



The Lessons of East Asian Development: An Overview

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Source: *Economic Development and Cultural Change*, Apr., 1988, Vol. 36, No. 3, Supplement: Why Does Overcrowded, Resource-Poor East Asia Succeed: Lessons for the LDCs? (Apr., 1988), pp. S273-S290

Published by: The University of Chicago Press

Stable URL: <https://www.jstor.org/stable/1566546>

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The Lessons of East Asian Development: An Overview

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Introduction

The East Asian area encompasses countries at widely different levels of economic development.¹ There is first of all Japan, the only developed country of the group, with per capita incomes of \$7,130 in 1985 in terms of purchasing power parities at 1975 prices.² In the same year, it had a population of 120 million.

There follow the four Far Eastern newly industrializing countries (NICs: Hong Kong, Korea, Singapore, and Taiwan) that have been called the Gang of Four and, more gently, the Four Little Tigers by the Chinese. In fact they are small in relation to China, but not with respect to a large number of developing countries as their populations range from 40 million (Korea) to 3 million (Singapore), with Taiwan (19 million) and Hong Kong (5 million) in between. The ranking by per capita incomes is just the opposite: Singapore leads with \$5,001, followed by Hong Kong (\$3,760), Taiwan (\$3,160), and Korea (\$2,648); all four of them belong to the group of higher middle-income developing countries under the World Bank classification scheme.

Next come the countries of Southeast Asia, which, together with Singapore, are the founding members of the Association of South Asian Nations (ASEAN). They include, with per capita incomes in parentheses, Malaysia (\$2,579), Thailand (\$1,393), the Philippines (\$896), and Indonesia (\$789). The ranking by population is again the opposite: Indonesia (159 million) is followed by the Philippines (53 million), Thailand (50 million), and Malaysia (15 million). According to the World Bank classification scheme, Malaysia belongs to the upper middle-income group and the other three countries to the lower middle-income group.

Further interest attaches to changes over time. Between 1950 and 1985, per capita incomes rose ninefold in Japan and approximately sixfold in the Far Eastern NICs. In turn, per capita incomes quad-

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0013-0079/88/3603-0089\$01.00

rupted in Malaysia, nearly tripled in Thailand and Indonesia, and doubled in the Philippines. Correspondingly, in 1950, Japan, Singapore, Hong Kong, and Malaysia would have been classified lower middle-income countries by the World Bank while all other East Asian countries would have been in the low income group.

These achievements are quite extraordinary, in particular if comparisons are made with other developing countries. The four Far Eastern NICs surpassed or, at least, caught up with Argentina, Uruguay, and Venezuela, the high-income Latin American countries, where incomes per head increased by less than one-half during the 1950–85 period. Apart from the Philippines, the Southeast Asian countries also did well in comparison with other Latin American countries, among which only Brazil achieved a tripling of per capita incomes between 1950 and 1985, followed by an approximate doubling in Colombia and Mexico. Comparison may also be made with India, which had seemed poised for economic progress at the time of independence but barely achieved a two-third increase in per capita incomes between 1950 and 1985.

But what are the reasons for the favorable record of the East Asian countries? I will consider this question in the following, with reference made to cultural and social factors as well as to the economic policies applied.

Cultural and Social Factors

People delight in putting forward *ex post* explanations, or rationalizations, for observed phenomena. Economists are no exception. Those who have failed to understand, nay foresee, actual developments because of faulty or inadequate economic reasoning fall back on noneconomic explanations, just as our ancestors thought to find the causes of lightning and thunder in the supernatural.

Explaining intercountry differences in economic growth rates is no exception. With little knowledge, but fertile imagination, economists have wandered onto the fields of cultural and social phenomena when their models have failed them. Several examples can be given for such “*ex post hoc*cery” in the context of East Asian economies.

First, the Chinese factor. Indeed, Hong Kong, Singapore, and Taiwan are Chinese, and the Chinese minorities in Indonesia, Malaysia, the Philippines, and Thailand have had an important, if not dominant, role in the economic life of these countries. By extension, Japanese and Koreans are included in the explanation in a modern version of the “yellow peril.”

As to the Chinese themselves, few explanations have been offered for the success of the emigrés in contradistinction to the lack of economic development of their homeland over the centuries. But the Chinese are not the only success stories in faraway lands. The Indians, the

Levantines, and the Irish have also done well economically in countries where the environment, or policy framework, was propitious.

And how about the economic success of Taiwan, where the Chinese have been living for centuries? Economic progress has come after a long period of unspectacular development as evidenced by the low level of per capita incomes after the war. It has come unpredicted by economists, following a fundamental change in policies.

James Grant, a former director of the Overseas Development Institute and presently the head of UNICEF, tells the story of how hopeless the case of Taiwan appeared to foreign observers at the time when policy changes were instigated. In late 1959, people in Washington were searching for a country that would adopt outward-oriented policies in exchange for initial help by the United States, a bargain to be announced in President Eisenhower's January 1960 State of the Union message. As the Agency for International Development (AID) representative in Taipei was informed of the choice of Taiwan, his reply was to pour cold water on the plans: "You are out of your mind. These Chinese are only interested in commerce; they will never go into manufacturing for export." After long—and acrimonious—exchanges, however, the AID representative was overruled, and the choice was made for Taiwan. The rest is history.

