Chapter 2

ECONOMIC DIVERSITY IN ASIA

2.1 HETEROGENEITY

Geographically, Asia stretches between Afghanistan in the west to the Korean peninsula in the east. This crescent-shaped region comprises several discernible, distinct, and dissimilar sub-regions and countries, which are at different stages of economic growth, and have widely differing economic characteristic attributes. While diversity is a universal feature, Asia represents an extreme form of it. Asia comprises some high-performing sub-groups of economies and those that have performed relatively poorly during the post-war era. Each economy has its idiosyncratic set of assets and liabilities.

Diversity exists not only in economic aspects of Asian life, but also in social, political, religious, cultural, ethnicity, linguistics, geographical features and systems of governments. Some eleven languages and eighty-seven dialects are spoken in the Philippines. Eight of these are native tongues for about 90 percent of the population. All eight belong to the Malay–Polynesian language family and are related to Indonesian and Malay, but no two languages are mutually comprehensible. Indonesia, the most ethnically diverse country in the world has three hundred ethnic groups that follow four major religions, namely, Buddhism, Christianity, Hinduism and Islam. The Indonesian government takes pride in its pluralistic society and describes it as "unity in diversity." The diversity on various fronts was, and continues to be, far greater than that in European Union (EU) of 15[37] and in North American Free Trade Area (NAFTA). Compared to them, Asia has much greater diversity in terms of levels of economic development, sizes of GDP, economic and industrial structures, depth and sophistication in financial markets, and broad economic and financial institutional frameworks.

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[37] In May 2004, the membership of the EU increased from 15 to 25.

A statistical comparison of economic indicators of the Asian economies clearly brings home their inter-country diversity. Added to that is the intra-country diversity, which is also enormous. Many countries contain differing ethnic groups of different races, who follow different religions and social norms and practices. For instance, the Han people are the China's largest ethnic group, but 56 ethic groups inhabit this vast country; 18 of them have population of one million or more. The largest of these minority ethnic groups is Zhuang, with a population of 16 million. Various ethnic minority groups live with the majority Han population, while some minorities prefer to live in separate compact groups. This diversity exists all over Asia. A small country like Myanmar has 135 different ethnic groups of eight races. Large Chinese, Indian and Malay populations are found in many East and Southeast Asian countries. In many countries they are minorities, and in some they are either large minorities or even majorities. These populations groups have maintained many of their native characteristics, yet have assimilated well in their societies of domicile. Families that are part of the Chinese Diaspora have earned a reputation for being astute business people and their business acumen is admired all over Asia. For instance, while the Chinese constitute less than three percent of the total population in Indonesia, they control as much as seventy percent of all private sector economic activity. The phenomenon has been attributed to a natural affinity the Chinese possess for business endeavors. This acumen is believed to be rooted in the Confucian work-ethic, the hierarchal structure of the family, which lent itself to effective creation of large businesses, even conglomerates.

Social indicators like literacy and life expectancy data for these countries also display extreme diversity in Asia. This heterogeneity reflects the economic diversity of the Asian economies. For instance, Korea was the most literate country having 1 percent illiteracy among male population and 4 percent among female. Cambodia was at the opposite extreme, with the corresponding proportions being at 41 percent and 79 percent, respectively. Likewise, life expectancy varies widely. In Hong Kong SAR and Japan it is more than 80 years, while in countries in Indochina (Cambodia, Lao PDR and Vietnam) it is merely 54 years.

2.2 HIGH-PERFORMING ECONOMIC SUB-GROUPS

The dynamic Asian economies began to be recognized as a distinct group of high performers in the latter half of the 1980s. If long-term GDP growth rate is taken as a yardstick, Thailand and countries east of it performed stupendously better than the seven south Asian economies. The reason for excluding the South Asian economies from this book is that over the preceding four decades, they never became a part of the vibrant and high-performing Asian economic

scenario. Economic growth did not seem to be the priority of South Asian economies. Their success in eliminating absolute poverty between 1981 and 2001 was also small. The World Bank reference line of poverty of $1.08-a-day remained virtually stationary. In 1981, there were 474 million people living below the poverty line in the seven South Asian economies. In 2001, this number did not decline appreciably and was 431 million—of these, 83.1 percent lived in India. The higher World Bank reference line for poverty was $2.15-a-day. The number of poor people living below this poverty line increased from 821 million to 1,064 million during the period under consideration—of these, 77.7 percent lived in India (Chen and Ravallion, 2004).[38]

When we say that the economies east of Thailand performed remarkable better, to be sure, the three former non-market economies in Indochina are unmistakably an exception. The successful sub-groups among Asian economies and their performance can be divided in the following manner. The dynamic Asian economies comprise a mélange of countries that can be justly called matured industrialized economy (like Japan), emerging market economies (EMEs)[39] and developing economies at varying strata of economic development. Following Japan, the four newly industrialized Asian economies (NIAEs) were the first and the most successful country group in adopting export-led or trade-induced growth, followed by the ASEAN-4 and subsequently the Peoples Republic of China (hereinafter China).[40]

As regards the individual countries, it was stated in Chapter 1 (Section 1.7) that the successful economies of Asia in this book are defined to include the ten dynamic Asian economies, namely, China, Hong Kong SAR, Indonesia, Japan,

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[38] See Chen and Ravallion (2004), Table 3. The other tables also buttress the same point.

[39] What are the emerging market economies? Other than the rapid endogenous growth endeavors, respect of property rights and respect of human rights are some of the basic prerequisites of becoming an emerging market economy. The national government should offer protection to property and human rights of both, the citizens of the country and the non-residents alike. An indispensable condition for an emerging market economy is its sustained ability to attract global capital inflows. Only an assurance of protection of property rights will attract global investors to a potential emerging market economy. Thus, protection of property rights is a fundamental, non-negotiable, condition, which an economy needs to meet before embarking on its road to becoming an emerging market economy. So far there is little agreement on the country count. In the industrial economies the emerging market economies were thought of as the newly industrialized economies (NIEs) and some middle-income developing countries. The latter group included those countries in which governments and firms are creditworthy enough from the perspective of global investors to successfully borrow from the global capital markets and/or attract institutional portfolio investment. Different international institutions include slightly different sets of countries in this category (Das, 2004b).

[40] Hong Kong SAR, Korea, Singapore and Taiwan are called the newly industrialized Asian economies (NIAEs), while Indonesia, Malaysia, the Philippines and Thailand are called the ASEAN-4 group of countries.

Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand. Majority of these economies are widely acknowledged to be the high-performers. The Philippines in thisgroup is a marginal case. Eight of them (excluding China and the Philippines) were called the "high-performing Asian economies (HPAEs)" by the well-regarded 1993 World Bank study, which tried to identify the ingredients that go into a recipe for rapid economic growth, with improvement in income distribution. The HPAEs were characterized by fundamentally sound development policies, outer-orientation, plus tailored government interventions. With high rates of GDP growth, the HPAEs recorded steady improvement in the Gini coefficient.[41] The market-oriented aspects of the experience of HPAEs were recommended to the policymakers in the developing world as well as transition economies with few reservations. However, whether government intervention should be attempted everywhere was another matter.

Japan, the second largest economy in the world after the United States (U.S.), the third largest exporter ($471.9 billion) accounting for 6.3 percent of world exports in 2003, and the sixth largest importer ($383.0 billion) accounting for 4.9 percent of world imports, is a denizen of Asia. Besides, China's importance in the global economy as well as world trade went on rising monotonically. By 2000, China had become the largest developing-country exporter, accounting for 3.5 percent of global merchandise exports. Global GDP growth rate decelerated from 4.7 percent in 2000 to 2.3 percent in 2001 and then recovered slightly in 2002, to 3.0 percent.[42] However China remained unaffected and continued to emerge rapidly as a highly successful trading economy, and accounted for 5.9 percent ($438.4 billion) of the global merchandise exports in 2003. It was the fourth largest exporter in the world after Germany, the United States and Japan, in that order. It also accounted for 5.3 percent ($412.8 billion) of merchandise imports in 2003, making it the third largest importer in the world after the United States and Germany, in that order (World Trade Organization [WTO], 2004).[43] As opposed to these, there are many regional economies, particularly in South Asia, which did not succeed in carving out a niche for themselves in the arena of international trade. Their export volume and value are so small that they do not appear on the WTO league table of traders.

The three small economies of Indochina suffered under the yoke of non-market economic system and remained impoverished. Myanmar's self-imposed autarky partially explains its abject poverty. Long-term GDP growth rate of the South Asian economies was not only low but they were also the last to adopt economic and financial liberalization measures and the slowest to

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[41] See *The East Asian Miracle: Economic Growth and Public Policy*, New York: Oxford University Press, 1993.

[42] The source of GDP growth statistics is IMF (2003), Table 1.1.

[43] Refer to WTO (2004), Appendix Table 1.

embark on export-led or trade-induced growth path. Their affinity for the import-substituting industrialization (ISI) regime was so strong that it could not be rooted out completely from their growth strategy. Setting up large and inefficient public sector enterprises is the characteristic feature of this set of economies. They did not consider a liberalized and diversified multilateral trade regime useful for their economies. This sub-group failed to develop and hone its supply-side synergy so badly needed for rapid economic growth. Little wonder they lagged behind the successful sub-groups of Asian economies, which were located east of them in the same region.

An admixture of bilateral trade ties, neo-mercantilist policy stance, and liberalized and diversified multilateral trade regimes were the driving forces behind the emerging trade patterns in the rapidly growing Asian economies. Market forces played a notable role in the developments of these trends. As the economies grew and the supply-side synergy gained momentum, Asia's intra-trade not only expanded rapidly, but also advanced ahead of regional institutional arrangements like the ASEAN[44] Free Trade Area (AFTA) and the Asia Pacific Economic Co-operation (APEC) forum. In October 2003, the members of ASEAN proposed to form an EU-like ASEAN Economic Community by 2020 (Chapter 4, Section 4.3.7). There was a steady growth of the internal Asian markets and, therefore, in intra-regional trade. Expanding intra-regional and global trade turned the high-performing Asian economies into traders of global significance. The WTO league tables of leading global exporters for 2003 included nine Asian economies. Other than Japan (3rd) and China (4th) noted above, it included Hong Kong SAR (11th), Korea (12th), Taiwan (15th), Singapore (16th), Malaysia (19th), Thailand (24th), and Indonesia (29th).[45]

Substantial intra-regional trade had existed in Asia since the beginning of the twentieth century. It had markedly increased among the successful economies of Asia. When the crisis broke out in mid-1997, most successful Asian economies were carrying on as much as 50 percent of their total trade with the other regional economies.[46] The only exception in this regard was Indonesia. Apart from this,

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[44] ASEAN stands for the Association for Southeast Asian Nations. It was established on 8 August 1967 in Bangkok by the five original Member Countries, namely, Indonesia, Malaysia, Philippines, Singapore, and Thailand. The ten present ASEAN members are Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

[45] Refer to WTO (2004), Appendix, Table 1.

[46] The Asian crisis began on July 2, 1997 in the financial sector of Thailand, but the contagion engulfed Indonesia, Korea, Malaysia, and the Philippines in no time. Other Asian economies were indirectly affected by it, including the relatively strong economies of China and Japan. Ultimately the crisis dampened the global economic growth. The immediate trigger was the devaluation of currencies in the region, which eroded the value of Asian currencies, making it much more difficult for Asian businesses and banks to pay back debts that they incurred in

only China saw the proportion of its intra-regional trade share decline during the decade of 1990s, essentially because of brisk expansion of its trade share with the United States. Over the recent period, most of the successful exporters in Asia held or reduced their share of trade with Japan, the dominant regional trader. Although Japan's significance as a regional trade partner has declined over the years, in absolute terms it has expanded its exports to the region. During the last decade and a half, the most rapid growth in trade opportunities came instead from the four NIAEs, as well as the ASEAN-4.

Essentially driven by market forces, a hierarchical trade and investment structure developed in the dynamic sub-groups of economies over the last three decades in Asia, which expanded both intra-regional trade and investment, in turn integrating the region. Lee and Roland-Holst (1998) show that the market expansion that took place in Asia was both vertical and horizontal. First, the NIAEs and then the other EMEs of Asia fit into the lower tiers of complex trade hierarchies. The NIAEs were the initial recipient of foreign direct investment (FDI) from Japan and the United States. Second, as labor costs in NIAEs rose, Japan and the United States became investors in the economies further below on the economic development ladder. This tendency was conspicuous in association with the large flows of FDI into the ASEAN-4 economies[47] and China, in that order.

Over the preceding quarter century, Japan, Taiwan and Korea provided massive amounts of FDI to the ASEAN-4 economies and subsequently to China, in the process increasing their commitments in these markets. Firms in the investing countries built subsidiaries or partnerships in these economies, which in turn exported intermediate goods to the investor firms in the home countries. These intermediate goods could also be exported to the subsidiaries of

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foreign denominations. A wave of loan defaults resulted and much of Asia's financial sector loomed toward bankruptcy. Unable to raise enough financial capital to fix their ailing economies, several Asian governments were forced to ask for international help. The help arrived in the form of loans from the International Monetary Fund (IMF) and several Asian countries pledged to provide around $100 billion in loans to help shore up Southeast Asia's struggling financial systems. China and Japan took lead in this respect. In return for the liquidity support, recipient countries were expected to implement a series of austerity measures designed to contain the crisis and improve their free-market economic policies. The Asian crisis and the IMF bailout kindled a wide-ranging debate on the merits of Asia's economic model. That model—called government-led development—is characterized by a strong alliance between government and business that gives political leaders a substantial role in shaping the private sector's course of development. Some analysts believed that the cozy, sometimes corrupt ties between government bureaucrats, bankers and the family-owned businesses that dominate Asian markets created an inept financial system that was doomed to failure. They generally back the IMF's demand that Asian countries sharply limit the government's intrusion into business and that corporate governance needs to be significantly improved.

