Capitalist Development and Economism in East Asia

The rise of Hong Kong, Singapore, Taiwan, and South Korea

Kui-Wai Li

London and New York

Capitalist Development and Economism in East Asia

The four Asian "dragon" economies have been widely studied in recent years, as investigations seek to disclose the secret of their rapid growth. Despite this, it is still unclear why other economies that shared the features of the East Asian countries have failed to develop with similar speed and success.

Taking a conceptual approach, this book studies the economic development of the four East Asian economies since 1950. The author summarizes and reconsiders many of the arguments and findings that supported and explained the economic "miracles" of Hong Kong, Singapore, Taiwan, and South Korea, analyzing the relationship between economic development, growth, and political economy.

The author puts forward a development paradigm, economism, that consolidates the key features of these economies into the following areas of concern:

- capitalism
- poverty reduction vs. income equality
- growth vs. distribution
- foreign investment and trade
- role of the government
- a pro-growth regime.

The paradigm provides a conceptual framework for the discussion and understanding of the "dragon" economies, as well as a guide for the development of other economies.

This pioneering book will stimulate further analysis of East Asian development. It will be an essential read for scholars of East Asian economics, and for all those interested in modern economic development.

Kui-Wai Li specializes in the areas of financial and economic development, industry, and trade, and has worked as a consultant to international institutions, foreign governments, and business. He visited Yale University and attended an executive program at Harvard University in 2000 and 2001 respectively. His research focuses on China and Asian economies, and his refereed articles have appeared in various journals.

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To foes, friends, and family

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Preface

At the very least, this book summarizes and reconsiders many of the arguments and research findings that have been used to support and explain the "economic miracles" of the four East Asian economies of the Hong Kong Special Administrative Region of the People's Republic of China (Hong Kong), Singapore, Chinese Taipei (Taiwan), and South Korea. At most, it offers a new dimension in development analysis, challenges the existing development literature, and proposes a new paradigm of economism that incorporates and reinterprets many of the post-war development issues. The book is largely conceptual in nature and philosophically knits together these development issues within the economic domain.

The publication of this book should be considered as just the beginning of a new era of debate and discussion on the economism paradigm of development. The ten chapters primarily lay out the fundamental elements of the paradigm, serve as a pivot and stimulant in further developing the paradigm, and introduce discussion on the development of East Asian and other developing economies. Discussions from supporters and sympathizers will help to consolidate the paradigm, and the work of critics will be equally welcome, as criticisms and the highlighting of drawbacks and shortcomings will add strength to the paradigm.

Many of the issues covered in this book have been given new interpretations so that existing issues and new arguments can be welded together to form a paradigm for further investigation, discussion, debate, and study. The new interpretations are mainly conceptual in nature and, although they show a high degree of logistical consistency, further work will be required to deepen, confirm, and establish the economic truth of the paradigm. The book begins by arguing that, although existing economic tools have been used successfully to explain growth in the four East Asian economies, a development paradigm can be developed to intricately combine the various components of the existing theories. The emphasis is not on individual issues or theories, but on the combination that melds together to form the economism paradigm.

The arguments challenge popular views. While equality is a socially desirable goal, the paradigm advocates that poverty reduction and income inequality should be considered on an absolute basis. Whereas the export-

led strategies of these economies and their inflows of foreign direct investment have been articulated as the causes of economic growth, the economism paradigm argues that the base for growth is internal economic strength and stability, which attracts foreign investment and trade. While growth has been explained by either the availability of capital or total factor productivity, the paradigm postulates the "law of first opportunity," according to which economic development begins with what is available in terms of resources. The role of the government should not be viewed simply as either interventionist or non-interventionist, but it should be acknowledged that government can act as a supplier of "economic fertilizers" that serve as incentives to individuals and businesses. Fiscal policy can also be growth oriented and concerned more with the supply side of the economy. Similarly, political regimes in these economies tend to be pro-growth and ensure a high degree of economic freedom.

The bulk of the work in this book was carried out at the City University of Hong Kong. The remaining chapters were completed while I was a Visiting Fellow of the Economic Growth Center at Yale University in the first half of 2000. My time spent at Yale University was fruitful. The academic environment there is very conducive to intellectual activities, and I had the privilege of attending seminars and lectures, and exchanging my ideas with Yale professors. I am grateful to a number of colleagues in Hong Kong and professors from other universities and institutions that have, through discussions and written comments, helped me to sharpen the ideas presented here and improved the texture of this book.

While I am solely responsible for every issue covered and mistake found, I would like to thank the following teaching and research assistants, Cici Leung, Wai Sum Hui, Irene Tam, Queenie W.P. Wu, and Anita Wong, who helped me with the literature searches and the data collection. Research funding from the City University of Hong Kong is gratefully acknowledged. I am indebted to Routledge for editorial assistance, and to the various reviewers for comments and criticisms. Last but not least, the support of my family has been invaluable.

Kui-Wai Li
City University of Hong Kong
November 2001

1 Economism and development

1.1 The paradigm of economism

The post-World War II economic development of the four East Asian economies of the Hong Kong Special Administrative Region (Hong Kong), Chinese Taipei (Taiwan), Singapore, and South Korea has shown a distinctive pattern. A superficial review of these four East Asian economies reveals that they are not too different from others nearby in terms of their shortage of natural resources and ready availability of other resources, e.g. labor. Their economies are not particularly strong, but, on the other hand, military expenditure is low. However, at the end of World War II, the economy of the Philippines was considered to have more potential for growth than that of its neighbors in Asia.

The economic success of the four East Asian economies has been documented in a great volume of literature. The culture heritage of Confucianism could be a historical convenience, while the stages of growth and capital accumulation theories are the conventional approaches. The economics of *laissez-faire*, together with foreign trade and investment, have constituted another area of study. The "flying geese" model of development looks at growth from a regional perspective. Studies of industrialization and changes in industrial structure tend to focus on the internal dynamics, while human capital and technology advancement are advocated by the endogenous growth theory. The change in East Asia's growth experience and its geopolitical position have also been examined.

A major failing of all these studies is that they do not provide a cohesive and comprehensive conceptual framework that goes beyond analysis based on individual subject disciplines and areas. At the conceptual level, these studies lack a comprehensive framework that examines the economic growth experience of these four economies in their entirety. The growth experience of the four East Asian economies represents a new paradigm that may not have parallels in other countries – a paradigm that requires specific conceptual interpretations, demands new ways of translating existing economic principles, and projects a growth pattern that can be exported to other economies.

The paradigm of economism attempts to provide a conceptual framework

that links together and reinterprets a number of independent macroeconomic developmental issues. Economism emphasizes the importance of using economic tools and means in arriving at a solution acceptable to society. Economic consideration has constantly been given top priority, as it often produces positive-sum, Pareto-optimal, or "win–win" solutions and absolute benefits, though the extent of the benefit varies among individuals. In a nutshell, the development experience of the four East Asian growth economies shows that economic growth takes paramount priority over wealth redistribution and other non-economic considerations. For example, in the pursuit of growth, poverty reduction is considered a good investment, but reduction in income equality may vary depending on income growth. However, another common concern among these four economies is political stability.

The economism paradigm consists of five basic economic conceptual elements that govern the successful operation of an economy. These five elements are the focus on poverty reduction rather than pursuit of equality; the role of government as a provider of "economic fertilizers"; the emphasis on domestic strength with changes in comparative advantages; a pro-growth political regime; and the presence of a market economy. Together, these economic concepts form the very fundamentals, or "floor conditions", upon which economic activities are conducted successfully. These "floor conditions" guarantee the different economic minima in the society. How much each individual or business prospers and achieves more than the minima depends on the initiative of individuals, the availability of economic opportunities, and on market disciplines and interactions. Economic cycles are periodic changes in income that arise as a result of fluctuations in investment and income activities.

The first conceptual element is the preference for absolute poverty reduction over the attainment of relative economic equality. A graph of income inequality over time in the four East Asian economies discussed here would take the form of a U-shaped curve over recent decades, that is, income inequality has fallen, leveled out, and then risen again. While poverty reduction has been achieved through the exercise of various effective internal and external policies, income inequality has, by and large, been tolerated. Internal policies such as development in infrastructure, education, employment, and training have ensured economic security. External policies have included the pursuit of an open and export-oriented economy. Foreign direct investments have supplemented domestic capital, facilitated industrialization, and ensured exports. Poverty reduction is a long-lasting phenomenon. However, population movements, for example, could lead to the re-emergence of poverty, helped along by the fact that the so-called poverty line is raised periodically.

Expansion in business and employment opportunities ensures economic security, which, in turn, guarantees social security. The provision of jobs as income grows secures the ability of individuals to look after their economic well-being. The greater the extent to which individuals are able to take care

of their own economic and social well-being, the less is the need for assistance from the state or the government. The lower requirement for government expenditure on social welfare, in turn, reduces the need to impose a higher tax burden. A lower tax rate further stimulates businesses and encourages individuals to pursue their own economic self-interest. The more people work, the larger the tax pie and the greater the opportunity for the government to lower the tax rates. A lower tax rate stimulates business, and, in turn, results in higher taxable earnings for the government. Economism argues that income inequality is inevitable, as it reflects individual differences in resource endowment. An absolute increase in income through expansion in economic opportunities is a more important socio-economic goal than relative income equality.

According to the second conceptual element, government maintains a suitable business environment through the exercise of appropriate fiscal incentives, infrastructure provision, education, and training. A minimum level of provision in such welfare-related items as health and public housing ensures that the workers' "survival cost" is minimized. The fiscal framework is biased toward the supply side of the economy, and government expenditures are geared primarily to the generation of income, employment, or skills. Thus, government serves two primary roles: welfare and infrastructure provision and promotion of wealth-generating activities. Government intervenes mainly through the exercise of instruments and incentives that provide "economic fertilizers" to businesses and households. This is the second conceptual element of the economism paradigm.

It has been argued that the open and export-led nature of the four East Asian economies led to economic growth. It is true that these four economies benefited from the buoyant external sector but, given the high mobility and competitive nature of foreign capital and investment, it must have been the strength of the domestic economy that attracted foreign capital. The strength of the domestic economy depends on, among other things, the rate of income growth and such factors as stability and an efficient institutional framework.

Domestic strength is the third conceptual element of the economism paradigm. Economism advocates an open-door, market-friendly economic policy and strategy that results in the international community both complementing and supplementing the domestic economy. Comparative advantage still forms the basis of trade, but economies are focused on economic flexibility and the changing or dynamic nature of the comparative advantage. Domestic economic advantages change in response to the needs of the international community. Thus, it would be more appropriate to argue that foreign investment and exports are the consequences of a successful domestic development strategy. However, foreign investment and exports constitute necessary but not sufficient conditions for economic success, a strong, growth-conscious domestic economy also being required.

Despite the lack of a freely elected political regime, the governments of the four East Asian economies have permitted a great degree of economic

freedom at both the macro and micro levels. Economic growth has overridden all other political objectives. Resource allocation and economic policies have been pro-growth, which fits in with the fourth conceptual element of economism: political stability. Political stability has contributed to positive investment activities. The increase in the number of wealth-holders, coupled with improvements in education, has meant that, as people become better educated and better off, they are in a better position to appraise and influence government policies. Responsible and effective governments have produced a consistent policy and investment environment. Economic freedom has been granted to individuals to conduct all forms of legitimate economic and financial transactions. Strikes, civil unrest, union activities, and open conflicts have been minimized and are regarded as disruptive to economic growth. A period of stability lasting a number of decades has enabled economic resources to gain efficiency. Improvements in human capital, gains in capital efficiency, and advancements in technology have enriched productivity. In short, economism believes that the economic engine sets its own pace, and economic results require the exercise of appropriate, consistent, and decade-long policies.

The fifth conceptual element is the capitalistic, market-oriented nature of these four economies. Competition provides market information to both suppliers and consumers. This ensures fair play and equal opportunities for individual market participants. The absolute gains so derived through competitive market disciplines may lead to relative differences in gains, but such differences are accepted as a reflection more of differences in individual endowment than of inequalities in the allocation or distribution process. Like capitalism, economism also advocates private ownership, intellectual property rights, a free market and the "invisible" hand, the dominance of the private sector, and a low level of government involvement in the economy.

These five elements form the "economism" paradigm in the four East Asian economies. The focus on poverty reduction rather than income inequality has cleared the way for absolute income to increase. The rise in absolute income has generated growth in a market economy in which different capitalistic elements have enabled individuals to maximize economic gains. With the pursuance of absolute income, economism is a game of "more" or "less." The "more" and the "less" survive in harmony and their "conflict" is exercised through the various forms of economic activities. No economy can do away with its governing body but, in this case, the presence of the government has assisted individuals by providing economic incentives and other growth-promoting activities. Government activities have encouraged further increase in absolute income for individuals. Similarly, no economy can shut itself away from the outside world, but the focus should be on the strength of the domestic economy in attracting trade and investment. Stability and competitiveness are important domestic factors. Careless political regimes can damage economic growth. However, in the case of these four

economies, a pro-growth political regime has ensured the separation of the economic game and the political game.

The economism paradigm concentrates on the combinations and outcomes of these five inter-related conceptual elements as they are applied consistently over a long period of time. Economism encourages and pursues virtuous circles. One relates to the reduction in poverty, a low tax regime, and a growing income pie that allows individuals to rely more on their own achievements and less on government assistance. The reduction in government expenditure means that more government resources can be devoted to "wealth-generating" activities. Another virtuous circle is initiated by a degree of economic openness, which invites foreign participation, which, in turn, supplements domestic shortage in terms of exports and capital. The third virtuous circle can be realized from sustained growth and the expansion of the real economy through expansion in exports, manufactures, and investment and infrastructure construction. An enlargement of the real economy gives rise to activities in the financial economy and services in the tertiary sector.

This chapter discusses the various conceptual elements of the economism paradigm. Section 1.2 outlines a simple economic theory of growth. Sections 1.3 and 1.4, respectively, relate the issue of absolute income versus relative income comparison and the importance of economic security. Section 1.5 talks about the role of government, giving special attention to tax as a government instrument, while section 1.6 examines the political and international setting that helps to promote growth. Section 1.7 then outlines the structure of following chapters.

1.2 The economic pie and its distribution

The first lesson in economics is that human wants are insatiable and individuals are economic maximizers. However, society has limited resources and opportunity cost is involved. Decisions have to be made on choice, priority and distribution between all economic outcomes. If more economic resource is devoted to one outcome, less will be available for others. The fundamental objective of economic growth is to create income and wealth for society. The economic pie of income and wealth can be enlarged by expansion in investment activities. There is also the impact of the economic multiplier, whereby one area of economic improvement spills over to another. A virtuous circle will then be generated in which an increase in income in one sector encourages the same effect in other sectors.

There are three types of economic resources, or factors of production, that can be utilized to improve the income of society. These are natural resources (agriculture, minerals, land, and all other forms of natural endowments), human resources, and capital resources. Studies have concentrated on the availability of these production factors. Equally

important, however, is their mobility. Natural resources are the least mobile. Land, forest, and minerals cannot be moved from one place to another, and they may not be useful to human beings when they are in their raw form. The process of "value-added" through investment activities turns natural resources into commodities. Human resources are slightly more mobile, as people can move to work in different areas and professions. But human beings are not born to be professionals and experts in certain areas. To turn human beings into human capital, investment is needed to increase the "value-added" content of human resources. Education and training take time, and financial capital has to be made available to set up schools, colleges, universities, and other training institutions. Human mobility is therefore constrained by geographical and professional limitations.

Capital resources are the most mobile, mainly because of their high liquid status. Financial capital, in the form of stocks and shares, bonds, and other forms of securities, can be transferred easily to different geographical areas and currency denominations, depending on the utility preference of its owner, the rate of return, and the regulatory framework governing the movements and liquidation of assets. Financial capital mobilizes other resources. Natural resources become "consumables" only when capital is injected into the value-added production process. Financial capital is the most powerful of all three economic resources. Through the investment process, when financial capital is mixed with natural resources and human resources, economic output, in its broadest sense, is generated, giving rise to consumption, employment, and income generation that will ultimately lead to an increase in economic well-being.

The three types of economic resources are located in the upper portion of the funnel in Figure 1.1. Natural resources, the least mobile form, are situated at the top of the funnel, followed by human resources. Financial capital, the most mobile form, mobilizes the other two forms of economic resources. The circuit, indicated by the arrow in the upper portion of the funnel, suggests that both natural and human resources have to be transformed by financial capital before they can be utilized.

The lower portion of the funnel shows the chain relationship created by the investment of financial capital. The outcome of investment activity is the generation of output, income, and household consumption. Output influences both income and consumption, which eventually determine the economic well-being of society. The arrow in the lower portion of the funnel shows the circuit in which the increase in economic well-being then requires a further increase in output. The size of the economic pie is the amount of output produced at any given time. This depends on the quantity and efficiency of financial capital.

The crucial link in the funnel is the cross between financial capital and output. At the macroeconomic level, the "quantity school" argues that the higher the level of investment, the higher the level of output. Important factors are the different types of investment (direct or portfolio investments)

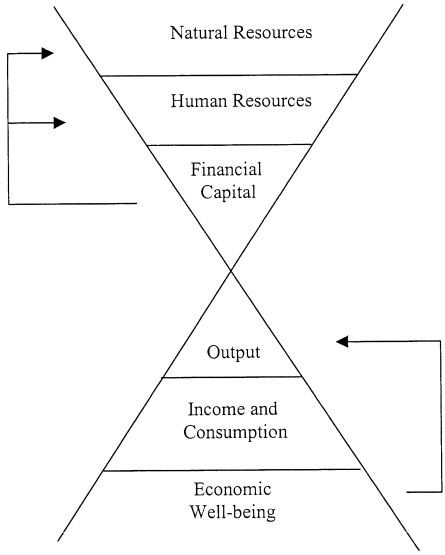

Figure 1.1 The investment funnel

and the source of investment (bank loans, shares, or corporate bonds). On the other hand, advocates of the "quality school" are concerned with the effectiveness of financial capital and the operations of financial institutions and financial instruments as vehicles to promote capital efficiency. At the microeconomic level, the various capital efficiency measures include the calculation of the incremental capital output ratio, the management structure (the principal–agent and corporate governance theories), the calculation of investment returns (project appraisal analysis, investment decisions), choice and location of investment (industries or services), and the return and profitability of investment (tax concessions, cost of production, and marketability).

Distribution of wealth is a more controversial area. Imagine the extreme case in which there are only two individuals, A and B, in a society with different initial endowments. Individual A (say, the employer or investor) has a much greater income than individual B (say, the worker). The unequal distribution of wealth between the two individuals is shown in Figure 1.2. Clearly, individual A is much wealthier than individual B. If there is an expansion of the economic pie, as indicated by a movement from the inner to the outer circle in Figure 1.2, the gain of the richer individual is indicated by the area A', while the poorer individual gains area B'. Despite their initial unequal shares, expansion of economic activities leads to both gaining, though their share of the gain differs. However unequal the original situation is, expansion of the economic pie still permits the poorer individual to gain through the achievement of a higher absolute economic well-being.

The argument is based on comparisons. If the comparison is made on a

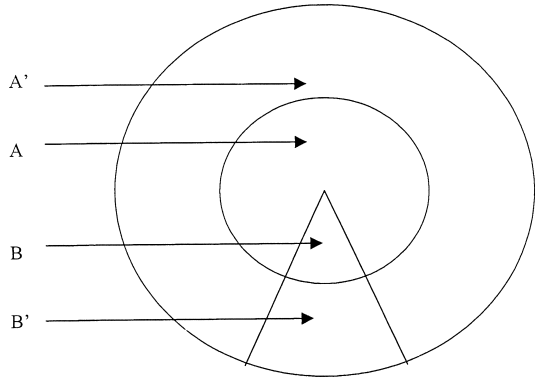

Figure 1.2 Showing the unequal shares of the economic pie

relative basis between the two individuals, A and B, inequality is a perpetual phenomenon; B will always be poorer. However, if the comparison is made on an absolute basis, the poorer individual has definitely gained. From an egalitarian stance, expansion may not be justified as the gap between rich and poor is preserved. From the viewpoint of economic well-being, however, the expansion is justified as it results in both individuals being better off.

It is true that economic expansion does not lead to a fair share between the two individuals, but this is acceptable so long as both individuals have gained and are better off than previously. In most instances, the end result of an investment process involves a number of non-quantifiable or qualitative inputs that yield different results. According to the permanent income hypothesis, for example, different levels of education result in differences in returns. Differences in time, risk, family background, and the size of investment inputs can also generate variations in investment returns. It is not surprising, therefore, that an enlarged economic pie can result in greater inequality in the distribution of wealth.

1.3 Inequality and poverty

Although modern economies aim to secure a more equal society, history tells us that there are various types of inequalities: social class, racial, religious, territorial, ethical, tribal, political, and income. Like freedom, fresh air, a secure social environment, and peace, equality is one of those things of which more is always better than less. Inequality can have a permanent impact and, in the very extreme, it can be a matter of life and death. Economic inequality, typically in the form of income inequality, is a more acceptable form of inequality, provided that equal opportunities are provided in other respects.

The concept of income equality can be considered both statically and dynamically. At a particular point in time, given the differences in individuals'

initial endowment and earning ability, comparing the income of any two individuals will give a measure of relative inequality. Figure 1.2 presents a static, or discrete, picture of income inequality. Over a period of time, however, if equal employment opportunities exist, poorer or underprivileged individuals could achieve a higher level of absolute income. Given a free market, capitalistic economy, in which economic gains are based on personal drive and achievement, the level of absolute income will vary. In a growing economy, in which income is generally rising, income inequality coexists with the rise in absolute income.

Absolute income pattern changes over time as a result of various dynamic factors. Changes in population structure, arising, for example, from changes in the birth rate or immigration policy, may change job opportunities and the absolute income of workers. Income inequality measurement depends largely on formal statistical figures of income and population. A considerable amount of informal earnings, however, are either not reported or under-reported in the calculations of Gross National Product (GNP). Therefore, income inequality should also be considered from a dynamic point of view. As a society develops, economic opportunities expand. Individuals make use of the growing economic situation to attain a higher level of absolute income. Empirically, one can observe the income trend of an individual or a group of individuals to determine if their absolute income level has improved over time.

There are five possible dynamic time trends in income inequality, as shown in Figure 1.3. Consider firstly Figure 1.3(a), in which the income trend of the richer individuals is represented by the line AC, while that of the poorer individuals is represented by the line BD. The vertical axis indicates the level of income, and the horizontal axis is time. The vertical distance AB shows the initial gap in income between the two groups. As time passes, the richer people get much richer, and their income reaches point C. The poorer people, probably because of lower initial endowments, become better off too, but at a slower rate. The income of the poorer people at the end of the period (point D) is higher than previously, but is still much lower than that of the richer people and, because the poorer people's income increased at a slower rate, the income inequality gap has actually become bigger, as represented by the vertical distance CD. Nonetheless, this result is acceptable because both groups are better off at the end of the period.

