollar terms. The deceleration of export growth in 1996 is widely recognised as one of the proximate causes of the crisis.

However, in another sense the role of exports in explaining the transition in many of these countries is perhaps exaggerated, especially in the later stages of their development. One striking feature of growth trends in the region is that in most of the important economies, net export (or the excess of exports over imports) is not an important contributor to GDP, and therefore a major stimulus to growth. It amounted to less than 10 per cent of GDP in China and Thailand and less than 5 per cent in Korea during the 2000s (Chart 1). Malaysia is an outlier, with its ratio of net exports to GDP fluctuating between 16 and 23 per cent in this period. Finally, India, the Philippines and Indonesia have consistently recorded a deficit on their trade account, implying that trade was a growth dampener, with that effect being particularly strong in the case of Indonesia. In sum, the perception that the leading economies of the Asian region are benefiting substantially from a stimulus from external markets is true, if at all, only of China and to a much lower extent Thailand. On the other hand, the high ratios of exports and imports to GDP suggest that economies in the region are exploiting the possibilities of transformation through trade, which increases their manoeuvrability. Trade matters, but not necessarily as the dominant stimulus for growth.

It must be noted that this applies to a period when, unlike in the 1960s and 1970s, most Asia-Pacific countries had liberalised their trade regimes, either voluntarily or under the influence of Fund-Bank programmes. Though such liberalisation was often advocated on the grounds that it would force the restructuring of domestic capacities and increase export competitiveness, it did not in most cases result in a significant increase in net exports that would have induced investment and growth. Part of the reason was that all countries are now competing for larger shares of global markets. However, trade liberalisation did increase integration and trade dependence with high import-to-GDP and export-to-GDP ratios. This did imply that measures aimed at leveraging the domestic market to build industrial capacity and strengthen industrial competitiveness were partly foreclosed, and the favourable effects of domestic market expansion were diluted because of competition from abroad. To that extent pursuit of development strategies of the kind adopted by the successful newly-industrialised countries of Asia is constrained, especially since a range of trade liberalisation measures have been rendered irreversible through WTO membership and rules.

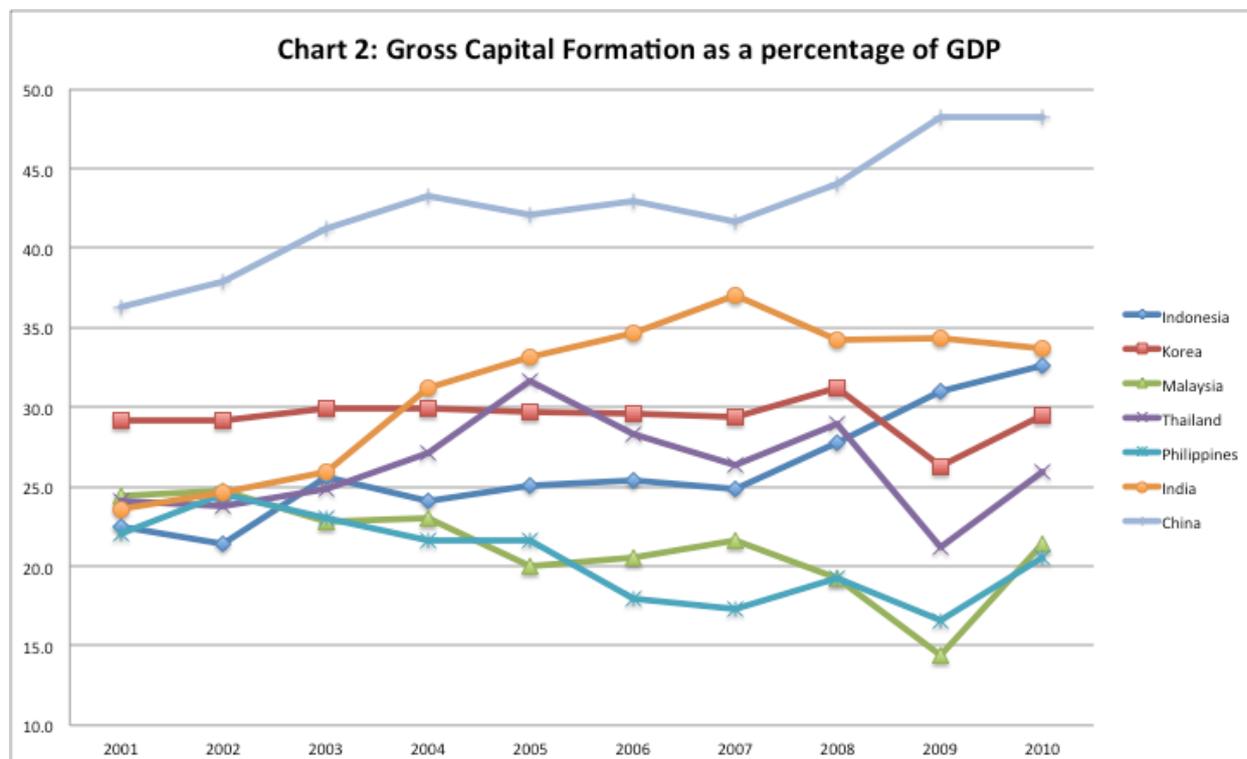


IV. THE ROLE OF DOMESTIC DEMAND

The evidence suggests that to the extent that many Asian economies are registering rates of growth that are creditable by international standards, the sources of that growth are largely domestic. Domestic demand comes from two sources: investment and consumption. Some investment is needed for growth, given that increases in output beyond a point must be based on capacity expansion and, therefore, investment. But if investment expands autonomously, as happens, for example, when governments decide to invest heavily in infrastructure, such investment directly and indirectly (through its multiplier effects) expands demand and induces further rounds of investment and growth. As compared to this, private investment is most often seen as induced and not autonomous, needing some external stimulus to occur. However, if governments adopt a strategy of implicitly or explicitly guaranteeing a minimal, acceptable return in particular sectors, and back this guarantee with easy access to adequate credit, debt financed private investment can also function as a source of autonomous demand.

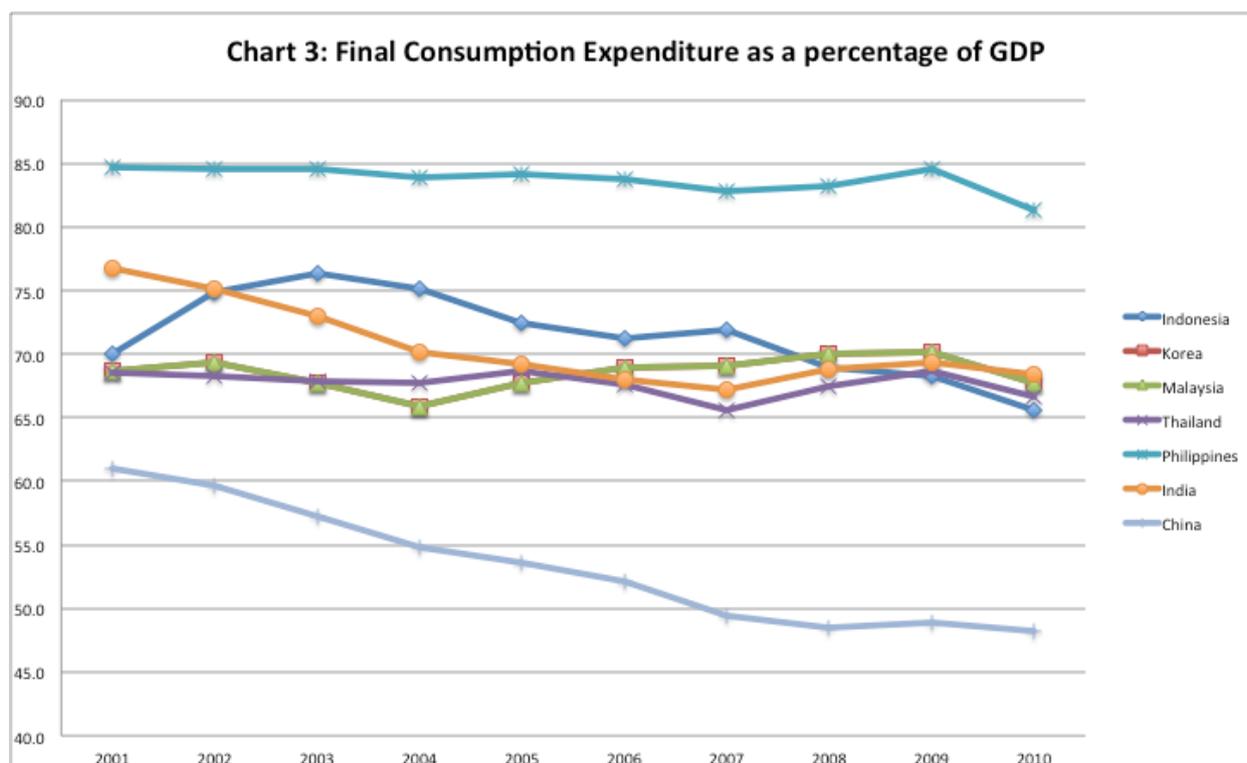
If investment serves as a dominant stimulus to growth via its demand side effects, it is most likely that the ratio of investment to GDP would be rather large. Interestingly, as Chart 2 shows, the two countries that have been topping the growth league tables in recent years, China and India, have indeed been recording increases in their gross capital formation to GDP ratios. The ratio for China, as widely discussed, is well above that in other countries, approaching half of GDP in recent years. The ratio in India rose sharply between 2001 and 2007, but is showing signs of slipping since, resulting in a slowing of the growth process. While Indonesia, Korea and Thailand have also recorded relatively high investment ratios, their levels (in the 25-30 per cent range) are not such as to warrant the conclusion that