[47] ASEAN-4 economies are Malaysia, Indonesia, Indonesia and Thailand.

the investing firms in other parts of the world. This kind of trade expansion was usually supported by complex commercial alliances in which both the partners enjoyed many growth externalities (Lee and Roland-Holst, 1998). Trade between China, Hong Kong SAR and Taiwan[48]—together referred to as greater China—is large and increasingly closely linked. Initially a great deal of China's exports went to the world through Hong Kong, but its trade dependence on Hong Kong SAR progressively declined in 1990, because its capability to trade directly had increased. Presently China trades much more directly both intra-regionally and globally. This interplay of trade and investment has been dealt with at length in Chapter 3, Section 3.2.

2.3 REGIONAL ECONOMIES AND ECONOMIC GROUPINGS

The Treaty of Amity and Co-operation (TAC) in Southeast Asia was signed at the First Association for Southeast Asian Nations (ASEAN) summit on 1967. It was intended to a political treaty of friendship and non-interference. The five founding members of ASEAN (namely Indonesia, Malaysia, the Philippines, Singapore and Thailand) were a fairly homogeneous group. As this group was enlarged to include Brunei Darussalam, Cambodia, Lao PDR, Myanmar and Vietnam, its diversity increased dramatically. Presently the ASEAN has ten members, ranging from tiny island republic of Singapore to Indonesian archipelago, which comprises over 17,000 islands. The areas they cover vary from 1,000 square kilometer for Singapore on one extreme to 2 million square kilometer for Indonesia on the other. Likewise, population size for this small country group varies between 300,000 for Brunei Darussalam to 207 million for Indonesia. Gross national income (GNI) per capita also has wide differences in this small country group, with Brunei Darussalam and Singapore having more than $24,000 and the three new members (Cambodia, Lao PDR and Vietnam) having per capital GNI in the neighborhood of $300 (see Chapter 4, Section 4.3.1).

Since 1997, ASEAN was endeavoring enlargement to include China, Japan and Korea, and become the ASEAN-Plus-Three (APT), which naturally would have much greater economic and social heterogeneity than the ASEAN of 10 members (or ASEAN-10). The members of ASEAN have held meetings with Japan, China and South Korea for seven years in a row, between 1997 and 2003. In 2002, ASEAN began work on a trade agreement with China, and in October 2003 ASEAN signed accords with Japan and India. In October 2003,

[48] Although Macao should be added to this definition of Greater China, it is conventionally not. Hong Kong is the special administrative region of China and is referred to as Hong Kong SAR.

the members of ASEAN proposed to form an ASEAN common market by 2020. China's population of 1.3 billion dwarfs the individual populations of the remaining 12 countries in the APT grouping. Likewise, Japan which is the second largest global economy, dwarfs the GDP of all the APT economies. Its current per capital GNI is the highest for the APT groupings, substantially higher than that of Brunei Darussalam and Singapore.

As set out in Section 2.1, in comparison to the European Union of 15 (EU-15) members, heterogeneity in Asia is much larger.[49] To be sure, there are variations in population size ranging from Luxembourg (400,000) to Germany 82 million, which is a far cry from the Chinese population of 1.3 billion. Asia and the EU-15 comprise different countries from the perspective of level of economic development. As indicated earlier, Asia comprises developing economies, EMEs and one matured market economy industrial economy. As opposed to this, the EU-15 consists of all industrial economies, although Greece, Portugal and Spain are at a much lower level of industrial development than the other members of the EU-15. These three economies also have the lowest per capita GNP in the EU-15. With the signing of treaties of accession with 10 more countries in April 2003, the membership of the EU extended to 25 in May 2004.[50] The EU of 25 members would come close to Asia in terms of diversity.

As the county group size is reduced, the smaller countries begin to matter more and become significant. In the APT grouping, the share of ten ASEAN countries is 8.6 percent. Japan is the largest economy in this group accounting for 69 percent of the ATP GDP, while the other two members, namely, China and Korea account for 15 percent and 6 percent of the ATP GDP. When the country group is enlarged to include all the 21 economies of the APEC forum, which includes both Asian and Pacific economies, the United States is the domineering economy accounting for 51 percent of the total APEC GDP. The ten ASEAN economies add up to only 3 percent of the total APEC GDP.

If the Asian regional groupings are compared to those of Europe or North America, differences in economic growth and the group sizes become obvious. With a GDP of $18 trillion APEC is the largest regional trading group (RTA),

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[49] On December 1, 1991, agreement was reached in Maastricht on the Treaty on European Union, with a timetable for the Economic and Monetary Union (EMU). The European Single Market was completed on January 1, 1993. On November 1, 1993, the Maastricht Treaty came into force after Danes voted yes at the second try, and the EEC became the European Union (EU).

[50] The Treaty of Accession between the European Union (EU) and ten countries, namely, the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, and Slovakia was signed in Athens, Greece on April 16, 2003. These 10 countries are to acquire formal membership status of the EU in May 2004. Save for Cyprus and Malta, these are all Central and East European Countries (CEEC) countries. Until the collapse of the Soviet Union in 1990–91, these eight economies were the satellite economies of the Soviet Union. Bulgaria, Rumania and Turkey, three candidates for future membership, are waiting on the sidelines.

accounting for 58 percent of the global GDP. The United States, the largest global economy, with $9 trillion GDP is part of the APEC forum. The 20 percent GDP share of the APT is not much less than the GDP share of the European Union (EU-15) and 33 percent of NAFTA[51]. The share of ASEAN-10 is very small in the global GDP—1.75 percent of the total—in comparison to these large RTAs.

Another comparison can be made with the Free Trade Area of the Americas (FFTA), which is a mega free trade area (FTA), comprising almost the entire Western Hemisphere.[52] The 34 countries of the FTAA account for 38 percent of the global GDP, which is larger than that for the ATP (20 percent), NAFTA (33 percent) and the EU (27 percent), although significantly less than that of APEC (58 percent). In case of the FTAA, the U.S. economy dominates the group again, without which the FTAA would account for merely 8.5 percent of the global GDP. For the APEC this proportion is considerably higher at 29 percent (excluding the United States) of the global GDP.[53]

The heterogeneity among Asian economies is also visible in the structures of GDP and economic development. When the value-added as a percent of total GDP is analyzed for the agricultural, industrial and services sectors, it is easy to see that the economies of the newer members of ASEAN (Cambodia, LAO PDR, and Myanmar) are highly reliant on agriculture. Conversely, in Singapore, the Philippines, Thailand and Vietnam, it is the services sector that provides the largest contribution to the GDP. Indonesia and Malaysia fall between these two extremes, the largest share of GDP originates in the industrial sector.

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[51] NAFTA came into effect on January 1, 1994, and created the largest free trade area (FTA) in the world of that period. At the time of creation it covered some 360 million people and nearly $500 billion in yearly trade and investment. NAFTA maintained the tariff elimination schedule established by the Canada—U.S. free trade area (CUSFTA) for the bilateral trade between Canada and the United States. Both countries negotiated separate bilateral schedules with Mexico for the elimination of tariffs. However, the three member countries agreed to abolish tariffs and non-tariff barriers completely by 2009. NAFTA had an enormous demonstration effect in Latin America. In fact, it is said to have had a "domino effect."

[52] The Free-trade area of the Americas (FTAA) has 34 members. As a hemisphere-wide FTAA was proposed in 1994 during the Miami Summit of the countries in the Americas. Since then the negotiations have managed to make a good deal of progress. The countries participating in the negotiations of the FTAA held their Seventh Ministerial Meeting in Quito, Ecuador, on November 1, 2002, with the intent to review progress in the FTAA negotiations so as to establish guidelines for the next phase of the negotiations. They are scheduled to conclude on January 2005 in accordance with the terms agreed by the Heads of State and Government at the Third Summit of the Americas, held in Quebec City in April 2001. The negotiations worked towards FTAA's entry into force as soon as possible after January 2005, but in any case no later than December 2005.

[53] The source of statistical data used in this paragraph is *World Development Indicators 2001,* the World Bank.

When an aggregated view is taken, largest (47 percent) contribution to GDP in the ASEAN economies is made by the services sector, industry is close at the heels of the services sector (39 percent), with a large part of the contribution being made in the manufacturing sector. In comparison, in the European Monetary Union (EMU), the services sector dominates the GDP, accounting 71 percent of the GDP.[54] Industry and agriculture account for 27 percent and 2 percent of the GDP in the EMU. This is a reflection of wide differences in the overall development levels of Asia and Europe. While individual economies like Singapore and Thailand can be compared to the EMU in terms of the structure of the GDP, the region as an aggregate cannot be compared to EMU in a similar manner.

Investment rates, measured by the ratio of gross capital formation to gross domestic product (DCF/GDP), are more consistent in the ASEAN economies than the rate of savings. The two exceptions in this case are Cambodia and Myanmar. Investment rate for the other eight ASEAN economies ranges between 20 and 30 percent. If the APT group is considered, China comes out at the top with 37 percent rate of investment. It can finance its recent rate of investment from its domestic savings, but it does not have a saving surplus like some of the ASEAN economies. Indonesia, Malaysia, Singapore and Thailand have consistently shown a saving surplus. For the low-income ASEAN economies even high rates of saving provide little investable capital, and these economies have little alternative but to rely on multilateral and bilateral development assistance.

The savings and investment rates in the Asian economies are higher than those in the other regions. In the ASEAN region, at 35 percent, the savings rate is almost double that of NAFTA and one-and-a-half times that of the EMU. Western economies are well known for a low long-term savings rate. For instance, the ratio gross domestic savings to gross domestic product (GDS/GDP) was 16 per cent in the UK and 18 percent in the United States in 1999. As for the investment rate, ASEAN was comparable to NAFTA and the EMU. However, when investment rate in APT is compared to that of NAFA and EMU, it becomes much higher because of the inclusion of China.[55]

2.4 JAPAN—THE DOMINEERING REGIONAL ECONOMY

Japan is the leading geese in the flying-geese paradigm of Asian economies (Akamatsu, 1961). In 1952, when the Allied occupation ended, Japan was called

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[54] All the 15 members of the European Union (EU) are the members of the European Monetary Union (EMU). They are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, and United Kingdom; only 12 participate in the Euro Zone (EZ). Greece became the 12th member of the EZ in January 2001.

[55] Discussion in this section is styled after Sakakibara and Yamakawa (2003).

a "less developed country." Building on the remnants of the war-ravaged infrastructure, Japan rapidly reconstructed and rejuvenated its economic strength. Since the early-1950s, it recorded high real GDP growth rates, sustained it for almost two decades, and began to catch up first with Western Europe and subsequently with the U.S. economy. At the end of this period, Japan moved several rungs up the industrialization ladder to acquire the "developed" or industrialized economy status. In 1968 the Japanese economy became the second largest in the world, after the United States.

Japan's brisk post-war economic recovery, followed by acquisition of economic and industrial strength, had enormous demonstration effect in Asia. The salient characteristics of this high-growth era were high rates of savings and investment, an industrious labor-force with strong work ethics, supply of cheap oil, adapting and adopting new technologies in the manufacturing sector followed by technological innovation and effective intervention by the government, particularly by the Ministry of International Trade and Industry (MITI). The strategy of "picking the winners" was a Japanese innovation. The government and bureaucracy led growth efforts in a neo-mercantilist fashion. Rapid export-induced growth led to immense changes in industrial structure. It shifted from agriculture and light industry to heavy and high-technology industries and services. Dominating the industrial sector were iron and steel, shipbuilding, machine tools, motor vehicles and subsequently, electronics.

Japan was a major beneficiary of the swift growth attained by the global economy during the period after the War, under the principles of free trade advanced by the multilateral organizations, particularly the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT). The macroeconomic policies followed in Japan were largely based on neo-classical economic principles and outer-orientation of the economy, which implies openness to trade and foreign investment. Openness has been clearly and positively linked to economic performance by numerous empirical studies and regression analyses (Bhagwati and Srinivasan, 1999).[56] The well-thought-out economic strategy was meticulously implemented. Exchange rate was not allowed to be overvalued. In the early stages, Japan had a "repressive" financial system (Chapter 6, Section 6.2). The high-growth period in Japan is also known for steadily rising competitive strength of the industrial sector. It is widely acknowledged that exports were the major contributor to GDP growth during the high-growth period. In the 1960s, they grew by an average rate of 18.4 percent annually. The size of the external sector (exports plus imports) as a proportion of GDP went on increasing by the year. Beginning the mid-1960s, current account balances began recording surpluses, although the post oil shock (1973) years were an exception.

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[56] A large volume of empirical and theoretical literature exists on the openness-growth nexus. In a recent survey of this literature Bhagwati and Srinivasan (1999) re-established this positive link.

The economy was buffeted by several external and domestic shocks in the 1970s. These included the two oil shocks, double-digit inflation and recession. The rate of domestic investment declined and real GDP growth rate for the 1974–79 dipped to an apathetic 3.6 percent. Economizing on energy consumption became an important objective after the first oil shock (1973), which affected the industrial structure. Notwithstanding the shock, major export sectors retained their competitiveness in the global markets by cutting costs and increasing general efficiency. Particularly, the automobile industry improved its over all competitiveness in the global market place. Energy demand was slashed down. The second oil shock (1979) created another shift in Japan's industrial structure. This time the emphasis shifted from heavy industry to development of higher technology products like the computer, semiconductor, along with other technology and information-intensive industries. This started a second period of rapid growth in Japan in 1980. Current account balances continued to remain positive and in 1985 Japan moved ahead of Britain, with net external assets of $130 billion. By the late 1980s, Japanese per capita income, at market exchange rates, exceeded that of the United States.

The yen remained undervalued until the Plaza Accord of September 1985 between the Group-of-Five (G-5) economies.[57] The Accord was the most significant economic event of the 1980s. It planned for a methodical, coordinated and steep appreciation of the yen, which in turn had an enormous and far-reaching impact over the Japanese, Asian and global economies (Das, 1992). During the latter half of the 1980s, a "bubble economy" was created. It was called the bubble economy because growth was not supported by economic fundamentals.[58] An appreciated currency affected the competitiveness of exports adversely, albeit fiscal and monetary measures increased domestic demand, which started contributing more than the export to GDP growth. In 1988 and 1989, corporate investment rose sharply. New equity issues rose in value and banks sought to fund real estate developments. Corporations used their real estate holdings as collateral for stock market speculation. Consequently, land prices doubled and Nikkei index rose by 180 percent. The bubble economy later became the legacy of large non-performing loan (NPL) overhang of the banks.