In offering an *ex post* rationalization for the success of (South) Korea, people also tend to forget the dire predictions made about this country less than a generation ago. Cut off from industry in the North, saddled with abject poverty, it was considered a hopeless basket case in the writings of the time, including World Bank reports. I recently spoke to an Indian who, having revisited Korea after 30 years, marveled at the progress made and compared it with the case of her own country.

And how about Japan? Today's praise for the superior characteristics of the Japanese contrast with the description contained in a report prepared by a foreign expert at the request of the Government of Japan and published in the *Japan Times* on August 18, 1915:

Japan commercially, I regret to say, does not bear the best reputation for executing business. Inferior goods, irregularity and indifferent shipments have caused no end of worry. . . . My impression as to your cheap labour was soon disillusioned when I saw your people at work. No doubt they are lowly paid, but the return is equally so; to see your men at work made me feel that you are a very satisfied easy-going race who reckon time is no object. When I spoke to some managers they informed me that it was impossible to change the habits of national heritage.³

And how about the Confucian ethic? Can one say that this common heritage of the Chinese, Japanese, and Koreans explains their economic success? We again find a particular case of hindsight as when

the 1950s' economic stagnation in Japan and Korea was routinely attributed to their Confucian heritage, which was also considered a hindrance to economic development in China.⁴

At the same time, there are a number of cases of successful reforms without changes in cultural and social conditions, in East Asia and elsewhere. They include, first of all, the reforms of the early 1960s in Korea and Taiwan, where large exchange rate changes, accompanied by export subsidization and import liberalization and by the establishment of realistic interest rates, contributed to rapid economic progress after the stagnation of earlier years.

A more recent case is that of Turkey, where the policy reforms of January 1980 included a large devaluation, export subsidization, and decontrol of prices, followed by import liberalization and increases in interest rates. These reforms led to a shift from virtual bankruptcy to creditworthiness in international financial markets, as rapid increases in exports generated a substantial improvement in the balance of payments and high rates of economic growth.

The experience of these countries may be considered to be the result of "controlled experiments" in the sense that the economic changes that have occurred have followed changes in policies, with cultural and social conditions remaining the same. They thus point to the importance of policies, an issue I will pursue next.

Exports and Economic Growth

Economic growth rates appear to be correlated with the growth of exports. To begin with, the Far Eastern NICs, which had the highest GDP growth rates, attained much more rapid rates of export expansion than comparable developing countries elsewhere. This is apparent from table 1, which provides data on nonfuel exports for these four countries, for the countries of Southeast Asia, and for the three large Latin American NICs (Argentina, Brazil, and Mexico), as well as for India.⁵

Between 1963 and 1984, Korea's share in the nonfuel exports of the 12 countries under consideration increased from 0.9% to 17.3% while Taiwan's share rose from 3.6% to 18.2%. Smaller increases are shown for Singapore (from 3.6% to 4.9%) and for Hong Kong (from 7.3% to 10.6%), which already had large exports relative to their size in 1963.

It is noteworthy that the increases were not limited to manufactured goods. Thus, both Korea and Taiwan gained market shares in nonfuel primary products as well. (Data for Hong Kong and Singapore are of limited importance as they largely relate to simply processed food and raw materials, which are included with primary products.)

At the other extreme, India's market share in the export of nonfuel products by the 12 countries fell from 17.1% in 1963 to 4.4% in 1984.

The decline was particularly pronounced, from 34.0% to 3.7%, in manufactured goods, but it also extended to primary products.

Among the three large Latin American NICs, Brazil's market share in nonfuel exports rose from 15.3% in 1963 to 16.2% in 1984, with the increases being especially large for manufactured goods (from 2.1% to 10.2%). In turn, Argentina lost export market shares in both nonfuel primary and manufactured goods, leading to a fall in its average share from 14.8% to 4.7% during the period. Similar conclusions apply to Mexico, except that the losses were smaller in this case, with its average market share in nonfuel primary exports declining from 9.0% in 1963 to 5.4% in 1984.

The Southeast Asian countries are at a lower level of development than the Far Eastern or Latin American NICs. Correspondingly, they had a much smaller share of manufactured exports at the beginning of the period. This fact explains the relative decline of their exports of nonfuel products, notwithstanding the gains they attained in export market shares in both nonfuel primary and in manufactured goods.

The Philippines provides an exception to the latter statement as it experienced substantial losses of export market shares in nonfuel primary products. It also had smaller increases in the exports of manufactured goods than the other three Southeast Asian countries.

The existence of a positive relationship between export expansion and economic growth has been reconfirmed by cross-section estimates for developing countries.⁶ And while it has been noted that the two variables are intercorrelated as exports are included in GDP,⁷ exports represent alternative allocations of resources under full employment and involve the use of otherwise unutilized resources in a situation of unemployment. Correspondingly, the estimated relationship does indicate the beneficial effect of exports on economic growth. Furthermore, a positive correlation has been obtained also in correlating exports with the growth of output net of exports.⁸

These procedures abstract from the fact that exports and output are affected simultaneously by other variables, such as increases in the capital stock and in the labor force. C. Michalopoulos and K. Jay attempted to remedy this deficiency by introducing domestic and foreign investment and labor as explanatory variables, together with exports, to explain intercountry differences in GDP growth rates for 39 developing countries in the 1960–66 period.⁹ The inclusion of exports in a production function–type relationship was designed to test for the favorable effects of export expansion on output growth.