autonomous investment has been the principal driver of domestic demand and growth. Investment has played a role, but in combination with other factors that have increased domestic demand.



The more difficult cases to understand are the ones where growth is not only based largely on domestic demand, but much of that demand takes the form of consumption expenditure. As Chart 3 shows, in most economies final consumption expenditure contributes around 65 to 75 per cent of GDP, serving as an important source of demand. The exceptions are the Philippines and China. In the Philippines, weak investment has meant that between 80 and 85 per cent of GDP is accounted for by consumption expenditure. That is by no means a positive from the point of view of growth. In China, on the other hand, extremely high investment rates have meant a decline in the final consumption expenditure to GDP ratio from a low of around 60 per cent to less than 50 per cent in recent years.

It is in the other economies of the region that consumption seems to matter as a source of demand and inducement to investment. However, increased consumption, since it is tethered to increases in income, is not normally seen as a stimulus to investment and growth, but an outcome of the latter. It is true that as per capita income increases beyond some threshold, if inequality is not excessive, increases in income are allocated increasingly to consumption, helping drive further investment and growth. The difficulty is that the level of equality conducive for such a path is uncertain, and so is the threshold beyond which this may occur. In fact, there is no certainty that all of the countries in the set being studied have crossed that threshold.



However, there is one way in which consumption can be “autonomous” in the sense that it is not tethered to current income. That would be true if a significant share of incremental consumption is financed with credit. In recent times credit has played an important role in financing personal investment (in housing) and consumption in developed and developing economies alike. In fact, pre-crisis growth in the US, for example, which has been characterised by rising inequality and a large trade deficit, is seen as having been substantially sustained by debt-financed household expenditure. This trend is also seen in Asian developing countries after financial liberalisation. To the extent that this tendency operates, “autonomous” consumption can spur demand and growth.

Overall, domestic demand seems to have played a significant role in driving investment and growth in many Asian economies, with the role of such demand rising even in economies like the Republic Korea and more recently China. In itself this is a positive trend inasmuch as there are limits to a growth process involving substantial dependence on trade, especially if a persistently positive trade balance accompanies that dependence. This results in the loss of trade preferences and an appreciation of the domestic currency, both of which affect exports adversely. There is also the more structural problem of fallacy of composition that makes the excessive focus on exports as the engine of growth more difficult as competing developing country exporters enter. In addition, dependence on global markets for goods leads to *quid pro quo* demands such as easing controls on cross-border financial flows. The resulting external financial liberalisation – in terms of allowing easy inflows of capital that enable short-term borrowing for long-term projects, of breaking the link between the ability to access foreign exchange and the need to earn it, and of causing appreciation of the real exchange rate that shifts incentives within the economy from tradeables to non-tradeables – fuels speculative bubbles leading to crisis of the 1997 kind which rein in growth. In sum, if a

shift to domestic market dependence is not voluntarily adopted, the system may force such a shift. However, with hindsight it is clear that the sustainability of growth based on domestic stimuli also depends on the nature of such stimuli. If the stimulus is autonomous investment, the financing of such investment (whether public or private) must be such that it is not inflationary or excessively dependent on credit. As for 'autonomous' consumption, being by definition financed with credit, there are limits to the role it can play without leading to financial instability and crises.

V. PUBLIC AND PRIVATE INVESTMENT

The real driver of growth must therefore be appropriately financed public investment. In predominantly market-driven economies the private investment needed for development needs to be induced. The inducement to invest can be provided by different forms of public intervention, directly through public investment that should then have a positive linkage with private investment, or indirectly through fiscal and monetary incentives that alter the relation between the projected costs and returns of private investment.

Two questions that have generated intense discussion and debate are the relative importance of public and private investment in ensuring growth and the degree to which these two types of investment are complementary or competitive. The 'marketist' position, besides favouring private over public investment, has held that public investment tends to crowd out private investment by either absorbing a part of a "given" volume of financial savings or by increasing the cost of capital or the rate on interest by competing for a share of a "given" volume of savings. This argument is flawed because as long as unutilised resources exist, output can be increased and so savings also can increase, so that the notion of a given volume of savings cannot be defended.

The argument also ignores the different roles that public investment can play in developing economies. To start with, public investment in developing countries is crucial to ensure investments in infrastructural areas characterised by lumpy investments, long gestation lags and relatively lower profits, all of which make the private sector unwilling to enter these areas. However, unless these infrastructural gaps are closed, the process of growth can run up against a range of infrastructural constraints such as inadequate roads, shipping capacities and air transportation, power shortages, poor communication and so on. Secondly, besides infrastructure, several basic industries required for industrialisation have characteristics similar to infrastructure even though they produce tradables, which make them unattractive to private investors in the early stages of industrialisation. Examples include steel, machine tools and basic chemicals. Unless the government invests and enters production in these areas, the process of industrialisation may be limited because of limited possibilities of transformation through trade and therefore the inadequacy of foreign exchange to import these commodities. Thirdly, in developing economies with a limited home market, the private sector may lack the inducement to invest unless the state expands its expenditure through public capital formation which directly increases the demand for private sector products (because of the purchases made by the state) or generates indirect demands because of the employment created by public expenditure and the multiplier effects of such expenditure. For these and other reasons

public investment can be seen as “crowding-in” rather than “crowding-out” private expenditure (Aschauer 1989, Erenburg 1993).

However, the role of public investment in developing countries has been undermined over the past two decades by widespread perceptions of government failure, not only in terms of mistakes in “picking winners” but also the greater inefficiency of public economic activity. It has been argued that governments should stay out of any areas that the private sector is willing and able to invest in, and instead provide an appropriate mix of fiscal and other incentives and regulation to ensure that the private provision is socially optimal. But it is now clear that this argument was probably accepted too uncritically. It is difficult to solve many co-ordination problems associated with development when the process is determined by several private agents operating on their own and responding to market stimuli (even if these are altered by government incentives) rather than through some planning mechanism. It has been found only too often that when governments have reduced investment in certain areas, private agents have not been forthcoming in sufficient measure, despite very large concessions that are provided and which become a large burden on the exchequer. For investment that involves large initial outlays and long gestation periods, there may be many factors that inhibit private investment, including multinational investment, even if numerous incentives are provided. This is particularly the case in small countries that are prone to political upheavals or economic instability for reasons outside the government’s control. So private investment in important areas that are “freed” for private players stays at levels that are inadequate to meet the requirements of the economy, and turns out to be even more expensive for the taxpayer than public investment because of the fiscal costs of meeting various incentives, such as guaranteed rates of return on investment.

This means that governments need to take a more inclusive approach to public investment and not necessarily exclude those areas where it is assumed that private players may be interested. The point is that public investment is not just complementary to private sector investment in several ways, but may also be a necessary addition. Griffin (1996) has noted that government investment in physical capital can be made much more labour intensive, thereby increasing employment, saving on foreign exchange and raising the overall rate of return. It can raise the profitability of private investment and stimulate private savings and domestic resource mobilisation more generally.

The empirical literature on the relationship between public and private investment in general tends to support this argument, by finding positive linkages between public and private investment, or crowding-in, for developing countries (Serven and Solimano 1993, Greene and Villanueva 1991, Gupta, Powell and Yan 2005). Of course, the type of public investment matters, and it has been found that public investment in infrastructure (especially in energy, transport and communication) is more effective in generating growth, although that also depends on the stage of development.