Figure 1.3(b) shows a similar outcome in that both groups become better off, but the difference here is that the poor (FH) get richer at a faster pace than the rich (EG) do. At the end of the period, both are better off, and the income inequality gap is narrower (compare the vertical distances EF and GH). Economically, this result suggests that the rich (say, the employers) are rewarding the poor (say, the workers) at a faster pace than themselves. This could be achieved by increasing wages or by wages rising faster than profits. Or, the government could be redistributing handsomely in favor of the poor at the expense of the rich in the form of tax and subsidies. In a growing

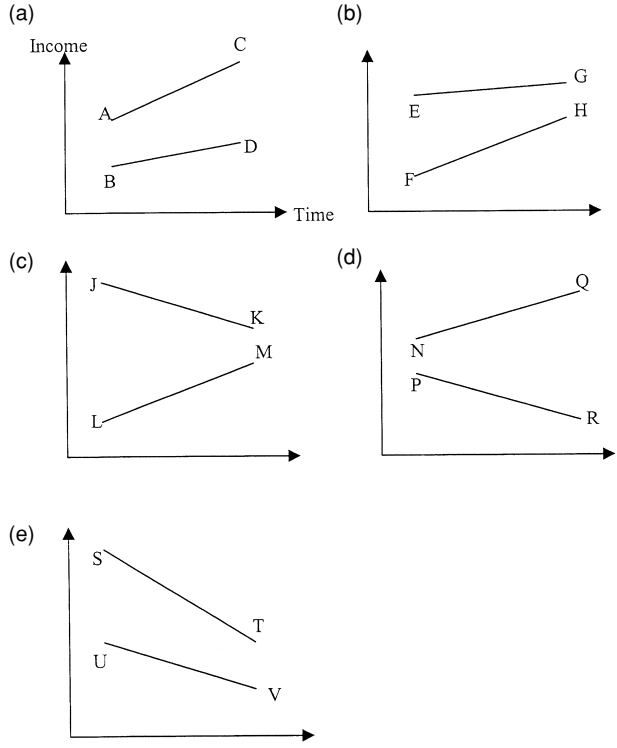

Figure 1.3 A measurement of income inequality over time

economy, employers are expanding their businesses and are prepared to reward workers with higher wages.

A more extreme case is illustrated in Figure 1.3(c), in which the gap in income is reduced over time as the rich (JK) get poorer while the poor (LM) get richer. This appears to be a perfect outcome to those advocates of equality. It is possible that wages can increase faster than profits for a while, but, should profits decline or costs increase drastically, the rich (employers) can choose to invest abroad or stop investing. In either case, employment opportunities will be restricted, thus limiting the growth in income of the poor (workers).

The outcome shown in Figure 1.3(d) is likely to be socially unacceptable. In this case, the rich (NQ) get richer while the poor (PR) get poorer. This is possible if the governing authority is biased toward the rich. Economic policies may favor the rich, while little is spent on improving the welfare of the poor, and the income gap actually gets larger over time (compare vertical distances NP and QR). This situation may not be acceptable. For example, the international community may not tolerate such an extreme situation. Or, drastic political activities may result if the large income gap coexists with a

decline in absolute income. A growing economy requires a high degree of economic complementarity between employers and workers, and skilled and experienced workers will benefit from this.

There are two possible explanations for the situation depicted in Figure 1.3(e), in which the absolute income of both the rich (ST) and the poor (UV) declines. One possibility is that the economy is suffering from a prolonged period of recession and economic hardship. Investment activities, employment, productivity, output, and income are falling. Another explanation is a drastic redistribution of income through non-economic means. For example, redistribution designed to make the rich poorer and the poor richer by political means, through either violent changes in government policies or radical removal of governments, has happened in the past. This has often resulted in the rich relocating their capital to overseas countries and the state eventually taking economic responsibility for the society. Politically, income equality is said to have been achieved, but investors have fled with their capital to a more secure and profitable destination abroad. Such an outflow of capital will lead to a fall in investment and income. In the extreme, the society experiences equality, but everyone is on the poverty line. Very often, other forms of inequality replace the former inequality in incomes.

Figure 1.3(a)–(c) are the socially acceptable cases, while Figure 1.3(d) and (e) are cases that should be avoided. Figure 1.3(a) and (b) are the more likely outcomes and have in common the fact that both groups experience an absolute increase in their incomes. Given time and the availability of economic opportunities, the rise in absolute income is more important than the comparison of income in relative terms. An increase in the absolute income of the poor could be due to economic complementarity between employers and workers. As employers begin to invest, both skilled and unskilled workers are needed and wages will increase. A virtuous cycle of employment and income generation will begin, stimulating absolute income to rise further.

Reduction in poverty requires an increase in absolute income, the exercise of appropriate economic policies, and a stable economic environment that attracts investment and creates jobs. Poverty is very often due to lack of skill on the part of the worker and lack of employment opportunities on the part of society. These two "lacks" are related to each other. To acquire a skill requires extensive education and training, while employment or job creation requires the expansion of investment activities, which in turn requires a stable and prosperous economic environment. Poverty reduction is a time-consuming process and can even be cross-generational. In other words, it is possible that the poverty level of the current generation may not be improved drastically, probably due to its low initial endowment. Therefore, it may be more appropriate to concentrate resources on providing opportunities for the next generation so that they can achieve a higher income. In turn, the younger generation may be more able to look after their parents when they become old, or to contribute indirectly to society by the payment of income tax.

1.4 Economic versus social security

The argument that the government can redistribute income through subsidies and welfare expenditure misses the point that it is the business sector and private individuals which generate wealth; government or government institutions can only facilitate the generation of wealth. Thus, it is economically unwise for any government to commit to large expenditure without securing enough revenue. This is particularly so if large expenses are devoted to short-term "poverty-reducing" strategies, rather than to strategies that have a long-run "wealth-generating" impact. The superficial argument that the government must provide social welfare assumes that the government has the ability to raise enough revenue for the various expenses. In many ways, the provision of social security cannot be sustained without the existence of an economy sufficiently wealthy to support the government with the necessary revenue. Since every dollar the government spends has to be supported by a similar amount of revenue input, it would be more appropriate for the government to focus its attention on revenue generation than on expenditure. The simplest way for the government to maximize its revenue generation is to maximize the taxable income pool. This requires a high level of employment and a buoyant business sector, and each taxpayer achieving the highest possible level of absolute income.

In other words, the prerequisite of social security is economic security, which is defined as the certainty of individual economic well-being, including a source of income, security of employment, and the ability to cope with the cost and standard of living. At the same time, economic security secures the source of government revenue. Social security, on the other hand, depends on government expenditure. The more prosperous the economy (the better the level of economic security) and the greater the job opportunities, the less the need for government support. Social security will then be made available only to the most needy. Thus, as income rises, the level of poverty and the need for social welfare assistance decline. It has been argued that government expenditure on social security provides a "free lunch", implying that such expenditure is the end in itself. However, government welfare expenditure is most effective when it is temporary and "endowment expanding", that is, the recipient gains skills or knowledge while receiving welfare assistance.

It is best for government to adopt a "growth-promoting" expenditure policy. Consider the case of unemployment benefits: unemployed workers will have less incentive to look for a job while their survival cost is being met by government assistance. The point, however, is that once a worker has remained unemployed for some years, his/her skills will have become inefficient, or even outdated, and soon he/she will be unable to compete with the next generation of younger and more energetic workers. If this is the case, it is likely that unemployed workers will remain unemployed and have to depend on welfare assistance in the long term. To prevent this, the government should foster a virtuous circle. Spending more on education today, for example, will increase the endowment factor of the young, who will then

have a greater ability to work. Once they are employed, they will be less reliant on government support and will even be contributing to revenue by paying taxes. Put simply, once people have become richer on an absolute basis, they will look after their own welfare and depend less on government support. The government will have a lesser financial burden on the one hand and, on the other, a healthier source of revenue.

1.5 The government and tax elasticity

A free market system knits together all economic activities through the movement of prices, wages, costs, and rates of return. The government functions primarily as a facilitator in the economy. However, because of the occurrence of various market failures, it has often been easy for individuals to point to the government for not doing one thing or another. In many developing countries, the weak private sector leads to the great expectation that the government will act as the alternative supplier of goods and services. The question then arises as to whether the ability of the government to collect tax revenues matches its desire to spend. It is easy for one to ask the government to intervene or for financial support, but few realize that government expenditure has to be supported by revenue. No government can maintain a persistent budget deficit for long, and its ability to spend must be matched by its ability to earn. The government should leave the bulk of income and output to be generated by the private sector. The most governments can do is to provide basic requirements, such as education, infrastructure, and some social services, and to intervene to correct cases of market failure.

The government exists to serve the economy in different ways. It supports private economic activities, corrects market failures, and ensures that economic activities are being conducted equitably and competitively. It builds and provides infrastructure and monitors the economy to avoid prolonged crises and to eliminate illegal practices. Some governments engage in protecting "infant" industries and other employers, but have to ensure that subsidies are used productively and competitively so that the industries can grow and survive on their own in the long run.

Government support, if any, is best provided in an indirect form. There are various advantages of indirect support. Firstly, it does not impose potential fiscal burdens on the government and it is not necessary for the government to raise taxes or seek additional forms of revenue. This, in turn, reduces the disincentive impact of high taxes on the business sector. Secondly, except in special circumstances, the growth of businesses and industries will depend entirely on their own efficiency, rather than relying on privileges from the government. This allows the business to survive, compete, and conduct its affairs in changing economic conditions. Thirdly, a high degree of economic flexibility is achieved, as private businesses are able to adapt to changing needs. Industries may change their lines of production according to changing

demands and businesses will change their lines of investment as the rate of return changes.

The more common forms of indirect support usually work on the cost side of production. A favorable tax structure that lessens the burden on the industrialist permits a greater degree of financial freedom. Lower rents for industrial land and lower costs of other infrastructure inputs reduces the fixed costs of manufacturing plants. The availability of public housing reduces the cost of living for workers. The nature of government support should be "wealth-generating" and "poverty-reducing". Government expenditure is best seen as a means to permit either firms or individual households to enrich their economic activities.

The role of government intervention has often been debated. Most market economies would argue for non-intervention, while planned economies favor more intervention. In reality, all economies experience some degree of government intervention. In the provision of public services, for example, many governments intervene. The more relevant question, however, is whether intervention serves as the "economic fertilizer" for individuals or businesses in society to intensify their economic activities. This depends on whether individuals and businesses make productive use of the "economic fertilizer". In other words, armed with the "economic fertilizer", how much is "harvested" depends on how much "cultivation effort" is committed by individuals or businesses. "Economic fertilizers" can take the form of a favorable monetary policy, such as a lower interest rate, or a marketing strategy, such as market information, research, and development support, or a lower survival cost, such as the various provisions in education, infrastructure, public health, and so on. As such, government intervention is always positive, because it often acts as a "cost-reducing" or "opportunity-increasing" stimulant.

In economics, the Laffer curve argues that there is an optimal tax rate that gives the highest level of tax revenue, beyond which tax revenue will fall. One popular economic redistributive instrument is a progressive tax system, through which the government can achieve greater revenue to help low-income earners in the form of social welfare. There are various unintended consequences of a progressive tax system. One misconception is the assumed positive relationship between the tax rate and tax collection, and that a higher tax rate enables the government to collect more revenue. Tax elasticity (t) is defined as the proportional change (Δ) in tax revenue (R) with respect to a proportionate change in tax rates (T), namely:

$$t = [\Delta R/\Delta T] \times [T/R] \tag{1.1}$$

A simple measure is to look at the absolute value of t. A value of $|t| > 1$ implies an elastic tax system in which a proportionate change in the tax rate leads to a larger proportional change in tax revenue. In contrast, $|t| < 1$ implies an inelastic tax system in which a proportionate change in tax rate leads to a smaller proportional change in tax revenue.

The tax base of an economy depends on four elements. The first is the tax structure which consists of the tax rates, the tax bands and the variety of tax. The second is the number of institutions and individuals falling within the tax net. The government usually has the authority to change the tax rate and the tax structure, but whether or not a rise in the tax rate will lead to a higher level of revenue depends also on the number of businesses and individuals in the tax net. The third element is the income and profit pool. A bigger pool means greater revenue. A higher level of income and/or a large working population lead to a greater income tax pool. Similarly, a higher profit level and/or a larger number of business enterprises result in a larger profit tax pool. The fourth element is the efficiency of tax collection. This relates to the ability of the government to identify taxpayers, and the time lag in tax collection. It is possible for low revenue to be due not to the tax rate, but to inefficient tax collection.

In theory, a progressive tax system provides the government with an exponential increase in tax revenue should income rise, but it also has various disincentive effects, including a fall in total output as people work less or leave employment entirely, and a tendency to under-report income or to engage in earning informal income. In the case of business or profit tax, a higher tax rate discourages business activities. There is, therefore, no guarantee that a higher tax rate will lead to greater revenue for the government. On the contrary, a lower tax rate will encourage work, employment, and business activities. It enlarges the "tax pie" as the income and profit pool gets bigger. Therefore, it is likely that a lower tax rate will generate more income and output and a higher level of tax revenue is probably the end result.

1.6 The economy in politics

Politics is the art of difference and would not exist if there were perfect agreement. A dichotomy between economic and political gains exists. Politics is a game of win or lose, while economics is a game of more or less. Economic achievements, such as growth and development, usually take a long time, perhaps decades, to materialize and mature. For an economy to achieve a continuous rate of growth, a stable environment has to be maintained. To attract foreign investment, the economy has to provide a positive economic environment for a prolonged period of time. Similarly, it is impossible to reduce inequality or poverty in a short time.

Popular short-term political decisions can impose short-term obstacles in the pursuance of long-term economic achievements. A typical example is the issue of income inequality. It has been common for politicians to accuse the governing authority of not "taxing" the rich enough to help the poor. This sounds great as equality has often been regarded as a virtue or a highly desirable social goal. Without making the distinction between relative and absolute income inequality, a change in government policy in favor of a "high-

tax, high-welfare expenditure" regime will lead to a short-term increase in equality but have a negative, long-term impact on investment, output, and income. As income growth is checked, government revenue will equally be limited. A vicious circle of "high tax rate – fall in investment and income – low tax revenue" will eventually develop. Thus, the long-term prospect of the economy is sacrificed in favor of some temporary, short-term gains.

Politicians are best not to introduce into economic activities political elements that will affect overall growth trends. A more appropriate strategy is to raise the political status of economic affairs, with economic success being regarded as a top priority in politics. A stable and continuous performance in the overall growth of the economy will ultimately improve welfare and reduce poverty. Economic growth is seen politically as an instrument to alleviate poverty and raise people's absolute income, as an instrument of increasing revenue for government, and as an instrument in promoting prosperity. An effective and efficient government with minimum political interference will permit long-term economic achievements to materialize, establish, and flourish.

A friendly international environment is a must for any economy to experience a steady path of economic growth. The international community usually provides three areas of support: international loans, foreign (portfolio and direct) investment, and an export market. An internationally favored economy will be accepted by various overseas organizations which permit the economy to enter into a number of trade, exchange, and investment agreements. Economic growth of the international community further complements and supplements the growth of the domestic economy. The complementary element arises when the domestic economy maintains comparative advantages in some respects, while facing comparative disadvantages in others. For example, a developing economy usually has its comparative advantage in labor-intensive industries. A friendly international community will complement domestic industries by importing foreign capital which will employ low-cost workers. And when labor-intensive manufactures are produced, a friendly international community can supplement the domestic economy by allowing its surplus manufactures to be exported. The international community acts as the outer boundary of the domestic market. Important pre-conditions of international acceptance are the pursuance of an open and liberalized market economy, support for a strong private sector that conducts the bulk of the economic activities, and demonstration of a vigorous and efficient government, and probably a pro-growth political regime.

1.7 Structure of chapters

This chapter primarily outlines the economism paradigm and its five components. There is a large volume of economic literature on free market, capitalist economics. However, the economism paradigm goes beyond

capitalism and assumes that capitalism is only one of the "floor conditions" or foundations of economism. As such, there will not be any formal discussion of capitalism here. Economism is the paradigm that produces the economic minimum in society, and it incorporates both economic and non-economic features that could damage economic growth. On the one hand, the minimum provision ensures that no individuals fall below the survival line. On the other hand, individuals are encouraged to work as much above the minimum as possible to take advantage of the free market mechanism and equality in economic opportunities.

Chapter 2 uses the relevant statistics to consider the trend in income growth of the four East Asian economies. It basically dissects the macroeconomy into the various components of success in the growth process of the four economies and examines a number of approaches used to study their economic success. Statistically and analytically, Chapter 2 serves to pull together the various macroeconomic attributes that are needed to prepare the economism paradigm.

Chapter 3 discusses the first element of the economism paradigm by examining the most important issue – inequality versus poverty. Using inequality data from the four economies over the last few decades, it is argued that inter-comparison of income differences is more of a quarrel than a construction, while intra-comparison can help to prepare individuals to gain a higher level of absolute income, which forms the basis of poverty alleviation. The chapter also notes the East Asian approach of not committing to large welfare expenditure or heavy redistributive policies, but concentrating on the expansion of economic opportunities. Conceptually, poverty reduction is equivalent to minimizing the "survival cost" of individuals.

Chapter 4 examines the role of the government and attempts to deal with a popular stigma of government intervention versus non-intervention, or positive non-interventionism. All governments intervene, and the difference is just a matter of degree and form. In the four East Asian economies, the government has "intervened" in the market and the process of industrialization through the use of fiscal instruments. The degree of government involvement in the economy can be charted, ranging from the least in Hong Kong to the most in South Korea. Public utilities and infrastructure development are the areas in which these governments have intervened most. The argument is not really about government intervention, but the extent to which the government provides "economic fertilizer" so that individuals and businesses can "cultivate" their "economic farm" successfully. The role of the government is also to establish economic pillars and to ensure that the economy is "carpeted" so that no individual can fall below the economic minimum.

Chapter 5 challenges the export-led growth debate and argues that, although foreign investment and trade favor open economies, domestic economic strength forms the core element. While foreign investment and

trade have promoted growth, they alone could not have satisfied the necessary conditions for growth if conditions in the domestic economy had been unfavorable. Therefore, domestic economic conditions are the main determinant of economic growth. The discussion in this chapter adds to the conceptual debate between the Marxist school of economic development, which believes that it is external conditions that are unfavorable for growth and development in poor economies, and the neo-classical advocates, who argue that favorable domestic economic conditions are the vital factors.

Chapter 6 steers the debate toward the importance of output growth. The economics of "first opportunity" is important in that growth and development often begins with the factors available. When a domestic economy has abundant labor, light and labor-intensive industries will be developed. In turn, a cheap and efficient labor force will invite foreign investment. Market forces dictate that output will grow depending on the initial endowment factors. The priority of a poor economy is growth in output and development has to be endogenous. Other considerations, such as pollution of the environment, will probably be taken care of at a later stage.

Chapter 7 brings into the discussion an important element in the economism paradigm. Despite the "siege mentality" of the four East Asian economies, political stability has been maintained even though the governing authorities were not democratically elected. Political change is an important dimension in any society, but a constant and consistent factor in these four East Asian economies has been the pro-growth nature of their governments. Given the political will, the mechanisms instituted include economic freedom and various elements of capitalism. This chapter rounds off the discussion on the various elements of the economism paradigm.

Chapter 8 asks whether the Asian financial crisis of 1997 has brought an end to the economism paradigm. By examining the various debates on the cause of the crisis, this chapter also provides alternative explanations of how an economy such as South Korea could end up in economic crisis. Possible explanations include the rapid emergence of the Chinese economy, the conceptual difference between protectionism and competition, and the importance of the difference between the real and nominal economies. The Asian financial crisis is a price worth paying if, after decades of continued growth, it demonstrated a number of lessons.

Chapter 9 considers the Hong Kong economy, since it is the only economy that has experienced a change in sovereignty. This chapter examines the pre- and post-1997 Hong Kong economy, outlining the success factors but, at the same time, identifying the factors that cumulated in the bursting of the economic bubble during the Asian financial crisis in 1997–98. Now economic restructuring or re-engineering is needed as Hong Kong is facing new challenges in its post-1997 era.

Chapter 10 concludes the discussion on the economism paradigm and asserts that economic growth among the four East Asian economies was no miracle. The chapter attempts to compare the different economic ideologies,

but argues that economism is the most comprehensive paradigm. Predictions are made on the future path of economic growth in the four East Asian economies and the chapter concludes by examining the various drawbacks of the economism paradigm. The paradigm is meant to be the beginning, not the end, of the debate, and so both supportive evidence and counter arguments need to be considered before the paradigm matures.

2 The expansion of the East Asian economic pie

2.1 The economic perspectives of the four dragons

In the early 1970s, Japan became the first Asian country to undergo rapid economic development that astounded the world. Its success in the commercialization of technology in household goods led to a prolonged period of trade surplus. By the late 1970s, however, world attention had shifted to the four rapidly emerging, newly industrializing East Asian economies (NIEs) of Hong Kong, Singapore, South Korea, and Taiwan. The extent and pace of industrialization in these four economies threatened the industrialized world with a sizeable level of exports, even when protectionist trade policies were imposed (see, for example, Balassa 1980; 1981; McMullen 1982; Turner and McMullen 1982). The developmental experience of the four East Asian economies is diverse, and each displays a different set of basic characteristics, briefly summarized as follows:

- *Hong Kong*: gradually integrated into the Chinese hinterland economy; traditionally *laissez faire* and service-based.
- *Singapore*: city-state economy, heavily dependent on foreign multinational capital; state activist and free-trade tradition.
- *Taiwan*: strong small and medium-sized enterprise-based domestic economy; dependent on international subcontracting networks.
- *South Korea*: domestic oligopoly-dominated economy; manufacturing-based, strong state influences, neo-mercantilist, and nationalistic economic tradition.

Various theories have been used to study and explain the economic success of the four East Asian economies. Classical economic theories, such as *laissez-faire* and comparative advantage, have been extensively applied to East Asia, especially Hong Kong (see, for example, Smith 1966; Owen 1971; Rabushka 1979; Chow and Papanek 1981; Schiffer 1983; Young 1989). In growth theories, Birdsall *et al*. (1995) have noted the importance of growth and education, resulting in a decline in income inequality. Page (1994) and Leipziger and Thomas (1994) raised the importance of capital accumulation and appropriate macroeconomic policies, and pointed out that the success of Hong Kong,

Taiwan, Singapore, and South Korea has encouraged the second generation of rapidly industrializing economies, namely the Philippines, Thailand, Malaysia, and Indonesia. Ranis (1995) argued that there is no single ingredient that could explain the economic success of East Asia. Within the framework of industrialization, Vogel (1991) has coined the term "late, late industrialization" to describe the growth experience of these four dragon economies. Chen (1979) and Chenery (1988) considered the technical factors in their industrial growth. Bauer (1992), Fields (1994), and Fukuda and Toya (1994) have studied the improvements in labor conditions and the lack of labor repression, industrial restructuring, and the role of human capital. Chen (1990; 1993) and Parry (1988) have looked at the favorable government policies that attracted foreign direct investments. Stiglitz (1996) and Wade (1988; 1990) considered the role of government in promoting the market, while Naya (1988), Page (1991), Pearson (1994), and Balassa and Noland (1994) studied international trade. Notably, Cole and Patrick (1986), Skully and Viksnins (1987), and Li and Skully (1991; 1992) have carried out financial development studies. Comparison between the four East Asian dragon economies and the Association of South East Asian Nations (ASEAN, comprising the Philippines, Indonesia, Thailand, and Malaysia) has also attracted a considerable degree of academic attention (Leipziger 1997). General assessment of economic growth in East Asia has been captured in Riedel (1988), Nolan (1990), and Park (1991). Lal (1988), O'Malley (1988), Martellaro (1991), Lee and Lee (1992), and Peng (1997) have also applied ideological analysis, including Confucianism. Studies by Hirono (1988), Takenaka (1991), and Chan (1993) have discussed growth experience based on Japan's model. Ichimura and Ezaki (1985) and Ichimura and Matsumoto (1994) have worked on the econometric modeling of Asian economies. There are also textbook-like studies that look at various issues in the four East Asian countries. Examples include the works of Woronoff (1986), James *et al*. (1989), and Chowdhury and Islam (1993).