While intercountry differences in domestic and foreign investment and in the growth of the labor force explained 53% of the intercountry variation on GNP growth rates, adding the export variable raised the coefficient of determination to 0.71. Applying the same procedure to pooled data of nine semi-industrial countries for the 1960–66 and 1966–

TABLE 1

DOLLAR VALUE OF NONFUEL EXPORTS AND EXPORT MARKET SHARES FOR
10 DEVELOPING COUNTRIES (in current prices)

	NONFUEL PRIMARY PRODUCTS		MANUFACTURED GOODS		NONFUEL PRODUCTS	
	\$million	%	\$million	%	\$million	%
1963:						
Far Eastern NICs:	469	6.6	938	47.6	1,407	15.4
Hong Kong	53	.7	615	31.2	668	7.3
Korea	45	.6	39	2.0	84	.9
Singapore	168	2.3	158	8.0	326	3.6
Taiwan	203	2.8	126	6.4	329	3.6
Southeast Asia:	2,499	34.9	95	4.8	2,596	28.4
Indonesia	425	5.9	2	.1	428	4.7
Malaysia	955	13.3	49	2.5	1,004	11.0
Philippines	683	9.5	33	1.7	716	7.8
Thailand	436	6.1	11	.6	448	4.9
Latin American NICs:	3,303	46.1	267	13.5	3,570	39.1
Argentina	1,275	17.8	78	4.0	1,353	14.8
Brazil	1,352	18.9	42	2.1	1,394	15.3
Mexico	676	9.4	147	7.5	823	9.0
India	888	12.4	671	34.0	1,559	17.1
Total	7,159	100.0	1,971	100.0	9,132	100.0
LDC Total	18,460	...	3,430	...	21,890	...
1973:						
Far Eastern NICs:	1,406	7.7	11,016	66.5	12,422	35.6
Hong Kong	125	.7	3,650	22.0	3,775	10.8
Korea	473	2.6	2,700	16.3	3,173	9.1
Singapore	108	.6	998	6.0	1,106	3.2
Taiwan	700	3.8	3,668	22.2	4,368	12.5
Southeast Asia:	6,738	36.8	929	5.6	7,667	22.0
Indonesia	1,533	8.4	61	.4	1,594	4.6
Malaysia	2,511	13.7	347	2.1	2,858	8.2
Philippines	1,493	8.2	277	1.7	1,770	5.1
Thailand	1,201	6.6	244	1.5	1,445	4.1
Latin American NICs:	8,809	48.1	3,050	18.4	11,859	34.0
Argentina	2,527	13.8	730	4.4	3,257	9.3
Brazil	4,779	26.1	1,217	7.4	5,996	17.2
Mexico	1,503	8.2	1,103	6.7	2,606	7.5
India	1,353	7.4	1,561	9.4	2,914	8.4
Total	18,306	100.0	16,556	100.0	34,862	100.0
LDC Total	42,349	...	22,945	...	65,294	...
1980:						
Far Eastern NICs:	4,881	9.8	50,962	69.9	55,843	45.6
Hong Kong	460	.9	13,079	17.9	13,539	11.0
Korea	1,727	3.5	15,622	21.4	17,349	14.2
Singapore	584	1.2	4,833	6.6	5,417	4.4
Taiwan	2,110	4.2	17,428	23.9	19,538	15.9
Southeast Asia:	21,081	42.4	6,467	8.9	27,545	22.5
Indonesia	5,633	11.3	501	.7	6,134	5.0
Malaysia	7,277	14.7	2,427	3.3	9,704	7.9

TABLE 1 (Continued)

	NONFUEL PRIMARY PRODUCTS		MANUFACTURED GOODS		NONFUEL PRODUCTS	
	\$million	%	\$million	%	\$million	%
Philippines	3,595	7.2	1,935	2.7	5,530	4.5
Thailand	4,577	9.2	1,604	2.2	6,181	5.0
Latin American NICs:	20,647	41.6	11,069	15.2	31,716	25.9
Argentina	5,883	11.8	1,857	2.5	7,740	6.3
Brazil	12,005	24.2	7,492	10.3	19,497	15.9
Mexico	2,759	5.6	1,720	2.4	4,479	3.7
India	3,054	6.1	4,404	6.0	7,458	6.1
Total	49,663	100.0	72,902	100.0	122,562	100.0
LDC Total	106,918	...	98,763	...	205,681	...
1984:						
Far Eastern NICs:	5,117	10.0	78,666	69.7	83,783	51.1
Hong Kong	542	1.1	16,913	15.0	17,455	10.6
Korea	1,737	3.4	26,681	23.7	28,418	17.3
Singapore	670	1.3	7,374	6.5	8,044	4.9
Taiwan	2,168	4.2	27,698	24.6	29,866	18.2
Southeast Asia:	17,890	34.9	12,040	10.7	29,931	18.2
Indonesia	3,839	7.5	2,201	2.0	6,041	3.7
Malaysia	7,109	13.9	4,411	3.9	11,520	7.0
Philippines	2,162	4.2	3,002	2.7	5,164	3.1
Thailand	4,780	9.3	2,426	2.2	7,206	4.4
Latin American NICs:	25,218	49.2	17,908	15.9	43,126	26.3
Argentina	6,353	12.4	1,420	1.3	7,773	4.7
Brazil	14,937	29.2	11,558	10.2	26,495	16.2
Mexico	3,928	7.7	4,930	4.4	8,858	5.4
India	3,006	5.9	4,183	3.7	7,189	4.4
Total	51,231	100.0	112,797	100.0	164,029	100.0
LDC Total	99,095	...	146,986	...	246,081	...