Given this background, it may not be so surprising that, growth in many developing countries has slowed after the 1980s. This was the period when public investment generally got a bad press and was sought to be reduced in scope and ambition across the developing

world. On the other hand, a country such as India, which ramped up public expenditure during the 1980s, experienced an escape from the low growth trap that it had been stuck in for long. Unfortunately, that expansion of expenditure was not accompanied by adequate resource mobilisation leading to deficits that had collateral adverse effects. However, if public investment does indeed provide a positive impetus to private investment, as common sense and much empirical evidence both suggest, then reduction of rates of public investment implies a substantial reduction of the inducement to invest by private players. If investment rates, and therefore growth, were not to suffer, this would have to be counteracted by other factors.

Among the more obvious other factors are various government incentives for private investment. It is increasingly recognised by economists – several decades after East Asian governments provided the practical examples - that government fiscal, monetary, trade and credit policies can change the structure of incentives in ways that promote high rates of private investment. Griffin (1996) had argued that an investment-led strategy of adjustment requires an appropriate structure of incentives: a set of relative prices that reflects social costs and benefits; attention to features such as lack of access to resources, barriers which exclude people from some markets, discrimination in the labour market and the effect on incentives of widespread missing markets. The well-known “success stories” of East Asia were typically based on systematic government intervention, in the form of trade protection, domestic industrial regulation, directed and subsidised credit, tax incentives and the like, that generated high rates of industrial growth and diversification (Amsden 1989, Wade 1990, Evans 1995). While this process definitely provided rents that are generally decried in the rent-seeking literature, it can be argued (Khan and Jomo 2002) that these were actually significant in promoting a certain pattern of accumulation and rapid growth.

Public intervention is also needed in countries that grow based on exports to global markets, because private capital has to be incentivised, disciplined and provided the “seeing power” needed to identify the appropriate markets to target. As El-Arian and Spence (2008) have noted, successful high-growth economies have had policies that were designed to help start and accelerate the process of export diversification and structural transformation. So even for export-orientation to be successful, it cannot simply be based on market signals, including those emanating from the world economy. This would generate a basket of goods determined by static comparative advantage, which would not generate the requisite diversification that would allow for high export growth. There are dangers of being locked into low-value added activities as a result of comparative advantage based on trade openness.

Since growth requires the diversification of both production and domestic demand, import substitution policies may well be required to enable a country to achieve the production capabilities that allow it eventually to export, and it is possible for both or neither to be associated with higher aggregate growth, depending upon how, and the context in which, they are implemented. Once this is realised, it also becomes obvious that the traditional policy dichotomy between import substitution and export promotion is a false one.

In fact, all the successful economies employed some combination of both strategies, in East and Southeast Asia as well as in Latin America.

VI. CONSTRAINTS ON SUSTAINING HIGH INVESTMENT

Given the importance of investment in ensuring higher growth, development theory had traditionally been concerned with identifying the factors that enable the “financing” of higher growth by raising the rate of investment. However, the issue was not seen as merely that of mobilising financial surpluses to expend on investment. Conventionally, the issue of financing for development has been concerned with the question of mobilising real resources, in the sense of restricting consumption and setting aside an adequate share of national output to finance investment.

One conclusion that was often arrived at by those who saw the problem purely in monetary terms was that since poor countries with low per capita incomes were already characterised by low levels of per capita consumption, they were not in a position to raise the rate of savings significantly by squeezing consumption. This was seen as trapping them in a vicious circle of poverty, since low per capita income meant low saving, which kept investment and growth low and therefore income and saving low. Escaping from this vicious circle, it was argued, required injection of surpluses from outside in the form of foreign aid and/or foreign investment. As was pointed out quite early in the debate, this view underestimated the ability of poor countries with substantial inequality to limit the “unnecessary”, luxury consumption of the rich and generate surpluses for investment. It also tended to ignore the fact that for various reasons foreign savings rather than add to domestic savings proved to be a substitute for domestic savings in practice, contributing little to increasing investment.

Moreover it was argued that shifting the focus to mobilising real resources seemed to offer various innovative alternatives for financing development. To start with, since many poor developing countries were characterised by the availability of unemployed or underemployed surplus labour, if this surplus labour population could be mobilised and put to work on building capital stock, surplus labour was a potential surplus available for investment. This was a point emphasised by Nurkse (1966) and others.

While the validity of this argument was unquestioned, it was recognised that realising this potential required ensuring that agricultural output does not fall when surplus labour is drawn from the agricultural sector where it normally resides and that when there are less mouths to feed in the rural areas the surplus food available there does not result in higher consumption of the remaining peasantry but is available for feeding workers now being put to work in building capital stock. That is, the potential surplus residing in a surplus workforce can be successfully mobilised only if it is supported with the mobilisation of surplus wage goods needed to feed these workers. *In sum, it was not only the volume of surplus that mattered but the physical forms in which this surplus was available.*

VII. OVERCOMING THE WAGE-GOODS CONSTRAINT

The argument that, given limits on the possibilities of transformation through trade, the institutionally determined maximal rate of growth of production of agricultural necessities sets a ceiling on the non-inflationary rate of growth of the system was explicated, among others, by Michal Kalecki (1972). This was one of the ways in which the availability of surplus real resources was seen to constrain the pace of development in predominantly agrarian economies.

In his seminal work, Kalecki demonstrated how the exogenously given rate of growth of agriculture, the principal supplier of commodities that enter the wage basket, determined the maximum rate of non-inflationary growth a country could achieve. Within the assumptions of the model, any attempt to raise the rate of growth beyond that level only results in inflation in the prices of essentials, which violates the objective of non-inflationary growth. The rate of growth of agriculture itself was exogenously given because Kalecki saw that rate as being institutionally determined. One implication was that countries that relaxed the institutional constraint by implementing land reforms would record higher rates of agricultural and overall growth. This they achieved because land reform (i) increased agricultural supplies by undermining land monopoly and semi-feudal relations that left the actual tiller with little means and little incentive to invest and thereby increasing land-augmenting investments; (ii) expanded the mass market for manufactures by raising incomes in a more egalitarian rural setting; and (iii) unleashed the energies of the peasantry.

The evidence from countries such as South Korea and Taiwan does support the argument that land reforms, even when implemented under US occupation, provided the backdrop for episodes of high growth. As Cristobal Kay notes (Kay, 2002: 1081): “The state played a key role in the development process of South Korea. The state was strong and had a high degree of autonomy from the domestic classes in deciding what specific forms of capital accumulation to promote. Through the land reform a relatively egalitarian farming system was created but at the same time the state greatly increased its control over the countryside. About half of the total farmland was transferred to the beneficiaries and two-thirds of all farm households received land under the land reform.” This helps in two ways. First, it provides the actual cultivator with the means and the incentive to invest, raising agricultural productivity and releasing both labour and agricultural surpluses to “finance” non-agricultural growth. In this process, rural-urban disparities widen as the peasantry is squeezed to sustain rapid industrialization. A similar set of tendencies was seen in Taiwan as well. Second, despite the squeeze on the peasantry, the relatively more egalitarian distribution of income in the rural areas creates a market for manufactured mass consumption goods, which grows as rural GDP rises.

Thus, the experience of these countries illustrates the key role that land reforms and institutional change in agriculture plays even within the framework of capitalist growth. More recently, there is evidence that other types of institutional change, rather than only land redistribution, can have significant effects on output. These changes can have different effects and implications in different phases of development. Thus, in China, the movement towards

co-operativisation/collectivisation as a means of consolidation in order to overcome the problems created by excessive fragmentation of peasant holdings played a role in a certain stage of Chinese agrarian development and was crucial in generating a surplus for industrial development. Subsequently, from 1979 onwards, there were institutional changes that moved away from a strict adherence to commune-based production, to allow peasant participation in markets for agricultural produce from 1979 onwards and then gradually recognised and increased their usufruct rights over their individual holdings.

VIII. STRUCTURAL CHANGE IN ASIA

Thus a key element of the Asian development experience seems to be that successful countries have been able to sustain high investment rates and ensure the necessary structural transformation. Following Kuznets (1973), modern economic growth has generally been seen to be associated with a shift from agriculture to non-agriculture and subsequently from industry to services, as well as a shift from self-employment to wage employment with the associated impersonal organisation of economic activity (in joint stock firms, for example). Kaldor (1966, 1967) saw structural change as not only a result of growth, but in effect a cause of it, with the causality running from manufacturing growth to GDP growth, and to growth of labour productivity. In terms of demand, this is because non-agriculture (manufacturing and services) has higher elasticity of demand for its products than agriculture. On the supply side, two processes cause manufacturing to play a special role, even relative to services. The first is Verdoorn's Law, whereby the growth rate of productivity in manufacturing industries rises with the growth rate of manufacturing output (but with a coefficient less than unity, so as to ensure continued employment growth in manufacturing). So productivity growth is higher in manufacturing than in services, and tends to have a greater impact on aggregate output and productivity. A corollary of this is that the growth of manufacturing is faster than that of aggregate output and therefore the share of manufacturing in output increases. The second process is a Lewisian mechanism of employment growth in industry increasing the rate of productivity growth in other sectors.