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[57] Ministers of Finance and Central Bank Governors of France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States, or the G-5 economies, met on September 22, 1985, at the Plaza Hotel in New York. They *inter alia* agreed to a coordinated market intervention by their central banks with the express objective of engineering an appreciation of the yen and the deutschmark and a depreciation of the dollar, which was considered highly overvalued at that time.

[58] Investors were buying up stocks at inflated prices not because they expected a solid dividend return but because they expected further gains in the market value. Real estate prices were so out of line that at one time the land beneath the Emperor's Palace in Tokyo was considered more valuable than all of California.

In May 1989, monetary authorities reacted by tightening policies to contain rise in asset values. Next year, the Nikkei index fell by 38 percent, wiping out over $2 trillion worth in stock market value. Land prices collapsed burdening financial institutions with massive bad debts. Banks became overly cautious and a severe credit crunch followed. The economic bubble of the late 1980s burst on the last day of 1989, which signaled the end of the second era of rapid growth and more than two decades of rapid overseas business expansion. The economy went into a deflationary phase and suffered four recessions during the 1990s. The economy became a classical example of a Keynesian "liquidity trap."[59] The deterioration in the economic performance was serious, with little endogenous mechanism for reforms. Until the late 1980s, Japan was the fastest growing economy in the Organization for Economic Co-operation and Development (OECD). During the 1990s it made a somersault and became the slowest one, with an annual average GDP growth rate of 1.1 percent over the 1992–2002 period. In one generation, Japan turned from having global economic driving force to a nation faltering on the brink of economic despair. Lavish fiscal spending packages and extensive monetary easing failed to show any consequences. The deflation persisted. This was the first time after the 1930s that an industrial economy had experienced this monetary phenomenon. Japan essentially went from an economy that was enjoying above peak level growth in the latter half of the 1980s, with soaring real estate and stock prices and major overseas expansion of industrial and banking operations, "to a 60 percent decline of asset prices within a period of two years. It was a decline that rivaled the Great Depression" (Hutchison, 1997).[60]

Several structural limitations came to the fore. For instance, in comparison to the other matured industrial economies, wage structure in Japan had become exceedingly high. Business services were high-priced and so were the prices of intermediate inputs, particularly those supplied by non-manufacturers. Although deregulation has been taking place, several sectors were completely left out of the process. Consequently they remained fettered by stringent licensing requirements and sector-specific regulations. These regulations and

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[59] The asset-price bubble burst in 1990 in Japan. To ward off a recessionary tendency, monetary authorities followed highly expansionary policy bringing interest rates down to zero. Although several reasons have been put forward to explain the sustained weakness of the Japanese economy, none is more intriguing from the viewpoint of a central bank than the possibility that monetary policy had been largely ineffective because the Japanese economy entered a Keynesian "liquidity trap." J.M. Keynes posited that the monetary authority would be unable to reduce interest rates below a non-zero positive interest rate floor if market participants believed that interest rates had reached bottom. Any subsequent monetary expansion, then, would lead investors to increase their holdings of idle cash balances and to become net sellers of government bonds.

[60] Hutchison (1997) provided a detailed analytical account of how the Japanese economy, after performing so well, fell into such a torrid quagmire of successive recessions and a deflation in 1990.

customs in the economy continued to impede the functioning of market mechanism. A recent study (NRI, 2002) inferred that the more highly regulated a sector was, the lower was its productivity growth and the more likely it was to pass on wage increases as direct price increases. Under the umbrella of regulations, inefficient wage structures tended to persist, in turn exacerbating the price gap and whittling away the competitiveness.

Another persistent structural problem was weak innovative activity, low productivity and relatively high prices in numerous key sectors of the economy. In many instances, the price line in Japan was as much as 50 percent higher than the OECD average (Cotis, 2003). In many important sectors Japanese prices were as much as 30 percent higher than those in the United States. Poor corporate governance was the other serious structural problem. In addition, as cost structure in the economy became high, total factor productivity (TFP) suffered. It rationally encouraged "hollowing out" of the industrial sector. Besides, the economic and financial environment of the 1990s strengthened the hollowing out and relocating trend of industries to China and other Asian economies. Competitively priced imports from China and the other Asian economies raised the specter of continuing deflationary trend in prices. In an increasing number of product lines these economies became highly competitive and Japanese manufacturers were not able to compete with them. These economies increasingly began to compete with Japan in the global market place.

Owing to high wages and prices, manufacturers in Japan face a serious challenge from China, where wages are lower by a factor of 20 to 30. Similar firms in the OECD economies also pose a serious challenge to the Japanese manufacturers for the same reason. There was a steady migration of production of low-cost mass-produced manufacturing products to Korea, ASEAN-4 economies, China, and other lower-wage Asian economies. Such products have also been seeping out of many other mature industrial economies.

Japan has the large electronics sector. Digitalization has changed the nature of production and competition in this sector. Besides, several digital products have rapidly become mass-produced items. This category includes DVD players, mobile phones, and digital cameras. Digitalization has proved to be beneficial to economies like China and other Asian economies that were playing catch-up in electronics technology. Now these economies can leapfrog the technologically difficult analogue production stages and manufacture newer and easier digital products.

Japanese firms could not compete with other Asian economies in low-cost manufactured items—and very seldom from the domestic base. A recent, albeit rare, example is that of Suzuki Motors, which became highly competitive in a stripped-down budget scooter that costs one-third as much as a regular scooter. The response of the Japanese manufacturers to this situation is to keep the core technologies and its output at home and move low-value-added

production activity and assembly operations abroad. Japanese firms become more secretive about the core technologies. Toshiba, the biggest chip maker in Japan and the inventor of DRAM[61] chip, has been busy developing high-end chips. It had developed DRAM in collaboration with a Korean firm, which soon became a commodity and rival Asian firms overtook Toshiba in a short time span. Learning a lesson from its past, Toshiba is determined not to let any other firm in on its high-end chips technology secrets. This new attitude would allow Japanese firms to hold on to high-technology end of manufacturing for a longer period in the future. Besides, notwithstanding the structural limitations, Japanese firms have certain inherent strengths. They excel at producing products whose manufacturing entails designing of many components in great detail, and close co-operation among teams in the firm and its suppliers. Therefore, the twenty-first century manufacturing strategy of the Japanese firms should be to focus on manufacturing products that allow them to cash in on this strength.

The bursting of the bubble marked the beginning of a crisis in the banking industry. A massive (8 percent of the total bank credit) overhang of NPLs persisted on the balance sheets of banks throughout the 1990s and beyond (NRI, 2002). Cost of NPLs in terms of undermined profitability and eroded capital base of the banks is high. Heavy infusion of capital did not resolve the Naples conundrum. They went on rising. A deflationary environment, marked by falling asset markets and recession, is not a solution for resolving the NPLs. If anything, deflation exacerbates the NPL problem. As all these daunting factors crowded in during the 1990s, they were christened the "lost decade" of Japan (see Chapter 6, Section 6.4.3).

After the bubble burst, growth efforts in Japan began to rely heavily on capital accumulation (Cotis, 2003). Although there was a declining trend in the 1980s, the rate of business investment continued to outpace the rate of GDP growth. Over-investment led to constantly rising capital-output ratio in the economy which, in turn, depressed return on investment (ROI), causing financial fragility. To return to growth, Japanese economy needs to reduce its reliance on the factors of production and increase depending more upon productivity growth. Because of demographic idiosyncrasy of expansion in the proportion of retired people, possibility of positive contribution of an expanding labor force is remote. The trend of declining investment in the background of "capital overhang," would indeed help in reducing the capital–output ratio.

Hindsight reveals that the strategic response of lavish fiscal spending and extensive monetary easing to combat deflation was barely enough. For a financial recovery, several concerted and bold measures were called for. Insolvent

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[61] DRAM is the abbreviation for dynamic random access memory chip.

institutions had to be allowed to fail, weak institutions had to be merged into stronger ones, and good assets had to be separated from bad. The short route to resolve the problem of outsized NPL was writing them off swiftly and simultaneously, easing the pain with loose monetary policy. The United States and Scandinavia provide examples of countries that had swiftly dealt with bad debt problems and gone on to revitalize economic activities. Japan did not take this route and this major failing continued to fester in the banking system, casting its shadow over the entire economy for a fairly long period.

The decade of 1990s was a highly disappointing period for Japan. Its per capital income fell relatively to the other OECD economies. As set out above, slowdown in Japan had structural roots. One of the crucial causal factors behind the deceleration of GDP growth rate was deceleration in the TFP. Bold and well-conceived measures were needed for making TFP the principal source of growth. Long-standing structural problems of high prices, weak innovative activity and low productivity need to be tackled head on. Promoting competition in the industrial and services sector would have gone a long way in resolving these problems. For sure, it would have brought down the prices. This implies that the potential for gains from intensification of competition in the Japanese economies was high. Aggressively promoting competition should, therefore, be a high priority of the policymaking community.

Although Bank of Japan (BoJ) reduced interest rate to zero and has been following the strategy of quantitative easing, but the monetary measures did not show any result on the real economy because of the numerous structural bottlenecks in the economy, particularly in the banking and corporate sectors. Persistence of deflation for a long time posed the danger of deflation turning into a self-reinforcing spiral of falling prices, output, employment and profits. For bringing the deflationary trend under control, the BoJ needed to continue its aggressive policy of supplying liquidity.

The corporate debt level peaked in 1996, at 125 percent of GDP. By early 2004, Japanese companies had repaid some loans and brought the debt level down to 90 percent of the GDP. The pre-bubble era average was 80 percent.[62] Having addressed the NPLs, Japan would need to earnestly turn to broader financial reforms and restructuring of the financial sector if it is to recapture its former economic vibrancy and dynamism. Financial sector needs to be more transparent and governed by the rules of self-governance. The Ministry of Finance (MoF) and the Bank of Japan (BoJ) still have a large presence in the financial system. Banks and other financial firms march in synchronized manner on orders from the MoF and the BoJ. Market forces and competition take the backseat in the financial markets. Artificial barriers need to be brought down

[62] Based on calculations of Merrill Lynch in Tokyo and cited by *The Economist*, "Japanese Debt: End in Sight," 14 February 2004. pp. 67–68.

and market forces and competition needs to be given full play in the financial markets as well. This is a large order of business awaiting the policymaking community in Japan.[63]

Driven by large fiscal spending and export demand, two fleeting cyclical upturns occurred in 1996 and 2000, but the pressure of myriad structural problems of the economy subdued them. In mid-2002 there was another discernible indication of a macroeconomic upturn and the economy gave a signal of being on the mend. Real GDP showed positive, albeit seasonally adjusted, growth for several subsequent quarters after that. The GDP growth rate in 2003 was a commendable 2.7 percent (IMF, 2004). This revival was supported by other indicators. According to the survey of business confidence, *Tankan,* business sentiments and business outlook had begun improving.[64] This applied more emphatically to large Japanese firms and the transnational corporations (TNCs). Both investors' and consumers' confidence were on the rise. Other indicators that underpinned this revival were inventory, capacity utilization, and corporate profits. Improvement in the macroeconomic situation was reflected in the upsurge in the stock prices (Hilpert, 2003). This broad indication of a moderate recovery spread to a large majority of industrial sectors. In March 2004, Moody upgraded Japan's debt rating to AA+—only one notch below the AAA maximum—and furtherupgraded to AAA in the second quarter. In 2004, deflation was moderating, GDP grew by an annualized 6.1 percent in the first quarter and IMF upgraded the GDP growth estimates for 2004 to 3.4 percent (IMF, 2004). Strong external demand—particularly from China—and laterally a pick up in domestic consumption and investment led to upward growth revision in estimated GDP growth. Unlike the previous two fleeting upsurges that had fizzled out, this one seems to be turning into an upswing of business cycle, albeit the structural snags in the economy are yet to be addressed.

2.5 CONTRASTING THE TWO POPULOUS GIANTS

It has been conventional wisdom to make comparison between China and India, two geographically large countries having long common border, entrepreneurial trading heritage, and enormous internal diversity. Until the end of 1980, the two countries were "impoverished" but comparable. India's population was 687 million, 300 million fewer than China's. Living standards as measured by purchasing power per capita, were roughly the same. As China adopted economic liberalization and modernization in 1978, it left India behind.

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[63] See *The Economist*, "Japanese Debt: End in Sight," 14 February 2004. pp. 67–68.

[64] *Tankan* is regularly conducted quarterly by the Bank of Japan.

India outperformed its neighbor in nothing but population growth rate. By 2001, China's national income per capita was $890, nearly double India's $450. Adjusted for purchasing power, the Chinese were 70 percent wealthier than Indians. Between 1992 and 2002, Indian per capita income grew at 4.3 percent per year, compared to China's twice as fast. In 2002, some 5 percent Chinese lived below the national poverty line, compared with 29 percent of Indian population (*The Economist,* 2003a). China's ability to attract FDI has far outpaced that of India. In 2002, $52.7 billion of FDI made its way to China, compared to $2.3 billion in India. China has emerged as a low-cost manufacturing juggernaut invading global markets in a large array of products, with total merchandise exports of $438.4 billion in 2003. The comparable figures for India are $49.3 billion. India fell behind in every indicator of economic and social well being.

2.5.1 China

Until 1980, China was grouped with the poorest economies of the world. Adoption of market-oriented reforms and economic liberalization was done under the doctrine of "open-door policy," conceived by Deng Xiaoping in 1978.[65] Their earnest implementation was responsible for transforming China from a small, low-income, centrally planned economy to a large "socialist market economy" as well as for its vertiginous economic growth of the last two-and-a-half decades. China has established new standards of sustained growth and dynamic resource allocation by any economy.

Open-economy reforms were essentially carried out in the areas of trade, exchange rate and foreign investment. The consequences of wide ranging liberalization and reforms were reflected in the real GDP growth rate. China recorded the average annual growth rate of 9.7 percent for the 1979–2000 period. Its GDP sextupleted in real terms over this period, while its per capita GDP quintupled.