Although theories explaining East Asia's success originated from developed economies, there is a lack of explanation as to why growth in so-called developed countries was slow at the time when these East Asian economies were experiencing rapid growth. The classic work of Rostow (1961) discusses the five stages of economic growth from a traditional society to an age of mass consumption. However, neither Rostow (1961) nor Kuznets (1966; 1971) explains the coexistence of groups of economies that are at different stages of growth. What reason is there for a latecomer experiencing a more rapid rate of growth than an early-developing industrialized economy? Surely, rapid growth by latecomers does not necessarily mean that early-developed economies must face a lower rate of growth?

Another observation is that the economic successes of the four East Asian economies have few parallels elsewhere, and their experiences are unique. Differences in culture and heritage have been used as a convenient, but not very convincing, argument that the East Asian experiences could only happen

in Asia. Both classical and neo-classical economic theories have been used extensively to explain economic developments in countries with diverse cultures. Different cultures may affect the pace of economic development, but the fundamental concepts and theories of development are culturally impartial.

Few, if any, have ever argued that the experience of East Asia can be made into a universal doctrine. But could Asian and non-Asian developing and developed countries learn from East Asia? The success of East Asia has produced a comprehensive body of concepts, theories, and interpretations that could equally be applicable elsewhere.

This chapter serves as a review of the post-war economic development of the four East Asian economies and studies their major macroeconomic trends. Section 2.2 examines the economic conditions in their initial stage of development and the subsequent income cycles. Section 2.3 considers the economic contributions arising from investment activities and the role of the private sector. Section 2.4 summarizes the process of industrialization in these four economies. Sections 2.5 and 2.6 look at the two external instruments of trade and foreign investment respectively. The last section gives a brief conclusion.

2.2 Initial conditions and post-war income cycles

The "savings gap" and "foreign exchange gap" (Chenery and Bruno 1962; Chenery and Strout 1966) are considered to be the two capital constraints in most developing countries. Economic growth proceeds at a rate permitted by the more limiting gap. Investment and savings are often the initial gap, but they are replaced by the trade gap as the binding constraint at a later stage of development. Thirlwall (1978: 295) argues that growth can be self-sustaining if two conditions are satisfied: a rising marginal savings rate; and a marginal rate of export rising faster than the marginal rate of import, or export increasing at a rate higher than national income. It can be argued, however, that, if foreign exchange is assumed to complement domestic savings, there is ultimately only one gap. The initial post-World War II conditions suggested that the four East Asian economies were blessed with a considerable amount of foreign assistance, in the form of either military or economic aid, and a favorable export environment.

There was a similar economic and political background in Hong Kong, Taiwan, Singapore, and Korea in the early 1950s, in that all four countries were recovering from the Japanese occupation, and were facing such economic difficulties as an influx of refugees, a shortage of housing, and poverty. Political realities in the late 1940s and early 1950s exerted considerable economic difficulties for a while, but the inflow of economic aid, other assistance, foreign capital, and "skilled" refugees later turned out to be the driving force in the revitalization and industrialization of the economies.

The emergence of Communist China in 1949 led to a large number of

immigrants coming to Hong Kong between 1948 and 1950. The estimated mid-year population increased by 20% in 1950 alone.[1] Between 1945 and 1956, net legal immigrants increased by 1,352,000, and the mid-year population in 1955 was close to 2.5 million. The population of Hong Kong increased by 400% between 1945 and 1955, but real national income dropped by 4% in 1951–52 (Szczepanik 1958: 138–154). The Korean War in 1950–52, and the subsequent embargo on Chinese exports by the United States, effectively put an end to Hong Kong's re-export trade (Hsia 1984; Li 1987a). On the positive side, however, many immigrants brought with them capital and technical skills. This enabled Hong Kong to transform its economy from a mere trading port into an industrial economy. Real capital formation increased from HK$234 million (£14.625 million) in 1953–54 to HK$318 million (£19.875 million) in 1954–55. National product (now gross national product; GNP) in 1954–55 amounted to HK$4,000 million, one-third of which was derived from manufacturing.

Since the Kuomintang government retreated to Taiwan in 1949, the government of the United States has provided massive economic aid. Between 1949 and 1952, total economic and military aid to Taiwan amounted to US$515.8 million. The figures increased to US$1,708.4 million between 1953 and 1957, US$1,222.7 million between 1958 and 1962, and US$705.8 million between 1963 and 1967, making a total of US$4,152.7 million for the period 1949 to 1967. Infrastructure was the largest recipient of all aid (37.3%), followed by human resources development (25.9%), agriculture (21.5%), and industry (15.3%) (Ho, 1978: 110 and 118). The non-military portion of aid equated to 6% of GNP, and about 40% of investment between 1951 and 1965. K. T. Li (1988: 55) pointed out the four effects of US aid: (1) financing foreign exchange deficit; (2) stabilizing prices; (3) providing investment funds; and (4) providing technical assistance. Mainland China also supplied foreign investment. For example, overseas Chinese investment reached US$2.5 million in 1956, while investment from the US reached US$4.4 million in 1955 (see Pang 1992: 217).

The Korean War in 1950–1952 destroyed the traditional authority and class barriers, as well as the old orders and other development barriers in Korea. The size of the military increased from 100,000 men in 1950 to over 700,000 men by 1956 (Cole and Lyman 1971: 35). The Korean economy was severely disrupted and recovered very slowly between 1953 and 1961. There was massive assistance from the United States. Cole and Lyman (1971: 175) reported that US military assistance to Korea amounted to US$1,275.7 million and US$974 million in the periods 1956–60 and 1961–65 respectively. In 1958, military assistance amounted to 17% of GNP in Korea, rising from 12.7% in 1956 and 13.4% in 1957. Korea at one time was the third largest US aid-receiving country after Vietnam and Israel (Song 1990: 5). The continued conflict with North Korea and the heavy military involvement made it difficult to introduce long-term, stabilizing economic policies. It was not until the Park Chung-kee regime took over in 1961 that economic development was given top priority.

The basic philosophy of President Park was "nation building through export promotion." Foreign investment and loans began to pour into Korea. Between 1959 and 1962, actual government loans amounted to a total of US$7.3 million. In 1963 they amounted to US$42.6 million, while private loans and foreign investment amounted to US$23.6 million and US$5.5 million respectively, making a grand total of US$71.7 million. The figures fell considerably in 1964 and 1965, but picked up again dramatically in 1966. Between 1959 and 1968, total government loans, private loans, and foreign investments, amounted to US$944.1 million in real terms. Government loans constituted 33.7% of the total and private loans 60.7%, while foreign investment accounted for the remaining 5.6%. This foreign capital helped to solve much of the balance of payment deficits in the early 1960s. In addition, the United Nations provided US$237.8 million between 1958 and 1966 in grant aid to finance various projects. Transportation was the largest recipient with 26.1%, followed by manufacturing (16.5%), power (11.5%), health (10.5%), agriculture (8.6%), education (6.3%), and so on. The outstanding loan of the Korean Construction Bank was 10.5 billion won. By 1966, it had increased to 46.6 billion won, half of which went to manufacturing (Cole and Lyman 1971: 193).

In the case of Singapore, there were population movements, mainly ethnic Chinese from Malaysia and Indonesia, but the economy was stable and did not suffer from any civil unrest. Singapore was trying to gain independence from Britain, but its decolonialization and independence movement did not lead to severe destabilization. Singapore first achieved internal independence in 1959, became part of Malaysia in 1963, and gained full independence in 1965 (Regnier 1987). During the 1950s, Singapore did not receive much foreign aid while its exports of staples continued to grow. There was no shortage of foreign exchange and investment funds (Huff 1994). Singapore's active trade with Malaysia and Indonesia in the 1950s was enough to sustain a small economy whose mid-year population was only 938,200 in 1947, rising by 54% to 1,445,900 in 1957.

The income pie of the four East Asian economies has grown tremendously since the 1950s, as shown by the growth in nominal and real gross domestic product (GDP) in Tables 2.1 and 2.2. In nominal terms, the four economies performed best in the 1970s (Table 2.1). In real terms, Hong Kong and Taiwan performed best in the 1970s, while Hong Kong experienced a lower growth in real GDP than Taiwan, Singapore, and South Korea in the 1980s and 1990s (Table 2.2). Singapore was the best overall performer in terms of real GDP, but at the same time Singapore has had the lowest nominal GDP. This suggests that Singapore is the smallest economy among the four. The four economies, however, experienced a decline in growth of real GDP between the decades (compare average growth in real GDP between the 1970s, the 1980s, and the 1990s in Table 2.2), suggesting a normal trend in that these economies were becoming industrialized and their accumulated large economic bases could only generate single-digit growth rates as the economies matured.

Among the income cycles of the four economies, those of Hong Kong are

Table 2.1 Trends in the growth of nominal GDP in the four East Asian economies, 1950–98

Year	*Hong Kong*	*Taiwan*	*Singapore*	*South Korea*
GDP (US$ million, current prices)				
1950	*635.1	1,050.6		
1955	*717.2	1,793.5		
196	*1,150.0	1,498.4	702.2	3,850.8
1965	2,436.8	2,815.7	1,964.1	2,995.9
1970	3,787.5	5,670.1	5,875.8	8,932.6
1975	9,786.4	14,741.3	11,669.0	21,271.5
1980	27,640.5	41,406.8	17,718.0	62,803.1
1985	34,778.5	62,077.4	36,691.3	94,322.1
1990	74,676.2	158,884.6	83,641.5	252,623.5
1995	139,310.0	252,780.0	84,551.6	489,257.7
1998	163,701.9	267,277.0	84,394.0	320,747.7
Percent change				
1965–70	55.4	101.4	94.6	197.9
1970–80	629.8	630.5	24.7	603.8
1980–90	170.2	283.7	812.7	302.2
1965–95	5,616.9	8,877.5	8,566.3	16,230.9
Per capita GDP (US$, current prices)				
1950	*283.9			
1955	*288.1	197.6		
1960	*374.0	151.7	426.5	154.0
1965	672.2	223.0	510.9	104.4
1970	948.0	386.3	904.2	276.8
1975	2,174.4	912.8	2,505.5	602.9
1980	5,372.2	2,325.6	4,854.4	1,647.3
1985	6,322.9	3,223.5	6,466.1	2,311.5
1990	12,982.6	7,806.5	12,147.4	5,892.9
1995	22,218.5	11,865.4	24,095.6	10,850.0
1998	24,054.0	12,188.3	21,832.1	6,908.2
Percent change				
1965–67	41.0	73.3	77.0	165.2
1970–78	466.7	501.9	436.9	495.2
1980–89	141.7	235.7	150.2	257.7
1965–95	3,205.3	5,220.6	4,616.3	10,292.7

Sources: Estimates of GDP and Hong Kong Yearbook, Hong Kong: Hong Kong Government, various years; Taiwan Statistical Data Book, Taipei; Taiwan Government, various years; *Yearbook of Statistics Singapore*, Singapore: Singapore Government, various years; *National Account, Monthly Statistical Bulletin*, Seoul: Bank of Korea, and *Economic Statistics Yearbook*, Seoul: Korean Government, various years; CEIC Data Company Limited; Ma and Szczepanik (1955); Szczepanik (1960) and Chou (1966).

Notes
GDP per capita = GDP/mid-year population; *GDP at 1966 prices, and annual per capita real GDP; the figures have been converted to US dollars at an exchange rate of US$1 = HK$5.7.

Table 2.2 Trends in the growth of real GDP in the four East Asian economies, 1961–2000

Year	*Hong Kong*	*Taiwan*	*Singapore*	*South Korea*
1961		3.0	8.5	
1962	13.6	6.9	7.1	
1963	16.3	11.4	10.5	
1964	8.1	25.5	–4.3	
1965	14.8	10.6	6.6	
1966	1.6	9.9	10.6	17.1
1967	1.7	12.3	13.0	12.1
1968	3.3	8.6	14.3	18.6
1969	10.9	10.9	13.4	18.4
1970	9.4	11.6	13.4	14.1
1971	7.3	13.5	12.5	10.0
1972	10.0	16.9	13.3	11.3
1973	12.5	21.6	11.3	25.6
1974	2.5	–0.1	6.8	17.1
1975	0.1	7.1	4.0	9.0
1976	16.4	16.4	7.2	21.5
1977	11.8	10.4	7.8	18.2
1978	8.5	12.0	8.6	20.3
1979	11.6	8.1	9.3	10.2
1980	9.9	2.5	9.7	–7.1
1981	9.2	9.9	9.6	3.6
1982	2.7	4.1	6.9	10.7
1983	5.7	8.4	8.2	8.2
1984	10.0	10.6	8.3	6.5
1985	0.5	5.0	–1.6	11.0
1986	10.7	11.6	2.3	11.0
1987	12.9	12.7	9.7	10.5
1988	8.1	7.8	11.6	6.1
1989	2.5	4.2	9.6	9.0
1990	3.4	9.5	9.0	9.2
1991	5.1	7.6	7.1	5.4
1992	6.3	7.5	6.5	5.5
1993	6.1	7.0	12.7	8.3
1994	5.3	7.1	11.4	8.9
1995	3.9	6.4	8.0	6.7
1996	4.5	6.1	7.6	5.0
1997	5.0	6.7	8.5	6.7
1998	–5.3	4.6	0.1	10.7
1999	3.0	5.1	5.9	
2000	10.5		9.9	
Average				
1966–70	5.4	10.7	12.9	16.1
1971–80	9.1	10.8	9.0	13.6
1981–90	6.6	7.8	7.4	7.6
1991–99	3.8	6.5	7.5	*5.9

Sources: Census and Statistics Department, Hong Kong: Hong Kong Government; CEIC, Hong Kong; *Country Profile Singapore*, London: Economic Intelligence Unit; *Economic Survey of Singapore* and *Yearbook of Statistics Singapore*, Singapore: Singapore Government, various years; *Economic Statistics Annual Taiwan Area*, Taipei: Taiwan Government, various years; *National Accounts and Economic Statistics Yearbook*, Seoul: Bank of Korea, various years.

Note
*1991–98.

very clear, as shown in Table 2.2. The low real growth rate experienced in 1966 was obviously due to the Cultural Revolution in China, which spilled over to Hong Kong in a series of street riots in 1966–67. The near-zero growth rate in 1975 was due to the oil crisis in the West. The low growth rates in the early 1980s and a near-zero growth rate in 1985 were due to the uncertainty generated over the Sino-British talks on the future of Hong Kong and economic recession in the West in the early 1980s. The 1989 political crisis in China caused the low growth rates in the late 1980s. Hong Kong experienced difficulty in 1995 when political uncertainty was high before the change in sovereignty in 1997; uncertainty over political reform in Hong Kong was especially marked between the then Hong Kong Governor and the Chinese authorities. Hong Kong experienced its worst decline in income in 1998 at the peak of the Asian financial crisis. The negative 5.3% growth rate was the poorest performance that year among the four East Asian economies.

Similar income growth trends have been experienced by the other three economies, though their causes may differ from that of Hong Kong (Table 2.2). Obviously, the oil crisis in 1974 and the economic slow-down in the early 1980s hurt all four economies. Taiwan experienced a prolonged period of growth in real GDP in the 1960s and 1970s. Since the late 1980s, however, Taiwan's growth has been consistently lower, and it has experienced single-digit growth rates. The worst performance in Singapore was in the mid-1980s, when a negative growth rate was experienced in 1985. High wages and a heavy reliance on overseas investment, or a lack of indigenous investment, were thought to be the major causes. However, a radical change in the government's policy has successfully rescued the Singapore economy, and has kept growth on a strong base since then. In fact, Singapore showed a better performance than the other three economies in the 1990s. The growth of the Korean economy was rapid in the 1960s and 1970s, with double-digit growth rates in many years. The negative growth rate in 1980 was the turning point, and, since then, the growth of Korea's economy has fluctuated, suggesting shorter business cycles.

Expenditure as a proportion of GDP is shown in Table 2.3. Hong Kong is the only one of the four East Asian economies that has experienced a growing trend in private consumption. With the exception of Hong Kong in 1999, government expenditure has declined. In the case of gross capital formation, with the exception of 1999, Taiwan has experienced a fall in percentage share; all the other three economies have experienced a rising share. However, the share of GDP accounted for by exports in the four economies has varied between years, suggesting the changing nature of trade.

Consumption of food items and basic necessities, as well as durables and services exhibits a common pattern, increasing as income has increased in the four economies. Hong Kong's growth in consumption was the highest among the four economies in the two decades 1960–70 and 1970-80, as Table 2.4 shows. Taiwan and Korea occupied second and third position respectively, while Singapore's growth in consumption remained below 6% over the two

Table 2.3 Private consumption, government consumption, gross capital formation, and net exports as percentages of GDP, 1975–99

	1975	*1985*	*1993*	*1999*	*1975*	*1985*	*1993*	*1999*
	Private consumption				*Government consumption*			
Hong Kong	60.2	63.1	68.0	60.2	7.4	7.0	6.7	9.8
Taiwan	59.5	49.8	55.5		17.8	15.9	15.0	
Singapore	57.9	45.1	44.9	40.4	12.1	14.3	10.8	9.7
Korea	68.9	55.4	54.7	55.7	12.2	11.3	10.0	10.1
Indonesia	74.4	58.1	53.0	74.0	10.9	10.6	9.2	6.6
Malaysia	55.5	51.2	46.9	41.6	17.9	16.5	14.3	11.4
Philippines	68.6	73.6	78.9	72.1	9.7	14.3	7.0	12.9
Thailand	69.1	60.7		56.1	11.1	12.7		11.1
Japan	58.2	58.3	57.7		10	9.8	9.6	
	Gross capital formation				*Net exports*			
Hong Kong	28.3	27.2	30.1	25.4	4.0	2.7	–4.8	4.6
Taiwan	28.9	18.6	26.4		–6.2	15.7	3.2	
Singapore	40.1	42.5	44.2	32.8	–10.1	–1.9	0.1	17.1
Korea	26.1	29	34.5	26.8	–7.2	4.3	0.7	7.3
Indonesia	21.6	30.9	26.5	11.6	–7.0	0.5	11.3	7.9
Malaysia	21.1	29.1	36.3	22.3	5.5	3.2	2.4	24.7
Philippines	40.1	15.3	23.2	18.6	–5.2	3.5	–9.1	–3.7
Thailand	24.3	29.0		20.7	–4.5	–2.4		12.1
Japan	30.7	27.5	30.3		0.6	3.7	2.3	

Sources: *Key Indicators of Developing Asian and Pacific Countries*, Manila: Asian Development Bank, various years; *Country Report – Japan*, London: Economic Intelligence Unit, various years; *Japan's Economic Almanac*, Tokyo, various years.

Notes
GDP figures are expressed at constant market prices with different base years from country to country. Japan's entries under 1975 are 1981 data.

Table 2.4 Average annual percentage growth rates of private consumption

	1960–70	*1970–80*	*1980–93*	*1990–99*
Hong Kong	8.6	9.0	7.1	9.7
Taiwan	7.8	8.3	8.3	10.2
Singapore	5.4	5.9	6.3	7.4
South Korea	7.0	8.2	8.6	12.7
Japan	9.4	4.7	3.5	
United States	4.4	3.1	2.9	

Source: *World Development Report*, 1982, 1985 and 1995, The World Bank.

decades, reflecting its small domestic economy. Hong Kong has fallen to third position since the 1980s, behind Korea and Taiwan. Taiwan maintained a similar growth rate between 1970–80 and 1980–93. Singapore's growth in private consumption increased marginally between 1960–70 and 1980–93. For the purpose of comparison, the growth of consumption in Japan in the decade 1960–70 was the highest of all the economies in Table 2.4, while that of the United States was the lowest. Private consumption growth in Japan, however, declined considerably between the 1960s and 1980s, while the decline in the United States over the same period was less steep.

Hong Kong's elasticity of expenditure in the 1970s for food items and durable goods was 0.67 and 1.88 respectively (Cheng 1982: 97–101). Low-income households tend to spend more on low-cost items, whereas luxury durable goods top the list of high earners. Peebles (1988: 253) found that the long-term marginal propensity to consume in Hong Kong lies between 0.64 and 0.68.[2] Schiffer (1983: 8) also found that food and housing account for about 70% of an average household's income. The consumption pattern of households in Hong Kong began to change in the early 1980s. Between 1973–74 and 1984–85, overall food consumption declined but eating out increased considerably. Clothing and footwear and durable goods showed the greatest increase.[3] Consumption of services has increased most rapidly since 1980. Major increases in consumption have occurred in the areas of personal care, medical care and health expenses, transport and communication, and recreation and entertainment.[4]

In the case of Korea, Song (1990: 149–54) found different consumption behavior in rural and urban households. Typically, rural workers consume less than urban workers as their income is less. Urban workers spend more on housing, whereas rural workers spend more on education. In the 1970s, final consumption expenditure on durable goods increased the most, followed by expenditure on services, semi-durable goods, and non-durable goods. In the 1980s, the greatest increase in expenditure was on semi-durable goods, followed by durable goods, services, and non-durable goods.

To a large extent, consumption behavior in Taiwan has been similar to that of Korea. The average share of private consumption was high in the 1950s owing to Taiwan's low per-capita income and high military expenditure

(Ho, 1978: 224–31). However, between 1952 and 1995, except for the three years from 1986 to 1988, private consumption exceeded 50% of national consumption.[5] Again, the consumption pattern of rural and urban households differed. Nonetheless, the growth of real private consumption more than doubled between 1951 and 1973. Food, beverage, and tobacco and rent, fuel, and power were the two largest groups of items of household expenditure in Taiwan. In the 1980s and 1990s, education, medical care, and health expenses recorded significant increases. Between 1952 and 1995, Taiwan's average propensity to consume ranged between 0.71 in 1986 and 0.97 in 1952. Its marginal propensity to consume ranged from 0.4 in 1986 to 1.37 in 1988.[6]

Private consumption expenditure in Singapore has increased considerably. Between 1970 and 1996, the percentage increases in expenditure at current market prices and at 1990 market prices were 1,276% and 436.5% respectively. In 1970, food and beverage were the dominant items of household expenditure, followed by transport and communication, clothing and footwear, rent and utilities, and recreation and education. By 1996, the food and beverage and clothing and footwear items had declined in importance considerably. The services sector has experienced the largest increase in expenditure. Recreation, education, transport and communication, and medical services increased in importance considerably between 1970 and 1996.[7] The other three economies have also experienced a trend in consumption in which there has been a marked shift to the consumption of service related items. Singapore's consumption pattern, by and large, has remained quite steady and stable, probably because of its small population.