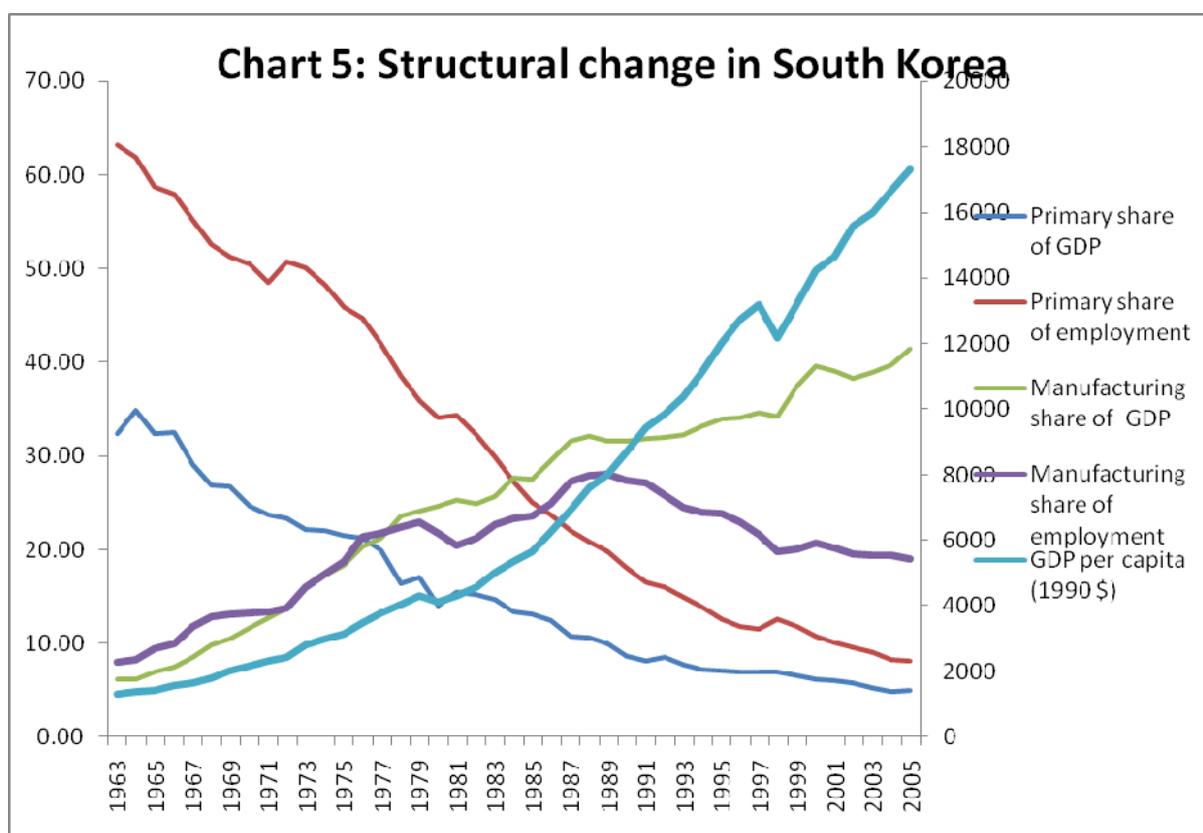
Either way, growth and structural change (in terms of the composition of both output and employment) are closely intertwined. Indeed, this is the essential process of development, whereby industrialisation generates not only higher per capita incomes but also less inequality, as noted by Galbraith (2008). However, even a relatively "slow-acting process of structural change" has not always operated in traditional (or even augmented) Kuznets fashion. While the share of agriculture in output has generally tended to decline, this has not always been accompanied by a commensurate decline in employment in agriculture, as evident from Kum (2008). It is possible to identify five types of economies with varying degrees of structural change and economic transformation, which in turn have implications for poverty reduction: countries that have successfully made the transition to manufacturing, such as the East Asian developmental states; instances of high but stalled levels of manufacturing that have produced dualist labour market regimes, as in some countries of Latin America and in South Asia; countries where services drive the current growth path; agrarian low-income economies; and mineral rich economies.

Successful Transition: South Korea

South Korea can be described as the "classic" Kuznets style structural change, whereby the share of the primary sector in both output and employment declines continuously over the process of economic development, with employment shares falling faster. Manufacturing rose in

both output and employment in the early phase of fairly rapid and sustained growth, from the early 1960s to the late 1980s (Chart 5³). By then, South Korea had reached the level of a middle-income developing country, and while the share of manufacturing in GDP continued to increase, its share of employment began to fall as labour productivity gains in manufacturing were greater than in other sectors. Thereafter, employment grew essentially in services, which by 2006 accounted for as much as 73 per cent of total employment and 54 per cent of GDP.

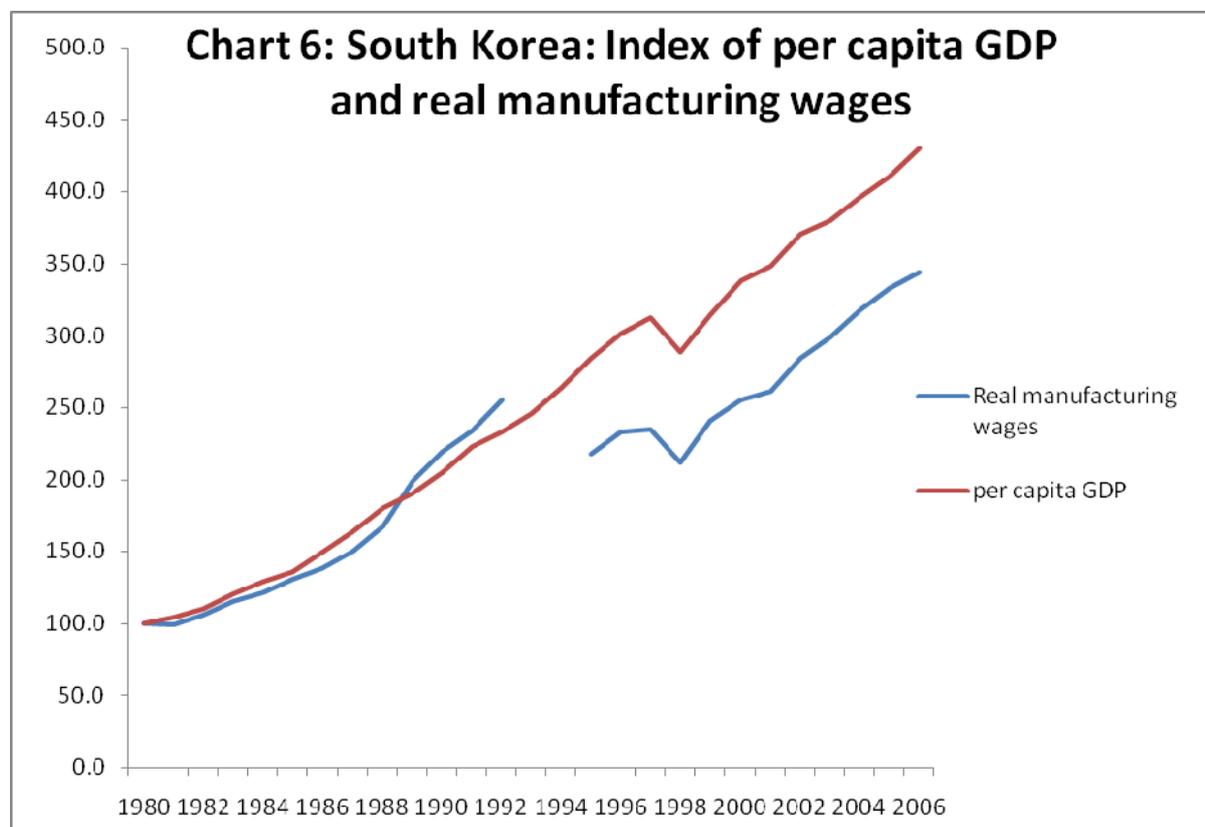
Associated with this progressive shift, the index of manufacturing wages in South Korea showed a generally positive relationship with real per capita GDP, as evident from Chart 6. Obviously, manufacturing wages are only one indicator of labour market patterns, but since evidence on other wages is less easily available, it serves as a way of assessing the extent to which increases in GDP translated into gains for ordinary citizens. In fact, South Korea witnessed a sustained decline in the incidence of poverty, with the head count poverty ratio falling from around 45 per cent in 1965 to around 15 per cent in 1980.