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[65] At the Third Plenary Session of the 11th Central Committee of the Chinese Communist Party (CCP) in December 1978, the People's Republic of China adopted its "open door policy". This became famous as the Deng doctrine because Deng Xiaoping was the intellectual father of this liberal economic strategy. This marked a turning point in Chinese economic performance as well as economic history. It grew with a healthy clip through the 1980s and 1990s. Gross domestic product (GDP) increased by 10 percent per annum in real terms over the 1980–2000 period. In a short span of two decades China economically transformed itself. Between 1978 and 2000, the GDP grew almost fivefold, per capital income quadrupled, and 270 million Chinese were lifted out of absolute poverty (*The Economist*, 2001). In 1990, China's GDP was $378.8 billion and per capital GDP was $341.60. A decade later, in 2000 GDP reached $1,080 billion, while per capital GDP rose to $853.40. Between 1981 and 2001, China succeeded in bringing down the population living below the World Bank poverty line of $1.08-a-day from 634 million to 211 million, a reduction by 66.7 percent. If the poverty line is moved up to $2.15-a-day, the population below the poverty line declined from 875.8 million to 593.6 million, a decline by 32.2 percent (Chen and Ravailion, 2004).

In 2003, with a GDP of $1.4 trillion, it was the sixth largest global economy, and had earned global kudos for its buoyant economy and well-documented emergence as a global export powerhouse. In 2003 China's imports expanded by a remarkable 40 per cent in nominal dollar terms (i.e. not adjusted for price changes) while its exports expanded by 35 percent—unprecedented levels of expansion for a country with such substantial trade volume.[66] The United States is China's largest market, accounting for one-fifth of China's exports. China's large and growing trade surplus with the United States reached $103 billion in 2002 and $124 billion in 2003 fueled trade friction.[67] In purchasing power parity (PPP) terms China was the second largest economy after the United States. It should be noted that while the PPP measure overstates China's GDP, the conventional measure underestimates it (Wong and Ding, 2003). Rapid growth ensured political stability, the Communist party survived the 1989 Tiananmen Square clampdown. Its present political leadership is widely considered well-educated, capable and pragmatic.

The Deng doctrine succeeded in integrating China with the regional and global economies. China's exports increased with an impressive annual pace of 17.4 percent during the 1979–2000 period. China gradually became the most successful EME in terms of attracting FDI. Between 1988 and 2000, the average rate of growth in FDI flows, as against approval, was 23 percent per annum. The cumulative total of FDI was $340 billion in 2000 (Wong and Ding, 2003). Only the United States receives more FDI than China. In the first quarter of 2004, it was the second largest holder of foreign exchange reserves ($403 billion) in the world after Japan ($730 billion). Chinese economy globalized at a brisk pace and dictated global prices of many products from cement and steel to microchips. While the four tiger economies (see the next section) were badly mauled by the Asian currency and financial crisis of 1997–98, China remained unaffected and offered to assist the crisis-affected neighboring economies. For all appearances, China's economic momentum would continue into the next quarter century. It is a highly diverse and continent-size economy; its internal dynamics can sustain growth for much longer than small economies.

The reforms were launched without a plan, sequence or a timeframe in China, rendering them a degree of tentativeness. The absence of a plan was officially referred to as the "process of crossing the river by feeling the stones" and was characterized by gradualism. They were essentially evolutionary in nature. Hindsight reveals that this reform strategy worked reasonably well. When the reform process was launched, domestic economy was far from integrated—it still is not. It continues to be an agglomeration of regional economies with

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[66] World Trade Organization (WTO). 2004. *World Trade 2003, Prospects For 2004*. Press Release. No. Press/373. 5 April.

[67] This is based on the statistics published by the U.S. Census Bureau.

widely differing resource endowments and comparative advantages. Various regions are known to resist trade and factor flows. This was one reason why China adopted a "dual track" liberalization and growth strategy.[68] The two tracks were the market track and the central planning track. Initially they coexisted, but with the passage of time the market track was to become more important of the two tracks and take over from the plan track. Establishing special economic zones (SEZs) was part of the first track of this strategy. This approach was an innovative solution to the political constraints on the direction and speed of reforms.

An important achievement of the dual track reform process was that China successfully avoided the so-called "supply failure" that badgered other transition economies of Eastern Europe and the former Soviet Union. The rapid transition strategy followed by these countries, referred to as the "big bang," apparently had its blemishes that became obvious in implementation. Economic analysis of the dual track approach showed that it was Pareto-improving (Laffont and Quin, 1999).[69] In fact, this approach to liberalization is by design Pareto-improving. It has minimal additional informational and institutional requirements and minimizes political opposition to reforms (Lau et al., 2000). One of the objectives of this reforms strategy was not to create losers. The dual track strategy not only succeeded in accomplishing this but also worked successfully in product- and labor-market liberalization. This strategy was all-pervasive, and all the facets of economy and policymaking reflected it. Sectoral and policy reforms were no exceptions to this generalization. Several well-regarded and comprehensive studies of China's reform process are now available.[70] Of all the areas of economic reform, those in the area of trade, exchange rate, and FDI were the most significant (Das, 2001b).

Setting up of SEZs was the mainstay of open-economy reform process. By establishing them, China endeavored to attract FDI, modern technology and managerial skills. Initially this was done in a cautious, experimental manner.[71] The SEZs were provided substantial decision-making autonomy. Each one of them decided on its own strategy for attracting FDI, particularly the tax incentives. Foreign firms based in SEZs were not only offered preferential tax and administrative treatment but were also given a more or less free hand in running their operations.

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[68] This was the polar opposite of the so-called "single track" or "big bang strategy" followed by Russia.

[69] Pareto-improving economic effects imply improvements in welfare without any systemic losses.

[70] Although this list is long, reader can refer to one, Zhang (2000).

[71] The first four and the best known SEZs were Shenzhen close to Hong Kong SAR, Zhuhai, close to Macao, Shantou, in Guangdong facing Taiwan and Xiamen, close to Taiwan across the Taiwan Straits.

When it was observed that the SEZ strategy is fructifying, it was expanded (in 1988) and called the coastal development strategy. The expansion was pragmatically planned and aimed at capitalizing on the transformations in global industrial structure. As many mature industrialized economies were abandoning their labor-intensive and low-end manufacturing industries and moving toward information-technology-intensive and knowledge-intensive sectors, China planned to attract their labor-intensive and low-end manufacturing industries to its coastal areas. The strategy essentially entailed importing industrial raw materials to the coastal areas in these carefully identified sectors, manufacture the goods and then export the finished products to the industrial countries. Given China's abundant labor resources, this was a sagacious and well-conceived re-positioning of industrial activity. This strategy successfully relieved the large pressure of surplus agriculture labor as well as relative scarcity of industrial raw materials. Exports generated the much-needed hard currency, which in turn contributed to the development of industry and services sectors. The coastal development strategy turned out to be a stellar success and was an important factor in China becoming an export-oriented economy (Das, 2001b).

Liberalization of trade policy regime led to substantial export growth in goods and services in China. The average annual increase was 12.9 percent for the decade of the 1980s and 15.2 percent for the 1990s. Import growth rates were comparable to those of exports for these two decades; consequently by 1980 China's trade to GDP ratio was 18.9 percent, by 1990 it reached 34.0 percent and by 2000 it soared to 49.3 percent. China's presence is being felt in Asian and global economies. In a short time span, it gained export competitiveness in a large array or products, from labor-intensive ones to high-technology products. Competing economies apprehend that China's rapid industrialization could allow it to become an industrial economy in a shorter time period than that taken by the mature industrial economies.

In 1982, China's constitution legitimized private sector economic activity or the "individual economy." A rapid increase in domestic entrepreneurial activity followed. Since then its fledgling private sector showed impressive growth. Several measures of output and investment in the state-owned enterprise (SOE) sector indicated toward its decline. Its shares in the fixed-asset investment as well as gross industrial output fell from 80 percent in the 1980s to 40 percent in case of investment and to 47 percent—when all the different kinds of SOEs are taken into consideration—in case of output in 2002. As opposed to this, industrial value-added data show that the SOE output declined from 54 percent in 1994 to 48 percent in 2002, which is not a dramatic decline by any stretch of imagination. The output of the private sector was 12 percent of the gross industrial output in 2002, up from 5 percent in 1999 (Lo, 2004). According to another estimate, made by the World Bank, private sector contributed approximately 30 percent

to the GDP in 2003.[72] This cannot be taken to mean that the private sector has become large and robust. Despite rapid growth it has remained small, fragile, fragmented and constrained, as China is toiling through its bumpy economic transition. Private sector cannot offer an effective counterweight to the SOEs. Private sector enterprises feel discriminated against, particularly in their lack of access to capital. This shows that China's structural changes have moved much slower than perceived. A significant recent development in this regard is the decision of the National People's Congress (NPC) in March 2004 to include private property rights in the constitution, which was a significant reform step forward. It means private property has now the same legal status as state-owned property.

High profile reforms were launched in banking but progress was much slower than necessary. After two failed recapitalization programs, in 1998 and 1999, financial authorities started another bailout of the Big Four state banks in 2004. They controlled over 60 percent of all banking assets. The bailout maneuver dealt with the banks individually and uses some $45 billion of China's large foreign exchange reserves to strengthen the capital base of these NPL ridden banks. Although the banks needed $300 billion for sustaining and rejuvenating them, the small capital infusion was made earlier than necessary. The banks should have first proven their commercial viability before they were granted liquidity. The former two recapitalization programs failed to transform the manner in which the state banks do their business. They are not driven by commercial consideration but by political criteria.

Bank credit expansion accelerated in 2001, as the monetary authorities tried to boost growth in the face of a global slowdown. Subsequently, the monetary authorities tried to clamp down on lending in late 2003, especially on property loans, because they apprehended overheating. It was customary for monetary authorities to direct boom-bust lending cycles. The Chinese banks are still taking orders instead of lending to viable investment projects on the basis of creditworthiness. In such a policy milieu banking reforms are likely to remain a mere myth. Authorities publicly promised to improve bank management, corporate governance and risk controls by bringing in foreign investors as both managers and strategic investors. The People's Bank of China (PBC) also took steps, albeit very slowly, to liberalize interest rates and some overtures have been made in this direction. Since January 2004, Chinese banks are allowed to charge up to 70 percent over the PBC's benchmark lending rate—instead of 30 percent previously—according to the borrowers' credit risks. However, such plans and proposed changes would certainly be slow to filter through the system (Lo, 2004). The Marxist mindset continues to be a serious drag on banking reforms.

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[72] This is according to "the Country Assistance Strategy Report" of the World Bank for 2003, which was cited by Ahmed (2004).

As alluded to above, there is a growing perception that China may join the ranks of industrialized countries by truncating the usually long industrial development process. As China has been effectively competing with Japan in many markets in high-technology and information technology (IT) products, many Japanese analysts are convinced about this leapfrogging hypothesis and tend to think of China as a future threat. Because of the growing strength of IT exports from China it is believed by some that the export structure of China is nearly on par with that of Japan. Evidence of these assumptions is generally drawn from isolated cases, rather than systematic analysis and comparison. One reason for this flawed perception is that while there are indicators to evaluate the international competitiveness of individual products and industries, an index to evaluate the competitiveness of the export structure of an economy does not exist. Kwan (2002) developed a methodology to measure the level of advancement of each economy's export structure, based on the weighted average of the level of sophistication or value-added of products that comprise the export structure. This study concluded that while manufactured goods and IT products have become a substantive part of China's fast expanding exports, its competitiveness still lies in low-value-added exportables. Even in the fast growing IT sector, China's competitiveness lags behind Japan's. Although there are overlapping areas, a clear division of labor was found between Japan and China, by Kwan (2002). The former having competitive advantage in high-value-added products, while the latter in the low-value-added products. This trend is in keeping with the Kaname Akamatsu (1961) age old "flying geese paradigm," and until the early 2000s China's industrial structure had not leapfrogged over Japan's.

Notwithstanding the outbreak of SARS (Severe Acute Respiratory Syndrome), the GDP and industrial growth of China was having a great deal of impact over the regional and global economies in the early 2000s.[73] Its accession to the WTO in November 2001 and the increasing contribution to domestic growth made by its own voracious consumers, made it feasible for the economy to depend far less on the problematic SOE sector for domestic growth. As a result, it is also exerting an unprecedented degree of influence over the regional and world trade. Several industrial sectors, including steel, are considered competitive in the global market place. Its imports of iron ore surpassed those of Japan in 2003, making it the largest consumer of iron ore and steel in 2003. Because of heavy construction activity, China became the largest importer of cement in 2004. According to the WTO trade statistics, China accounted for 5.9 percent ($438.4 billion) of the global merchandise exports in 2003, up from

[73] Real GDP growth forecast by the Economic Intelligence Unit (EIU), London, for the 2003 to 2007 period is of 8 percent growth, comparable to the rate recorded in the previous five years (EIU, 2004).

2.7 percent in 1995 (WTO, 2004). Rising level of intra-regional and global trade put severe pressure on China's fast-growing ports. In mid-2003, the southern Chinese city of Shenzhen overtook Kaohsiung in Taiwan to become the world's fifth-largest container port (*The Economist,* 2003b).[74] The TNCs regard China as a special economy in their strategic plans. That China is being regarded as an important market is indicated by the fact that General Motors announced (June 2004) plans to double its capacity and introduce 20 new models into China over the next 3 years. Given that every important car manufacturer on the planet was making similar plans, it appears that the industry could be driving toward excess capacity as early as 2007. Nonetheless, General Motors remained convinced that it can continue to succeed in China, largely at the expense of less-experienced local players. General Motors has been highly successful in China, increasing its market shares from 4.5 percent in 2001 to 10 percent in 2004 (EIU, 2004).