2.3 Fixed capital formation and the private sector

Capital formation in Hong Kong, South Korea, and Singapore has largely been driven by the private sector. A considerable degree of public or government finance has been invested in Taiwan. Table 2.5 summarizes the average percentage growth in gross domestic capital formation in nine Asian economies in the period 1980–93.[8]

Investment in the form of gross fixed capital formation and investment–income ratios is presented in Table 2.6. Hong Kong experienced two decades of high investment growth rates between 1970 and 1990. In the other three economies, investment growth rates were much higher in the decade 1970–80 than in 1980–90, probably as a result of the positive attitude of the government in encouraging investment. The investment–income ratios show the amount invested out of every unit of GDP. Hong Kong, Taiwan, and Singapore achieved the highest investment–income ratios in 1980, and since then the ratios have gradually leveled off (Table 2.6). On average, between 1960 and 1995, Singapore had a much higher investment–income ratio (0.43) than the other three economies. Both Taiwan and Hong Kong had an average ratio of 0.25, whereas Korea had the lowest average of 0.22. Singapore's high ratio largely reflects its small economy. In terms of gross capital formation,

Table 2.5 Average growth of gross domestic capital formation in nine Asian economies, 1980–93

Country/area	*Average percentage*	*Remarks*
Hong Kong	14.90	Large growth rates experienced in most years; a negative growth rate in 1982–83 and 1985
Taiwan	10.35	Large growth rates experienced in most years with a negative growth rate in 1982 and 1985
Singapore	11.81	Large growth rates experienced in most years with a negative growth rate in 1985–86
Korea	16.38	Large and positive growth rates, but growth fell below 5% in 1992 and 1993
China	14.08	A small negative growth rate in 1981but large percentages experienced in most years
Indonesia	22.51	Positive growth rates in all years but sharp differences occurred in the early 1980s
Malaysia	11.81	Large growth rates in most years but a negative growth rate in the 1985–87 period
Philippines	13.65	Performed better in late 1980s; experienced a negative growth rate in 1985 and 1991
Thailand	17.43	Performance improved since 1987; a negative growth rate in 1982 and 1986

Korea experienced the greatest investment, but the small investment–income ratio reflects its large domestic economy.

The private sector component of gross fixed capital formation in Hong Kong has accounted for more than 84% of the total since 1966, and rose as high as 91.2% in 1970. The composition of gross fixed capital formation includes two major categories: (1) all construction, transfer costs of land and buildings, and real estate developers margin; and (2) machinery and equipment. In most years since 1966, the former category has taken the lion's share of investment expenditure and has accounted for between 52% and 73% of the total, the remainder going to machinery and equipment.[9]

In the case of Taiwan, the composition of gross fixed capital formation can be divided into three sources: government, public enterprise, and private sector. The private sector owns the largest portion. Between 1952 and 1955, the average percentage share of private sector ownership was 54.3%, with the highest share (66.5%) recorded in 1965 and the lowest (44.1%) in 1975. Government ownership has increased gradually from 17.8% in 1952 to 32.5% in 1995, and the increase has been more rapid since 1990. In contrast, public enterprise had a share of 31.7% in 1952, but by 1995 its share had declined to 14.4%.[10] The composition of gross fixed capital formation by type of capital goods shows that transport equipment and machinery and other equipment accounted for approximately 50–60% on average between 1952 and 1995; the remainder went to residential and non-residential buildings and other construction. Composition by industry shows that the percentage share of agriculture has declined drastically from 20.5% in 1952 to 1.5% in 1995.

Table 2.6 Gross fixed capital formation and the investment–income ratios

Year	*Hong Kong*	*Taiwan*	*Singapore*	*South Korea*
Gross fixed capital formation (US$ million)				
1950	32.1	172.7	108.1	
1955	68.3	257.1	63.7	261.8
1960	120.6	346.8	326.7	274.7
1965	483.9	638.7	686.3	408.3
1970	821.6	1,447.2	613.1	434.1
1975	2,233.9	4,711.8	2,237.3	2,077.0
1980	9,590.1	14,630.8	4,555.5	18,526.4
1985	7,348.6	12,120.1	7,862.8	25,653.3
1990	19,970.9	36,104.8	10,523.4	93,669.1
1994	28,213.4	53,830.0	19,378.5	140,457.3
1995	41,871.4	60,069.1	28,501.3	166,081.7
Percent change				
1950–60	273.8	100.8	201.7	
1960–70	581.3	317.3	87.7	58.1
1970–80	1,067.2	911.0	643.0	4,167.8
1980–90	1,082.4	146.8	131.0	405.6
1990–94	41.3	49.1	84.1	50.0
Investment–income ratio				
1950	*0.10	0.16		
1955	*0.13	0.14		
1960	*0.22	0.21	0.47	0.07
1965	0.20	0.22	0.71	0.14
1970	0.18	0.26	0.33	0.05
1975	0.23	0.30	0.51	0.10
1980	0.35	0.35	0.56	0.25
1985	0.21	0.20	0.42	0.28
1990	0.26	0.23	0.24	0.37
1994	0.29	0.22	0.34	0.36
1995	0.30	0.23	0.33	0.37

Sources: *Hong Kong Monthly Digest of Statistics* and *Estimates of GDP*, Hong Kong, various years; *Economic Yearbook of the Republic of China*, Taipei, various years; *Economic Survey of Singapore*, Singapore, various years; *Yearbook of National Account Statistics*, Seoul, various years; *Country Profiles: Hong Kong, Taiwan, Singapore and South Korea*, Economic Intelligent Unit, London, various years.

Note
*GDP at 1996 prices.

Between 1960 and 1987, industry's share exceeded 40%. However, by 1995, the share of gross fixed capital formation that went to industry had fallen to 34.2%. The category of service industry that showed the most significant increase in share of gross fixed capital formation is government services, which increased from less than 12% in the early 1970s to 32.5% in 1995.[11]

Korean statistics show that gross fixed capital formation is divided into two major categories: (1) building, construction, and land development; and (2) transport equipment and machinery equipment. The third category, breeding stock, draught animals, dairy cattle, and the like, occupies a minority

share. The ratios of share of gross fixed capital formation in the two major categories in 1970, 1980, and 1996 were 69:31, 56:44, and 65:33 respectively. When categorized by type of economic activity, industry consumes the lion's share of fixed capital formation. In 1970, the top three users of fixed capital assets were finance, insurance, real estate, and business services; agriculture, forestry, and fishing; and manufacturing. By 1980, transportation, storage, and communication had assumed the third position. By 1988, manufacturing had become the largest user (33%) and finance, insurance, real estate, and business services (22%), and transportation, storage, and communication (9%) were in second and third place.

In Singapore, gross fixed capital formation consists of three major items: (1) construction and works (including residential and non-residential buildings and other construction and works); (2) transport equipment; and (3) machinery and equipment. Their shares of total gross fixed capital formation in 1970 at current market prices were 41%, 11%, and 48% respectively. By 1996, construction and works accounted for a much larger share, whereas machinery and equipment had declined, giving respective proportions of 56%, 16%, and 28%. The large increase in construction and works was largely due to the increase in investment in the private sector. For example, between 1995 and 1996, gross fixed capital formation in construction and works in the private sector increased by 27% at current market prices. Similarly, the decline in machinery and equipment was a result of the large decline in gross fixed capital formation in the public sector. In 1994–95 and 1995–96, for example, it fell by 17% and 45% respectively.[12]

2.4 Industries: structure, growth, and strategies

The increase in both domestic and foreign investment has aided the process of industrialization in the four East Asian economies. Low labor costs in the 1950s and 1960s facilitated labor-intensive manufacturing, but this soon gave way to the more technical and knowledge-based manufacturing, typically in electronics, in the 1970s. Government played a major role, especially in Taiwan and South Korea, where a considerable amount of heavy industry was developed in the 1980s. While the Singapore government was keen on encouraging development of, for example, the electronics industry through direct intervention, the Hong Kong government pursued a much more indirect approach, relying mainly on the private market for development of industry. By the late 1970s, Hong Kong and Singapore had become the banking and financial centers in the Asia-Pacific region. In the late 1980s, as many low-cost manufacturing industries moved to nearby economies, the service sector developed rapidly, and it was claimed to be the largest economic sector by the 1990s. Industrialization in Hong Kong, Taiwan, Singapore, and South Korea is said to have taken place between the 1950s and the 1970s. These economies have passed through several stages of development, as described in Kuznets (1966). For example, Chenery (1988: 42) found that, between

1960 and 1980, the primary sector's share of production, exports, and employment fell significantly, while manufacturing expanded considerably. On the demand side, industrial growth depended on (1) the expansion of domestic demand; (2) export expansion; (3) import substitution; and (4) technological change. Owing to the outward-oriented nature of the four Asian economies, export expansion has been the dominant contributing factor to industrial growth.

Statistics show that the contribution of the agriculture sector to the GDP of the four East Asian dragons has been declining, whereas both manufacturing industry and services have experienced an increase in their share of GDP. The extent of industrialization can be seen from the size of the manufacturing sector, as shown in Table 2.7. Between the 1960s and the 1980s, manufacturing was an important generator of GDP in all four economies. Since the 1990s, however, the Hong Kong economy has experienced a rapid decline in manufacturing, although it has maintained a steady share in the other three economies.

Both demand and supply factors have led to growth in the manufacturing sector. On the demand side, a hard-working and entrepreneurial labor force, a flexible institutional framework, and a stable government have been the major contributors to growth in Hong Kong and Taiwan (Szczepanik 1958; Cheng 1982; K.T. Li 1988). Taiwan's nineteen-point economic reform, introduced in 1961 with the aim of further liberalizing the economy, gave preferential treatment to private business and reformed the tax, foreign exchange, and trade systems (Kuo *et al*. 1981: 74). The two major factors contributing to growth in Singapore were the infrastructure, established in

Table 2.7 Percentage share of manufacturing in Gross Domestic Product

Year	*Hong Kong*	*Taiwan*	*Singapore*	*South Korea*
1955	33.0	15.1	21.6	13.8
1960	31.7	15.9	16.5	9.4
1965	23.7	13.8		38.2
1970	30.9	29.2	20.0	21.0
1975	26.9	30.9	23.9	25.9
1980	22.4	36.0	29.2	28.2
1985	20.7	37.6	23.6	29.3
1990	16.9	33.3	27.2	28.8
1995	7.9	28.1	24.8	29.4
1997	6.0	27.7	22.9	28.9
1998	6.2	27.1	23.2	30.7

Sources: *Key Indicators of Developing Member Countries of Asian Development Bank*, Manila, various years; *Yearbook of Statistics Singapore* and *Country Profile Singapore*, Economist Intelligence Unit, London, various years; *Country Profile Taiwan*, Economist Intelligence Unit, London, various years; *Estimates of GDP*, Hong Kong, various years; *Economic Statistics Yearbook* and *Yearbook of National Account Statistics*, Seoul, various years; CEIC Data Company Limited; Szczepanik (1958); Chau (1972, 1974); Wong and Ng (1997).

the 1960s, that formed the basis for growth in the 1970s, 1980s, and 1990s and the combination of external free trade and strong internal control (Huff 1994). The existence of a strong, stable, and "economic-achievement oriented" government and the pursuit of a "growth-favoring" policy are also thought to have been beneficial (Lim and Lloyd 1986). In the case of Korea, the "export first" concept advocated by President Park in 1963 provided various government incentives that have generally been considered efficient (Song 1990). On the supply side, the main factors that led to growth in the manufacturing sector were the increase in available labor and capital and advancements in total factor productivity. The latter consists of factors that are difficult to measure, such as improvements in education, economies of scale, greater use of technology, and value-added elements.

Hong Kong

The industrialization of Hong Kong has often been celebrated as a successful case of a free market, open, and *laissez-faire* system. Business people have been given maximum freedom, and there is very little government intervention and red tape (Riedel 1973; 1974). The growth of the manufacturing sector was a direct result of an influx of capital and workers rather than of a deliberate shift in resource use (Owen 1971). There are several notable features of industrialization in Hong Kong. Labor-intensive methods were used to manufacture low-cost and highly perishable light-manufactured products for export. A number of products experienced a high degree of variability in volume and seasonal cycles. Industries were dominated by small- and medium-scale manufacturing establishments. Strong support from foreign investors and a sub-contracting system involving upstream and downstream processing activities was widespread. Sit and Wong (1989) classify the growth of the manufacturing industries into six stages:

1 reconstruction after the World War II, 1947–51;
2 transition, 1951–59;
3 industrialization, 1954–62;
4 take-off, 1962–70;
5 industrial diversification, 1970–81; and
6 industrial doldrums, 1981–85.

The period 1960–80 was the golden era of Hong Kong's manufacturing sector, when domestically produced exports grew at an average compound rate of 17.2% per year (Lin and Ho 1982: 83). The aggregate percentage share in gross output of the five major manufacturing industries (textiles and clothing; plastic products; basic metal and fabricated metal products; machinery and equipment; and electrical and electronic products) declined from 82% in 1973 to 79.8% in 1988 (Chen and Li 1991: 7). Mainly as a result of the protectionist trade policies imposed upon Hong Kong textile exports by the European and

North American countries in the form of multi-fiber agreements and country of origin rules, industrial diversification in terms of products and markets occurred in the late 1970s and early 1980s. It was, however, argued that export markets were protected by these policies (see, for example, Li 1991) whereas industrial processing in China restricted exports. For example, punitive measures were taken in June 1996, when five categories of clothing manufacturers were required to submit additional documents for export to the United States.[13] On the question of intervention, the Hong Kong government became involved in the promotion of industrial development, including the provision of institutional support, technical back-up, facilities for manpower training, and low-cost industrial land (Chen and Li 1988; 1991; 1994a,b; 1997).

Hong Kong's manufacturing industries, however, lost their cost-competitiveness when China opened up its special economic zones in the Pearl River delta region in the late 1980s. For example, average annual salaries in 1987 in Hong Kong and Shenzhen were HK$45,876 (US$5,881.5) and HK$5,621 (US$720.6) respectively, and even lower in other Pearl River delta cities.[14] The plentiful supply of low-cost labor in southern China attracted Hong Kong industrialists to relocate and establish their industrial bases across the border. Various other suggestions have been put forward to explain this shift, including industrial amalgamation, an "office–factory" relationship between Hong Kong and southern China, and "Manhattanization" (see, for example, Li and Lo 1993).

The contraction of the manufacturing sector was accompanied by a rapid expansion in the tertiary sector (Li and Lo 1993: 125). Statistics show that manufacturing employment fell from 46% in 1980 to just 17% in 1994, while its contribution to GDP declined from 23% in 1980 to just 9.3% in 1994. By 1996, the service sector (which comprises the following industries: wholesale, retail, export and import trades, restaurants and hotels, finance, insurance, real estate and business services, and community and personal services) was contributing over 90% of Hong Kong's GDP.[15] Other manufacturing industries, such as the printing industry, jewelry, food and beverages, have also been prospering. The Hong Kong Government Census and Statistics Department (1993) report shows that the fall in gross output is matched by a rise in value-added output. Debates on the future development of manufacturing industries have been reiterated. For example, the Hong Kong Economic Survey Limited (1989) report concludes that there should be a five-part strategy for the post-1997 Hong Kong economy:

1 the maintenance of autonomy and uniqueness;
2 an improvement in human resources, technology and physical infrastructure;
3 internationalization of the economy;
4 the building of an economic relationship with South China; and
5 the promotion of partnership between the business sector and the government.

Berger and Lester (1997) discuss the factors that have driven the economic success of the Hong Kong's manufacturing sector. These include: (1) flexibility of production capabilities despite a high labor turnover and a constant need for training; (2) effective coordination of global activities; (3) developed managerial skills; and (4) public institutions motivated by non-interventionist policies in the private sector economy. Hong Kong has the potential to become a leading producer of service-enhanced manufactured goods. A total of six important and inter-related elements for the survival of Hong Kong's manufacturing industries have been identified. One is to strengthen the capability to create new products and processes, including research and development (R&D) activities. Another is to upgrade the capabilities of the industrial workforce and strengthen the public institutions of "safe harbor". The rate of formation of new technology-based industries should be increased. and more technological expertise should be brought into Hong Kong from the West and from the mainland.

Taiwan

Many studies have been undertaken on the industrialization of Taiwan and its relation to technology growth, trade, value-added goods, and government policy (Ho 1978; Ranis 1979; Kuo 1983; Wade 1988; Yu 1988; Pack 1992; 1995; Dollar and Sokoloff 1994; Wang 1997; K.T. Li 1998). A number of general characteristics can be identified. The period 1952–80 was characterized by government intervention. Between 1949 and 1954, the Taiwan authority pursued an import substitution strategy mainly for post-war construction. Between 1955 and 1960, Taiwan underwent a transition to export promotion, and export diversification was the dominant feature between 1963 and 1973. Taiwan's industrial policy has been successful in establishing public enterprises when there was a lack of private funding, restricting imports, and occasionally financing private enterprises. The role of government enterprises has been declining continuously, and their economy-wide domestic value-added share fell from 12.9% in 1951 to 11.6% in 1965 and had dropped again to 10.5% by 1988. K.T. Li (1988) considered the creation of the export processing zones in 1963 to be an important feature in encouraging private enterprise, though by 1978 progressive liberalization had reduced the usefulness of the export processing zones. The advantages of small- and medium-scale enterprises included the flexibility to adjust to changing market needs and the ability to draw surplus labor from the declining agriculture sector. The activities of multinational corporations, on the other hand, accounted for less than 10% of employment and manufacturing value-added during the late 1970s.

In terms of growth, the manufacturing sector experienced double-digit growth rates until the mid-1970s, peaking at 22% in 1970. Since 1975, growth rates have been in single figures. Taiwan's manufacturing index (relative to 1991 = 100) increased from 1.06 in 1952 to 117.62 in 1995. In terms of employment, the agriculture sector declined from 56.1% in 1952 to only 10.5%

in 1995. Until recently, the secondary sector accounted for the highest share of employment, taking 42.5% in 1980, 41.6% in 1985, and 38.7% in 1995. The tertiary sector, however, has now overtaken the secondary sector, accounting for 46.3% and 50.7% of employment in 1990 and 1995 respectively.[16] The private element has expanded tremendously. The ratio of private to public ownership in manufacturing in 1983 was 87:13. By 1995, the ratio was 91:9. Heavy industry, however, expanded much faster than light industry. The output index (relative to 1991 = 100) for heavy industry increased from 56.44 in 1984 to 136.99 in 1995. In contrast, the index for light industry only increased from 79.65 to 91.96 over the same period.

Economic liberalization has been given a high priority in Taiwan since the early 1980s. Many measures have encouraged Taiwan's labor-intensive industries to relocate to the ASEAN countries and to mainland China (Wang 1997: 75). By the 1990s, the urge to become a member of the World Trade Organization (WTO) had pushed the Taiwan authority to further liberalize its economic activities. In 1994, the government proposed to develop Taiwan into an Asia-Pacific regional operational center majoring in six areas: manufacturing, sea transportation, air transportation, finance, telecommunications, and media. The government plans to establish various "hi-tech" industrial parks, and to organize joint-venture corporations to strengthen its industrial capacity (Executive Yuan, 1995). The Asia-Pacific center concept aims to make Taiwan an operational base, as well as connecting Taiwan to various other activities in the region (Wang 1997: 74)

The Industry Technology Research Institute was established in 1974. Since 1979, infant industries have been promoted provided they meet the "two-high, two-large, and two-low" guidelines (high technology and high value added, large industrial linkage and large market potential, and low pollution and low energy consumption). There were 150 types of products classified as strategic industries in 1982. These businesses are given special treatment by the government, including low-interest loans and tax holidays for up to five years. In the early 1990s, the Taiwan authority also developed the Science and Technology Project, which aimed to promote high-technology industrial development, to facilitate the upgrading of the traditional industries, to establish the infrastructure for industrial development, to increase energy efficiency, and to solve problems facing industries (Wang 1997: 76).

South Korea

Statistics show that manufactured output in Korea has increased considerably overall. In nominal terms, the average annual increase between 1970 and 1979 was 35.7%. However, smaller increases were experienced in the 1980s and 1990s. In the periods 1980–89 and 1993–96, average annual increases were 16.6% and 11.8% respectively. Nonetheless, Korea's industrial growth is such that it is on the way to becoming Asia's next giant. The Korean government has played a significant role since the early 1960s in the following

areas: the choice of appropriate development strategies, leadership commitment, institutional reforms, and budgetary and financial resource allocations. The main features of Korean industrialization were the availability of foreign direct investment, the acquisition of foreign technology, and the accumulation of local know-how (Westphal *et al.* 1981; Mukerjee 1986; Franco *et al.*1988; Amsden 1989; Choi and Lee 1990; Seong 1997).

South Korea's industrialization was divided into three or four phases. Import substitution and stabilization featured in the period 1952–63. The turning point was the overthrow of the Rhee regime and the emergence of the Park Chung-kee regime in 1961, which adopted an export-oriented strategy. Policy reform and the establishment of various institutions assisted export promotion. The average annual rate of growth in the index of manufacturing output was 11% between 1955 and 1965, and increased to 24% between 1965 and 1975. Between 1973 and 1979, the drive to increase heavy and chemical industries was implemented through subsidized credits, special tax policies, selective promotion, entry restriction, and direct government involvement in industrial decision-making. As a result, the average nominal growth in manufacturing output in this period was 37.2%. Evenson (1998) goes to the extent of arguing that recent developments in the industrial and technological capacity of South Korea has allowed it to move from being a "newly industrialized country" (NIC) to having the status of a "recently industrialized country" (RIC).

Since the 1980s, the Korean government has continued its export-oriented strategy and emphasized domestic price stability and industrial restructuring. The second oil crisis and the assassination of President Park Chung-kee in 1979 resulted in economic hardship with a decline in exports and a rise in inflation. A market liberalization policy was chosen. It comprised a reduction in the government's role in credit allocation, deregulation of the interest rate, relaxation of the restriction on foreign direct investments, and writing off the various losses accumulated in the heavy industry sector. The decline in the oil price in 1985 provided another turning point and exports subsequently picked up. The Korean government turned to promoting innovation activities by making direct investments in R&D, whose share in GNP increased from 0.77% in 1980 to 1.95% in 1990 and to 2.61% in 1994 as a result. Development of R&D has directly benefited the large corporations, known as the *chaebols* in Korea, which then turned round to assist the small-scale firms.

The four measures of liberalization and readjustment pursued by the South Korean government in the 1980s were inflation stabilization, structural readjustment of the heavy and chemical industries, elimination of monopolistic structures, and growth of small and medium-sized firms. According to a World Bank report (World Bank 1984: 60), the seven largest manufacturing subsectors at that time were textiles, footwear, steel, machinery, automobiles, shipbuilding, and electronics. They accounted for 73% of exports and 53% of employment. The sixth five-year plan (1987–91),

recognizing Korea's potential areas of growth, includes, among other targets, a strategy for industrial development, a strategy for technology development, a strategy for fostering small and medium-sized firms, and a strategy for developing the information industry.[17] The 1993–97 industrial development strategy is for the transformation of Korea's industrial structure to one similar to those of the advanced OECD countries by the development of "hi-tech" industries (OECD 1996). In 1992, a ten-year program, known as the Han project, was initiated to promote technology development in seven areas.