The other issue of interest is the pattern of labour use in the course of growth in South Korea, whereby women were drawn into paid employment progressively and at a fairly rapid pace. Between 1960 and 1981, the work participation rate for women increased from 17 per cent to 29 per cent, while that for men increased from 42 per cent to 47 per cent. In the period between 1965 and 1980, female employment accounted for more than half of the total increase in employment. Subsequently, the rapid increase in export-oriented employment was associated with a further, and significant, increase in female shares. While there were several reasons for this (Ghosh 2007, Seguíno 2005) there is no doubt that the large gender wage gap (with female

³ The data used in Charts 5, are based on the Groningen Development Centre's 16-sector database. The output shares are derived using the estimates based on national currencies in constant price terms, while the GDP per capita is in constant US dollar terms. The

wages only 45 per cent of male wages) played a role in making women workers attractive for employers. As that gender wage gap fell with the growing work participation of women in the 1990s, the proportion of women in export employment also declined, even before the Asian crisis caused sharper falls in women's employment. In the period of post-crisis adjustment, the wage gap increased once again.



This “classic” pattern of structural change was not an accident, but rather a clear result of the state-led accumulation process that actively encouraged diversification into specific manufacturing activities. In the current international context, China appears to be on a similar trajectory, which is particularly remarkable given the size of its population.

The Chinese experience

The Chinese economy has grown at an average annual rate exceeding 9 per cent for three and a half decades. As noted earlier, high growth in China has essentially occurred because of a high rate of investment in China. The investment rate in China (investment as a share of GDP) has fluctuated between 35 and 50 per cent over the past 30 years. Within this, there is the critical role of infrastructure investment, which has averaged 19 per cent of GDP from the early 1990s.⁴ It is sometimes argued that China can afford to have such a high investment rate because it has attracted so much foreign direct investment (FDI), and is the second largest recipient of FDI in the world at present. But FDI has accounted for only 3-5 per cent of GDP in China since 1990, and at its peak was still only 8 per cent. In the period 2000-07, FDI accounted for only 6 per cent of domestic investment. In fact in recent times, the inflow of capital has not added to the domestic investment rate at all, macroeconomically speaking, but has essentially led to the

⁴ China Statistical Yearbooks, various years.

further accumulation of international reserves, which have been increasing by more than \$100 billion per year.

In terms of economic diversification and structural change, China has also followed what could be described as the classic industrialisation pattern, moving from primary to manufacturing activities in the past 25 years. The manufacturing sector has doubled its share of workforce and tripled its share of output, which, given the size of the Chinese economy and population, has increasingly made China “the workshop of the world”. Chinese export growth has been much more rapid, involving aggressive increases in world market shares. This export growth has largely been based on relocative capital, which has been attracted not only by cheap labour but also by excellent and heavily subsidised infrastructure resulting from the high rate of infrastructure investment. In addition, since the Chinese state has also been keen on provision of basic goods in terms of housing, food and cheap transport facilities for registered urban dwellers, this has played an important role in reducing labour costs for employers. Until the late 1990s, the rapid export growth generated employment which was a net addition to domestic employment, since until WTO accession China had undertaken much less trade liberalisation than most other developing countries. This is why manufacturing employment grew so rapidly in China, because it was not counterbalanced by major losses of employment through the effects of displacement of domestic industry because of import competition.

IX. GROWTH, STRUCTURAL CHANGE AND POVERTY REDUCTION

However, agriculture still has an important role to play. The Chinese case has often been cited as an example of how rapid aggregate growth and industrialisation are associated with poverty reduction. Yet in fact it illustrates quite sharply the crucial importance of growth in agricultural incomes for poverty reduction, in a context of relatively equitable distribution of land. What is striking about the post-reform Chinese experience with growth and its effects on poverty reduction is that while Chinese growth was consistently high across time, poverty reduction was concentrated in particular periods. The relation between poverty reduction and growth has varied over time, being strong at the beginning of the “reform” period and somewhat weaker afterwards.

Chart 2 indicates the changes over time in the incidence of rural poverty, based on official Chinese estimates. These are likely to underestimate poverty for several reasons. Even so, it can be seen that much of the reduction in rural poverty was concentrated in two relatively brief periods: the first five years of the reform period, 1979-1984; and the period 1995-97. (This has also been noted by Bouche et al 2004 and Riskin 2004.) This change had much to do with the nature of the growth, which began by being centred on agriculture and the rural economy where most of the poor lived, and then shifted toward the industrialisation of the coastal cities where the poor were less evident except as migrants.

The first period 1979-84 was when policies of economic reform focused on the countryside. Over these years, the “reorganisation” and dismantling of rural people’s communes led to the parcelling out of land to households on a broadly egalitarian basis, with peasant households being given control over the use of land without having the right to sell. Instead of the previous “grain first” policy, farmers were encouraged to diversify production to more high-value produce. At the same time crop prices were raised 30 per cent over the five-year period. In addition, supplies of agricultural inputs including chemical fertilizers were sharply increased and provided to farmers at subsidised rates. All this led to significant increases in agricultural incomes, and this translated directly into reduced poverty because most cultivators were net sellers of both cash crops and food grains.

The second period of substantial decline in rural poverty occurred in the middle years of the 1990s. Once again this was driven by the intersectoral terms of trade: specifically, a steep rise in farm purchase prices, especially of food grain, which doubled in the middle of the decade. After a long time, rural per capita incomes increased faster in real terms than urban incomes, leading to the decline in urban-rural income gap described in Chart 1. It is evident that in this period 1994-97, poverty reduction proved to be highly income-elastic, as a 21 per cent increase in rural income was accompanied by a 40 per cent decrease in rural poverty (Chen and Wang, 2001). However, this was essentially because of the forces driving the increase in rural incomes (the higher returns to cultivation) in a context of egalitarian land distribution and domination of agriculture in rural livelihood.

Hu, Hu and Chang (2004) have argued that notwithstanding China's substantial improvement in poverty reduction since 1978, the pace of poverty reduction has decelerated and new forms of poverty have arisen. This is explained by the authors in terms of two factors: the deteriorating quality of growth in terms of its employment generation potential and an increase in the degree of inequality. Trends in poverty have also been closely linked with the trends in employment (Sengupta and Ghosh 2005). In the rural areas, slow growth in the agricultural sector resulted in almost stagnant rural employment after the mid nineties. Rising unemployment was a major driver of urban poverty in the post 1985 phase, a scenario further strengthened by migrant population from rural areas. Despite high growth, the most important and urgent economic problem China has been facing is unemployment. According to Yu Yongding, in every year of the early 2000s, a labour force totalling 10 million was thrown into the job market. In addition, there were more than 5 million redundant workers from former state-owned enterprises waiting for re-employment. Finally, there are hundreds of millions of migrant farmers constantly moving around the country seeking jobs. As a result, even the high rate of growth in China, if not accompanied by structural and other changes that ensure more job creation, cannot meet the pressure for job creation.

It is known that reforms in China impacted adversely on urban poverty by generating unemployment through the restructuring of the state-owned sector in a context where the social security system was weak or absent. Bouche *et. al.* argue that urban poverty is closely associated with inability to work, and that the increase in urban unemployment as a result of market-oriented reforms and withdrawal of financial support for ailing state enterprises, had been a prime cause of the increase in urban poverty.

X. THE ROLE OF FINANCIAL POLICY

It is evident from the preceding discussion that successful development requires in many forms a proactive role for the state. Conventionally, the financial counterpart of a proactive state was seen as a proactive fiscal stance. One way in which the system can finance a higher rate of investment and a higher rate of non-inflationary growth is by having the government use a combination of direct taxes on the rich and indirect taxes on luxuries to restrict inessential consumption and mobilise the surplus for investment. So long as supply side constraints can be relaxed with such investment, adopting such a stance would drive employment and output growth, rather than lead to inflation. However, in recent years, the role for government in influencing and even leading development has been under challenge by those who argue that this would strain its fiscal balances, result in fiscal deficits and therefore lead to inflation. Implicit in this view is the notion that most developing countries have little "fiscal headroom" to raise revenues through taxation.