Notwithstanding the commendable achievements, Chinese economy is still in transition from one system to another. Additionally, several structural, institutional and sector-specific quandaries persist. Despite rapid and meaningful progress, reforms are incomplete. The financial sector as well as institutions continued to remain problem ridden, which have not been addressed so far. Infirmities in the semi-reformed fiscal system encouraged rent-seeking behavior at the provincial level and cause frequent budgetary problems. Performance of the SOE sector reached nadir in 1996, when it incurred huge losses. Since then some improvement has been observed due to large layoffs, corporatization, and external factors, but reforms that enhance internal efficiency in firms have not been launched so far. Of the 520 large SOEs, only 10 generated 77 percent of total profits in 2002. All these 10 enjoyed monopoly or semi-monopoly positions in telecommunications, power, oil, and tobacco industries (McNally, 2002). SOE reforms are in a poor state. Closure of loss-incurring SOEs rendered large number of workers redundant. Inaction in this area would have high economic and social costs. China still does not have a truly competitive global firm, which is regarded a failure of its industrial development strategy.

In addition, the ownership structure in the economy still distorts resource allocation, in the process creating large systemic inefficiencies and losses. Inter-provincial and inter-regional disparities are large and have not declined, in the process threatening social stability. Of the 1.3 billion Chinese, 900 million live

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[74] The rapidly growing export value and volume in China is reflected in its fast expanding ports. The Chinese city of Shanghai, which overtook Kaohsiung as the world's fourth-largest port (after Hong Kong SAR, Singapore and South Korea's Pusan), in 2002 saw traffic rise by almost 40 percent during 2002–03. Thanks to a surge in exports from southern China, throughput at Hong Kong SAR's container terminals is soaring. Traffic at the Kwai Chung terminal, for instance, was up by 25 percent in the first half of 2003 compared with the same period in 2002, according to the Port and Maritime Board of Hong Kong SAR (*The Economist,* 2003b).

in the rural areas and work on farms. This neglected constituency is rapidly becoming aware of the growing economic chasm between them and the rising urban middle class, as China rushed on to modern age. With the WTO accession, competition has intensified in the domestic economy and the structural snags became more challenging and problematical. Majority of the SOEs either run at break-even or worse, and their working capital is tied up in "uncollectible bills or unsaleable inventory." SOEs are more concerned with maintaining patronage and employment than operating in a commercially profitably manner (Ahmed, 2004). In general, they cannot be expected to be competitive commercial enterprises.

It was set out above that in their quest for rapid GDP growth, state-owned banks went on providing easy credit and have managed to create massive overinvestments and large NPLs. The sclerosis in China's financial sector has been worsened by the mountain of NPLs. Stock markets have remained moribund, incapable of efficaciously allocating capital and creating long-term wealth. The corporate bond market is tiny and venture capital industry is insignificant. The silver lining behind this dark cloud is that the Chinese policymakers have begun to take financial market reform seriously (Ahmed, 2004). Foreign enterprises operating in China feel that the most pressing need is of protection of property rights and strengthening of financial laws. This has been a bane of the business and economic life of the foreign companies operating in China.[75] Where such laws exist, enforcement is woefully feeble.

In the early 2000s, Chinese policymakers worried about overheating because price bubbles were being generated in several sectors, conspicuously in property, steel, and automobile. Several industrial sectors were identified as having overinvestment. Consequently, a large number of goods were in oversupply. Still investment in fixed assets grew by 30 percent in 2003, and contributed 47 percent of GDP. According to the IMF estimates, three-quarters of China's growth comes from capital accumulation, yet TFP on an average rose by 2 percent per year between 1995 and 1999.[76] The real GDP growth rate was 9.1 percent in 2003. In the first quarter of 2004, the economy grew by an annualized 9.8 percent, and growth in fixed investment soared at an annualized 50 percent. In some sectors it grew by 170 percent. New lending by some banks was rising at 40 percent. Inflation rose to a seven-year high in the first half of 2004 and overinvestment problem worsened. The PBC called for restraint in credit disbursement. In April 2004 PBC upped banks' reserve requirements for the second time in eight months, and took the novel step of telling a clutch of

[75] Ahmed (2004) provided graphic accounts of several instances of American and European companies falling victims of fraud and loosing their valuable assets because of their naiveté and limitations in the legal system.

[76] Cited in Ahmed (2004).

big banks to stop lending in the near future. These drastic measures raised fears of a credit crunch leading to a "hard landing."

The spillover effects of China's slowdown would be both regional and global. Given that "China accounted for about a third of the growth in the world economy over the past three years (in purchasing power terms), a credit crunch in the Middle Kingdom could also spell trouble" for the regional and global economy (The Economist, 2004a). The Australian dollar and Korean stock market plunged at the news. China's insatiable demand for energy (6 million barrel of oil per day in June 2004), raw materials and inputs for manufactures—both to meet domestic demand and to feed its massive export machinery—has made it an increasingly important export market for other countries.[77] In 2003, it was the largest consumer of steel, tin, copper, zinc, platinum, and the second largest consumer of aluminum, lead, oil and the third largest consumer of nickel. To modify an old metaphor, it is increasingly becoming the case that when China sneezes, the world catches cold (EIU, 2004). If consumers in the United States ignited the recent global economic upturn, Chinese producers played an equally important role on the supply side (Roach, 2004).

2.5.2 India

All-round weaknesses in infrastructure continued to be a perennial feature of the economy, but many non-economic characteristics of the society contributed much more to the underperformance of the Indian economy. Lackadaisical long-term economic performance is often blamed on *inter alia* rambunctious democracy and multiplicity of political parties, leading to chaos, compromises, inordinate delays, acceptance of erroneous economic policies and a massive network of subsidies. In a democratic environment, governments at federal and state levels remain short-term oriented, with their time horizon limited to the next election. They are tempted to give in to populist policies as against adopting sound, positive, pragmatic and well thought out macroeconomic strategies that spawn real GDP growth. In addition, for decades India has creaked and groaned under dull, unimaginative and low-quality political leadership and highly corrupt, inapt, intrusive, albeit powerful, bureaucracy, that seems to belong to another time period, India's feudal past. Besides, India did not adopt serious economic reforms and liberalization process until quite late, and progress in its implementation was tentative, grudging and tardy. The bureaucratic behemoth has not been dismantled. Systemic efficiency is not part of Indian culture.

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[77] China accounted for 35 percent of global rise in oil demand in 2003, which gave the oil industry a demand shock. When benchmark price for West Texas crude reached a record of $42 in mid-2004, 50 percent higher than the average crude price for 2002–03, Chinese oil consumption was being regarded as part of the reason.

Indian politicians and bureaucrats have stubbornly remained reluctant to unleash the market forces. Creating an efficacious economic system was never a part of their priorities. Indian economy remained highly distortion-ridden for decades.

Since its independence (1947), Indian government was run by the Congress Party, which did not cast aside its Fabian socialistic ideas about the economy until the mid-1990s. These erroneous ideas *inter alia* included public sector dominance of the economy, meticulously drawn out five-year plan exercises, a large and active (meaning excessively intrusive) government superstructure, and the age-old Gandhian maxim of *swadeshi* or economic self-reliance.[78] Private sector economic activity was considered unnecessary and was kept under harsh control with Byzantine requirements of licenses. Neo-classical economic principles like capitalizing on comparative advantage were rejected out of hands and inward-looking import-substituting industrialization (ISI) policies were vigorously, even devotedly, followed until 1991. Labor and bankruptcy laws were inflexible and archaic. A strong anti-market and anti-private sector environment had existed for decades. Market forces were either quashed or allowed to work only on the periphery. Hindsight reveals that these were all wrong-headed, inimical and pernicious policies. The GDP growth rate barely kept pace with population growth rate. The latter remained high and population crosses the one billion mark. This policy environment kept India mired in poverty for decades. It was accepted as a way of life by the docile Indian society. While the dynamic Asian economies continued to grow rapidly, India hopelessly, if somewhat smugly, stagnated. The economy languished and lost ground vis-à-vis the dynamic regional economies by the year.

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[78] On the one hand, neither Mahatma Gandhi nor Jawaharlal Nehru was an economist. Both were trained lawyers and had some naïve, unidimensional notions that they thought were sound economics. On the other hand, the two national leaders enjoyed enormous popularity and mass adulation in India. Their economic legacies, that is, Fabian socialism in case of Nehru and *swadeshi* in case of Gandhi, were adopted by the Indian society and the government, without the least bit of analysis and questioning. Trained economists did point to the inappropriateness of the former concept and absurdity of latter, but they were treated by the society and the government with contempt for being nerds, who did not know what they were talking. In contrast to these two Indian leaders, Lee Kwan Yew, also a trained lawyer, and Chung Hee Park, an army general, honestly believed that while they were successful individuals in their own right as well as well-intentioned, they were not economists. This realization made them seek high-quality economic advice in running Singapore and Korea, respectively. What they succeeded in achieving for their countries in a short span of time is history. Deng Xioping was also not an economist, but he learned from the failure of the centrally planned economic system in China. Also, he was a clear-headed, dispassionate, result-oriented and pragmatic political leader, not an ideologue. His oft-repeated dictum was, "How does it matter whether the cat is white or black, as long as it kills the rats?" The moral of the story is that the quality of political leadership makes enormous difference in determining a country's economic future.

Although methodical reforms and liberalization was not adopted, something meaningful and durable happened to the supply-side of the economy in the 1980s, and significantly affected the labor productivity. It grew at an average rate of 0.9 percent per year in the decade of 1970s. The average for the 1980s was 3.7 percent. This growth was triggered by an attitudinal shift on the part of the national government toward a pro-business—as opposed to pro-liberalization—approach. When the Congress government returned to power in 1980 after an electoral defeat, it stopped breathing populist fire and sought to court the business constituency. It intended to signal to the market that India is a safe place for business and investment (Rodrik and Subramanian, 2004).

Economic liberalization and reforms were not taken up until it was quite late. Some minor reform measures were taken in the mid-1980s, albeit there was little change in the mindset of the bureaucracy and politicians. Even these half-hearted liberalization measures had a small favorable effect over the GDP growth rate. Between 1987 and 1990, economic growth rate spurted to an average annual rate of 7.6 percent, much higher than the annual average (4.8 percent) for 1980–86. Small relaxation in distortions leading to a significant response in growth rate need not be surprising because it is explained by the theory of distortion. The larger the degree of initial distortion, the greater is the benefit from the marginal reforms and liberalization. When Manmohan Singh, the maverick Finance Minister, launched a relatively comprehensive economic reform program in July 1991, in his budget speech he called it the continuation of the old efforts.

The 1991 stabilization and reform program was launched in the hope that India would be able to emulate the dynamic economies of the east.[79] It was a move away from the ISI strategy that India followed for over four decades, to the outer-oriented growth strategy. It cannot be ignored that the immediate motivation for launching into the liberalization and reform program was a major fiscal-cum-balance-of-payment (BoP) crisis, which brought foreign exchange reserves down to a $1.2 billion, sufficient for three weeks of imports. The Reserve Bank of India (the central bank) had to send its gold reserves to the Bank of England to borrow hard currency from it. The International Monetary Fund (IMF) had to be approached for assistance.

Many economists believed that the deep fiscal-cum-BoP crisis was caused by incorrect and contradictory macroeconomic policies followed during the

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[79] Indian bureaucracy and politicians, two of the most powerful groups in the society, are of firm belief that there is little wrong with Indian economy and that it is doing as well as, if not better, the dynamic Asian economies. They have made make-belief an art form. Logic is not their long suite when they compare Indian economic performance to that of the dynamic Asian economies. Although they are perturbed about the global accolade earned by the Chinese economic performance, they are convinced that it is spurious and based on incorrect statistics. Ostrichism knows no bounds.

1980s and earlier. Other believed that the BoP crisis, and growing inefficiencies and non-competitiveness of Indian products in the global markets were caused by subversion of market forces for decades through an array of controls and regulations, quantitative restriction and the public-sector dominance of the economy. Inefficiencies in the public sector had multiplied over time, were of gargantuan proportion, and had existed since its inception. As you will sow so shall you reap. Thus, the economic system created under the guidance of the socialist-minded Prime Minister, Jawaharlal Nehru, had problems galore and served India poorly. A major reform program was long overdue. The stabilization and reform program adopted in 1991 entailed broad measures for macroeconomic policy improvements, measures to improve the efficiency levels in the economy, opening up of the economy to foreign trade and investment, and dismantling the stifling industrial licensing system. It had an unmistakable imprint of the Washington consensus over it.[80]

Reforms program was not only launched belatedly but also implemented in a hesitant, halting and inept manner; therefore, progress in implementation has been slow and tardy. Privatization moved only in fits and starts and foreign ownership of Indian firms was liberalized piecemeal, with a glacial pace. When the government changed in 1998, privatization program regressed.[81] Quantitative restrictions (QRs) on imports and tariff barriers have been reduced in the 1990s, but in terms of the IMF's restrictiveness index for 2001, India (along with Bangladesh) was the most closed Asian economy. India's average tariffs were three time the Asian average. This IMF ranking also applies to non-tariff barriers (NTBs) in India (IMF, 2002). There are well-known static and dynamic gains from free trade, which include domestic efficiency gains through market discipline and integration with the global economy and markets. By devising a rigid system of high tariffs, NTBs and QRs India deprived itself of the benefits of a liberal free-trade regime.

Bardhan (2002) noted that there were flagrant disjunctures in the Indian reform process, particularly "between the policy of economic reforms and the political and economic processes." Therefore, one should not be surprised to see

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[80] The term "Washington Consensus" is considered synonymous with "neo-liberalism" and "globalization." John Williamson propounded the concept as a set of neo-liberal policies, which in turn referred to the lowest common denominator of policy advice that was being given by the Washington-based Bretton Woods twins to Latin American countries in 1989. This policy advice essentially entailed: fiscal discipline, a redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution (such as primary health care, primary education, and infrastructure), tax reforms (to lower marginal rates and broaden the tax base), interest rate liberalization, a competitive exchange rate, trade liberalization, liberalization of inflows of foreign direct investment, privatization, deregulation (to abolish barriers to entry and exit), and secured property rights.