Singapore

Foreign direct investment and the role of the government are the two major issues in Singapore's industrialization experience (Chia 1986; Krause 1987; Nyaw 1991; Wong 1991; Ng and Yang 1994; Wong and Ng 1997). The more important issues which are discussed in these studies include the importance of added value, the development of high technology, and the role of government. Although the original intention was to industrialize in 1959 by diversifying economic activities to reduce dependence on the re-export business, industrial development effectively began in 1967 when an export promotion strategy was adopted. There have been three key factors in Singapore's industrial growth: (1) an open economy approach; (2) creation of a growth-conducive environment for private enterprises by pursuing stable macroeconomic policies; and (3) aggressive investment in public infrastructure and human resources. The "first industrial revolution" of the 1970s was the result of the increase in the labor force arriving in Singapore from neighboring economies. Since 1980, the "second industrial revolution" has been characterized by the promotion of high-value-added and skill- and technology-intensive industries. The key strategies adopted have been: wage increases; tax incentives to encourage substitution of capital for labor; policies to attract value-added and skill-intensive activities; and emphasis on skill development.

The economic recession in 1985–86 marked a turning point. The Ministry of Trade and Industry (1986) noted that the causes of the recession were both external and internal. The external factors were the fall in the petroleum price, the slow-down of the US economy, and falling commodity prices. Internal factors included rising domestic costs, loss of competitiveness, a mismatch of savings and investments, depression in the construction industry, and economic rigidity. An economic committee was formed to consider the long-term problems and prospects. There were several key problems in the manufacturing sector. One was the contraction of the established industries, such as petroleum refinery and ship repairing. Another was the decline in competitiveness and the various difficulties faced by local manufacturing companies. Nonetheless, the value-added per worker in manufacture increased by 47% and 104.7% in the periods 1975–84 and 1986–92 respectively. Productivity growth in manufacturing at 1968 factor costs increased by 4.3%

and 5.9% in the periods 1975–79 and 1980–84 respectively. New growth opportunities were identified. Aeronautics, biotechnology, electronics and information technology, chemicals, telecommunications, and optics were to be the key industries. The electronics industry experienced rapid development from only two local companies in 1968 to occupy one-third of total value-added in manufacturing in 1984. By 1995, electronics occupied 51.4% of total manufactured output. The economic committee also recommended that the Singapore economy should move beyond merely a production base, and aim to attract foreign companies to establish their regional headquarters in Singapore.

In 1990, when Mr Goh Chok Tong took over power from Mr Lee Kuan Yew, a ten-year program, known as "the Next Lap", which took the form of a strategic economic plan (SEP), was adopted to prepare Singapore for the tougher competition among the most advanced nations. Eight areas were identified as important: human resources; national teamwork; international orientation; innovation; manufacturing and service clustering; economic redevelopment; international competitiveness; and reduction of vulnerability. The SEP aims to keep manufacturing at about 25% of GDP, and to attract investment in technologically advanced industries, notably electronics and chemicals. Furthermore, a "growth triangle" concept was established, including Malaysia's Johor State and a number of islands in Indonesia as a single economic unit, which combines Singapore's skills and the lower labor cost in the other two regions.

Singapore's success, however, has been questioned. High technology implies three elements in Singapore: high-quality scientific skill, bold entrepreneurship, and a large amount of venture capital. A high-tech product may be a star performer, but it will have a short life, and profits may be driven down once others enter the market. High-tech entrepreneurs are lacking in Singapore, and there are not enough private venture capital companies to propagate the high-technology industry (Krause 1987: 61). Young (1994) criticized the massive amount of government intervention in Singapore compared to Hong Kong's *laissez-faire* approach to industrial development. Krugman (1994: 71) concluded that "all of Singapore's growth can be explained by increases in measured inputs, and there is no sign at all of increased efficiency". Nonetheless, gross R&D expenditure in Singapore has been increasing gradually from 0.21% of GDP in 1987 to 0.84% in 1990 and to 1.12% in 1994 (Wong and Ng 1997: 132).

2.5 Trade

Development strategies initially differed between Hong Kong and Singapore, which opted for export-led growth, and Taiwan and South Korea, which opted for import substitution, but by the 1960s, all had chosen export-oriented growth strategies. The small domestic markets in Hong Kong and Singapore naturally urged all manufacturers to look for overseas markets from the very

beginning of industrialization in the 1950s. Singapore's export market concentrated on staples and raw materials, such as rubber and petroleum, all the way through the early 1960s (K.T. Li 1988: 10). It was only in the 1970s that manufacturing become the leading sector (Table 2.7), and since then foreign investment by multinational corporations has become dominant. There have been three phases in Taiwan's thirty years of trade: (1) the import substitution phase (1950–62); (2) the external orientation phase (1962–80); and (3) the technology orientation phase (after 1980) (Krause 1987: 61).

Exports from the four Asian economies have grown tremendously, and there has been a clear change in export destination from the four Asian economies. In the case of Hong Kong, North America and Europe were traditional export partners, but export diversification since the late 1970s has made Asia a major market for Hong Kong's exports. In 1985, for example, Hong Kong's exports to Asia exceeded those to North American and major European countries. The Asian market is clearly Taiwan's largest export destination. Taiwan's exports to North America, although they increased considerably between 1990 and 1995, still fell significantly behind the Asian market. The same is true of Singapore and Korea. In terms of the sources of export growth in all four Asian economies, export increases have been dominated by the world trade and competitiveness effects, while the commodity composition and market distribution effects have been insignificant (Kuo 1983: 177; Chen and Li 1994a: 116). Between 1980 and 1999, the term of trade (a comparison of imports and exports in terms of prices relative to 1990 = 100) of Hong Kong (Table 2.8) has remained more or less static. In Korea there was slow improvement up to 1990, followed by a rapid decline in the late 1990s. Singapore has experienced a gradual decline of about twenty points. Taiwan is the only economy that has experienced a considerable improvement in its term of trade. In general, the East Asian economies have maintained their term of trade mainly by improvements in the value-added content of their exports.

Hong Kong

Hong Kong's external trade has experienced several phases. Beginning as an entrepôt center before the 1950s, its exports were mostly labor-intensive, manufactured products and were highly concentrated in a handful of items for a few Western countries. In 1981, for example, exports to the US, the UK, and Germany totaled 54.7% of Hong Kong's total exports. The four categories of SITC5 (the fifth category of the standardized industry and trade classification; chemicals), SITC6 (manufactured goods classified chiefly by materials), SITC7 (machinery and transport equipment), and SITC8 (miscellaneous manufactured articles) have accounted for over 90% of total exports since the 1960s. SITC8 is the largest category, accounting for over 60% before 1990 and over 50% since. Textiles and clothing is still the largest export earner, followed by electronics, watches and clocks, and plastics and

Table 2.8 The term of trade (1990 = 100)

Year	*Hong Kong*	*Taiwan*	*Singapore*	*South Korea*
1980	99.0	76.7	109.8	94.0
1981	97.0	75.0	112.0	92.0
1982	99.0	76.7	114.1	96.0
1983	98.0	80.0	112.0	97.0
1984	99.0	80.8	107.6	100.0
1985	103.0	83.3	108.7	100.0
1986	100.0	91.7	105.4	109.0
1987	99.0	94.3	100.8	100.5
1988	98.0	93.3	98.8	105.9
1989	100.0	100.2	98.6	103.5
1990	100.0	100.0	100.0	100.0
1991	101.0	100.7	97.8	100.6
1992	101.4	101.9	94.5	100.6
1993	101.6	100.8	94.3	97.8
1994	100.3	96.1	91.5	101.1
1995	98.7	98.0	89.9	102.5
1996	99.7	99.4	89.5	92.7
1997	100.4	101.6	87.4	90.3
1998	101.6	103.7	87.2	86.3
1999	100.8	106.6	86.3	84.4

Source: *Key Indicators of Developing Asian and Pacific Countries*, Asian Development Bank, various years.

toys. Imports from Japan, China, and the US constitute over 50% of all imports.

Trade barriers and protectionist policies in the 1970s threatened the survival of Hong Kong's export market (Lin and Mok 1980). It has also been argued, however, that trade quota policies actually protected Hong Kong's exports and allowed the industry to grow to its maximum possible capacity (Li 1991; Chen and Li 1994a: 120). Since the 1980s, however, diversification, both in markets and in export items, has been successful, and the value-added content has been emphasized.[18]

Hong Kong's external trade entered a new era with the opening up of the Chinese economy in the late 1970s. The first impact was the re-emergence of Hong Kong's entrepôt trade, which together with trans-shipment activities experienced a multi-fold expansion in the 1980s. The relocation of Hong Kong industries' manufacturing bases in southern China has facilitated the entrepôt activities, exploited the quota system of China, and also resulted in the expansion of the service trade (Chai and Kwong, 1996). Economic reform in mainland China has permitted economic integration between mainland China and Hong Kong (Chai 1988). By 1992, China had become Hong Kong's largest trading partner and was Hong Kong's largest source of imports and destination of re-exports. Hong Kong's role has been as a middleman between China and the world economy (Sung 1991). Indeed, the total export trend of Hong Kong shows a rising share of re-exports and a declining share of

domestic exports.[19] Table 2.9 shows exports and imports as a proportion of GDP (at current market prices). The figures confirm that the growth in Hong Kong's exports in the 1960s and 1970s was due to the rise in domestic exports and that, since the mid-1980s, re-exports have dominated the growth of total exports.[20]

Taiwan

The success of Taiwan's trade has depended on a comprehensive government policy that has targeted export growth as the fundamental goal since the late 1950s (World Bank 1993). Taiwan's trade development policy began in 1949–52 with a successful land reform program that increased agricultural exports to pay for imports of machinery and equipment. During the import-substituting industrialization period (1953–57), as the government invested heavily in infrastructure and subsidized some light industries, consumer goods industries developed quickly. Since 1960, efforts to promote foreign investment and trade have been made and banks have offered low-interest loans to exporters. Export promotion was followed by industrial consolidation in 1973–80. Competition from other low-cost manufacturing centres led to the development of capital-intensive industries. Since 1980, as a result of loss of competitiveness, high wages, and the appreciation of the Taiwan dollar, Taiwan has turned to modernizing its high-technology industries. Other key features have included the establishment of the export-processing zone in Kaoshiung in 1965 and the various tax deductions and export loans put forward (Kuo *et al*. 1981; Lee and Wang 1986; K.T. Li 1988; Wang 1994).

Taiwan's foreign trade can be characterized by three major factors. One is the high import content in domestic final demand and exports. A triangular trade pattern exists between the US, Taiwan, and Japan, and income and price have relatively important effects on exports. The two other factors are a sharp product transformation and low domestic inflation (Liang 1994:. 115–20). Using econometric techniques, Kuo (1983: 149) found that output expansion due to domestic growth was more important in the period 1956–66, but output expansion due to export growth was the dominant factor in the period 1966–76.

Table 2.9 Trade to GDP ratios at current market prices for Hong Kong, 1961–98

Trade/GDP ratios	*1961*	*1965*	*1970*	*1975*	*1980*	*1985*	*1990*	*1996*	*1998*
Total exports/GDP	52.9	46.9	66.2	60.6	69.3	86.6	109.8	116.9	104.8
Dom.exports/GDP	39.5	36.1	53.6	46.4	48.1	47.8	38.8	17.7	14.7
Re-exports/GDP	13.3	10.8	12.6	14.2	21.2	38.8	71.1	99.2	90.1
Imports/GDP	80.3	64.5	76.6	68.1	78.8	85.6	110.8	128.8	111.1
Exports (serv.)/GDP	31.8	23.2	28.4	24.0	20.6	22.5	24.4	25.3	20.6
Imports (serv.)/GDP	12.0	9.1	10.3	11.1	12.0	14.0	15.1	14.5	13.7

Statistically, Taiwan's trade has been strong in the last few decades.[21] It has experienced a trade surplus since 1976, and this exceeded US$10 billion for the period 1985–91. Its export value index (relative to 1991 = 100) increased from 5.86 in 1972 to 144.54 in 1995. The corresponding import value indices were 5.96 and 162.23 respectively. Exports of industrial products have dominated total exports since 1965. By 1995, they occupied 96.2% of total exports. The largest export items include machinery, electronic products, textile products, basic metals and articles, information and communication products, plastic products, transport equipment, electrical machinery products, and toys, games and sports. Imports are dominated by agricultural and industrial raw materials Taiwan's major trade partners are Japan, the US, Asian economies, the UK, and Germany.

Singapore

Being a small economy with few natural resources, international trade is crucial to the survival of the Singapore economy. There are four characteristics in Singapore's trade sector: (1) trade in manufactures; (2) a low level of international price distortion in tradable commodities; (3) a high proportion of re-export trade; and (4) a high level of foreign investment in the trade sector (Lloyd and Sandilands 1986: 183). Singapore is very much a trade-dependent economy, and various fiscal incentives were exercised by the Singapore authority to boost exports soon after its independence in 1965. This included the Economic Expansion Incentive Act in 1967 and its amendment in 1970. By 1981, the largest non-entrepôt exports were petroleum products, oil bunkers, televisions and radios, electronics components, ships, boats and oilrigs, and clothing. Being one of the more developed economies among the ASEAN members, Singapore's trade links with other ASEAN members, notably Malaysia and Thailand, have been close, though their importance declined between 1960 and 1980. The US and Japan are Singapore's major trading partners (Chia 1985).

Industrial exports as a proportion of total domestic industrial output have increased over the years. The total net export earnings as a percentage of GDP also increased from 26.9% in 1964 to 49.8% in 1982 (Lloyd and Sandilands 1986: 196). The role of foreign investment has been important in Singapore's external trade, and internationalization of the economy and the multi-dimensional activities of foreign investors have been important in its trade with the Organization for Economic Cooperation and Development (OECD) and Asian countries (Tee 1987: 26). Singapore also has an ASEAN flavor whereby companies from other ASEAN countries have set up their headquarters in Singapore.[22]

The economic setback in 1985 led the Singapore government to revise its emphasis on external trade and re-export activities. The Ministry of Trade and Industry in 1986 identified the various constraints faced by exporters. They were: (1) market dependence on developed countries; (2) market

diversification constrained by the lack of reliable information; (3) inadequate export credit financing facilities limiting the competitiveness of exporters; and (4) inadequate incentives to promote the export of services. The Ministry recommended additional fiscal incentives for the export of services, the encouragement of third-country trade, improving trade infrastructures, the introduction of new schemes to improve export financing, and promoting Singapore as a counter-trade center.

A notable point about Singapore's export trade is its increasing dependence on electronics. In 1995, electronics (taking a broad definition) accounted for around 54% of domestic exports. The next largest items were oil exports (14%), and chemicals (5.7%).[23] Singapore has also remained in trade deficit for a number of years. In 1980, the trade deficit was S$9,893 million, which increased to S$18,128 million in 1993, though it then dropped to S$8,911 million in 1996. However, the trade deficit is compensated by a strong surplus in the export of services, resulting in a positive overall balance. Merchandise trade figures have far exceeded GDP, as shown in Table 2.10.[24] Singapore's exports are divided into domestic exports, which are further split into oil and non-oil exports, and re-exports. Over the years, the export of oil has

Table 2.10 Merchandise exports and imports as a proportion of GDP for Singapore, 1975–98

Year	*Merchandise exports as % of GDP*	*Merchandise imports as % of GDP*
1975	94.90	143.35
1980	165.21	204.64
1985	128.92	148.54
1987	140.24	159.20
1989	149.71	166.46
1991	137.96	154.64
1992	129.47	147.24
1993	128.43	147.92
1994	138.24	146.74
1995	141.45	148.88
1996	136.76	143.67
1997	130.38	138.10
1998	130.11	120.26

Table 2.11 Value and composition of Singapore's exports, 1980–98

Singapore	*1980*	*1990*	*1995*	*1998*
Exports (S$ million)	41,452	95,206	167,515	183,763
Percent share in				
Domestic exports	62.3	65.9	58.8	57.6
Oil	34.2	18.0	8.2	7.3
Non-oil	28.0	47.9	50.6	50.3
Re-exports	37.7	34.1	41.2	42.4

declined significantly, while non-oil (manufactured) exports have expanded. Their percentage shares are shown in Table 2.11.[25]

South Korea

In the case of Korea, President Park chose an outward-, industry- and growth-oriented (or OIG-oriented) strategy. His two famous maxims, "*suchul ipguk*" (nation building through exports) and "export first," were well accepted by Korean businesses. The need for industry to catch up was reflected in the second five-year plan (1967–71); export agreements were drawn up between the government and businesses, and firms that failed to achieve their export targets without an excuse risked administrative sanctions from the government. Exports, which contributed to less than 10% of GNP before 1960, grew to 25% in the early 1970s and had reached over 30% by the late 1970s. The share of manufacturing employment created by exports increased from 27.8% in 1968 to 29.6% in 1970, 44.7% in 1980, and 52.5% in 1985 (Song 1990: 94). The advantages of Korea's export-led growth can be summarized into two main categories. The first was static efficiency gains, which included the correction of various distortions associated with import substitution, and was the strategy taken up in the 1950s. The second was dynamic efficiency gains, which included expanded market size and economies of scale, and improvements in technology and skills. Overall improvement of economic policies complemented natural market forces. The policy instruments introduced to improve export incentives included credit allocation through a favorable interest rates and exchange policies, administrative supports, and the establishment of export industrial zones and wage controls.

Korea's export success, according to Amsden (1989: 244–5), is largely due to a policy of dynamic comparative advantage that has allowed Korea to switch exports to its industrial advantage over the years. In the 1950s, the cotton textiles industry, which accounted for as much as 20% of GNP, was considered to be the modern industry at the time. Korea also developed other heavy industries, such as sugar refining, cement manufacture, and so on. During the third five-year plan (1971–76), the average annual growth in Korean exports was 45.5%, though it slowed down to 20% during the fourth five-year plan (1976–81) (World Bank 1984: 42–5). Both industrial exports and market diversification occurred in the late 1970s. Light-manufactured exports (clothing, plywood, silk, toys, and so on) fell from 53.6% of total in 1978 to 39.6% in 1983. Electronics, shipping, iron and steel, and chemicals were the expanding industries. The problem that Korean exports faced, as the World Bank (1984) study pointed out, was the extension of backward and forward linkages requiring an increase in the value-added content of exports.

Despite Korea's rapid expansion in exports, its export and import to GDP ratios are still much lower than those of Hong Kong and Singapore, though they have increased considerably since 1970. By the mid-1980s, the export and import to GDP ratios were similar, as shown in Table 2.12.[26]

Table 2.12 Exports and imports as a ratio of GDP for Korea, 1975–88

Year	*Exports/GDP ratio*	*Imports/GDP ratio*
1975	23.25	34.20
1980	30.28	38.56
1985	32.85	33.78
1989	28.42	28.00
1993	23.95	24.40
1995	25.67	27.74
1997	42.51	45.15
1998	35.55	25.06

2.6 Foreign direct investment

Traditionally, studies on foreign direct investment concentrate on outward investments from developed countries to developing countries (see, for example, Goldsbrough 1985). The debate mostly relates to employment generation, technology transfer, revenue generation, capital accumulation, and income distribution issues. There are various costs and benefits of foreign direct investment in developing countries. In cases where the investment originates from developing countries, especially from East Asian countries (see, for example, Wells 1984), it differs from investment originating from developed countries in three respects. In terms of ownership and control, most multinationals from developing countries tend to establish joint ventures with local partners rather than wholly owned subsidiaries in the host countries. There is also a difference in geographical distribution in that foreign direct investment from developing countries frequently operates within the region from which it arises. The third feature is the use of less capital-intensive technologies and a smaller scale of production (Chen 1983a,b; 1987; 1990; 1993).

In the 1950s and 1960s, the US and European countries were the major foreign investors. In the 1970s and 1980s, Japan's investment in the Asian region expanded substantially, overtaking that of all European countries, and in some years exceeding that originating from the US. By the late 1980s and early 1990s, the four Asian dragons had become capital exporters. The main reasons for this were the rising domestic costs (the push factor) and the favorable economic consideration granted in neighboring countries (the pull factor). Since the early 1980s, the major destination of Hong Kong's foreign direct investment has been mainland China, especially the special economic zones in the south. The ASEAN countries, notably Malaysia and Thailand, have become the host countries for investments from Singapore, Korea, and Taiwan.

In Hong Kong, the Industry Department regularly reports the foreign investments in the economy's manufacturing industry.[27] Over the years, the greatest foreign investors in Hong Kong have been the US, Japan, mainland China, and the UK. The most popular recipient industries are electronics,

non-metallic mineral products, and textiles and clothing. The various local and overseas chambers of commerce in Hong Kong annually use the inductive method to survey the attitude of foreign firms toward Hong Kong as their destination of investment, including the push and pull factors.[28] Chen and Wong (1990) compared and contrasted the behavior of different foreign firms (from developed and developing countries) in the context of Hong Kong. They concluded that foreign firms from developing countries are smaller in size, less dependent on their parent firms, use less capital-intensive technology, are less export-oriented, compete on price, and undertake R&D, manpower training, and technological modification and adoption.

Like Hong Kong, Taiwan and Korea are facing rapid growth in intra-regional investments. Between 1981 and 1991, Taiwan's approved inward foreign direct investment increased from US$396 million to US$1,778 million. The US, Japan, and Hong Kong were the largest investors. Electronics, chemicals, and services were the largest industrial recipients (Chen 1993: 45 and 47). Although 1966 was the year when Taiwan began to attract foreign direct investment after the establishment of two export-processing zones, it also suffered various setbacks leading to a fall in foreign investments in 1972, 1975, 1978, and 1982. Statistics show that expatriate Chinese played a key role in the ownership structure of foreign enterprises. Between 1952 and 1987, expatriate Chinese invested US$1,435 million, ranking third after the US (US$2,268 million) and Japan (US$1,783 million) (Schive 1990: 236). Imported machinery formed a large portion of foreign direct investment in Taiwan, but the proportion dropped significantly in the 1970s. On average, foreign firms now tend to use less capital-intensive technology than local firms because they concentrate more on labor-intensive industries.

Taiwan's outward investment has been greatly underestimated. The US and ASEAN countries are the major destinations of outward investment. Four reasons are given to explain Taiwan's outward investment:

1 to secure supplies of raw materials;
2 to pursue profits by supplying host-country markets;
3 to facilitate exports; and
4 to gain access to technology in its country of origin (Schive 1990: 252–3).

The inductive approach distinguishes between foreign direct investments from developed and developing countries. Developed countries regard foreign direct investment as a vehicle to strengthen their competitiveness in the home market, while developing countries stress the need to collect overseas information on technology and marketing. Foreign investment from developing countries tends to be weaker and less effective than foreign investments from developed countries in promoting technological sophistication, managerial advancement, labor upgrading, and economic expansion in Singapore (Hock 1990: 125).

Recognizing its limitations of land and labor supply, the Singapore

government set out to encourage outward investment by introducing a set of incentives in 1993. There has also been a shift in destination away from the Malaysia–Indonesia growth triangle to mainland China, India, and elsewhere. The bulk of Singapore's overseas investment, which stood at S$37.7 billion in 1994, is in financial services (53%), followed by manufacturing (20%), commerce (11%) and real estate (7%). Singapore's outward investment concentrates mostly on Asia (56% of total). Malaysia (22%) is the largest recipient, followed by Hong Kong (18%). The US and mainland China account for 7% and 5% respectively.[29]

Singapore's official policy toward foreign direct investment can be summarized in three features: (1) the presence of liberal incentives; (2) the absence of restrictions; and (3) a pattern of consistency. The official aims are to minimize investment risk, reduce production and market costs, and raise the after-tax returns for foreign investors. The Singapore government adopts a pragmatic attitude toward foreign investment, and maintains political stability and a socially cohesive discipline (Chia 1985: 281; 1986: 85). With the exception of defense industries and the mass media, Singapore welcomes all kinds of foreign direct investment. In 1995, 71.3% of investment in manufacturing came from overseas. The US is the largest foreign investor (S$2,076 million out of a total of S$6,809 million). The European Union as a whole is the second largest (S$1,511 million) and Japan ranks third (S$1,153 million). Electronics, industrial chemicals, petroleum, machinery, and fabricated metal products are the top five recipients of inward investments.