The idea that ‘surpluses are limited’ challenges what was for long considered sound economic judgment. In the 1950s and 1960s, economists concerned with development had concluded that national savings and government revenues in most developing countries were as low as they were not because these countries were poor, but because their governments had failed to adequately tax the rich in their countries. This meant that tax revenues of the government were lower than warranted. Further, since these richer sections allocated a significant share of their incomes to consumption that would be considered non-essential at the levels of average income recorded in these countries, savings rates were also below their potential. So an appropriate fiscal policy is a central instrument for development.

However, even in contexts where the state has failed to adopt a fiscal strategy favouring growth, state intervention can play a role in influencing the investment trajectory. One country that illustrates this is India, which is among the countries routinely criticised by international financial institutions for harbouring high and unsustainable deficits. To the credit of the Indian government, it needs to be noted that it did for four decades starting from Independence in 1947 strive to evolve a financial system which can intermediate between savers and investors in ways that channel savings to those sectors to which investment has to be directed if growth has to be maximised without increasing inequality.

As noted earlier, the experience of successful industrialisers makes it clear that a growth-oriented pattern of production of goods and services requires the state to guide the allocation of investment. One way to do this is to use the financial sector as an instrument for investment coordination and targeting. Even in developing countries that choose outward-oriented strategies or are forced to choose a more mercantilist strategy of growth based on rapid acquisition of larger shares in segments of the world market for manufactures, the relevant segments have to be identified by an agency other than individual firms. Through its financial policies, the state must ensure an adequate flow of credit at favourable interest rates to these entities so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the means to sustain themselves during the long period when they expand market share. The state must not merely play the role of investment coordinator; it needs to use the financial system to direct investment to sectors and technologies at appropriate scales of production. Equity investments and directed credit are important instruments in such a state-led or state-influenced development trajectory.

However, if the financial sector is left unregulated, in economies with substantial private assets and an important role for private agents in investment decision-making, market signals would determine the allocation of financial resources. This could mean that the demand for financial resources from crucial sectors would not be matched by supply because uneven development and inequality may imply that inadequate collateral is on offer, transaction costs are high and/or private returns in particular activities to financial entities are lower-than-expected even though the social returns from such activities are high.

Unregulated allocation of financial resources inevitably leads to the problems conventionally associated with a situation where private rather than social returns determine the allocation of savings and investment. To start with, the allocation of investment may not be in keeping with that required to ensure the profile of production needed to raise the rate of saving and investment. Further, certain sectors such as the rural sector in general or agriculture in particular and the small industrial sector may be largely excluded from formal sector credit provision on the grounds that the transaction costs associated with such lending are high or that default risk is greater. But the problem could go deeper. Unregulated financial entities could direct their investment financed with the savings of depositors to “sensitive” or risky sectors such

as real estate and stock markets. Loans to these sectors can be at extremely high interest rates because the returns in these sectors can touch very high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. These activities thrive because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

Two countries that used financial policies to further broadbased growth and ensure inclusion are India and Republic of Korea. In India, despite efforts to regulate and ensure social control over banking after Independence in 1947, even as late as the mid-1960s, only 2 per cent of bank credit was allocated to the agricultural sector even though it accounted for more than 40 per cent of GDP. Medium and large-scale industries on the other hand absorbed two-thirds of bank credit, even though they contributed only about one-tenth of the net domestic product (at 1960-61 prices) or less than 25 per cent of the gross value of output in the commodity producing sectors. To correct for this anomaly the government took the radical step of nationalising 14 major banks in 1969.

Much was achieved after bank nationalisation. The presence of nearly 62,000 bank branches in the country as of March 1991, of which over 35,000 (or over 58 per cent) were in rural areas, within a short span represented an unprecedented growth of commercial banking in terms of both geographical spread and functional reach. The system promoted financial intermediation of a high order, pushed up household saving in financial assets, extended vast investment and inventory credit to medium and large-scale industries in the private and public sectors, promoted new entrepreneurship, and also ensured access to credit to several million borrowers hitherto neglected, specially in agriculture, small-scale industry, small business and other informal sectors.

In the event, steady increases were recorded in the share of rural areas in aggregate deposits and credit. From 6.3 per cent in December 1969, the rural deposit share touched 15.5 per cent in March 1991 and the credit share rose from 3.3 per cent to 15.0 per cent. Historically underbanked regions, also underdeveloped economically, received special attention in the branch expansion programme of scheduled commercial banks until the 1990s. This was reflected in a sizeable reduction in the average population covered by each bank office in the under-banked and moderately-banked states.

Sectorally a major achievement of the banking industry in the 1970s and 1980s was a decisive shift in credit deployment in favour of the agricultural sector in particular. From an extremely low level at the time of bank nationalisation, the credit share of the sector had moved to nearly 11 per cent in the mid-1970s and to a peak of about 18 per cent at the end of the 1980s which was the official target. The share of the small-scale industrial sector in total bank credit also rose from 6.9 per cent in June 1968 to 12.0 per cent in June 1973.

Inclusive finance of this kind inevitably involves the spread of formal financial systems to areas where client densities are low and transaction costs are high. Further, to ensure sustainable credit up-take by disadvantaged groups, interest rates charged may have to diverge from market rates. This regime of differential or discriminatory interest rates may require policies of cross-subsidization and even government support to ensure the viability of chosen financial intermediaries. Intervention of this kind presumes a substantial degree of "social control" over commercial banks and development banking institutions. Public ownership provided the basis for such social control in India, as it did in many other countries.

Public ownership of banks also serves a number of overarching objectives:

- It ensures the information flow and access needed to pre-empt fragility by substantially reducing any incompatibility in incentives driving bank managers, on the one hand, and bank supervisors and regulators, on the other.
- By subordinating the profit motive to social objectives, it allows the system to exploit the potential for cross subsidization and to direct credit, despite higher costs, to targeted sectors and disadvantaged sections of society at different interest rates. This permits the fashioning of a system of inclusive finance that can substantially reduce financial exclusion.

By giving the state influence over the process of financial intermediation, it allows the government to use the banking industry as a lever to advance the development effort.

In the Republic of Korea, when Park Chung Hee assumed power in 1961, gross domestic saving was negative, gross investment was mainly financed by aid and accounted for barely 10% of GDP. After 2 years of poor economic performance, the new government introduced a series of reforms in the economy. After the amendment of the Bank of Korea Act in 1962, the Finance ministry had direct control over the Monetary Board of Korea, which was the supreme authority in deciding monetary policies in the country. The Finance Minister was made the de facto Chair of the Board, and had powers to ‘request’ the board to ‘reconsider’ decisions previously taken. The Central bank of Korea was thus not an autonomous institution but was an arm of the Finance Ministry, using which the state could directly intervene in the economy.

Further, all commercial banks were nationalized after the military coup of 1961 and the wealth and assets of these institutions, which were allegedly accumulated illicitly under the previous regime, confiscated. The direct authority over the Monetary Board along with nationalization of all commercial banks meant that the Finance Ministry had direct control over the approval of annual budgets, appointment of officials and their decisions regarding credit allocations. Effectively, the state controlled the entire banking system of Korea and used its institutions as credit rationing outlets in the economy. The logic for such strict control was that capital was scarce, warranting strict supervision to ensure efficient utilization. The aim was to generate capital accumulation via increased domestic savings. Long term trade credits and export orientation were also used as tools to drive economic development.

This structure played an important role in the implementation of Republic of Korea’s Promotion heavy and chemical industries (HCI) strategy, which required the financing of large-scale projects at cheap rates with what were known as ‘policy loans’. These loans carried negative real interest rates and the annual interest rate subsidy grew from about 3% of GNP (for the period 1962-71) to 10% of GNP (1972-79).

In order to successfully implement strict governmental industrial policies, it was essential for the government to restrict the number of financial institutions, so that they could be influenced if not controlled, and the manufacturing sector forced to resort to these limited institutions for funding. Alternate sources of funding too were intentionally stunted, as the government discouraged the development of an efficient auction and secondary market for government bonds and no swap, bond, or interest future markets were allowed to develop.