[81] The Congress Party lost election in March 1998, and a new Bharatiya Janata Party (BJP) led coalition government took over.

a lack of direction and indifferent results of the post-1991 liberalization measures. The reforms still lack a political constituency. To succeed, reform process needs to have a long-term framework to which governments can credibly commit and in reference to which progress, or lack of it, may be calibrated. This framework did not exist. In the process of day-to-day political wheeling-dealing, the weak political commitment to reform process constantly eroded. There was little reason to feel assured that even the weak government commitment to the reform process and implementation. It was observed that a government that proposed certain reform measures began to oppose them when it was no longer in power. In addition, the powerful Indian bureaucracy was more than merely apathetic to the liberalization and reform program. If anything, it remained committed to perpetuating the status quo of the pre-reform period. Red tape continued to thwart all economic and financial activities. Bureaucratic antagonism toward implementation was easy to comprehend. This group saw reforms as measures that would loosen its stranglehold over the economy and in turn reduce their rent-seeking opportunities.

Even slow and tardy implementation was reflected in improvement in GDP growth rate and some progress in poverty alleviation. Annual growth rate of per capita GDP in real terms accelerated from 1 percent in the 1960s and 1970s to 3 percent during the 1990s. In nominal terms, GDP growth rate during the 1990s was 6 percent. This implied about one-third increase in per capita consumption over the decade of the 1990s and 5 percent to 10 percent increase in the rate of poverty alleviation, depending upon the methodology and data used (Ferro et al., 2002).[82] Given that one-third of world's poor live in India, this can rationally be considered a valuable contribution of the liberalization and reform program. If implementation of reforms becomes earnest and efficient in future, the power of the market forces would be unleashed and long-term growth trend would surely improve.

The current macroeconomic scenario of the Indian economy presents a mixed picture. Its growth performance for the decade of 1990s was exceeded by only 19 out of 139 countries. However, troublesome levels of fiscal deficits persist. Unlike the dynamic Asian economies, Indian economy was always plagued with fiscal profligacy, a long-lasting weakness. In 2000, 74 countries with population over 10 million were arranged in order of descending fiscal deficits for the decade of the 1990s. Only seven countries, including India, had government fiscal deficits of 7 percent or above. Besides, only Turkey and Zimbabwe had recorded higher fiscal deficits than India (Srinivasan, 2001). In

[82] Change in survey methodology of National Sample Survey in 2000 (the 55th round) made comparison of results with the previous rounds of survey impossible. Empirical studies attempted to correct for the changes in survey methodology. Most new estimates indicated that there was a 5 to 10 percent improvement in the incidence of poverty.

2000, India's fiscal and debt indicators were comparable to Argentina, Brazil and Turkey, all three fell to major macroeconomic crises over the 1998–2003 period. In spite of macroeconomic weaknesses, India was not considered immediately vulnerable to a crisis because of its high foreign exchange reserves (discussed later), restrictions on both inward and outward capital flows, flexible exchange rate, and substantially large public sector ownership of the banking sector. This situation contrasted with the circumstances in 1991, when India suffered a major fiscal-cum-BoP crisis with fiscal deficits of comparable size and lower debt levels (Pinto and Zahir, 2004). Notwithstanding the lower probability of a 1991-like crisis, the macroeconomic health of the economy is far from robust and there is a pressing need to tame the precariously, if not perilously, high levels of government deficits, which currently runs at 10 percent of the GDP and absorbs far too much of the budget.

Unlike China, India follows an old and established system of common law, inherited from the British colonial rule. Property rights are generally well protected and financial and corporate laws are far superior to those in China. However, the legal system is over burdened and, therefore, moves with glacial pace. Every now and then, plans of reforms are made but they remain merely on paper.

Globalization—or to be more precise expanding global trade in services—created new opportunities for India in a small segment of its economy. By virtue of having a large educated, English-speaking young population available to work at low salaries compared to the industrial economies norms, India first found comparative advantage in software and computer programming. Second, it found a profitable niche in back-office outsourcing of business services and call centers. India became world's largest recipient of the U.S. outsourcing in the IT sector, Canada took the second place (Scoffield, 2004). One direct outcome of this success was rising level of foreign exchange reserves. They doubled in 2002 and again in 2003, reaching $103 billion in early 2004, creating pressure on the rupee to appreciate beyond what the fundamentals could justify. The Reserve Bank of India had to purchase huge quantities of dollars to keep the rupee from appreciating.

The business-process outsourcing (BPO) firms have been expanding the range of work that can be performed remotely. Its applications are virtually endless. There were some 3000 BPO firms and a large number of outsourcing jobs. Revenue from BPO alone grew by 50 percent in 2003 to $3.6 billion. Four kinds of firms were scrambling for performing these white-collar jobs. First, the large Indian software firms like Infosys and Wipro, which aspired to be full-service providers to their clients. Second, the specialist third-party outsourcing firms like Evalueserver, Cognizant and Daksh, which provided narrowly specialized services to their clients. Of these IT firms, Daksh was set up in 1999; its turnover doubled every year since its establishment. Third, large

captive units created by TNCs, particularly by financial services TNCs, like GE Capital, American Express, HSBC, Citigroup and Standard Chartered. Fourth, the establishments created by the gigantic global professional-services consultancies, like IBM, Ernst & Young and Accenture (*The Economist,* 2004b). India's thriving BPO industry faced two major uncertainties, namely, growing protectionism in its important markets, particularly the United States, and the usual meddling of an incompetent and parasitic government. Besides, competition from the other countries (such as Barbados, Brazil, Bulgaria, China, Malaysia, Mexico, the Philippines, Rumania, Russian Federation, South Africa, and Vietnam) is likely to start making inroads and challenge the Indian IT-enabled services and BPO industry (see Chapter 5, Section 5.4 for greater details).

India's GDP growth rate was 6.8 percent in 2002 and 7.4 percent in 2003, which is far superior to the past achievements. Trade balance recorded a surplus in 2003. However, India has not been attracting global financial resources commensurate with its size and potential. Its engagement in the world trade is also not comparable to those of the dynamic Asian economies. Despite considerable improvement in policies and performance, all the usual economic indicators confirm that India's integration with the global economy has been moderate, at best. Indicators like trade to GDP ratio, FDI to GDP ratio, and country credit rating place Indian economy in the slots far removed from the dynamic Asian economies. Future growth prospects are at best tepid because of slow and inadequate macroeconomic and structural reforms, high levels of fiscal deficits, which crowds out investment in export-related industrial sectors and slow privatization. Global investors are generally unimpressed with the large deficits. As noted above, the level of protection is still very high, both in absolute and relative terms. Inefficiencies and weaknesses of an overstretched infrastructure continue to badger the economy. Power outages impose sizable costs on firms. Labor force has serious quality problems, which is compounded by inflexible and archaic labor laws. Under this set of circumstances, the large domestic market that should have furthered prospects of integration with the global economy, discourages Indian firms to pay attention to the external sector. The Congress-Party-led coalition came back in power in May 2004. In their budget (July 2004), again nothing was done to advance the reforms. Status quo continued even on pressing issues like privatization, labyrinthine subsidies, and labor laws. If the new government does not adhere to the philosophy of rapid liberalization and deregulation, and removing itself from all the things it does not do well in the area of business and economy, and focuses its energies on areas where markets alone do not provide the answer, Indian economy is certain to continue to underperform. Decades of flawed macroeconomic policies *inter alia* provide little reason to be optimistic about the future of Indian economy.

2.5.3 Why India lagged behind China?

It is evident from the above exposition that adoption of wrong economic philosophies (Fabian socialism, *swadeshi* or economic self-reliance) and strategies like ISI, a shackled private sector tied down with Byzantine requirements of licenses and controls, smothering of market forces, rejection of neo-classical economic principles like capitalizing on comparative advantage had high and perpetual costs for the Indian economy. Gigantic public sector enterprises and intrusive governments soon became albatrosses around the neck of the economy. The Chinese economy also suffered when it was a centrally planned economy, but with the adoption of the Deng doctrine these unproductive ideological notions were rejected in China and the economy made a complete volte-face. Despite being a communist country, China adopted capitalist economic philosophy and moved pragmatically toward an open market economic system. No such turnaround in economic philosophy and strategy ever took place in India. Design and successful implementation of the SEZs and coastal development strategies enabled China to prepare a firm and sizeable base for modern manufacturing industries and put China ahead in terms of manufacturing output and exports. India not only did not have any strategy parallel to this but also its industrialization process progressed lethargically.

Systemic rigidities in India have not declined and cause much more constriction in India than in China, leading to high costs to the economy. For instance, in the Global Competitiveness Report for 2000, in terms of restrictions on hiring and firing of workers, India ranked 73rd out of 75 countries, while China ranked 23rd. Bankruptcy laws in India are still archaic and it is an impossibility for large enterprises. Over 60 percent of the bankruptcy cases take more than 10 years in Indian courts. At the other end of the spectrum, starting a new small business takes much longer in India than in China. It takes 90 days and 10 permits in India, while 30 days and 6 permits in China (Wolf and Luce, 2003).

To add to the woes, non-economic malaise like low-quality political leadership, unimaginative governments, large, inefficient and corrupt bureaucracy, exceedingly delayed adoption of economic reforms followed by poor implementation kept India way behind China. Conversely, not having a democratic system helped China at crucial points in its recent economic history. Deng Xiaoping could never have launched his 1978-reform program—which immediately caused a spike in the unemployment rate—if he had to muster a parliamentary majority and hope to be reelected.

It has been debated why the response of liberalization measure was weaker in India than in China. Other than the reasons put forth above, there is a structural explanation for it. Over the 1980–2000 period, substantial structural transformation took place, essentially due to declining significance of the agricultural sector in the two economies. In India, the entire decline in the agricultural sector

was added to the services sector. Its industrial sector did not rise as a proportion of the GDP. China experienced similar transformation in its economic structure but in China, initially the size of the industrial sector as a proportion of GDP was twice that of India. Over the next two decades, it rose further. Therefore, in 2000 the share of services sector in China was 33.2 percent of the GDP, while in India it was as high as 48.2 percent. The industrial sector was 50.9 percent of the GDP in China, as opposed to 26.9 percent in India.

This change in the economic structure matters a great deal. When a developing economy takes to liberalization, its prospects of exporting goods, particularly labor-intensive products, from its industrial sector improve. If it has a large industrial sector, its export industries can try and find niches in the global market place for initially low-technology exportables and then move up the product value chain. As China's industrial and manufacturing sectors were much larger than that of India, it benefited more and succeeded in globalizing at a far brisker pace than did India. The same logic applies to FDI. Compared to China, India received modest amounts of global FDI and there are little prospects of a sharp pickup. Investment in industry has remained sluggish. This includes both domestic and foreign investment. Global investors feel hesitant for the same reason as do the domestic ones. The formal services sector can absorb FDI in India, but its capacity to do so is limited. Owing to these structural factors India has lagged further behind China over the preceding quarter century (Panagaria, 2004).

2.6 NEWLY INDUSTRIALIZED ASIAN ECONOMIES

The four newly industrialized Asian economies (NIAEs), namely, Hong Kong SAR, Korea, Singapore and Taiwan earned the fond sobriquet of the "tiger" economies and the "little dragons." These economies are known for their rapid and sustained GDP growth, between the early 1960s and the mid-1990s, and are of interest to the developing economies in that they were able to graduate from developing country status to industrial economy status in a short span of three decades and were able to progress past other developing economies in Africa, South Asia and Latin America. They provided large investment opportunities and attracted attention of the global investment and financial community (see Chapter 1, Section 1.7). Their growth was characterized by even income distribution, that is, they recorded consistent improvements in the Gini coefficient along the growth trajectory. The rapid growth in this sub-group of economies in a short span of time is exemplified by the Korean economy, which is known to have doubled its per capita income every 5 years between 1961 and

1996.[83] It not only became a NIAE, but also a member of the prestigious club of industrialized economies, namley the OECD in 1996.[84] In early 2000s, Korea led the world in broadband Internet access; nearly 60 percent of the population could access the web at ultra-high speed.

In the early 1960s, the four NIAEs were characterized by their low-income and excess labor supply. Though the exact timing of the beginning of rapid growth varies from economy to economy, their growth performance for the following decades was noteworthy—the Asian crisis of 1997–98 was an aberration. Their economic policies contain both similarities and differences. They were largely based on pragmatic and result-oriented neo-classical economic principles. They learned lessons from the impressive economic growth of Japan and espoused the model of outer-oriented, export-induced growth, with relatively closed domestic markets and rejected the ISI at an early stage in their economic growth process. Like Japan, their financial system was "repressive" in the initial stages. Tailored government intervention was a hallmark of their growth strategy, although Hong Kong was an exception in this regard. As they followed outer-orientation, they were open to FDI, which helped them in achieving rapid GDP growth, with technological catch up. In the initial stages of their growth, Japanese TNCs and large firms invested massively in these economies and became a source of industrial learning and technology transfer (Das, 1996).

The four NIAEs together accounted for less than 2.5 percent of world merchandise exports in 1971. Compared to that, in 2003 their exports added up to 9.5 percent of the world's total merchandise exports, which is only a trifle less than that of the Germany (10.0 percent). As a proportion of world's merchandise exports, these four economies were almost equal to the United States (9.7 percent), the second largest exporter in the WTO league table of exporters after Germany, and substantially higher than Japan (6.3 percent), the third largest exporting economy.[85] These statistics make it clear that brisk

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[83] In 1960, Korean economy was agrarian and poor, with scarcity of arable land and a large part of labor force underemployed or unemployed. Conversely, today's Korea is an industrial-urban society, with almost 80 percent of the population in urban areas having exceedingly low unemployment rate. In 1960, Korea was nearly an autarky, with heavy dependence on the U.S. aid, which accounted for 10 percent of its GNP. Today's Korea is the 12th largest trading nation in the world, and has turned from a recipient economy to a donor economy, providing official development assistance to other developing economies.

[84] On October 25, 1996, Korea became the 29th member nation of the OECD, the second country in Asia—the first was Japan—to accomplish this feat. This membership was expected to raise Korea's level of credit and push the country toward a full status as an advanced economy and a progressive society. It was also expected to help the country to deregulate and to fully open its economy to the world.