The Korean government first began to attract foreign investment in the first five-year plan in 1962. The Korean Reconstruction Bank and the Bank of Korea then provided guarantees of repayment to foreign lenders. The primary intention was to move toward self-support and to diversify the sources of foreign capital away from dependence on the US (Cole and Lyman 1971: 181–3). Foreign financial capital is divided into three categories: government loans, private loans, and investments. Between 1952 and 1968, the total received amounted to US$944.1 million. By the early 1970s, Korea had moved from heavy dependence on governmental grant assistance to a situation in which private sources were dominant.

The contributions of foreign direct investment in Korea include a means of technology transfer in chemicals, electronics, and petroleum refining and a principal source of technology and innovation in joint venture business activities (Westphal *et al.* 1981). The first tax concession legislation was introduced in 1960. Further changes were made in 1966 and 1970, when administrative procedures were simplified and the "one-stop service office" was introduced in order to centralize all foreign investors' activities with the government. Korea's first free trade zone was introduced in 1970 to attract foreign participation in exports. Korea normalized its relationship with Japan in 1965, and Japanese investors were responsible for almost 40% and 71% of total foreign direct investment in the periods 1967–71 and 1972–76 respectively. As a result, inflows of foreign direct investment increased

significantly. Korea's specific advantage is its closeness to Japan, and investment by many Japanese firms appears to have been in the form of second-hand machinery that was no longer used profitably in Japan. The manufacturing sector has been the principal recipient of foreign direct investments (Westphal *et al*. 1981: 20).

Since September 1980, there has been further liberalization on foreign investment regulations. For example, a 100% equity share by foreigners in industries was allowed. In 1984, a "negative list" system of investment that shortened and simplified the approval process was introduced. By 1988, the manufacturing sector was almost completely open to foreign investment.[30] Korean statistics use different terms: foreign direct investment, foreign investment, and net lending to the rest of the world. Between 1970 and 1985, foreign investment figures remained negative. From 1986 to 1988, foreign investment increased from 4,020.5 billion to 10,210 billion won, but then fell to 3,234.3 billion won in 1989.[31] Net lending to the rest of the world amounted to US$22.05 billion in 1996, an increase from US$8.88 billion in 1995, US$4.96 billion in 1994, and US$0.338 billion in 1993. Foreign direct investment in 1996 amounted to US$5.37 billion.[32]

2.7 Conclusion

This chapter has examined a number of factors that have worked in favor of economic growth in the four East Asian economies. This growth began with a handsome supply of foreign aid and assistance, or an injection of overseas capital to alleviate capital shortages. Productivity, which started with the emergence of labor-intensive manufacturing, promoted exports, employment, and domestic income. Economic stability encouraged the private sector to invest. For open market economies, engaging with the West ensured a dual-level economic security. At the first level was the large supply of economic aid from Western governments, mainly the US, and the inflow of foreign direct investment from private enterprise. The second level of economic security was the external market for finished products. The rising income in the developed world after World War II provided a "tailor-made" market for exports from East Asian economies.

Domestically, industries expanded and diversified. A variety of light industries multiplied, while new developments extended to heavy industries as well as hi-tech and knowledge-intensive industries. Externally, these economies' industrial strength ensured and widened their comparative advantages, enabling them to ride along with the economic tide of the advanced countries. Continuous growth over three to four decades transformed the four East Asian economies; their income caught up with the advanced countries. By the 1980s, the four economies, in turn, were aiding the development of neighboring economies in terms of outward investment, serving often as headquarters of foreign enterprises in their business activities in Asia.

These various favorable factors have generated numerous economic virtuous circles, with one followed by another over the last few decades (Adams 1998). Capital availability, industrial development, external trade, and comparative advantage and foreign direct investment analysis have all been used to explain the success of the four East Asian economies. The paradigm of economism uses and reinterprets a number of factors to give a deeper conceptual understanding of the growth process in East Asia. In other words, it is not just the individual or independent analysis of industrialization, or comparative advantage in trade, or the availability of foreign direct investment, or openness and free market mechanisms that counts, but the possibility of a level of understanding that conceptually incorporates and combines various economic factors and goes beyond itemized analysis.

3 Growth, inequality, and the survival cost

3.1 Introduction

This chapter presents a conceptual argument against the misconceived correlation between income growth and equality, or between growth and distribution. By looking at the Gini coefficient of the four East Asian economies over the decades, it will be argued that growth and equality are separate issues, and the more relevant socio-economic goal is poverty reduction. The Gini coefficient measures the degree of income inequality (the higher the Gini coefficient, the greater the degree of income inequality, or the larger the gap between rich and poor), but it is not necessarily the best measurement of distribution. Inter-personal income comparison always shows inequality, but intra-personal income comparison can reveal how the absolute income of an individual has increased and poverty has been reduced.

The "Asian style" of poverty reduction was not the provision of "free lunches" through government assistance, but promoted self-help and the principle of "temporary" need. Welfare provision concentrated mainly on public housing and education that reduced the "survival cost" of low-income earners. A low "survival cost" enables employers to keep wages down to prolong economic competitiveness, but it also allows a greater purchasing power to be realized should absolute income rise. The discussion on poverty reduction leads to the conceptual importance of the "survival cost." The government can create a lower "survival cost" for individuals, either by the provision of various social and welfare items or by enabling the attainment of a high endowment through education and training.

Section 3.2 elaborates on the conceptual difference between growth and equality, while section 3.3 examines the Gini coefficient and its various measurement defects. Section 3.4 turns the discussion to the importance of poverty reduction instead of equality pursuance. The various instruments and experiences of poverty reduction among the four East Asian economies are presented in section 3.5. A comprehensive concept of "survival cost" is elaborated in section 3.6, and a conclusion is given in the final section.

3.2 Growth and equality

A number of studies have argued that, since the 1950s, economic growth in the four East Asian economies (Hong Kong, Taiwan, Singapore, and South Korea) has been accompanied by an increase in income equality. *The East Asian Miracle* (World Bank 1993: 29), for example, argues that the high-powered Asian economies (HPAEs) of Japan, Hong Kong, South Korea, Taiwan, Singapore, Indonesia, Malaysia, and Thailand have achieved a reduction in their levels of inequality. Their Gini coefficients showed some improvement (that is, the coefficient decreased) over the period between 1965 and 1990. Government policies, such as education and training for the labor force, stimulated growth as well as reducing poverty and income inequality (Birdsall *et al.* 1995: 478), thus ensuring sharing of economic benefits as growth proceeded. An endogenous virtuous circle of "education – growth – investment – productivity – greater equality – growth" was created.

A similar conclusion is supported by economy-wide studies. In the case of Taiwan, the rate of increase in income was greatest for those in the lowest income families and smallest for those in the highest income families during the period 1964–1979. Income inequality in Singapore declined between the mid-1960s and mid-1970s, largely as a result of an increase in employment of over 40% (Kuo *et al.* 1981: 31–4; Bhanoji *et al.* 1980: 25). Differences in opinion arise between the anti- and pro-equality advocates. The former believe that greater inequality resulted in greater savings, while growth was promoted by government policy. The pro-equality proponents argue that greater equality generated consumption that, in turn, promoted investment and increased equality. Between 1963 and 1980, Korea experienced an increase in equality but it was thought that a marginal redistribution of income to households from corporations would have produced greater growth (Leightner 1992). This is in broad agreement with Bénabou's (1996) findings that greater endogenous income distribution and social mobility over a similar period have resulted in a reduction in inequality as growth has proceeded. However, other studies on Hong Kong and South Korea have reached a different conclusion. When the South Korean economy was at its subsistence level in the 1950s, incomes were relatively equal, but inequality become significant after 1963 when South Korea experienced accelerated economic growth (Song 1990: 169). Similarly, Hong Kong's Gini coefficient fell between 1957 and 1971, but the trend has been reversed since then (Li 1987b: 370; Tsang 1993: 367).

Table 3.1 shows a rather comprehensive picture of income inequality in the four economies over the period between the 1960s and 1990s. Both Hong Kong and Singapore show a tendency toward greater income inequality (marked by higher Gini coefficients) than South Korea and Taiwan. Deininger and Squire (1996a) report that the average Gini coefficient for Hong Kong over this period was 0.416, slightly higher than that for Singapore at 0.401. South Korea had an average of 0.354, while Taiwan's average was the lowest at 0.297. In the case of Hong Kong, there was some improvement in inequality

Table 3.1 The Gini coefficients of the four Asian economies

	Hong Kong		*Singapore*		*South Korea*		*Taiwan*		
Year	*DS*	*OT*	*DS*	*OT*	*DS*	*OT*	*DS*	*Kuo*	*Rao*
1953					0.340				
1959								0.558	
1961					0.320			0.440	0.440
1963		0.462							
1964					0.330		0.322	0.321	0.360
1965					0.343	0.344			
1966		0.467		0.498	0.342		0.324	0.323	0.358
1968					0.305		0.289	0.326	0.362
1969					0.298				
1970					0.333	0.332	0.294	0.293	0.321
1971	0.409	0.409			0.36				
1972		0.443		0.443			0.290	0.290	0.318
1973	0.398		0.410	0.457			0.336		
1974		0.398		0.434			0.281	0.300	0.319
1975		0.448		0.448		0.39	0.312		
1976	0.409	0.409			0.391	0.391	0.284	0.289	0.307
1977							0.280		
1978			0.370				0.284	0.289	0.306
1979		0.373		0.424			0.277		
1980	0.373		0.407		0.386	0.390	0.280		0.303
1981	0.452	0.453		0.443			0.282		
1982				0.465	0.357	0.357	0.285		0.308
1983			0.420	0.474			0.285		0.312
1984							0.288		0.317
1985					0.345	0.36	0.292		
1986	0.420	0.435					0.293		
1987							0.297		
1988			0.410		0.336	0.336	0.300		
1989			0.390				0.304		
1990						0.327	0.301		
1991	0.450	0.462					0.305		
1992							0.308		
1993						0.310	0.308		
Gap	0.077	0.094	0.040	0.074	0.045	0.080	0.056	0.268	0.137
Average	0.416	0.434	0.401	0.454	0.342	0.354	0.297	0.372	0.333

Sources: Deininger and Squire (1996a); Tsang (1993, p. 362); Bhanoji Rao and Ramakrishnan (1980, p. 153); Rao (1988,p. 26–45); Kuo, Ranis and Fei (1981, p. 45, 92–93); Ahn (1999) and Song (1990, p. 173).

Notes
DS, Deininger and Squire (1996a); OT, others.

up to the late 1970s, but since then the trend has been reversed, and by 1991 it had risen to a level similar to 1963. The gap between the highest and lowest coefficients is less than 0.1. A similar trend can be detected for Singapore.

Its Gini coefficient declined until the late 1970s, and then the trend was reversed quite markedly, though it has a smaller gap than Hong Kong. South Korea's downward trend was short-lived; the Gini coefficient declined only in the 1960s, and by the early 1970s it had started to rise; thus it has an even smaller gap. In the case of Taiwan, although the Gini coefficients differed between studies (Table 3.1), the overall trend is similar (Warr and Wang 1999: 145). The results of Deininger and Squire (1996a) and Rao (1988) show that there was a tendency for inequality to decrease between the 1960s and 1970s, but that the trend has been reversed since the early 1980s. Nonetheless, Taiwan has experienced the largest gap in coefficients of the four economies (Kuo *et al*. 1981; Rao 1988).

The picture presented in Table 3.1 does not seem to support the arguments in *The East Asian Miracle* (World Bank 1993). The four East Asian economies seem to fit the "U-shaped curve" hypothesis (Kuznets 1955) better than the findings of Birdsall *et al.* (1995). They have experienced dramatic economic growth, but there has not been a consistent tendency for inequality to decline, as measured by the Gini coefficients. Furthermore, any improvement in income inequality has been marginal, as the gap between the highest and lowest Gini coefficients is less than 0.1 in most cases. In other words, the rise in income in these economies over the period from the 1960s to 1990s has not correlated positively with a reduction in inequality.

South Korea's sizable difference in income between wage earners and property owners has been attributed to the rapid urbanization of the cities, and the reduction in unemployment, which contributed to a reduction in the Gini coefficient between 1966 and 1972 (Bhanoji *et al.* 1980: 25; Song 1990: 171). The Gini coefficient measurement has also reflected the differences in the average income of various industries in Singapore and Hong Kong, and the urban–rural difference in South Korea and Taiwan (Chowdhury and Islam 1993: 225–7). In Hong Kong, labor segmentation resulting from the influx of refugees in 1976–81 and, in Singapore, the importation of foreign workers between 1979 and 1983 contributed to a decline in income equality. Other factors which have contributed to this trend in Hong Kong include the aging of the population, a lack of unionization of workers, and the changing industrial structure that displaced workers (Kapur 1983; Lin 1985; Islam and Kirkpatrick 1986; Tsang 1993). Bénabou (1996) argues that it is not income inequality that matters, but inequality in the "relative distribution of earning and political power". Deininger and Squire (1996b, 1997) query the narrowness of using inequality measures based solely on wage income and ignoring other representative data, and point out that there is no systematic link between growth and changes in aggregate inequality as indicated by the Gini coefficient, but rather a relationship between growth and poverty reduction.

The growth experience of Hong Kong in the 1980s and 1990s has been one of rising incomes coexisting with a deterioration in income equality. This has been used by social welfare advocates and politicians to criticize the Hong

Kong authority for not doing more to improve income inequality. The real GDP growth rate of Hong Kong averaged 7.5% in the period 1986–96, while per capita expenditure increased from US$10,452.3 in 1986 to US$16,211.7 in 1996. Unemployment and under-employment remained low at average rates of 1.99% and 1.51% respectively between 1985 and 1996. However, there are opposing exogenous variables and underlying trends that have led to the failure to produce a positive correlation between income growth and improvement in equality.

One was the political uncertainty generated in 1982–84 over the sovereignty of Hong Kong after July 1997, which resulted in a wave of emigrants leaving Hong Kong for such popular countries as Australia, Canada, and the US. The shortage of skilled workers and professionals soon led to rapid increases in wages. Large wage increases (up to a double-digit percentage increase in some years) in the high-income groups continued throughout the 1980s and early 1990s. This created an upward pull effect on wage levels (Table 3.2).

Working in an opposing direction, however, was a fall in the wages paid to low-skilled workers, probably as a result of the coexistence of a falling demand and a rising supply. The increasing skilled labor wages, combined with rising property prices and rents, resulted in high costs of production. The low production costs in southern China pushed Hong Kong industrialists into establishing their manufacturing plants across the border. Such a process of "industrial hollowing" resulted in a fall in the demand for workers in Hong Kong. On the other hand, the number of legal immigrants from China, mainly as part of family reunions, expanded on a daily basis from a quota of 100 in the 1980s to a limit of 150 per day since the early 1990s. This large intake of immigrants has added to the labor pool in Hong Kong and increased the competition with indigenous workers for jobs (Table 3.2).

The rising wages at the high-income end due to a fall in supply, coupled with a much smaller increase, or even a fall, in wages at the low-income end due to an increase in supply, would definitely lead to an increase in the Gini coefficient, corresponding to an increase in income inequality. This is because of the discrete "snap-shot" nature of the Gini coefficient., that is, it is a static measurement made at a single point in time. The truth is that the population size in the low-income group has been artificially enlarged. Given a slower increase in the wages of low-paid workers compared to higher-paid professionals and skilled workers, the discrete nature of the Gini coefficient will show a rise in income inequality.

The income gap in Hong Kong increased between 1986 and 1996, as shown in Table 3.3. In 1986, the poorest one-fifth of workers earned 15% of the highest earners. By 1996, the corresponding figure had dropped to only 11%. The increase in the number of new immigrants, a growing number of foreign contract workers, and a decrease in household size are thought to be the reasons for this. It may be appropriate for Hong Kong to consider separately the impact of the new immigrants and the question of income inequality.

Table 3.2 Hong Kong: average monthly industrial wage and number of legal immigrants from China

Year	*Average monthly industrial wage (US$)*	*Legal immigrants from China*	
		Number	*As percent of population*
1970	73	1,200	0.03
1971	94	2,500	
1972	99	20,400	
1973	124	55,700	
1974	134	32,900	
1975	139	25,600	0.58
1976	180	19,600	
1977	192	25,400	
1978	219	67,500	
1979	237	70,500	
1980	249	55,300	1.10
1981	272	54,300	
1982	416	36,300	
1983	373	26,700	
1984	375	27,400	
1985	413	27,200	0.50
1986	446	27,000	
1987	479	27,000	
1988	568	26,400	
1989	647	27,300	
1990	759	28,000	0.48
1991	842	26,800	
1992	936	28,400	
1993	996	32,900	
1994	1,154	38,200	
1995	1,224	46,000	0.74

Sources: *Hong Kong Monthly Digest of Statistics*, Census and Statistics Department, Hong Kong; Immigration Department, Hong Kong.

The costs of assistance in finding jobs and the provision of education and housing for new immigrants needs to be weighed against the benefits of a larger population for the tiny island of Hong Kong. Allowing low-skilled immigrants will further increase the size of the "low-income" population. In some countries, a "wealth-qualifying" or "asset-qualifying" requirement is imposed on new immigrants, which means that they qualify as mid-income earners upon entry.

3.3 Measurement of inequality

At the theoretical level, Atkinson (1983: 3) says that the term "inequality" may be applied practically, to describe different levels of income or wealth, or its use may be restricted to the wider moral sense, as in describing the difference between the haves and have-nots in society. The most popular measurements of income inequality are the Gini coefficient, which is a

Table 3.3 Percentage increase of income in Hong Kong, 1986–96

Median monthly income group	*Percentage increase*	*From HK$ (US$)*	*To HK$ (US$)*
Highest	61	30,500 (3,910)	49,300 (6,320)
Second highest	56	16,800 (2,153)	26,000 (3,323)
Third highest	51	11,600 (1,487)	17,500 (2,244)
Fourth highest	38	8,100 (1,028)	11,300 (1,449)
Lowest	21	4,500 (577)	5,500 (705)

Source: *South China Morning Post*, December 6, 1997, p. 3.

numerical value, and the Lorenz curve, which shows inequality graphically. The formula used by the United Nations (Department of Commerce 1971) and a number of economies to calculate the Gini coefficient (g) is:

$$g = \sum_{j=1}^{n} X_j Y_{j+1} - \sum_{j=1}^{n} X_{j+1} Y_j \tag{3.1}$$

X_j and Y_j are the cumulative percentage of households and household incomes respectively, and n is the number of income groups; Σ stands for summation. Household incomes are broken down into four quartiles: the lowest 25% of incomes fall into the first quartile; the second lowest 25% of incomes into the second; the second highest 25% of incomes into the third; and the highest 25% of incomes into the fourth quartile. This breakdown is thought to be most appropriate as it takes into account the various sections of populations in terms of their income. The basic idea of the Gini coefficient is to show the percentage of population (in an income group) over the percentage of income received (relative to the highest and lowest incomes). The Gini coefficient ranges from zero to 1. The closer it is to zero, the more equally income is distributed, and the closer it is to 1 the more unequal the distribution of income (for a theoretical discussion, see Eatwell *et al.* 1987: 529–32). The Gini coefficient can also be worked out for the income of various sectors of the population, such as the urban and rural sectors, different property sectors, the industrial and manufacturing sectors, age and sex groups, and so on.

Similarly, the horizontal axis of the Lorenz curve (see Figure 3.1 for a hypothetical Lorenz curve) shows the percentage of income enjoyed by the different income categories, say the lowest 20%, the second lowest 20%, and so on, of the population, while the percentage of population, from the poorest to the richest, in these categories is shown on the vertical axis. The diagonal line at 45° is the line of perfect income equality. The further the Lorenz curve deviates from the 45° line, the higher the level of inequality. The Gini coefficient is simply the ratio of the difference between the line of perfect equality and the Lorenz curve (area A) to the triangular region underneath the diagonal (area A + B).

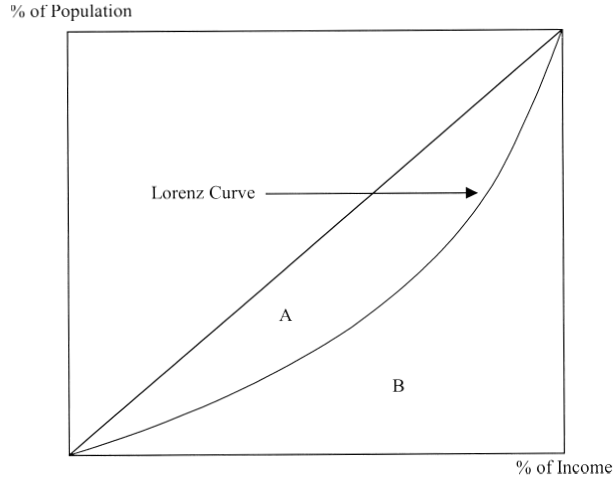

Figure 3.1 The Lorenz curve

Other objective measures of income inequality have been constructed (Dalton 1920; Atkinson 1970; Sen 1973; Aghion *et al*. 1999). Two such measures are the standard deviation of "logs of income" [σ (log x)] and the Champernowne measure [1 – (GM/AM)], where GM and AM stand for the geometric mean and the arithmetic mean of the given income distribution (Bhanoji *et al* 1980: 26). Sen (1973: 24–31) suggested two other measurements. The relative mean deviation (M) compares each household's income with the mean income, then sums the absolute values of all the differences, and looks at this sum as a portion of total income. If income equality is perfect, $M = 0$. If only one person receives all the income, then $M = 2(n - 1)/n$, where n is the number of households. The other measurement proposed by Sen (1973) is the coefficient of variation (C), which is the square root of the variance divided by the mean income level. The variance (V) is calculated by squaring the absolute values of the income gaps (that is, the differences between individual household incomes and the mean). Dalton (1920: 350) associated equality closely with economic welfare, and argued that a formula connecting income with economic welfare should satisfy three conditions. The first is an equal increase in economic welfare, regardless of the rate of increase, after income exceeds a certain amount. Secondly, economic welfare should tend toward a finite limit, although income can increase indefinitely. And, thirdly, economic welfare should be zero for a certain level of income, and negative for smaller amounts.

The conceptual ambiguity of income inequality, however it is measured, has been questioned. For example, Ok (1995) points out that any inequality measure has its strengths and weaknesses, and used mathematical tools to construct "fuzzy Lorenz orderings." There are other dimensions, too, in which income inequality has been analyzed. For example, Blackcorby and Donaldson

(1978) and Arneson (1989) looked at income inequality in relation to welfare and social opportunity. Mathematical models have been constructed to study the various aspects of income inequality (see, for example, Dagum and Zenga 1989). Creedy (1994), Nelissen (1994), and Young (1994), considered inequality in relation to social security and taxation policy. Ideologically, Dworkin (1981) and Frankfurt (1987) questioned the concept of inequality and its relation to morality. Similarly, Rawls (1971) and Meade (1976) examined the issue of justice in inequality. Myrdal (1989) and Jones (1997) looked at inequality from an international perspective, and from studying a number of countries, Adelman (1999) concluded that there exists a multifaceted and complex relationship between income distribution and various factors of economic, social, and political development. At the other extreme, some even argue that income equality should not be pursued. In a series of edited articles in *Against Equality*, Letwin (1983) and Lucas (1983) questioned the validity of income equality as a social ideal, and supported Coleman (1983) and Frankel (1983) in their argument for equality of opportunity instead.