XI. SPECIALISED FINANCIAL INSTITUTIONS

However, the policy of restricting the number of financial institutions was accompanied by one of creating specialised development financial institutions providing long-term credit and special “policy loans”. To cover the shortfall in funds required for long-term investment, developing countries created *development banks* with the mandate to provide long-term credit at terms that render such investment sustainable. According to an OECD estimate quoted by Eshag (2000), there were about 340 such banks in some 80 developing countries in the mid-1960s. Over half of these banks were state-owned and funded by the exchequer; the remainder had mixed ownership or were private. While such institutions are essential for developing countries, they have fallen into disfavour in the recent past as part of the general move towards deregulation of finance and greater reliance upon private financial agents to fulfil all the roles of financial intermediation for development. However, it is a mistake to discard the role of such banks, because sustained growth requires not just an adequate volume of credit but an appropriate distribution of such credit, especially for the infrastructure sectors. Hence, specialised policy development banks are needed, with sources of finance other than deposits by small savers. While such institutions can be funded by the government or the central bank, government guarantees on borrowing by these entities is needed if adequate capital is to be mobilised. In addition, separate development banks are usually required to provide long-term capital at near-commercial rates and “policy banks” to provide credit to special areas such as agriculture or the small scale sector where interest rates have to be subsidized and grace periods have to be longer. This allows different criteria to be applied to the evaluation of the performance of these banks, with profitability a more important consideration in the case of the former.

While such institutions can be funded by the government or the central bank, government guarantees on borrowing by these entities are necessary if adequate capital is to be mobilised. In Vietnam, for example, the government continued with targeted lending for specific purposes even after the adoption of financial liberalisation policies. This involved the creation of a special Development Assistance Fund (DAF), separate from the commercial banking system, which had as its objectives: (i) the provision of subsidized state loans for medium to long-term investments in priority sectors such as infrastructure, heavy industry and public services, (ii) provision of interest-rate support and investment guarantees for chosen projects, and (iii) provision of short-term export promotion credit. Support in these forms can go to both private and state-owned enterprises, taking account of both commercial and policy criteria, such as encouraging investment in underdeveloped areas, preferential sectors, and projects related to health, education, culture and sport. The DAF has branches in all sixty-one provinces. Initially, the Office of the Prime Minister determined allocation of funds. Funds came from the Social Insurance Fund, the Sinking Fund, the Vietnam Postal Service Savings Company (VPSC), the government budget, loan repayments, and official development assistance (ODA). Subsequently, the DAF has been expected to mobilize its own resources. It continues to draw funds from the sources mentioned above, through negotiation. If funds come from the government budget, this usually involves issuance of investment bonds.

To sum up, the Asian experience suggests that in developing countries adopting a mixed economy framework where private initiative and investment are significant, the financial sector would have to play a major role in: (i) channelling large volumes of cheap capital to purposefully chosen units and agents; (ii) using the leverage provided by this activity to coordinate and

influence investment decisions and ensure that production occurs as per guidelines provided; (iii) ensuring that financial flows are inclusive and reach sectors and sections that would otherwise be bypassed or neglected; and (iv) regulating the sector so as to guard against financial fragility and failure.

XII. COPING WITH FINANCIAL FRAGILITY AND VOLATILITY

Despite the benefits that can be derived from regulated and state-controlled financial sectors, many developing countries including those in the Asia-Pacific opted for financial deregulation and liberalisation. It is now widely accepted that financial liberalization has resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. These relate both to internal banking and related crises, and currency crises stemming from more open capital accounts. The origin of several crises can be traced to the shift to a more liberal and open financial regime, since this unleashes a dynamic that pushes the financial system towards a poorly regulated, oligopolistic structure, with a corresponding increase in fragility. Greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure. In addition, the emergence of universal banks or financial supermarkets increases the degree of entanglement of different agents within the financial system and increases the domino effects of individual financial failures.

Thus, it was no accident that all the emerging market economies experiencing substantial financial capital inflows also experienced property and real estate booms, as well as stock market booms around the same time, even while the real economy may have been stagnating or even declining. These booms, in turn, generated the incomes to keep domestic demand and growth in certain sectors growing at relatively high rates. This soon resulted in signs of macroeconomic imbalance, not in the form of rising fiscal deficits of the government, but a current account deficit reflecting the consequences of debt-financed private profligacy.

However, once there is growing exposure in the form of a substantial presence of internationally mobile finance capital, any factor that spells an economic setback, however small or transient, can trigger an outflow of capital as well. And the current account deficits that are necessarily associated with capital account surpluses (unless there is large reserve accumulation) eventually create a pattern whereby the trends becomes perceived as an unsustainable one, in which any factor, even the most minor or apparently irrelevant one, can trigger a crisis of sudden outflows.

One very common conclusion that has been constantly repeated since the Southeast Asian financial crisis in mid-1997 is the importance of “sound” macroeconomic policies, once financial flows have been liberalized. It has been suggested that many emerging markets have faced problems because they allowed their current account deficits to become too large, reflecting too great an excess of private domestic investment over private savings. This belated realization is a change from the earlier obsession with government fiscal deficits as the only macroeconomic imbalance worth caring about, but it still misses the basic point.

But with unregulated capital flows, it is not possible for a country to control the amount of capital inflow or outflow, and both movements can create consequences that are undesirable. If, for example, a country is suddenly chosen as a preferred site for foreign portfolio investment, it can lead to huge inflows which in turn cause the currency to appreciate, thus encouraging investment in non-tradeables rather than tradeables, and altering domestic relative prices and therefore incentives. Simultaneously, unless the inflows of capital are simply (and wastefully) stored up in the form of accumulated foreign exchange reserves, they must necessarily be associated with current account deficits.

Large current deficits are therefore necessary by-products of the surge in capital inflow, and that is the basic macroeconomic problem. This means that any country which does not exercise some sort of control or moderation over private capital inflows can be subject to very similar pressures. These then create the conditions for their own eventual reversal, when the current account deficits are suddenly perceived to be too large or unsustainable. In other words, what all this means is that once there are completely free capital flows and completely open access to external borrowing by private domestic agents, there can be no “prudent” macroeconomic policy; the overall domestic balances or imbalances will change according to the behaviour of capital flows, which will themselves respond to the economic dynamics that they have set into motion.

XIII. A ROLE FOR CAPITAL CONTROLS

One country that was seen as having weathered the East Asian crisis well and sustained high growth is China. This was because of the policy of capital controls adopted in this period to protect domestic policy from the influence of volatile capital flows. The controls involved inter alia:

- Well defined borrowing limits and limits on inflows of foreign capital in keeping with national economic planning.
- A preference for foreign direct investment (FDI) among capital flows
- Stringent restrictions on short-term borrowing to ensure stability of capital inflows.
- Restrictions on foreign investments in stock markets. Foreign investors were prohibited from using the RMB to invest in the stock exchanges inside China and were allowed to use foreign exchanges to invest inside the mainland only in the so-called B shares. Moreover, the total amount of B shares floated each year must be within the quotas set by the government.
- Only a small number of Chinese companies were allowed to list abroad in the in New York and Hong Kong (The shares they sell are called N shares and H shares, respectively).

These controls served China well as the experience during the 1997 crisis showed.

Thailand's experience to the contrary in the middle of the last decade is telling. On December 19th, 2006 the stock market in Thailand collapsed after the government introduced limited market-based capital controls aimed at stalling the rapid appreciation of the Thai baht. The collapse was the result of the decision made by a bunch of foreign investors to dump their holdings in the Thai stock market. The stock exchange of Thailand (SET) index fell 15 per cent in a single day, losing much of the gains it had registered over the previous year. The collapse forced the government to retreat by limiting its intervention, raising questions about policy sovereignty in developing countries that have opened their financial markets to flows of portfolio capital.

The controls on cross-border capital inflows were imposed by the government in a bid to reverse a runaway appreciation of the Thai baht. The baht, which stood at 41.28 baht to the dollar at the beginning of December 2005, had been on a near-consistent climb since then, to touch a 9-year high of 35.18 at the middle of December 2006. The reason for this appreciation was a surge in capital inflows into equity securities over two years, with gross inflows amounting to between \$8 and \$12 billion per quarter. Even though outflows were considerable as well, there was a significant net inflow into the country. Flows of this magnitude were not needed to finance Thailand's balance of payments, which recorded small current account surpluses or small deficits in most quarters.

These flows proved a problem because, after the last crisis, Thailand moved to a floating exchange rate, so that any excess supply of dollars results in an appreciation of the currency. Exchange rate management in such situations involves intervention by the central bank to acquire foreign currency and reduce the pressure on the local currency. Clearly, the Bank of Thailand had resorted to this instrument in large measure. As a result, Thailand's international reserves rose by more than \$11 billion (starting from around \$53 billion) in the first 11 months of 2006.