[85] See WTO (2004), *Leading Exporters and Importers in World Merchandise Trade, 2003.* Appendix Table 1.

growth in trade has been an important element in the development of these dynamic economies. Large trade and investment flows closely integrated the NIAEs with Japan. As the industrialization process progressed, the composition of exports evolved toward higher capital-labor ratio products. They started to export more sophisticated manufactured products, such as machinery and equipment. Subsequently, they became important exporters of computers and IT products. This shift in the composition of exports reflected a major shift in the industrial landscape of these economies. Services sector recorded rapid growth, particularly in Hong SAR and Singapore.

Structural transformation of this nature required large investment and until 1970 these economies only had rudimentary financial systems. Government mandates and schemes encouraged savings and they played an active role in mobilized savings for financing export-oriented industrialization—Hong Kong was an exception again. In Singapore, government encouraged high private savings through mandatory provident fund contributions by both employers and employees. A member of a provident fund could use savings for housing, education, medical care, or retirement. Though less formal and limited in scope, the governments of Korea and Taiwan also operated various specialized saving instruments. These savings were utilized to establish government-owned development banks in all the three economies. In addition, in keeping with the strategy of "picking the winners," which was learned from Japan, special funds were created for financing the targeted sectors of industries (Section 2.4). Commercial banks also played a noteworthy role in mobilizing domestic savings. In Korea and Taiwan, the governments required commercial banks to extend credit to industries targeted in the government development plans. Interest rates on these loans were regulated and kept below the market rate.

Economic development in the four NIAEs, in particular in Korea, followed the Japanese model of government-bureaucracy-led growth within a mercantilist framework (Das, 1991). Korea carried the Japanese model so much further that it was often referred to as the Korean model of growth. Korean government and political system was much more intrusive in the economic affairs than was the Japanese government (Krause, 1997). Often the chosen instrument of government intervention was control over financial resources. In all the four NIAEs, resource allocation process treated export industries and sectors as well as large infrastructure projects as priority sectors. In the early stages of growth, exchange rate policies were carefully crafted, currency overvaluation was meticulously eschewed and the real effective exchange rate (REER) was never allowed to get out of line.

In the early stages of growth, more than half of bank credit went to the manufacturing sector. Contribution of manufacturing sector to GDP remained substantial and policy emphasis on this sector persisted, although in the early 1980s the Korean government discontinued an ambitious policy to create large

heavy and chemical industries and had to address banking sector problems with a massive credit infusion (Das, 1991). In Taiwan, the pattern was similar, that is, more than half of the bank credit was allocated to the manufacturing sector in the early stages, and manufacturing output contributed even more than Korea to the GDP. In the 1990s proportion of bank credit going to manufacturing sector declined significantly in both Korea and Taiwan.

Although government channeling of credit from state-owned institutions to the targeted industrial sector was done in Singapore also, commercial banks were not involved in the process. Proportion of bank credit going to the manufacturing sector was smaller in Singapore than in Korea and Taiwan. Taking advantage of its geographic location, Singapore developed itself as *entrepot* and regional financial center. Therefore, controls on interest rates, foreign capital, and entry barriers in banking were abolished in the 1970s. In comparison, removal of these restrictions was carried out piecemeal in Korea and Taiwan in the mid-1990s. Although Singapore still strictly limits offshore transactions on its currency, it allowed liberal international financing operations for both domestic and foreign financial institutions. It was necessary for guaranteeing transparent and unencumbered operations of commercial banks for fostering a vibrant financial sector.

Hong Kong's case clearly differs from the other three NIAEs because the government did not support the financing of the industrial sector and took a *laissez faire* stance. The financial and industrial sectors developed their own relationship without any external interference. Government kept its role limited to maintaining the rule of law and did not intervene in most facets of economic activity. Despite such disparate arrangements between the industrial and financial sectors, the four NIAEs collectively achieved remarkable growth, raising the oft-asked question of whether the structure of the financial sector really matters much for growth.

In addition, there was a strong government commitment in all of the four economies to improving education, particularly elementary education, and to egalitarianism, in the form of adoption of land reforms. The strategic priorities of these societies were clear. Unlike the South Asian economies, they assigned economic growth high priority, while other social objectives were relegated to secondary positions. They subordinated the objective of social goals to economic growth. Civil liberties were deemed unimportant at the early stages of growth. All the three NIAEs, except for Hong Kong, initially maintained somewhat non-democratic, and rather stern and authoritarian governments, which contributed to disciplined economic growth.

TFP growth in the ANIEs was slow but steady. The causal factors were low growth in labor productivity, rising capital intensity, and changing pattern of reallocation of resources. Much debated TFP studies showed that economic growth in Asia was essentially driven by input growth not by productivity or

efficiency growth (Kim and Lau, 1994; Young, 1994, 1995).[86] The growth model of these economies was castigated for being factor input-based. No matter how you slice it, the accusation seemed correct. Among the industrial economies, TFP growth is considered to be the key to GDP growth. During rapid post-war growth period in Japan, the TFP increases contributed about half to GDP growth. The average annual GDP growth rate of Japan between 1953 and 1971 was 8.8 percent, of which 4.9 percent was attributed to technological progress (Denison and Chung, 1976). Various calculations of GDP growth in the United States attribute half of it to TFP.

Until the mid-1970s it was not clear whether the four NIAEs comprised a particular group known for rapid growth and whether their development model produced superior results to either non-market or ISI models. Gunnar Myrdal's Nobel Prize winning *Asian Drama* (1968) made no mention of the ANIEs.[87] Myrdal vaxed eloquent about the planned developmental efforts of India and its neatly drawn out five-year plan exercises. However, soon thereafter ANIEs' success began to draw a lot of global attention. During this period, Taiwan had recorded brisker GDP growth than China, and was frequently presented as an example of the triumph of market-economies over the non-market systems. The spectacular ascent of the NIAEs to economic prominence attracted much scholarly interest and led to numerous theoretical analyses and explanations. Many economists, and notably at the World Bank, depicted NIAEs' economic ascent as a vindication of free-market system or neo-classical economic principles. This interpretation of their success formed a large part of the Washington consensus. It was expected that the other developing economies would take a leaf from the development paradigm of the NIAEs and move on to a higher growth trajectory.

The Asian crisis (1997–98) mauled the Korean economy severely. Export growth in the NIAEs decelerated in 1998, although there was a huge depreciations of the Korean won (33.3 percent), which had resulted from the financial crisis. This was counter-intuitive because currency depreciation normally leads to spurt in export performance. At least Korean exports did not recover following the steep won depreciation. There were three reasons for the drop in exports in the NIAEs. For one, the build-up of capacity in the electronics industry, which had led to large inventory build-up as well as a collapse in world

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[86] In a dissenting empirical study Drysdale and Huang (1997) concluded that both TFP growth and factor accumulation were equally responsible for output growth in Hong Kong SAR, Indonesia, Japan, Korea, and Thailand, while this did not apply to output growth in Malaysia and Singapore. In another dissenting paper, Liang (2002) reached the inference that TFP was the major source of economic growth in Taiwan over the 1960–93 period.

[87] Gunnar Myrdal shared Nobel prize in 1974 with his ideological rival Friedrich von Hayek. He received it for his classic work entitled the *Asian Drama: An Inquiry into the Poverty of Nations,* published in 1968.

prices for semiconductor and electronic goods, forced a slowdown in economic growth in the NIAEs. Second, intraregional trade accounted for around 50 percent of the total. Therefore, when the crisis-affected economies reduced their imports—which included their regional imports—exports of the other regional economies declined, which propelled the spread of contagion. Third, the credit crunch that emerged in the regional economies because of the collapse of financial markets and institutions, additionally hamstrung NIAEs' exports. Many firms found themselves hard pressed for working capital, and they could not import their raw materials and parts and components.

There was a clear disparity in how badly the Asian crisis, and the contagion generated by it, affected the NIAEs (Chapter 7, Section 7.1). Among the ANIEs, Korean economy had suffered the maximum, while Taiwan the minimum. The recovery was rapid, although the same observation of diversity applied to the recovery. Korea was the first to show signs of an upturn, in the fourth quarter of 1998. Rapidity in the recovery was supported by three major developments. First, exports of semiconductor and the other IT-related product lines demonstrated a strong pick-up. Second, the much-needed inventory adjustment was completed during the crisis period. Production suffered during the crisis due to difficulties in importing components and intermediate materials, which led to a fall in inventories. Relaxation in domestic fiscal and monetary policies also helped in bringing down the level of inventories. The NIAEs had successfully completed inventory adjustment by the second quarter of 1999. The third contributing factor was revival in domestic consumption. As opposed this, unemployment remained higher than the pre-crisis level even in 2000. However, it did not rise because of rejuvenation of the production machinary.

2.7 SOUTHEAST ASIAN ECONOMIES

This diverse sub-region comprises Brunei Darussalam, a petro-rich economy, four relatively better-off ASEAN-4 economies (namely, Indonesia, Malaysia, the Philippines, and Thailand), which are included in the EMEs group by some definitions, and three low-income, small economies of Indochina (namely, Cambodia, Lao PDR and Vietnam), which are in a state of transition from centrally planned to market economies. Brunei Darussalam is the richest economy of the sub-region, with its enormous oil wealth. Although Singapore is geographically located in this neighborhood, in terms of GDP, growth rate, economic structure and level of industrialization and development it resembles the other NIAEs and is justly included with them. Three of world's megacities, population exceeding 10 million, are located in this sub-region. They are Bangkok, Jakarta, and Metro Manila. The sub-region has enormous economic, social and cultural diversity.

The resource-based economy of Brunei Darussalam is small and rich, and encompasses a mixture of foreign and domestic entrepreneurship. The source of its riches is sizeable oil and gas reserves. The energy sector accounts for around 90 percent of exports and the same proportion of government revenue. Brunei's GDP per capita of about $18,600 is among the highest in the sub-region. The government provides a wide range of free or heavily subsidized public services, and it employs over half of the labor force. Under a currency board arrangement, the exchange rate of the Brunei dollar is maintained at par with the Singapore dollar.

Some of the noteworthy features of the individual sub-regional economies are as follows: From 1966 to 1999, Indonesia was under the New Order regime of President Suharto. It benefited from the oil boom of 1973–85. As a member of the Organization of Petroleum Exporting Countries (OPEC) its production quota is 5.2 percent of the total OPEC production.[88] In Malaysia, ethnicity impinged upon both pattern of development and government policies. The New Economic Policy (1971–93) was designed to restructure Malaysian society and economy to assure the long-term dominance of ethnic Malays, or the *bhumiputra*, over more recent immigrant communities of Chinese and Indian origin. The Philippines has been regarded as an exception among the market economies of Southeast Asia in the sense that its economic growth has been far less stable or rapid than that of the neighbors. Since independence it has been plagued by a series of crises, both in the economic and political spheres. Unlike the other sub-regional economies, Thailand never became a colony of a foreign metropolitan power. It is difficult to comprehend whether it made any substantive difference to its post-World War II pattern of development. The country was ruled by a series of military dictatorships, until the early 1990s.

At the time of independence, the agricultural sector in these economies dominated the economic structure. Since the 1960s, several sub-regional economies benefited from the Green Revolution, a term coined by William Gaud, director, USAID, in 1968. It was a movement to increase agricultural yields by using new crop cultivars, irrigation, fertilizers, pesticides and mechanization. To be sure, agricultural output improved, but its impact on income distribution, distribution of land holdings, employment in the rural sector and more generally on national economic and social development has been controversial. In this regard, Vietnam was a special, if somewhat complex, case. Frequent and major changes buffeted the agricultural sector in Vietnam. It carried out a radical land reform in the 1950s and then, as the socialist model was implemented after 1959, agriculture was collectivized. After the re-unification of the country in 1975, the socialist model of collectivization was imposed on the South as well.

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[88] The largest OPEC production quotas are held by Saudi Arabia (32.5 percent), Iran (14.7 percent) and Venezuela (11.5 percent).

However, increasing difficulties in the agricultural sector led to a gradual process of de-collectivization and the re-establishment of family-based farming in the 1980s. In 1988, the agriculture sector began to be run in normal market-economy fashion.

As regards the policy structure for industrialization, Indonesia, Malaysia, the Philippines, and Thailand began with adopting the inward-looking ISI strategy, but by mid-1970s they had observed the favorable results of the outer-orientation in Japan and the NIAEs. They pragmatically switched to the export-induced industrialization strategy. Although ISI was never completely abandoned, as a strategy for this group of economies it had a marginal influence. Outer-oriented industrialization led to high rates of industrial growth as well as rapid changes in socio-economic structure. As these economies were learning strategic lessons from Japan and Korea, governments in these economies played a decisive role in the growth and industrialization process. The consequences of intervention were favorable in some cases and unfavorable in others. Birth and abuse of "cronyism" is a notorious illustration of the latter.

Indonesia, Malaysia, and Thailand turned in stellar performances, albeit individual economic differences remained. The contributing factors essentially included adoption of outer-orientation in growth strategy, sound macroeconomic policies, high savings and investment rates, substantial investment in human resource development, favorable demographic shifts, flexible labor market policies, low price distortions in the economy, eagerness to absorb advanced technology, and absence of bias against agriculture. Consequently, this country group was able to achieve real GDP growth rates well above the norm for the developing economies. Little wonder, the 1993 World Bank report classified Indonesia, Malaysia and Thailand as "miracle" economies. Between 1985 and 1995, there were signs of a turn around in the Philippines as well, which was an underachiever in comparison to the other three economies.

Asian crisis, which began in Thailand and the contagion spread to the other economies of this sub-group, was a veritable economic trauma. Before the outbreak of the Asian crisis, these economies were posting rapid GDP growth rates, ranging between 6 percent and 10 percent per annum. Between December 1996 and October 1997, stock market indices plummeted sharply. In Indonesia they fell by 21 percent, in Malaysia 41 percent, in the Philippines 39 percent and in Thailand by 39 percent. During the crisis-induced downturn, GDP contracted in these economies. It was most severe in Indonesia and Thailand (see Section 2.8). Many banks and other financial institutions collapsed under the weight of NPLs, and had to be taken over by the respective governments. Consequently, in Indonesia three fourths of the banking sector had to be nationalized, while in Thailand this proportion was one-third (see Chapter 7, Section 7.1).