SOURCE.—United Nations, *Commodity Trade Statistics*, various issues.

NOTE.—Nonfuel primary products include Standard International Trade Classification (SITC) classes 0 + 1 + 2 + 4 + 68; manufactured goods comprise SITC classes 5 to 8 less 68.

73 periods, I found that adding export variables increased the explanatory power of the regression equation from 58% to 77%.¹⁰ Subsequently, G. Feder separated the effects of exports on economic growth into two parts—productivity differentials between export and nonexport and externalities generated by exports—and obtained highly significant results for broadly as well as for narrowly defined categories of semi-industrial countries for the 1964–77 period.¹¹

The cited estimates refer to the period of rapid growth in the world economy. Further interest attaches to the question as to whether these results hold up in the subsequent period of external shocks, in the form of the quadrupling of oil prices and the world recession. Applying

production function estimation to the 1973–78 period, the earlier findings on the importance of exports for economic growth have again been reconfirmed.

Data available for 43 developing countries have further permitted analyzing the implications for economic growth of export orientation at the beginning of the period of external shocks and of policy responses to external shocks in the 1973–78 period. The extent of export orientation in the initial year has been defined in terms of deviations of actual from hypothetical per capita exports, the latter having been estimated by reference to per capita incomes, population, and the ratio of mineral exports to GNP. In turn, alternative policy responses have been defined as export promotion, import substitution, and additional net external financing.¹²

The impact of export orientation on economic growth is indicated by the existence of a difference of one percentage point in GNP growth rates between developing economies in the upper quartile and the lower quartile of the distribution in terms of their export orientation. Furthermore, a difference of 1.2 percentage points in GDP growth is obtained in comparing the upper and lower quartiles of the distribution as regards reliance on export promotion, as against import substitution and additional external financing.¹³

The results are cumulative, indicating that both initial export orientation and reliance on exports in response to external shocks contributed significantly to economic growth in developing countries during the period under consideration. These factors explain a large proportion of intercountry differences in GNP growth rates in the 1973–78 period, with a difference of 3.2 percentage points between the upper quartile and the lower quartile of the distribution in the 43 developing countries.

Factors Affecting Economic Growth

There are various reasons for the favorable effects of exports on economic growth. First of all, exports contribute to resource allocation according to comparative advantage. At the same time, these gains cumulate over time as the efficiency of new investment is enhanced through its orientation toward industries that correspond to the comparative advantage of the countries concerned.

Also, exports make it possible for developing countries to overcome the limitations of their domestic markets in exploiting economies of scale and ensuring full capacity utilization. In this way, developing countries can avoid the dilemma of building ahead of demand and operating with a low degree of capacity utilization or constructing less than optimal size plants. This dilemma arises under traditional economies of scale, which entail reductions in production costs with in-

creases in plant size in industries producing standardized products, such as steel, copper, and newsprint.

Other forms of economies of scale include cost reductions obtainable through horizontal specialization (involving reductions in product variety as in the case of machine tools) and vertical specialization (involving the manufacture of parts, components, and accessories in separate establishments as in the case of automobiles) in differentiated products. These forms of specialization can also be exploited through exports.

But, even in cases when a country's domestic market can provide for the exploitation of economies of scale and full capacity utilization, it will rarely permit effective competition leading to the establishment of monopolies and oligopolies. It has been observed that such firms prefer "quiet life" to innovative activity that entails risk and uncertainty. In turn, "the carrot and the stick" of competition provides inducement for technological change in export industries that have to keep up with modern technology in order to maintain and to improve their market position.

These conclusions are supported by empirical evidence. Thus, export expansion has been shown to be positively, and import substitution negatively, correlated with changes in total factor productivity (i.e., the productivity of the factors of production combined) in 13 Korean, Turkish, and Yugoslav industries during the period preceding the quadrupling of oil prices in 1973.¹⁴

The growth of total factor productivity also appears to be correlated with the growth of exports in intercountry relationships. Estimates of total factor productivity for a large number of countries are summarized by Hollis Chenery whose results are cited below.¹⁵

Estimates pertaining to the post-1960 period show Japan in the lead, with increases in total factor productivity averaging 4.5% a year. Japan is followed by Hong Kong, 4.3%; Korea, 4.1%; and Taiwan, 3.1%. And while no change is shown for Singapore, the data on the extremely rapid increase of the capital stock are suspect.

Among the Southeast Asian countries, estimates of total factor productivity are available only for the Philippines. They show an increase of 2.5% a year, exceeding the 2.0% average for all developing countries. With economic growth rates in the other Southeast Asian countries being substantially higher than in the Philippines, it may be assumed that their growth rates of total factor productivity are similarly higher than the average.