Sen (1991; 1992; 1993) has questioned the foundation of welfarism, and instead developed a normative theory based on individuals' "capability" and "functioning." "The capability of a person reflects the alternative combinations of functionings the person can achieve, and from which he or she can choose one collection" (Sen 1993: 31). Some functionings are elementary, whereas others are more complex. These normative concepts are extended to the discussion of freedom, justice, and the demand for equality. On the relationship between income and individual achievement, Sen (1997) suggests five types of parametric variation:

1 personal heterogeneities
2 environmental diversities
3 variations in social climate
4 differences in relational perspectives
5 distribution within the family.

These variations suggest that the achievement of equality is more of a conceptual framework used for economic analysis than a likely occurrence.

There are problems with the Gini coefficient as a measurement of income inequality. The first is the "snap-shot" or discrete nature of the measurement. At any particular point in time when different wages are paid to workers as a result of differences in productivity and demand, the Gini coefficient simply reflects these differences in a static and aggregate form. It does not explain why some workers are paid more than others. It does not provide information on how workers can move up to a higher income bracket, and it does not show the economic responsibilities, such as the amount of tax paid or the size of family, of each income earner. Equally, it does not reflect either the kind of economic opportunities open to the worker or the "investment" a

worker has made in his or her skills. The usual trend of an individual's income is one of increasing over time as the individual becomes more experienced, is promoted, changes to a higher-paid job, or gains additional qualifications – all of which may enable the individual to move to a higher-income category. The Gini coefficient fails to reflect these continual changes in the income of an individual.

Secondly, the Gini coefficient assumes a static population structure and that time is required for a worker to move up the income ladder. The high-income end of the population tends to be more stable, but there are fluctuations that can easily expand the low-income end. For example, legal immigrants and school leavers tend to belong to the lower-income category. As long as the "poor" sector of the population increases faster than the "rich" sector, the Gini coefficient will naturally deteriorate as inequality increases. The change in demographic structure in Taiwan is regarded as a cause of the income inequality experienced since 1980 (Fields and Leary 1999).

The use of only taxable income in the calculation of the Gini coefficient has been questioned, and inclusion of a wider range of earnings arising from various sources has been suggested (Deininger and Squire 1996b). In Asian economies, small or family businesses, and informal incomes, such as hawkers' earnings, are rather common, but these sources of income are not recorded in the Gini coefficient. Furthermore, there are other forms of inequality that may equally restrict the ability of individuals to earn more (Bénabou 1996). Social immobility, for example, due to racial differences, religious orientations, or political affiliations, and regional disparities can influence individuals' earnings.

Income distribution can be cross-generational. In the case of workers who are unskilled, uneducated, and have a very low earning power, and whose opportunities for improving income mobility are low, it would be wise to put more effort into educating their children, provided that the opportunity for schooling and employment is available, so that they will achieve a higher earning power and can either look after their poor parents financially, or pay tax for the government to take care of the elderly (for a study of Taiwan, see Cheng and Chu 1999). This is exactly what most parents prefer to do if they can (Ehrlich and Lui 1991). In a similar vein, Becker and Tomes (1979: 1156) argue that "a parent can change the wealth of his children by investing in their human and non-human capital", and the income of the children can also be raised by their endowment, including race, knowledge, and skill. Finally, North (1994: 361) has correctly pointed out that economies change through time, and that economic change is "a consequence of the choices individual actors and entrepreneurs of organizations are making everyday."

3.4 Reduction in poverty versus reduction in inequality

Income inequality can be considered on a dynamic, time-series basis in which comparison is made between the different time periods for the same individual

household. The intra-household comparison is more meaningful because it reflects the wealth of the household and economic changes over time. The more relevant question is not the difference in rewards between individuals, but whether an individual has gained and become better off than he or she was before. Over a period of time, reduction in poverty is a more easily achievable social and economic goal than the pursuit of income equality. The crucial element is the difference in personal endowment that gives rise to differences in earning power and income. The more relevant strategy or policy, therefore, is to ensure that individual endowments are improving over time so that the individual's ability to make a decent living is assured.

The *World Development Report* (World Bank 1990) defined poverty as "the inability to attain a minimum standard of living" and rightly pointed out that "poverty is not the same as inequality". Inequality refers to the "relative" living standards enjoyed by households in a society, while poverty is the "absolute" level of living standard (ibid.: 26). A perfect measurement of poverty does not exist, but poverty is judged in relation to some norm. A consumption-based poverty measurement consists of two parts. One is the objective element of necessity, which is the minimum expenditure required to maintain a basic level of nutrition and standard of living, and the other is the subjective measurement of an individual's ability to participate in the everyday life of society. Based on the experience of thirty-four countries, the *World Development Report* (ibid.: 27) suggests an upper poverty line of US$370, and a lower poverty line of US$275 per annum, in terms of purchasing power at 1985 prices. In 1985, the number of poor people in East Asia amounted to about 270 million, but by 2000 the number is expected to have fallen to fifty million. The three common indicators used to study the progress of poverty over the years are consumption per capita, average life expectancy, and net enrolment rate in primary education.

Since the 1970s, the measurement of poverty has gone beyond the simple head-count technique and recognized the limits of an income-centered or commodity-centered concept and introduced multifaceted measurements, including the ideas of basic needs and human capabilities (Bardhan 1995: 60). Poverty measurement consists of two elements: (1) an individual's quantified standard of living; and (2) how to determine a minimum acceptable standard, or the poverty line (Ravallion and Huppi 1991). Various criteria (the monotonicity axiom or the transfer axiom) used to measure poverty have taken into account the distribution of living standards among the poor, not just the absolute number of poor. An additive decomposable measure that takes into account various subgroups of the population in order to arrive at an aggregate poverty measure was developed (Foster *et al* 1984). Similarly, a poverty gap ratio, which is the difference between the poverty line (z) and the poor household (i)'s standard of living (y_i), namely $(z - y_i)/z$, can also be used as an indicator of poverty.

History has taught us that severe and drastic redistribution of income from the rich to the poor has often led to radical ideological revolutions,

political changes, and replacement of governments and regimes. The desire to remove economic inequality has often led to the emergence of different, possibly more undesirable, forms of inequality. Two approaches to solve the poverty problem have been suggested. The welfarists prefer an income-based approach that looks solely at the importance of the rise in income. However, non-welfarists focus their attention on broader pro-poor public policies for improving longevity, literacy, basic health and sanitation, basic freedom, and so on (Bardhan 1995: 60).

Development economists have changed their views on poverty and distribution. Chenery *et al* (1974), in *Redistribution with Growth,* pointed out that rising income in the early 1970s in many developing economies coexisted with poverty and income inequality, and that the responses on the part of the policy-makers in dealing with relative poverty and underemployment were inadequate, and so growth was concentrated. The poor were prevented from sharing equitably because of lack of access and lack of physical and human capital. Instead of individual, isolated projects of development, an overall program or policy package to deal with poverty was needed. This required not only instruments that operate through the factor and product markets, but a range of direct measures, including land reform, education programs, and asset redistribution. Poverty-focused strategies aimed at examining different poverty groups were proposed. There had to be a "reorientation" of planning methods that would not abandon growth as an objective, but concentrate on the "redistribution of the benefits of growth"(ibid.). To have a lasting impact on the poverty problem, redistribution should begin at the increments of capital formation. Chenery believed that economic planning is a more desirable instrument than the free market mechanism in solving the poverty problem. The World Bank's discussion on poverty and distribution has also changed. The *World Development Report* on poverty put its emphasis on the importance of promoting economic opportunities for the poor (World Bank 1990: 56–74). The two fundamental principles are: (1) to encourage a pattern of growth that increases the efficient use of the assets owned by the poor; and (2) to expand the access of the poor to land, credit, infrastructure, and productive inputs.

There are two possible misconceptions in the analysis of poverty and inequality. One is the idea that aiding the poor, either by heavily taxing the rich or by considerable government subsidy, can improve equality; this makes a crucial assumption of capital mobility. In a free market, capitalist economy, mobile capital resources are put into the most profitable form of investment. Thus, the economy will end up with fewer investments if a heavy redistribution program discourages investors and wealthy capitalists. Fewer investment programs in turn mean fewer jobs for the workers. Wealth and poverty should therefore not be seen as opposing ends. To reduce poverty requires the presence of economic opportunities, typically employment and jobs. And wealth is required to create economic opportunities. Wealth holders invest and their investments create jobs that are filled by the job seekers. A direct means of alleviating poverty is employment, which provides economic security.

The quality of workers will be reflected in wage levels, depending on skills and experience. There is thus inequality between wealth and non-wealth, between employers and employees, and also between employees with different skills, education, and experience. This "law of economic inequality" is a perpetual phenomenon and the crucial issue is not so much the solution of inequality or the pursuance of equality as the reduction in poverty.

Another possible misconception is that economic growth will result in greater equality. Although it is morally preferable to see a fall in inequality as economic growth proceeds, it certainly is not an economic "law." It is perfectly feasible for inequality to be reduced as employment proceeds, but this depends on the rewards of employees and employers. There are, however, newcomers to the society who seek employment and jobs. A "new poor" emerges as a result of the changing pattern of the labor market, or the population structure. The emergence of the "new poor" leads naturally to a decline in equality. The more relevant concern is the absolute comparison for each economic agent over time, and not the comparative or relative difference between individuals. Poverty is reduced when a worker receives pay today as compared to no pay yesterday.

These conceptual discussions lead one to conclude that a primary concern of society is the reduction in poverty, and it does not follow that a redistribution of wealth from the rich to the poor is a sound policy worth pursuing. Similarly, economic growth provides employment and economic security, and it does not follow that equality improvement is a natural by-product of economic growth. The more important question, of course, is the persistency and sustainability of economic growth, and not the extent of inequality as growth occurs. There is no economic law that says economic growth results in equality. It can be a coincidental outcome, but equally the two may deviate from each other.

3.5 Poverty reduction: the East Asian approach

Poverty reduction in East Asia has been described as a "silent revolution" as absolute poverty dropped, from claiming a third of the population in 1970 to a tenth in 1990. Various social indicators used to examine absolute poverty include food intake; availability of safe drinking water and sanitation; average life expectancy and infant mortality rates; population growth; literacy; urbanization; GNP per capita; and income distribution (Johansen 1993). In Taiwan, poverty declined from 55% to 20% of the population between 1964 and 1973, with a constant poverty line of NT$30,000. Hong Kong's poverty declined from 18% to 7% between 1966 and 1976, with a poverty line of HK$3,000 at 1966 prices. The proportion of the population living in poverty in Singapore declined from 37% to 18% between 1966 and 1980, with a poverty line of S$200 per capita at 1975 prices. Between 1965 and 1980, Korea's poverty has declined from 41% to 10% of the population, with a poverty line of 121,000 won at 1980 prices (Fields 1989).

The East Asian experience suggests that poverty reduction can be dealt

with from the supply side, involving primarily expansion in the economic endowment of the younger generation. A better-educated person, for example, can easily seek employment in a growing economy, and this in turn reduces absolute poverty. The provision of public housing is considered to be an instrument of "poverty reduction," which minimizes the cost of living for the poor. Expansionary policies on the demand side have been discouraged. For example, large welfare expenses are avoided, although the minimum is provided to the needy, and this is reflected in the relatively low welfare expenditure of the governments of these four economies. Economic security is considered as a better means to solving the poverty problem and ensuring social security than the provision of welfare.

There are two approaches to the study of poverty reduction. One is the examination of various poverty indicators within the framework of basic needs (Richards and Thomson 1984) or urban poverty (Pernia 1994). Such an approach usually identifies various poverty indicators and examines the supply shortages in comparison with the existing international norm. The more comprehensive approach is conducted within the framework of public policy, which covers the provision of education, housing, social welfare, transport, and infrastructure. Public policy analysis looks at the resource constraints and the totality of poverty reduction. A common characteristic of many public policies is their overemphasis on the expenditure side, and their optimism on the revenue side. It has often been considered that public policy is expenditure led, but their execution is often constrained by government revenue. Three public policy approaches have been suggested in *The East Asian Miracle* (World Bank 1993). One is the neo-classical view of government non-intervention that the market takes the center stage in economic life while the government plays a secondary role. The revisionist view argues that some Asian governments, such as South Korea and Taiwan, have extensively and selectively promoted individual sectors. The third approach, the market-friendly view, advocates a strategy in which government ensures adequate investment in people, provision of a competitive climate for enterprise, openness to international trade, and stable macroeconomic management.

Table 3.4 shows the percentage shares of the three most important items of public expenditure, housing, education, and social welfare, in the four East Asian economies. Social welfare expenditure has occupied the smallest share in most cases. One exception is Taiwan since 1985, when the percentage share increased to two digits. In the case of Hong Kong and Singapore, their shares of expenditure on social welfare have not exceeded 7%. Education has occupied the largest share of public expenditure in all cases, reflecting the importance of investment in human capital as a long-term means of reducing poverty and promoting economic growth. In Taiwan, the initial expenditure on education was small, but its share has expanded rapidly since 1985. Hong Kong has put a heavy emphasis on education since the 1970s and its percentage share has increased steadily. In contrast, in Singapore, the

Table 3.4 Public expenditures and percentage shares

Year	*Public expenditures*	*Percent share in housing*	*Percent share in education*	*Percent share in social welfare*
Hong Kong (HK$ million)				
1955	402	0.6	3.2	0.5
1960	845	0.7	4.0	0.7
1965	1,769	0.3	4.4	0.9
1970	2,478	6.2	20.1	1.5
1975	6,080	7.2	20.9	5.8
1980	23,593	10.4	14.2	3.7
1985	43,444	12.7	17.4	5.7
1990	95,198	13.0	16.9	6.1
1993	155,207	10.7	16.4	6.8
Taiwan (NT$ million)				
1955	6,534	2.8	7.0	0.8
1960	12,193	4.0	2.2	3.0
1965	22,391	2.7	1.6	1.4
1970	49,153	3.8	1.3	1.9
1975	126,436	3.0	1.4	1.9
1980	345,396	1.1	1.6	2.4
1985	563,729	0.9	13.8	11.2
1990	702,812	2.3	18.1	10.3
1994	1,149,780	0.6	31.7	12.0
Singapore (S$ million)				
1960	243.4	19.7	23.5	1.2
1965	226.0	13.7	27.0	5.8
1970	1,254.10	27.8	13.8	4.1
1975	3,256.70	17.0	9.9	6.5
1980	3,651.00	4.3	30.8	6.2
1985	6,678.30	7.3	20.2	3.4
1990	11,282.00	7.7	15.4	3.7
1994	14,118.00	13.3	17.2	4.1
South Korea (won billion)				
1960	38.5	5.5	17.4	4.0
1965	84.1	5.7	18.3	5.2
1970	166.4	10.5	15.0	1.6
1975	1,895.80	2.3	14.5	5.3
1980	8,018.00	2.7	14.0	5.5
1985	13,585.00	4.5	18.1	5.7
1990	33,836.90	9.5	16.7	8.0
1994	52,774.30	6.0	15.9	10.7

Sources: *Hong Kong Yearbook*, Hong Kong, various years; *Taiwan Statistical Data Book* and *Statistical Yearbook*, Taipei, various years; *Yearbook of Statistics Singapore* and *Economic Survey of Singapore*, Singapore, various years; *Monthly Statistical Bulletin*, *Economic Statistics Yearbook* and *Yearbook of National Account Statistics*, Seoul, various years; and *Key Indicators of Developing Asian and Pacific Countries*, Manila, various years.

percentage share of expenditure on education has been declining from over 30% in 1980 to 17% in 1994. The equivalent figures for South Korea have remained very steady over the decades at around 16%.

As Table 3.4 shows, the percentage share of public expenditure accounted for by housing differs between the four economies. Hong Kong began spending a large proportion (over 10%) on housing in 1980, while public expenditure on housing in Singapore declined sharply in 1980 and was remained at a low level until 1994, when it increased again to 13.3%. Taiwan's government has spent very little (4% or less) on housing. Housing expenditure in South Korea has varied over the years, but has rarely exceeded 10%. Hong Kong and Singapore have concentrated on housing and education, whereas Taiwan has put more resources into education and social welfare. Again, education seems to be the most important public policy target for South Korea. The emphasis on education and investment in human capital is regarded as a crucial element of the East Asian economies' success in *The East Asian Miracle*, which concluded, "East Asian children tend to perform better than children from other developing regions – and even, recently, better than children from high-income economies" (World Bank 1993: 45–6).

Social welfare provisions

Similar philosophies and criteria to those used in the provision of social welfare have been maintained for decades across the four East Asian economies. The ability to stand on one's own feet, the incentive to develop one's endowment capacity, and the tradition of family support are common elements in the welfare policies of the four economies. Welfare assistance and social protection provide a comprehensive range of services, but they are given only to those in real need.

Hong Kong

In the case of Hong Kong, the government's overall philosophy is to recognize a responsibility to help the disadvantaged members of society to attain an acceptable standard of living, depending on the resources available.[1] Social welfare plays a vital preventive, developmental, and supportive role, and encourages individuals to develop their capacities to the full and to be active and productive members of society.[2] The two central principles that govern Hong Kong's public expenditure are (Huque *et al*. 1997: 7):

1 the size of the public sector should not exceed 20% of GDP;
2 the growth rate of public expenditure should not exceed the growth rate of GDP.

The social security system in Hong Kong consists only of "public assistance for the very poor and nominal allowances for the elderly and the severely

disabled" (Chow 1981: 118). The two main social security schemes that existed in the 1970s included a means-tested scheme that provided essential needs, and a non-means-tested scheme that provided non-contributory allowances to the elderly and the disabled. Public assistance in the 1970s was classified into the following deserving categories: old age, ill health, low earning, widow with dependent children, blind, physically disabled, mentally ill, drug addicts, unemployed, deaf, and others (Chow 1981; 1982; 1985; Brewer and MacPherson 1997).

Singapore

In Singapore, only the destitute, disabled, or chronically ill and those with no independent means of financial support are entitled to welfare assistance (Lim and Tay 1991: 95). The provision of a minimal cash allowance is to encourage self-help and help from the family. The Central Provident Fund (CPF) is regarded as an effective means to look after the poor and the retired. In the pre-independence years, few resources were devoted to the welfare of the Singapore people, and the twin economic problems at the time of independence in 1959 were unemployment and shortage of housing (Ow 1986: 228–9). In the 1960s, half of the total public expenditure went to social and community services, but by 1974–75, the proportion had dropped to a quarter. Public expenditure was financed almost entirely from domestic borrowing. A development fund was established in 1960 to finance the various developmental needs. The principal stockholders (75% of total in 1975) in the fund were the clients of the Central Provident Fund (Bhanoji *et al* 1980: 72).

Taiwan

In Taiwan, a social insurance scheme was instituted in the 1950s, while personal social services were provided on a piecemeal basis in the 1960s. The social insurance scheme was provided for three categories: military servicemen, laborers, and government employees. The piecemeal nature of welfare development has been maintained. In the 1994 *Guiding Principles of Social Welfare Policy* (outlined in Ku 1997), for example, various principles were used. One was the emphasis on the balance between economic and social development. Another was the establishment of a proper social administration system. The family as the center of social welfare policy was the third principle. The adoption of a team approach among different government departments and harmony and cooperation between employers and employees were also regarded as important principles. And, finally, a financially independent social insurance system, the provision of public housing for the low-income households, and equal opportunity of access were the remaining principles (Ku 1997: 247–8).

Personal social insurance schemes emerged as a result of social unrest

between 1976 and 1979, culminating in the promulgation in 1980 of three laws relating to special needy groups. They were the Aged Welfare Law, the Handicapped Welfare Law, and the Social Assistance Law. Welfare expenditure at all levels of government grew rapidly with an average annual growth rate of 26.6% between 1950 and 1979. This exceeded the average annual growth rate of GNP at 18% over the same period. The establishment of the Council for Labor Affairs in 1988 was a radical change in Taiwan's provision of state welfare. The Vocational Training Law (1983) and the Labor Standard Law (1984) set the scene for the new council. It now deals with various labor affairs, including industrial relations and conflicts, vocational training, employment services, wage policy, and labor insurance. Furthermore, the Department of Health has set up a number of regional centers. Subsequently, welfare expenditure at all levels of government has exceeded 3% of GNP in 1982, increasing to 4.59% by 1990 (Ku 1997: 41–2, 50–5).

South Korea

There are three reasons for the lack of social welfare in South Korea (only 11.3% of GDP in 1978): firstly, the burden of the defense budget; secondly, the coexistence of public and private provision of social welfare and the various economic development plans since the 1960s; and, thirdly, the dominant Confucian ethos of family care and responsibility that often functions as a supplementary safety network (Chang 1985: 185; Palley 1992). There are four elements and three criteria in the provision of social welfare in South Korea. The four prominent value elements are humanism, a sense of community, free democracy and acceptance of welfare, and national efficiency (Chang 1985). The three criteria are that welfare services expenditure should never exceed 10% of government expenditure; priority is given to various welfare services, beginning with national medical care protection, pensions, care of disabled people, the poor and the old, and housing; and both private and quasi-public institutes are encouraged to join the government in planning, adopting, implementing, and delivering various social services (Pae 1992: 395).

There are three major areas in Korea's social welfare legislation: social insurance, public assistance, and personal social services. Between 1960 and 1983, there were nine pieces of legislation passed on social insurance (for example, the Government Employee Act 1960, the Social Security Act 1963, and the Military Veteran Pension Act 1983). Five pieces of legislation on public assistance were passed in the early 1960s. In the case of personal services, there were eight pieces of legislation passed between 1961 and 1981 (Chang 1985: 182). The 1980 Social Welfare Fund Act permitted private organizations to raise social welfare funds. The Confucian system is dominant in the care of the elderly. The traditional role of the family ensures that the eldest son and daughter-in-law take responsibility for the care of the parents. As a result, national expenditure on the elderly has been small; for example, in 1990 it amounted to 0.17% of the total national budget (Palley 1992: 792).

By the 1990s, there were four major areas of social security in Korea: social insurance, public relief, social welfare services, and disaster relief.[3] Education and human capital development has been the dominant item in national public expenditure. Migration from rural to urban areas required the government to pursue a long-term manpower development plan. Public expenditure on education increased from 15.2% of the total government budget in 1960 to 20.3% in 1985. The rate of increase in the budget of the Ministry of Education was higher than the economic growth rate between 1960 and 1985 (Choo 1990). However, marked regional differences may generate a sense of deprivation that could prove to be an obstacle to Korea's socio-political stability (Ahn 1999).