With over 6 percent GDP growth rate in 1999, a V-shaped economic recovery set in Southeast Asia. The recovery broadened and deepened in 2000 (ADB,

2003). The driving forces behind the recovery included robust external demand for the sub-region's products and a slender increase in the domestic demand. The export growth in the sub-region was supported by strong U.S. growth in 2000 as well as recovery in the Asian economies. Also, expansionary fiscal and monetary policies underpinned domestic demand in the sub-region. Since the recovery began, public sector consumption and investment picked up in the sub-region. Conversely, private sector consumption and investment remained somewhat subdued in spite of tax breaks. The overall GDP growth trends for the sub-region masked a good deal of diversity in economic performance. For instance, while Malaysia recorded GDP growth of 5.8 percent in 2000, the Philippines posted a weak performance of 3.9 percent (ADB, 2003).

Transition to market economy proved to be a difficult proposition for Cambodia, Lao PDR and Vietnam. When the transition exercise began, the production structure collapsed and severe supply problems arose; consequently these economies grew poorer than they were before adopting the transition measures. However, by 2000 these economies had managed to reduce the levels of absolute poverty. Vietnam is regarded as the most successful in this respect. It is considered a special case in this sub-group of economies and has performed markedly better than its two neighbors.

To be sure, the transition process was difficult and complex for Vietnam. The war had a disastrous impact over economic development endeavors. Although by 1989 central planning had been abandoned entirely, many political and institutional features of the old system continued to influence Vietnamese economic development, especially the preponderance of state-owned firms and a system of highly interventionist government regulations. During the decade of 1990s, agriculture-led growth helped in cutting down the level of absolute poverty from half the population to one quarter. Its growth endeavors were supported by increasing liberalization of the economy, growing exports and adoption of far-reaching economic reforms. The present political leadership seems committed to this economic strategy.

2.8 POST-CRISIS PERFORMANCE

Although five Asian economies (Korea, Indonesia, Malaysia, the Philippines and Thailand) were categorized as crisis-stricken, Asian crisis affected virtually all the regional economies, some more others less. Seven Asian economies recorded negative GDP growth rates—that is, it contracted in 1998. Maximum contraction was recorded by Indonesia (−13.1 percent) and Thailand (−10.5 percent). The crisis was deep, not wide. In 1999, the five crisis-affected as well as the other Asian economies made a V-shaped recovery and the average regional growth rate improved from 1.7 percent in 1998 to 6.4 percent

in 1999. The East Asian economies recovered more than the Southeast Asian ones. During 2000, regional GDP growth rate was 7.1 percent, although next year it dipped to 4.1 percent. The following two years were also moderate GDP growth years, with a GDP growth rate of 5.7 percent in 2002 and 6.3 percent in 2003 (ADB, 2003).

To be sure, much was accomplished after 1998. One sign of how far Asia has come is that all the five crisis-affected Asian economies completed their IMF-supported reform and restructuring programs. Indonesia was the last to do so at the end of 2003. Most economies shifted to sounder macroeconomic and financial policy frameworks than before the crisis. Monetary policy became more focused. Fiscal policy reforms were under way in several countries, albeit not completed. Between 1999 and 2003, Asia excluding Japan, was the most rapidly growing region of the global economy, although GDP growth rates did not reach their pre-crisis levels. Even Indonesia, laid low by the crisis, got back on its feet (Krueger, 2004). In March 2004, it succeeded in issuing the first bond in the global financial markets in eight years. Emerging market spreads dropped dramatically from 760 basis points to 420 basis points between January 2003 and April 2004. That being said, much remains to be done, especially in the area of macroeconomic, financial, structural and institutional reforms. Even in 2004, Asian economies were not in the pink of health. Indubitably the recovery from the crisis was rapid, the crisis left some lasting blemishes over the region before retreating.

One post-crisis commonality in sub-regions and economies in Asia was that real GDP growth rate declined markedly after the crisis. A comparison of average annual real GDP growth rates for the pre- (1990–98) and post-crisis (1998–2002) periods demonstrated that it declined for China from 10 percent in the former period to 7.6 percent in the latter, for Hong Kong SAR from 4 percent to 2.3 percent, and for Southeast Asian economies the decline was sharper. For instance, in Indonesia it declined from 5.3 percent to −0.1 percent over the two periods. Likewise, in the South Asian economies, which were affected only indirectly by the crisis, there was a small decline. The imperative of arresting and reversing the declining GDP growth rates applied to all the Asian economies.

Macroeconomic policy framework adopted during the post-crisis period was in general thoughtfully devised and well calibrated, but for the fiscal deficits where a lot more was needed to be achieved. This macroeconomic limitation was acute in South Asian economies as well as in the Southeast Asian ones, particularly in Malaysia and the Philippines. It was also growing serious in Hong Kong SAR (ADB, 2003). Measured as percentage of GDP, South Asian economies had the highest levels of fiscal deficits in the post-crisis period. Expanding fiscal deficits started raising the cost of capital, in turn, affecting volume of investment in several Asian economies. Real cost of capital was

6 percent in South Asian economies in 2002, which was double of the other Asian economies including China (Wolf and Luce, 2003). High cost of capital is a major disincentive to augmenting the rate of investment in an economy. As the fiscal deficits are financed by public borrowings, they tend to increase the level of public debt and interest payment burden as well as crowd out private investment. Share of public investment in many Asian economies declined appreciably; in India and Thailand it fell steeply to almost half the pre-crisis levels.

Inadequacies in regulatory framework and supervision further raised the cost of capital, particularly in economies where the banking sector has substantial public sector ownership. The large amounts of NPLs, spawned by the crisis in several Asian economies, also led to higher interest rates and a credit crunch. NPLs tend to shrink bank profits by cutting down interest income and raising loan loss provisions. For meeting the capital adequacy ratios Asian banks had to raise capital in the equity markets, which was not easy during periods of financial distress. Thus, NPLs put banks under severe financial strain, resulting in interest rate hikes and stringent assessment of loan quality for the new loan applicants. Therefore, credit growth has slowed down significantly in many Asian economies (ADB, 2003). The principal attributes of the post-crisis macroeconomic environment were growing budget deficits, rising public debt, high cost of capital, and deceleration in the growth rate of bank credit. Consequently, governments were unable to provide essential social services, infrastructure weaknesses could not be removed, and high costs of capital raised production costs. In this *mise-en-scene,* at the enterprise level, TFP has suffered in many Asian economies.

The post-crisis restructuring and reform endeavors were far from uniform. There was a variety in their intensity and scope. It was increasingly felt that other than fiscal stability noted above there was a pressing need for further strengthening of the financial sector. On this count, NPL overhang and corporate governance were among the most important issues to be addressed. Until 2004, banks and corporations were still struggling with weak balance sheets in several crisis-affected economies. To be sure, this weakness undermined growth opportunities. It was no coincidence that those economies that were more aggressive in the area of financial sector reform after the crisis were enjoying better growth performance. Second, in many economies there was a need to put effective bankruptcy laws in place, and improve prudential oversight and supervision in the capital markets. Until this is accomplished, Asian economies would be far from having open and competitive environments, which can best foster the sustainable, rapid growth. Third, more efforts were needed to deepen financial markets, with an express objective to extend the number and variety of instruments available. Asian economies need to rapidly shift toward equity and bond financing, because it would reduce the heavy reliance on the banking sector—a long-term characteristic of the Asian financial sector. It would

improve the assessment and management of credit risk as well as help in the creation of a thriving financial market (Krueger, 2004). Chapter 2.7 addresses these issues in sufficient details.

The Asian crisis forced the affected economies off their de facto exchange rate pegs. Past experience demonstrated that for the post-crisis period, Asian economies either need to adopt floating exchange rate or its polar opposite fixed exchange rate. This imperative has been necessitated by a financially integrating global economy. Hernandez and Montiel (2001) raised doubts about the post-crisis exchange rate policies of the crisis economies. They contended that these economies seem to be returning to the same set of policies that served them so poorly during the pre-crisis era. That is, the currency values have been stabilized at new levels without adopting any commitment mechanism. As the "soft" currency pegs have little prospects of surviving in the present global financial milieu, resumption of such practices in the crisis makes these economies as vulnerable as they were before the crisis (see Chapter 7, Section 7.9.1).

As officially declared and found in the IMF classification, crisis caused Indonesia, Korea and Thailand to move in the direction of greater flexibility in their exchange rate regimes. Malaysia moved in the opposite direction and adopted a fixed exchange rate. While the Philippines did not make any changes and retained its pre-crisis independent floating exchange rate regime (Chapter 7, Section 7.9). Knowledgeable observers believe that these official positions are not correct and that little has changed during the post-crisis period. With the exception of Thailand, currencies in crisis-affected and non-crisis economies returned to formal or informal dollar pegging, and they fluctuated in much the same way as they did before the crisis, meaning thereby, they are not fluctuating at all (Calvo and Reinhart, 2000; McKinnon, 2000). To be sure, the post-crisis floaters have allowed their currencies much more flexibility than they did during the pre-crisis era, but they are far from the so-called "clean" floats practiced in the mature economies.

2.9 SUMMARY AND CONCLUSIONS

The dynamic group of Asian economies represents enormous diversity in economic as well as in social, political, religious, cultural, ethnicity, linguistics, geographical features and systems of governments. The heterogeneity among Asian economies is also visible in the structures of GDP and economic development. This group can be divided into sub-regions and countries that are at different stages of economic development, and have widely differing economic characteristic attributes.

The Association for Southeast Asian Nations (ASEAN) is the oldest regional grouping and has ten members, ranging from tiny island republics like Singapore

to Indonesia, which comprises over 17,000 islands. ASEAN has enlarged to include China, Japan and Korea. The new group is ASEAN-Plus-Three (APT), which has more heterogeneity than the ASEAN of 10 members.

Japan is the leading geese in the flying-geese paradigm of Asian economies. Its brisk post-war economic recovery had enormous demonstration effect in Asia. The salient characteristics of this high-growth era were high rates of savings and investment, an industrious labor force with strong work ethics, supply of cheap oil, adapting and adopting new technologies in the manufacturing sector followed by technological innovation and effective intervention by the government. The government and bureaucracy led growth efforts in a neo-mercantilist fashion. Rapid export-induced growth led to immense changes in industrial structure. It shifted from agriculture and light industry to heavy and high-technology industries and services. Dominating the industrial sector were iron and steel, shipbuilding, machine tools, motor vehicles and subsequently electronics. In 1989, monetary authorities reacted by tightening policies to contain rise in asset values. Next year, the Nikkei index fell by 38 percent, wiping out over $2 trillion worth in stock market value. Land prices collapsed, burdening financial institutions with massive bad debts. Banks became overly cautious and a severe credit crunch followed. The economic bubble of the late 1980s burst on the last day of 1989, which signaled the end of the second era of rapid growth and more than two decades of rapid overseas business expansion.

China adopted market-oriented reforms in 1978 and economy was liberalized under the doctrine of "open-door policy," which transformed China from a small, low-income, centrally planned economy to a large "socialist market economy," noted for its vertiginous economic growth of the last two-and-a-half decades. China has established new standards of sustained growth and dynamic resource allocation by a large economy. Open-economy reforms essentially cover the areas of trade, exchange rate and foreign investment. China recorded real GDP growth rate of 9.7 percent for the 1979–2000 period. China's GDP sextupleted in real terms over this period, while its per capita GDP quintupled. In 2003, with a GDP of $1.4 trillion, it was the sixth largest global economy. In PPP terms China was the second largest economy after the United States. It should be noted that while the PPP measure overstates China's GDP, the conventional measure underestimates it. The flip side of the coin is that Chinese economy is still in transition from one system to another and several structural, institutional and sector-specific quandaries persist.

Lower real growth rate and slow progress in the Indian economy is sometimes blamed on *inter alia* rambunctious democracy and multiplicity of political parties, leading to chaos, compromises, inordinate delays, acceptance of erroneous economic policies, and all round weaknesses in infrastructure. In a democratic environment, governments at federal and state levels remain short-sighted, with their time horizon limited to the next election. They are tempted

to give in to populist policies as against adopting sound, positive, pragmatic and well-thought macroeconomic measures. Reforms program was not only launched belatedly in 1991, but also implemented in a hesitant, halting and inept manner; therefore, progress in implementation has been slow and tardy. The favorable recent developments include India first finding comparative advantage in software and computer programming, and second finding a profitable niche in back-office outsourcing of business services and call centers. Also, the BPO firms have been expanding the range of work that can be performed remotely.

The four NIAEs are known for their rapid and sustained GDP growth, between the early 1960s and the mid-1990s, and are of interest to the developing economies in that they were able to graduate from developing country status to industrial economy status in a short span of four decades. Their economic policies contain both similarities and differences. They were largely based on pragmatic and result-oriented neo-classical ecomnomic principles. They learned lessons from the impressive economic growth of Japan and espoused the model of outer-oriented, export-induced growth, with relatively closed domestic markets and rejected import-substitution at an early stage in their economic growth process. Like Japan, their financial system was "repressive" in the initial stages. Tailored government intervention was a hallmark of their growth strategy, although Hong Kong was an exception in this regard.

In the diverse sub-region of Southeast Asian economies, Indonesia, Malaysia, and Thailand turned in stellar performances, albeit individual economic differences remained. The causal factors essentially included adoption of outer-orientation in growth strategy, sound macroeconomic policies, high savings and investment rates, substantial investment in human resource development, favorable demographic shifts, flexible labor market policies, low price distortions in the economy, eagerness to absorb advanced technology, and absence of bias against agriculture. Consequently, this country group was able to achieve GDP growth rates well above the norm for the developing economies. The Philippines became a marginal member of this sub-group of economies. In 1997–98, Korea, Indonesia, Malaysia, the Philippines and Thailand were roiled by a serious currency and financial crisis.

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