In turn, among the major Latin American countries, total factor productivity growth approximately equals the developing country average in Colombia (2.1%), with Brazil (1.6%) and Argentina (0.7%) being below the average. And although Mexico matched Brazil's per-

formance until 1974, more recent estimates made at the World Bank show a decline in total factor productivity. The same result obtains for India for the 1960s and the 1970s.

Calculations of total factor productivity assume that capital as well as labor are valued at their opportunity costs. Sir Arthur Lewis suggested that such was not the case by reason of the existence of surplus labor in the developing countries. Now, an extreme assumption is that labor has zero opportunity cost. In such an event, the productivity of capital would be the relevant variable.

Incremental capital-output ratios may be used as a proxy, however imperfect, for the productivity of capital. In the 1963–85 period, these ratios were the lowest in Indonesia, Taiwan, Korea, and Thailand, followed by Hong Kong, Singapore, Malaysia, Mexico, and Brazil, with the latter two countries experiencing a doubling between 1963–73 and 1973–85.¹⁶ The ratios were the highest in India, the Philippines, and Argentina (table 2).

In turn, the Far Eastern NICs other than Korea, as well as Indonesia and Malaysia, had the highest domestic savings ratios. They were followed by Brazil, Thailand, Korea, the Philippines, Mexico, and Argentina, while savings ratios were by far the lowest in India. And Korea exhibited one of the highest domestic savings ratios in the second half of the period (32.5% in 1973–84, compared with 11.7% in 1963–73).

The Policies Applied

The next question concerns the choice of policies that have contributed to differential economic performance among the countries concerned. This question may be dealt with by comparing the policies applied by the Latin American and the Asian NICs and further examining the policies followed by the Southeast Asian countries and India.

Apart from Hong Kong, all developing countries passed through the first stage of import substitution, involving the replacement by domestic production of imports of nondurable consumer goods and their inputs. The manufacture of these products, including clothing and textiles, shoes and leather, and furniture and wood, conform to the production possibilities of the developing countries. They utilize in large part unskilled labor, involve the use of simple production processes, are not subject to important scale economies, and do not require the existence of a sophisticated industrial structure.

Once the first stage of import substitution has been completed, however, the rate of growth of industrial production cannot continue to exceed that of consumption. Now, countries face two choices: embarking on the exportation of nondurable consumer goods and their inputs or moving to the second stage of import substitution, entailing the replacement by domestic production of imports of producer and

TABLE 2
ECONOMIC GROWTH RATES, SAVINGS SHARES, AND INCREMENTAL CAPITAL-OUTPUT RATIOS

	1963-73				1973-85				1963-85			
	$\Delta Y/Y$	$\frac{\Delta(Y/P)}{(Y/P)}$	S/Y	ICOR	$\Delta Y/Y$	$\frac{\Delta(Y/P)}{(Y/P)}$	S/Y	ICOR	$\Delta Y/Y$	$\frac{\Delta(Y/P)}{(Y/P)}$	S/Y	ICOR
Far Eastern NICs:												
Hong Kong	8.2	6.0	34.5	3.6	8.7	6.3	31.7	4.3	8.5	6.2	32.4	4.1
Korea	9.6	7.1	11.7	2.0	7.3	5.7	26.3	4.3	8.7	6.8	22.8	3.6
Singapore	11.6	9.5	16.5	2.5	7.9	6.5	32.5	5.5	9.5	7.8	28.8	4.5
Taiwan	10.7	7.6	18.1	1.9	7.9	5.9	30.0	3.9	9.2	6.8	27.1	3.3
Southeast Asia:												
Indonesia	6.9	4.6	35.2	1.3	5.9	3.6	35.0	4.2	7.0	4.6	34.8	3.2
Malaysia	6.6	3.9	28.1	2.8	7.0	4.5	31.4	5.0	7.1	4.5	30.4	4.3
Philippines	5.2	2.2	17.9	3.9	4.0	1.3	24.0	8.8	5.1	2.3	22.1	6.6
Thailand	8.0	4.9	21.2	3.2	6.6	4.3	23.8	3.9	7.2	4.5	23.1	3.6
India	3.5	1.1	14.3	5.8	4.4	2.1	15.3	4.7	3.8	1.5	14.8	5.1
Latin American NICs:												
Argentina	4.8	3.2	20.8	4.2	.2	-1.4	21.6	59.9	2.4	.8	21.3	9.8
Brazil	8.3	5.5	25.1	2.8	4.3	1.9	26.2	5.7	7.1	4.6	25.9	4.5
Mexico	7.8	4.4	20.3	2.6	4.8	1.9	22.5	5.7	6.3	3.2	21.8	4.3

SOURCE.—World Bank data base.

NOTE.— $\Delta Y/Y$ = rate of growth of the gross domestic product; $\Delta(Y/P)/(Y/P)$ = rate of growth of per capita GDP; S/Y = share of domestic savings in GDP; ICOR = incremental capital-output ratio.

consumer durables and intermediate products, such as chemicals and steel.