The dangers of piling up reserves to stabilize the currency are well known. It results in an excessive accumulation of foreign exchange assets with the central bank reducing its control over money supply. Further, it can never completely prevent appreciation. Foreign investors, skeptical of the ability of the central bank to keep the currency down, would make speculative investments to benefit from an appreciation of the currency. Investments made by converting dollars into baht, when redeemed, would not merely deliver capital gains because of stock value appreciation, but an additional gain in dollar terms when baht receipts are converted back into dollars, because of appreciation of the baht. As more and more investors troop in to capture these benefits, the market and the baht are likely to appreciate, fuelling further speculative investments.

Speaking on radio immediately after the imposition of capital controls, Bank of Thailand Governor Tarisa Watanagase reported that returns on investments in Thailand were around 20 per cent, of which just 5 per cent came from capital gains, whereas 15 per cent came from gains from Baht appreciation. The speculation this had triggered had meant that

speculative capital inflows had risen to US\$950 million per week in December 2006 from \$300 million in November.

In the event the baht appreciated quite sharply. The danger from such appreciation is a loss of export competitiveness. To prevent the baht from breaking through the 35-to-the-dollar floor, the central bank crafted a cautious set of market-based measures aimed at preventing short term inflows from investors planning to hold their investments for less than a year in search of speculative returns. The measure amounted to imposing a reserve requirement on all *incremental, short-term* capital flows. As per the policy announced on December 19, 2006, financial institutions were required to withhold (as a no interest deposit) for a year, 30 per cent of foreign currencies bought or exchanged against the baht, except those related to trade in goods and services, or repatriation of investments abroad by residents. After a year, investors could request and obtain a refund of the reserve after submitting evidence of having held their investments for a year. Should an investor wish to sell out and repatriate funds earlier than one year, s/he will be refunded only two-thirds of the amount brought in. What is important to note is that foreign exchange transactions that had occurred prior to December 19, 2006 were exempt from this reserve requirement. Foreign direct investments or unrequited transfers too were obviously exempt.

Clearly, the Bank of Thailand was operating with the expectation that these measures would have no major impact on past investments, while simultaneously limiting purely speculative short-term investments in future. Its expectations were possibly based on three grounds. First, there was no quantitative control on the amount of flows, but merely intervention to reduce the returns on speculative short term flows. Such reserve requirement measures—identified as market-based capital controls—had been experimented with successfully in other contexts such as Chile, in the past. Second, the penalty being imposed even on speculative flows was small. Tarisa Watanagase reportedly estimates that investors' profits would be trimmed by around 1.5 per cent as a result of the introduction of the reserve measure, which was a small part of the 20 per cent return they were making. Finally, the Bank of Thailand seems to have expected that the measure would bother only new investors, since it was not applicable to transactions completed before December 19, 2006.

In practice, however, there was not just a sharp cutback in incremental investments but a sellout by existing investors. Once we accept that a substantial share of the surge in capital inflows was speculative, then the panic exit was to be expected. Speculative investments are made not on the basis of where the value of a stock index or the value of a currency rests, but expectations of where they are headed. The latter expectations, with regard to the direction and extent of future movements, are in turn based on presumptions of how much new liquidity would come into the market. Thus, if controls are placed on new, incremental investment, this does not mean that investors who came in earlier would not respond. Since their investments were made on expectations of future capital inflows, they are bound to adjust their portfolios in the new environment. That is what triggered the exit of investors and the collapse of the market.

This obviously suggests that countries that have been operating with a relatively open capital account and have accumulated a stock of portfolio investment cannot plan capital control measures directed purely at new inflows. If such measures have to be successful they have to place restrictions on outflows as well. In Thailand's case the failure to do this resulted in an outflow, a collapse of the market and a decision of the central bank to "partially" relax the reserve requirement rule by exempting equity investments from its ambit and promising to do the same for property purchases. However, much the government and the central bank may protest, this retreat amounted to an almost complete withdrawal of the measures since most of the speculative flows came into these two areas. In sum, the effort to stem the appreciation of the baht had been aborted, leaving the problem unresolved.

If there is consensus on the policy but it cannot be implemented, the signs are clearly of a loss of policy sovereignty. Thailand, like other developing countries that have liberalised their capital accounts to differing degrees, found it difficult to even marginally reverse the extent of liberalization even though the evidence clearly shows that the economy is now being held to ransom by speculators.

Besides making a case for capital controls in some form, now recognised by the IMF as well, these experiences point to a new challenge to development. With most developing countries having opted for financial liberalisation in recent years, many have become home to a large cumulative stock of foreign financial capital. This does make resort to capital controls difficult to implement. To the extent such controls are needed to create the domestic policy space needed to adopt appropriate policies for enhancing growth and improving welfare, this also constrains the development effort in the current conjuncture.

XIV. ROLE FOR REGIONAL COOPERATION

Strategies based on growth led by domestic markets, which seek to avoid the vulnerabilities associated with large cross-border capital flows, can benefit a great deal from regional cooperation. Not all countries have domestic markets that are large enough to permit adequate diversification in favour of manufacturing, which exploit technologies characterised by significant economies of scale. If they then have to build a significant domestic manufacturing base, as happened in Taiwan and Singapore, they would necessarily be over-dependent on export markets. That, as we noted earlier, can be a disadvantage in the long run. However, if such trade dependence is based on a regionally coordinated strategy in which countries share regional markets and distribute regional capacities among themselves, trade dependence can be exploited by those that need to, while trade can deliver adequately large markets for countries seeking to maximise the benefits from establishing a domestic manufacturing base. This strategy of moving industrial policy from a national to a regional level would also reduce the extent to which the benefits of local markets "leak" out of the region.

Another way in which regional cooperation can be used to facilitate stable growth is through regional financial cooperation aimed at reducing the vulnerability resulting from the

accumulated stock of foreign capital inflows. By pooling reserves and formalising swap arrangements, individual countries faced with capital flight and currency volatility can insure themselves against debilitating crisis of the kind experienced in the region in 1997. Moreover, during the period when countries seek to transit to a regime of tighter capital controls, they can insulate themselves from the effects of any large scale exit of foreign capital, till such time as matters stabilise. The Asian region already has experimented with such an arrangement, with initiatives such as the Chiang Mai Initiative. The size of that initiative is as yet inadequate in terms of funding and the swap arrangement specifies that 80 per cent of funds provided would be subject to conditions determined by the IMF. Those conditions may not be in the interests of the countries concerned or of the region. However, these and other weaknesses can be corrected and cooperation advanced.

A third area of cooperation that can serve macroeconomic goals such as demand and employment generation as well as facilitate industrialisation is investment in infrastructure. Here too ASEAN countries have finalised details and launched an ASEAN infrastructure fund with support from the Asia Development Bank. The initial equity investment in the fund has been targeted at \$485 million and as of now the maximum support for a single project has been set at \$75 million. This too can be substantially enhanced and the membership widened as part of a new design to reinvigorate a region that has performed well over many years.

Finally, there are significant emerging opportunities for regional co-operation in the realm of knowledge creation and dissemination. In a world in which intellectual property rights still largely controlled by Northern multinational companies have emerged as a major constraint on development, there are immense possibilities for technology sharing and even co-ordinating technology development, to ensure access to the most frontline technologies as well as to develop knowledge that is more relevant for the specific problems faced by the countries in this region. This is also important for the development of “green” and carbon-emission reducing technologies as well as adaptation to the implications and effects of climate change that are already having an impact on many countries in the region. Once again, this requires going beyond purely private initiatives to developing and strengthening public structures that can encourage such regional and South-South co-operation.

XV. SOME LESSONS

The above discussion highlights the importance of a wide array of macroeconomic policies adopted in various Asia-Pacific economies in delivering broadbased growth with positive implications for employment and poverty reduction. However, there are three overarching lessons that, in particular, warrant emphasising. The first is that while developing countries as late industrialisers do not have much of an option to opt out of integration, such integration should be pursued with moderation. Excessive export dependence, even if it delivers success for an extended period, finally generates structures that work to subvert the growth process, as the Southeast Asian experience illustrated and the Chinese experience is pointing to. What is needed is a judicious combination of growth based in both external and domestic markets. The second is that while structural diversification in favour of

manufacturing delivers much benefit, even in successful countries financial liberalisation justified as the basis for shifting to services led growth can be extremely damaging. It would be even more damaging if adopted before diversification away from primary production to manufacture has been adequately realised. Third, though these are lessons that should be learnt, the fact that many countries in the region have for various reasons traversed the path to financial liberalisation implies that they are home to structures which make appropriate policy difficult to pursue. If a government chooses to pursue a domestic market-oriented and equity-based strategy of development, one requirement would be relatively strong controls on the cross-border flow of capital into and out of the country. But, accumulated legacy foreign capital is a burden that makes the adoption of such initiatives difficult and, therefore, sets limits on macroeconomic policy making.

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