The choice was made for the first alternative in Korea, Singapore, and Taiwan in the early 1960s. In turn, the three large Latin American countries shifted to the second stage of import substitution. The latter alternative proved costly as the commodities in question did not conform to the production possibilities of the countries concerned.

Thus, the manufacture of producer and consumer durables requires the existence of a sophisticated industrial structure to provide parts, components, and accessories made to precision. Also, such vertical specialization, as well as horizontal specialization, needs a large domestic market for manufactured goods. Yet even the largest developing country, Brazil, has a market only one-sixth of that of Germany.

Large domestic markets are also necessary for the production of intermediate goods, where traditional economies of scale obtain. Furthermore, the manufacture of producer and consumer durables relies to a considerable extent on skilled and technical labor while intermediate products are highly capital intensive. Also, the margin of transformation for intermediate products is often small and can be squandered through the poor organization of production.

The resulting high domestic costs reduced the efficiency of investment in countries pursuing a strategy of continued import substitution. In order to compensate for the higher costs, these countries also increased import protection, thereby discriminating against exports.

As the costs of continued import substitution became apparent, leading to declines in export and economic growth, the three large Latin American countries undertook reforms aimed to provide improved incentives to exports. The most far-reaching reforms were undertaken in Brazil, while its favorable balance-of-payments position—due first to workers' remittances, tourism, and border industries and, subsequently, to the discovery of petroleum—hampered reform efforts in Mexico, and the opposition of labor unions obstructed the course of economic reform in Argentina.

The reforms undertaken in the mid-1960s have permitted reducing the bias against exports in Brazil, to a lesser extent in Mexico, and even less in Argentina. But not even Brazil has provided equal incentives to exports and to import substitution as has been the case, on the average, in the Far Eastern NICs. In turn, despite some half-hearted reform efforts, India has continued with import substitution behind high protection, involving a considerable bias of the incentive system against exports.

The Southeast Asian countries have come to industrialize in a later period than the aforementioned countries. In the process of industrial development, Malaysia and Thailand have eschewed serious discrimination against exports. Also, despite its oil wealth, Indonesia has at-

tempted to limit the bias of the incentive system against nonfuel products. However, the Philippines has relied on an import-substituting strategy, with high protection.

A review of the data of table 1 indicates the existence of a correspondence between the incentives applied and export performance. But can one explain differential export performance in terms of incentives alone? It has been suggested that such is not the case and that governmental action has played an important role in the rapid export growth of the Far Eastern NICs.

In this connection, reference has been made to the monthly meeting on exports, where the president of Korea exhorted major firms to meet their export targets. The fulfillment of export targets has also been said to be a source of benefit to manufacturers in Korea. One should not exaggerate, however, the importance of these factors. It should be recalled that, at the early stage of its export development, Korea's two most important export products were plywood and wigs, neither of which would have been foreseen by government planners. Rather, they represented a response on the part of entrepreneurs to incentives for exports.

Plywood was produced from timber imported from the Philippines, where such incentives were not available. And the exports of human hair, which could not be supplied in the quantities demanded, were followed by exportation of synthetic hair and, subsequently, wigs in response to the incentives provided for exports.

The emergence, and the subsequent expansion, of the exports of textiles and clothing also occurred in response to the incentives provided rather than as the result of government decisions. In turn, President Park, compelling the producers of nondurable consumer goods to undertake investments in heavy engineering and chemicals in the second half of the 1970s, brought disastrous results. In 1979, Korea's exports declined in absolute terms while the exports of the other Asian NICs continued to rise, and in 1980 Korea suffered a 5% decline in GDP that is only partly explained by the poor harvest of that year.

There followed a return to earlier policies, which led to the resurgence of exports. In fact, the scope of government interventions had been reduced in subsequent years. The paraphernalia of export targets and meetings has disappeared without affecting export performance. At any rate, incentives had never been linked to the attainment of export targets but were provided across-the-board.

In Taiwan, too, export incentives have been available to all firms, and there has been little interference with private decision making. The development of exports had also been left to private interests in Singapore—with the government concentrating on how to attract foreign direct investment—until Prime Minister Lee decided that Singapore should upgrade its exports. There followed substantial wage increases

decreed by the government that have led to the deterioration of Singapore's competitive position without materially affecting its export composition. Finally, Hong Kong has continued to pursue a *laissez-faire* policy throughout the period.

Among the Southeast Asian countries, Malaysia and Thailand have allowed private firms to make decisions concerning exports, and Indonesia has also relied on private initiative. The government of the Philippines, however, has attempted to directly influence the transformation of the export structure.

The Role of Government in Economic Life

The above remarks are not meant to deny the role of government in the economic life of East Asia. But, apart from the promotion of shipbuilding and steel in Korea and of a few strategic industries in Taiwan, the principal contribution of government in the Far Eastern NICs has been to create a modern infrastructure, to provide a stable incentive system, and to ensure that government bureaucracy will help rather than hinder exports.

The creation of modern infrastructure has contributed significantly to economic development in the Far Eastern NICs. In particular, providing up-to-date communication facilities was a precondition for establishing Hong Kong and Singapore as financial centers, and it assisted in the rapid expansion of exports in Korea and Taiwan. Improvements in infrastructure have also been observed in Malaysia and Thailand and, to a lesser extent, in Indonesia while the Philippines and most Latin American countries are lagging behind.

The stability of the system of incentives requires particular emphasis. Apart from the 1975–79 episode in Korea, the Far Eastern NICs have avoided an appreciation of the real effective exchange rate,¹⁷ and exporters could confidently expect that the incentives they receive will be maintained in the future. This has also been the case in recent years in Malaysia and Thailand. In Indonesia there have been fluctuations in real effective exchange rates, and repeated instances of overvaluation as well as changes in the system of incentives have been observed in the Philippines.

Among the large Latin American countries, Brazil has maintained real exchange rates at realistic levels and has continued to provide export incentives. Argentina and Mexico have had several periods of substantial overvaluation, and there have been changes over time in the treatment of exports.¹⁸

The stability of the incentive system, or the lack thereof, significantly affects business decisions. This can be illustrated by a recent case relating to a Latin American country. In 1986, a businessman with interests in the United States told me of his plans to set up plants in Korea and Taiwan for supplying his U.S. operations. When I asked

why the plants would not be established in his own country where the exchange rate was highly favorable for exports, the reply was that one cannot expect this situation to continue. He has proved to be right, as the country's export exchange rate has since been revalued and wages have been raised to a considerable extent, greatly reducing the profitability of exports.

An additional consideration has been the role of the bureaucracy in facilitating or hindering exports. The Far Eastern NICs have long assisted exports by establishing an efficient system of export incentives, eliminating administrative obstacles to exports, and, more generally, creating a favorable environment for exporters. This has also been increasingly so in Malaysia and Thailand, while bureaucratic obstacles remain in Indonesia and, in particular, in the Philippines.

Apart from Brazil, this has not been the case in Latin America. Export incentives are often difficult to obtain and they may lose part of their value in the process, owing to domestic inflation. Also, export controls are often applied to primary exports and in several countries considerable paperwork is required for undertaking manufactured exports. And, governmental pronouncements notwithstanding, there is a lack of export mentality on the part of the bureaucracy.

More generally, the scope of administrative controls is much more limited in East Asia than in Latin America. In the latter case, there are pervasive controls of investment, prices, and imports, and decisions are generally made on a case-by-case basis, thereby creating uncertainty for business decisions.

Also, while labor markets are generally free in East Asia, they are extensively regulated in Latin America, with the principal exception of Brazil. In particular, prohibitions to discharge labor and high severance payments increase the cost of labor, as do minimum wage legislation and social security schemes.

Capital markets, too, have been freer in East Asia than in Latin America. With interest rates set to clear markets, low-return investments have been generally avoided, and incentives have been provided for domestic savings while discouraging the outflow of capital. In turn, artificially low interest rates have reinforced the effects of overvalued exchange rates in contributing to the outflow of capital in several Latin American countries.

Public enterprises, too, tend to be more important in Latin America than in East Asia. In the early 1980s, the outlays of public enterprises accounted for 12% of the gross domestic product in Argentina, 11% in Brazil, and 26% in Mexico.¹⁹ In the same year, the ratio was only 4% in Korea and 8% in Japan.²⁰

With the large role of government bureaucracy and of public enterprise, the share of public-sector outlays in GDP has also been greater in Latin America than in East Asia. As shown in table 4.1 of Balassa et al.

(see n. 20), in 1982 this ratio was 35% in Argentina, 32% in Brazil, and 48% in Mexico, compared with 28% in Korea. (It was 27% in Japan.)

There is considerable evidence that economic growth is negatively correlated with the size of the public sector in developing countries. To begin with, there is a strong negative correlation between the share of government expenditures in GDP and the rate of growth of the latter.²¹ Also, the share of private investment in total investment and the rate of growth of GDP are positively correlated.²² Finally, a negative correlation exists between the tax burden and GDP growth rates.²³

Conclusion

I come finally to the lessons of the East Asian experience for other developing countries. The relevant issues include the determinants of the favorable performance of the countries of East Asia and the replicability of this experience elsewhere in the developing world.

As to the former question, it would appear that the lack of discrimination of the incentive system against exports has led to rapid export growth in the Far Eastern NICs that, in turn, has contributed to high rates of economic growth. The recent experience of Malaysia and Thailand confirms these conclusions, while Indonesia represents a mixed case, and the Philippines has largely conformed to the Latin American pattern (Brazil excepted).

The lack of discrimination against exports has been associated with the stability of the incentive system in much of East Asia. Also, the Far Eastern countries, in particular, provide evidence of an export mentality, with the government bureaucracy helping rather than hindering exports. More generally, less use has been made of government regulation and bureaucratic controls in East Asia than elsewhere in the developing world. Finally, there have been fewer policy-imposed distortions in labor and capital markets, and greater reliance has been placed on private enterprise.

The neutrality and stability of the incentive system, together with limited government interventions, well-functioning labor and capital markets, and reliance on private capital, thus appear to have been the main ingredients of successful economic performance in East Asia. At the same time, these factors are interdependent. For example, while export expansion requires well-functioning labor and capital markets, the neutrality and the stability of the incentives system will improve the operation of factor markets.

But can these conditions be duplicated elsewhere? Mention has already been made of the experience of Turkey, where the reduction of the bias against exports and increased reliance on markets have led to quite spectacular results after 1980. This was also the case in Chile after the 1973 reforms until fixing the exchange rate, together with the backward indexation of wages, introduced considerable distortions in the economy.²⁴

A final question is the political preconditions of the reforms. It has often been suggested that major reforms require a dictatorship to put them into effect. But it would be inappropriate to link reforms to dictatorial regimes.

With few exceptions, dictatorships have not shown an inclination to undertake economic reforms in developing countries. And while in Turkey reform measures came to fruition under a military government, in the subsequent election the architect of the reforms obtained the popular majority over the opposition of the military regime. Also, there have been reform efforts under democratically elected governments in Southern Europe, Colombia, and Sri Lanka.

Notes

* This paper was written when I was visiting fellow at the Institute for International Economics. I alone am responsible for the opinions expressed in the paper, and they do not necessarily reflect the views of the institutions with which I am associated.

1. In what follows, the countries of East Asia will be considered with the exclusion of China, which has a different political and social system from the rest.

2. Robert Summers and Alan Heston, "Improved International Comparisons of Real Product and Its Composition, 1950–80," *Review of Income and Wealth* 30 (June 1984): 207–62, updated on the basis of the national income statistics of the countries concerned. All dollar figures in this paper are in US\$.

3. Quoted in Keng-Swee Goh, "Public Administration and Economic Development in LDCs," *World Economy* 6 (September 1983): 229–44.

4. James Riedel, "Economic Development in East Asia: Doing What Comes Naturally?" in *Explaining the Industrialization Success of East Asia*, ed. Helen Hughes et al. (Sydney: Cambridge University Press, 1987).

5. Fuels have been excluded because of the dominant role of OPEC after 1973.

6. Bela Balassa, "Exports and Economic Growth: Further Evidence," *Journal of Development Economics* 5 (June 1978): 181–89.

7. Michael Michaely, "Exports and Growth: An Empirical Investigation," *Journal of Development Economics* 4 (February 1977): 49–53.

8. Peter S. Heller and Richard C. Porter, "Exports and Economic Growth: An Empirical Reinvestigation," *Journal of Development Economics* 5 (June 1978): 191–93.

9. Constantine Michalopoulos and Keith Jay, "Growth of Exports and Income in the Developing World: A Neoclassical View," AID Discussion Paper no. 28 (Washington, D.C.: Agency for International Development, 1973).

10. Balassa, "Exports and Economic Growth: Further Evidence," p. 185.

11. Gershon Feder, "On Exports and Economic Growth," *Journal of Development Economics* 12 (February–April 1983): 59–73.

12. Export promotion is represented by changes in export market shares; import substitution refers to decreases in the income elasticity of import demand; and additional net external financing has been derived by extrapolating past trends in such financing. For definitions and a detailed discussion, together with estimates for the newly industrializing countries, see Bela Balassa, "The Newly-Industrializing Developing Countries after the Oil Crisis," *Weltwirtschaftliches Archiv* 117, no. 1 (1981): 142–94. Republished as essay 2 in

Bela Balassa, *The Newly Industrializing Countries in the World Economy* (New York: Pergamon, 1981).

13. Bela Balassa, "Exports, Policy Choices, and Economic Growth in Developing Countries after the 1973 Oil Shock," *Journal of Development Economics* (May-June 1985): 23-25.

14. Mieko Nishimizu and Sherman Robinson, "Trade Policies and Productivity Change in Semi-Industrialized Countries," *Journal of Development Economics* 15 (September-October 1984): 177-206.

15. Hollis B. Chenery, "Structural Change," in *Industrialization and Growth: A Comparative Study*, ed. Hollis B. Chenery, Sherman Robinson, and Moishe Syrquin (Oxford: Oxford University Press, 1986), chap. 2.

16. A doubling also occurred in Singapore, but it has been due, in large part, to the establishment of petroleum refining facilities.

17. The trade-weighted average of nominal exchange rates, adjusted for changes in prices at home and abroad.

18. Bela Balassa, Gerardo M. Bueno, Pedro-Pablo Kuczynski, and Mario Henrique Simonsen, *Toward Renewed Economic Growth in Latin America* (Mexico City: Colegio de Mexico; Rio de Janeiro: Fundacao Getulio Vargas; Washington, D.C.: Institute for International Economics, 1986).

19. In the latter case, the operation of the state-owned oil company greatly increased the ratio, which was 10% in 1970.

20. Balassa et al., table 4.1, p. 126.

21. David Landau, "Government Expenditure and Economic Growth: A Cross-Country Study," *Southern Economic Journal* 45 (September 1983): 440-58.

22. Mario I. Blejer and Mohsin S. Khan, "Private Investment in Developing Countries," *Finance and Development* 21 (June 1984): 26-29.

23. Keith Marsden, "Links between Taxes and Economic Growth: Some Empirical Evidence," World Bank Staff Working Paper no. 605 (Washington, D.C., World Bank, 1983).

24. Bela Balassa, "Policy Experiments in Chile, 1973-83," in *National Economic Policies of Chile*, ed. Gary M. Walton (Greenwich, Conn.: JAI Press, 1985), pp. 203-38. Republished as essay 8 in Bela Balassa, *Change and Challenge in the World Economy* (London: Macmillan, 1985).