Public housing and land reform

In an export-led economy, housing and property development is a non-exportable commodity, though it generates domestic employment and income. An increase in housing and property investment means fewer capital resources for investment in other exportable commodities. The relatively large supply of public housing in Hong Kong and Singapore has fulfilled two basic principles. First of all, housing is regarded as a necessity and the relatively low rent on public housing enabled industrialists to keep wages down, ensured a supply of cheap labor, and maintained cost competitiveness in the 1960s and 1970s. Intervention in housing permitted private investors and industrialists to concentrate on exportable industries, and aided economic development and social stability in Hong Kong. Secondly, the provision of public housing through the home ownership scheme succeeded in reducing poverty. The home ownership scheme and privatization of public housing "forced" the low-income earners to save. Over time, such changes enabled the low-income families to depart from poverty.

Instead of providing housing, the Taiwan authority conducted the land reform program in 1950–53, which enriched the rural sector and turned the landlords into industrialists in the urban areas. The virtuous circle of Taiwan's land reform program could be summarized as follows. Originally, large landlords controlled the ownership of land, rural wages were extremely low, and income inequality was severe. The government stepped in and employed a dual strategy. On the one hand, the wages of rural farmers were raised. On the other hand, a "land-to-the-tiller" program was introduced so that large landlords sold their land to the farmers at a price subsidized by the government. Land liquidation enabled the landlords to increase their financial capital, and some moved to the urban areas and engaged in industry. Surplus labor from the rural areas provided a stable supply of industrial labor. Everyone benefited from the land reform process. Some farmers and rural workers saw an increase in wages, while others bought agricultural land. The original landlords sold their land, and the newly acquired financial capital permitted them to start their industries. Rural farmers also had the choice of remaining in the rural areas or becoming industrial workers in the cities.

Hong Kong

In the case of Hong Kong, public housing has been a major item of government intervention since the 1950s when poverty was widespread (Hopkins 1971). The basic definition of public housing is simply the provision of a "shelter", meaning "a place to accommodate a person's body". Initially, the standards were poor, but by the 1970s, the standard set by the ten-year housing program included "an independent unit with water and electricity supply, toilet, and kitchen, in a living space of not less than 3.2 square meters per person for each family" (Ho 1986: 331). By 1981, the provision of more than 100 public housing estates housed about 40% of the population of 2.02 million (Cheng 1982: 346). Although the conditions were generally poor, the rent was extremely low. In the 1970s, for example, the Home Ownership Scheme was introduced to help the middle-income group (sometimes called the "sandwich class"). By the early 1990s, there were five government housing subsidy schemes intended for the general public according to eligibility. They are the public rental housing program; the Home Ownership Scheme; the Private Sector Participation Scheme; the Home Purchase Loan Scheme; and the housing scheme for the sandwich class implemented in August 1993 (Leung 1993: 269).

The Hong Kong government's involvement in housing has passed through four stages: minimal intervention before 1954; *ad hoc* direct intervention between 1954 and 1972; restructuring of housing programs between 1972and 1987; and finally, a demand-led strategy for private sector housing since 1988 (Yip and Lau 1997: 40–2). By the late 1980s and early 1990s, however, the provision of public housing and housing for the sandwich class was facing new challenges. One is the emergence of "rich households." Initially, poor families were housed in the low cost public housing. Rapid economic growth, however, improved the income of many households. As entitlement to public housing lasts a lifetime and can even be handed down to one's offspring, many "rich households" are reluctant to vacate their public housing quarters. It is also difficult to ask these households to review their true level of income and earnings. At the same time, other low-income and needy families have to wait for a long time before public housing can be provided. Thus, one drawback of the initial public housing policy in Hong Kong was its indiscriminate and lifetime entitlement, which overlooked the possibility of poor households moving up the income ladder and anticipated that low-income families could only "rent" and would not have the ability to "own" their living quarters.

In his first policy speech delivered on 8 October 1997, Mr Tung Chee-hua, the Chief Executive of the Special Administrative Region Government of Hong Kong, attempted to privatize public housing, and projected that 80% of households in Hong Kong would own their housing quarters or apartments, via either the private market or government-aid housing projects. Occupiers were encouraged to purchase their own quarters at an attractive, below-market, price, which ranged from HK$70,000 (US$8,974) to HK$250,000

(US$32,051), depending on the size, age, and district of the estate. Funds have been set aside to renovate the buildings before ownership changes. The newer estates will be sold in the first instance. The government intends to privatize 17,000 public housing units per year, and over 70% of households living in these units have expressed their interest to purchase.[4]

Although privatization of public housing has attracted some criticism, it has a number of positive theoretical implications. It allows an automatic market mechanism for the "rich households" to switch over from public housing quarters, so that more public housing units will be available to the needy families. Substitution through the market mechanism has enabled households which have reached a sufficiently high income level to liquidate their ownership of public housing and purchase a private apartment, though there are restrictions on change of ownership in the first five years. Privatization has encouraged the low-income families to save. Unlike the payment of rent, which does not have the bonus of capital accumulation, mortgage payments effectively help the household to accumulate more capital assets. Furthermore, by using a market mechanism to regulate public housing supply and demand, the government will have a lower financial burden on housing in the long run. Lastly, and most importantly, the privatization of public housing will break the decades-long practice of a life-long government assistance.

Singapore

Under the home ownership scheme launched in 1964 by the Housing Development Board (HDB), an applicant has to pay 20% of the selling price of an apartment, the remaining 80% being payable over a maximum period of twenty years at an annul interest rate of 6.5%. The allocation is made on a "first-come, first-served" basis. In 1980, for example, apartments sold under the scheme totaled 213,371.[5] The peak rate of construction was achieved in 1984 with a new supply of 67,017 units (Lim and Tay 1991: 97). The role of the HDB is to provide public and middle-income housing and. in so doing, the HDB has adopted a total approach to housing.[6] In contrast to the provision of a simple "shelter" as the initial objective of public housing provision in Hong Kong, the primary objective in Singapore was to encourage property ownership from the very beginning, particularly among the lower- to middle-income group. Between 1960 and 1980, for example, there were four five-year building programs.[7] The number of households in HDB units increased from 0.45 million in 1965 to 1.05 million in 1975 and to 2.09 million in 1985 (Lim and Tay 1991: 98).

The housing policy in Singapore worked from both the demand and the supply side. On the demand side, rent subsidies to low-income families have been granted. Landlords of private housing units have been provided with a predetermined rent. On the supply side, the government owns and manages low-cost housing units and rents them out at below-market price to low-income

families (Lim and Tay 1991: 92). A major element in the housing policy has been the role of the CPF in financing public housing. Occupants are permitted to utilize their accumulated pension fund contributions for the downpayment and monthly mortgage repayments on their HDB units. The CPF scheme requires that both the employer and the employee contribute 5% of their wages to the fund. In 1980, 59% of Singapore families were owner-occupiers, with 42% having owned HDB units. By 1990, the proportion of owner-occupiers exceeded 90%, with almost 80% owning HDB units (Sandilands 1992: 132).

Taiwan

Taiwan's land reforms comprised a "three-pronged package": the program to reduce farm rents, the sale of public lands, and the land-to-the-tiller program. Between 1949 and 1957, the number of owner-occupiers increased from 224,378 (36% of total) to 455,357 (60%), while the number of tenants decreased from 239,939 (39%) to 125,653 (17%). Between 1952 and 1964, fixed capital and working capital in agriculture expanded by about 34% and 140% respectively. The purchase price of land was set at 2.5 times the annual yield of the main crop. Landlords were paid 70% of the purchase price in land bonds, while the remaining 30% was allocated in the industrial stocks of public enterprises previously owned by the Japanese. It was concluded that "the landlords, deprived of the privilege of living comfortably off the land, were encouraged to participate in the industrial development of Taiwan through ownership of four large-scale industrial enterprises" (Kuo *et al.* 1981: 49–53). Furthermore, the incentive to make an extra effort to farm well was greater after land reform, and farmers had a free choice of crops.

The land reform program was carried out in three stages: compulsory rent reduction; sale of public land to actual farmers; and the compulsory sale of private land to farmers. Two basic changes were introduced: a sizeable number of sharecroppers became owner-farmers and a ceiling was placed on rent. The income of the tenant-farmers increased in two ways: lower rents and the choice of purchasing land. Regression analysis suggests that regional differences both in land improvement and in agricultural education were closely related to the initial impact of land reform. Thus, land reform has profoundly transformed social attitudes and altered the rural power structure (Ho 1978: 159–75).

South Korea

The situation in South Korea regarding public housing is different from that of Hong Kong and Singapore. In principle, the Korean government is more determined to improve dilapidated urban areas than to meet the human need of housing (Shin 1994). In the 1950s, the Korean government was involved in the relocation of war victims, while in the 1960s, settlement of the two types of squatters (owner-squatters and tenant-squatters) was the

major concern. In the 1980s, the Korean authority considered the private sector to be the major supplier of housing. Nonetheless, the Korean government worked out a number of policy measures to meet the increased housing demand. Housing production increased by an annual average of 65,000 units in the first five-year plan (1962–66) to an annual average of 477,000 units in the sixth five-year plan (1987–91). Over the same period, investment in housing increased from 1.5% of GNP to 4.7%.[8]

Several observations can be drawn from the experience of the four East Asian economies. First, despite their similarity in terms of economic growth, their social and welfare expenditure patterns differ considerably. For example, Korea's social security system is based on social insurance, while Singapore's consists of a package based on forced savings, tax allowances, public assistance, and public insurance schemes based on market principles. Korea has emphasized health care programs, while Singapore's "Medisave" compels people to save for their health care, so that the demand on public funds can be reduced. On the contrary, Singapore favored a child-allowance program directed at young and educated mothers. Since 1990, tax rebates have been given to women having their second child. A tax rebate of S$20,000, S$15,000, S$10,000 or S$5,000 is given if the child is born before the mother reaches the age of twenty-eight, twenty-nine, thirty or thirty-one respectively (Ramesh 1992; 1995).

None of the four East Asian economies can be regarded as a welfare state. For example, in the case of Taiwan, around 10% of GNP spent on social security in 1990 was equivalent to the level of social expenditure in the UK in the 1930s. In Singapore, social security expenditure is unlikely to provide sufficient social protection for the weaker sections of society (Ku 1995: 350; Ramesh 1992). One of the major characteristics of a welfare state is its high expenditure on social welfare, which provides indiscriminate assistance to households as a variety of benefits, such as unemployment, pension and retirement, ill health and disability, and so on. These are considered as "free lunches", which merely enlarges the fiscal burden of the state without generating any return for the government, either directly or indirectly, immediately or in the long run. On the contrary, the principle of "self-help" has been adopted in the East Asian economies, and reliance on government assistance has been kept to a minimum and, in most cases, only for the short term.

Other than the key social welfare expenditure items, there are a number of endowment-enriching items that can be obtained by individual members of the community or specific groups of needy individuals. These include the provision of public utilities, such as road construction and sewerage, social infrastructure, and vocational training. In Singapore, the number of vocational trainees increased from 10,000 in 1980 to 148,100 in 1987 and in Taiwan, their numbers increased from 53,732 in 1966 to 485,491 in 1994.[9] Similarly, vocational and industrial training in Hong Kong, and, since 1992 retraining of local workers, has been given high priority. By 1994, for example, the

Vocational Training Council in Hong Kong had expanded to include twenty training boards and twenty-four industrial training centers. Here the older workers, displaced by economic restructuring, can receive allowances to undertake retraining. In 1994, the training allowance was HK$3,400 (US$436) per month for attending day courses, and HK$30 (US$ 3.8) per day for evening courses.[10]

3.6 The survival cost concept

The concept of poverty reduction suggests that the lowest-income group may have difficulty surviving economically. John Maynard Keynes (1936), in the *General Theory of Employment, Interest and Money,* gives the classic example. One way to solve the problem of unemployment, and probably poverty, is to employ one worker to "dig a hole" and another worker to "fill it up again". Keynes' ideas were based on employment creation, and although he went on to talk about the consequent multiplier impact of income and consumption, the very fact of being employed, in turn, allows the poor to survive. In other words, the poor can also be made better off if they face a lower "survival cost."

The difference between a rich person and a poor person in a modern economy is that the former can survive economically whereas the latter cannot. Other than income, which is derived from employment, there are a great number of items which are related to a person's economic survival – education, health, transport, housing, the cost of raising children, retirement pension, social infrastructure, and so on. In aggregate and measured in economic terms, the portion of income spent on daily living is the survival cost. Reducing one's survival cost can improve one's economic welfare. For example, public transport is likely to be used by people without their own means of transport, therefore an efficient and economical mass transport system will be of benefit to the workers, by minimizing their (survival) cost of getting to work. Similar arguments can be applied to such other survival factors as health, vocational training, housing, and so on. When compared to a poor person, the wealthier person will have a lower survival cost, as their total "survival" expenses will occupy a much smaller portion of their income. Similarly, a well-educated person is likely to cope with the survival cost more easily than an uneducated person.

There are two ways to reduce the individual's survival cost. One is to make the survival factors more easily accessible to individuals at a low cost by government provision. The other is to ensure that the individual has the ability to earn enough to support his or her survival cost. A person's income is the basic guarantee of their ability to pay survival costs in housing, health, and so on. The experience of the four East Asian economies strongly suggests that government involvement in a number of social welfare factors helped to reduce the survival cost of a great number of households. Most government assistance was given only to those most in need, so social assistance was regarded as a "last resort" when a household was unable to cope with the

cost of survival. As soon as they could survive economically, they would withdraw from seeking government assistance, or become disqualified according to official criteria.

There are two categories of survival factors. Social survival factors comprise mainly public services, such as health, education and vocational training, housing, transportation, social infrastructure, and so on. On the supply side, these social survival factors can be supplied either by the government or by the private sector under government regulation. If supplied by the government, a subsidized user fee will normally be charged, but the market price will be charged if private institutions make provisions. On the demand side, this category applies to all individuals, regardless of their income level. The choice, though it is likely to be dependent on income level, is left to the individual. The experience of the four East Asian economies shows that government and private institutions provide many of these social survival factors. The second category can be labeled as welfare survival factors, which are designed to serve specific needy income groups. Examples include unemployment assistance, old age pensions, single-parent allowances, and so on. On the supply side, the government mostly funds these welfare provisions through the budgetary process, though charitable institutions at times contribute to various welfare services. The demand for welfare survival factors is restricted to a specific group of low-income individuals.

The governments of the four East Asian economies are keen to expand the first category of social survival factors, while minimizing expenses on the second category. In the case of Taiwan, education, health, and the social insurance system have made significant progress over the last forty years (Ku 1995: 353). There are economic reasons why the provision of social, rather than welfare, survival factors is preferred. Firstly, the indiscriminate nature of the provision of social survival factors can lead to significant economies of scale. Secondly, they can be "revenue-generating" for the government in the long run. The provision of vocational training, for example, enables the younger generation to acquire skills, and their future income will provide tax revenue for the government. Thus, today's government expenditure ensures tomorrow's revenue. Thirdly, the misuse of welfare assistance can be minimized. The danger of a generous unemployment benefit scheme, for example, is the fear that the unemployed will be discouraged from seeking employment, and thus rely on the benefit for a long period of time, thereby imposing a burden on government budgets. Welfare survival assistance is provided only when it is needed, though there are such exceptions as the retirement pension. The basic principle is for households to look after themselves as soon as they are able to do so.

The survival cost index of an individual can be expressed as a ratio of the amount spent on survival items to total income. There are primarily five survival items, namely housing, clothing, food, transport, and health. The sum of expenditure on these survival items, expressed as a percentage of income, is the survival cost index. Government subsidy of the cost of any of

these elements can reduce an individual's survival cost. Typically, education increases a person's employment opportunities and ability to earn more. An efficient and economical public transport system will help to reduce workers' transport costs, and government assistance with housing or health will also lower the survival cost.

Income equality is more of a conceptual objective than a practical goal. The alleviation of poverty over time is a more sustainable social and economic target than the eradication of income inequality. The first point is that one should not set an upper limit on a household's assets, earning ability, or wealth, as these often reflect the consequences of economic growth and development. On the contrary, more attention should be focused on the means of alleviating poverty, so that poor individuals will be better off over time. The emphasis should not be on inter-household comparison (comparing one household against another), but rather on intra-household comparison (comparing the household with itself over time). Secondly, poverty implies the inability to survive economically. Poverty alleviation, therefore, can be incorporated into a more comprehensive concept of survival cost. Social survival can could be made available to all households regardless of their income. They can either be provided by the government or franchised to private institutions. Welfare survival factors are only provided, mostly by government, to specific groups of needy households. Thirdly, if the survival cost is kept low, it is then up to each individual to maximize his or her economic benefits through the market system. The question, then, becomes: how much can an individual household gain economically, given the market opportunity? It is equally likely, however, that there will be "newcomers" to society who have high survival cost. The reduction of survival cost, therefore, is a continuous process.

3.7 Conclusion

This chapter argues that there may not be any long-term correlation between economic growth and increased equality; rather, they are separate issues. While economic growth depends on the provision of economic factors, income inequality is a relative but permanent issue as it depends on the individual endowment and mobility of income earners. Inequality can coexist with economic growth. The experience of the four East Asian economies suggests that it would be more appropriate to separate the analysis of economic growth and inequality, and that emphasis should be given to improving factors that promote growth on the one hand and reduce poverty on the other hand.

The Gini coefficient, which is commonly used to measure income equality, has its own problems. It tends to make comparison of different individuals at one particular time and excludes such factors as changes in the population structure and the mobility of households' income. The inter-household comparison shows only the difference between income groups at a given point in time. The intra-household comparison is more meaningful, as it looks at the income of a single household over time. Poverty can be eliminated only

when every household has increased its earnings over time, even though the amount of income earned differs between households.

Differences in income arise due to differences in personal endowment. The more relevant concern is to concentrate on how to reduce the survival cost of the low-income earners so that their absolute income will increase. Conceptually, although a reduction in poverty is the primary social and economic target, income redistribution as a means to solve the problem of poverty may backfire, as capital is the most mobile form of production factor. It is more appropriate to encourage the wealthy to engage in investment activities, so that the rise in employment can benefit job seekers directly. The relationships between wealth holders and the poor and between employers and employees can be regarded more as complementary than conflicting groups of economic agents.

4 Economic fertilizer and the government

4.1 Introduction

The role of government in economic development has been debated for a number of years. It has often been polarized into two extremes of either zero involvement or total involvement or intervention. One can use a simple scale of measurement to look at the role of the government. At the one extreme, Adam Smith, in his *Wealth of Nations,* writing in 1776, talked about the "invisible hand" and the free market. The doctrine of *laissez-faire* advocates that economic activities are best left in the hands of the private sector. In contrast, many argue that a lack of government intervention can lead to market failure. Keynes (1936) argued the case for government expenditure at a time of economic recession, and Samuelson (1954) discussed the important relationship between public services and market failure. In developing countries, the development of infrastructure by the government has eased industrial bottlenecks (Rodsentein-Radan 1943; Nurske 1953; Kuznets 1973). Government intervention in the form of economic planning has also been advocated. Economic planning "is to ensure the wholesale transformation of people's attitudes, values and institutions, and planning for development must aim at jerking the entire social system out of its low-level equilibrium and setting off a cumulative process upwards" (Myrdal 1968: 1901). It has also been argued that government intervention in the form of public expenditure is justified because of the shortcomings arising from the disparity of the provision of private and public goods and services (Galbraith 1976: 15 and 294).

Realistically, as long as there is the presence of government, there is bound to be some degree of intervention. The more likely danger is that people tend to consider the government as an ultimate provider, look for government action or support whenever economic difficulties arise, and blame the government if the economy performs poorly. The "instant" call for government to act has, at times, invited unnecessary government intervention, or has provided an excuse for the government to intervene. In an attempt to promote growth and development, the government performs six major functions (Wade 1990: 11). The maintenance of macroeconomic stability and the provision of the components of the physical infrastructure, such as harbors, railways, and

so on, are the first two functions. The next two are the supply of public services, such as defense, education, the legal system, and so on, and contribution to the development of institutions for improving the markets for labor, finance, and technology. The remaining functions include the duty to offset or eliminate price distortions arising from market failures and the redistribution of income to the poorest in order to meet their basic needs.

Despite a history of strong economic growth over the last few decades, the development experiences of the four East Asian economies of Hong Kong, Taiwan, Singapore, and South Korea have been diverse in terms of government intervention. Their experiences suggest that the choice is not whether or not there should be government involvement or intervention, but to what extent, and what form it should take. Four major economic areas that have often been identified for government intervention are markets, industries, fiscal and budgetary policy, and public utilities and infrastructure.

The government intervenes in the market by imposing price controls and restrictions. The rental price of properties, minimum wage legislation, and interest rate ceilings are clear examples of price intervention. The South Korea government exercised a considerable amount of intervention in the market in the form of five-year economic plans. A multiple interest rate system was exercised to reward different economic sectors. The Taiwan authority also constructed five-year economic plans, and the government deliberated agricultural reform in the 1950s. Government subsidy has also been used in industrial development in the form of favorable interest rates on industrial loans. The governments of both Taiwan and South Korea also targeted industry, and the establishment of large corporate business in South Korea has discouraged the establishment of small-scale enterprises or family businesses. In Singapore, the government has been active in luring foreign enterprises to invest there. Hong Kong enjoys the lowest taxes of the four economies and, in general, the fiscal policy is geared to the supply side of the economy. The provision of public utilities and infrastructure by the Hong Kong government has been beneficial to the economy and to society. On the whole, infrastructure development is the category in which the governments of the four economies have been involved more than in other areas. Public utilities are the social infrastructure that helps the market to become more efficient and households to reduce their survival cost.

The level of government intervention can be demonstrated conceptually. Table 4.1 conceptually summarizes the position of the four economies on a scale that ranges from low to high levels of government intervention. This evidence suggests that Hong Kong is the least and South Korea the most interventionist of the economies. Singapore is closer to Hong Kong, while Taiwan is close to South Korea. The next four sections (4.2–4.5) examine the role of government in each of the four economic areas of markets, industrial development, fiscal policy, and public utilities and infrastructure, using references and experience from the four economies. Section 4.6 presents the conceptual point of view that the governments in the East Asian economies

Table 4.1 Scale of government intervention

Area	*Low*		*Medium*		*High*
Market	HK	Sing	Taiwan	Korea	
Industrial development		HK	Sing	Taiwan	Korea
Fiscal and budgetary policy	HK	Sing	Taiwan	Korea	
Public utilities and infrastructure			HK Sing	Taiwan	Korea

function as suppliers of economic fertilizer. Like the construction of a house, the government builds economic pillars that can lead to sustained growth, and "carpets" the house to ensure no single individual will fall below the minimum survival line. Section 4.7 compares the use of tax incentives and credit provision as government instruments in promoting foreign investment. The remaining two sections reiterate the constraints of government involvement and conclude the chapter respectively.

4.2 The government and the market

By and large, the governments of the four East Asian economies have adopted a free market attitude when it comes to the price determination of most private consumer goods and services. Wade (1990: 22–5) presented three theories to explain the East Asian successes: the free market theory, the simulated market theory, and the governed theory. In the free market theory, the government is supportive to growth, but the private sector is free to respond to market opportunities. In the simulated market theory, the government provides moderate incentives to ensure that the relative prices of products and factors prevail in a situation of free trade. For example, an export promotion strategy would generate an equal exchange rate between exports and imports. The governed market theory argues that the government actively nurtures and pushes industrial growth and technological change.

The role of the government in the market can be indicated on an increasing scale of intervention (see Table 4.1). Both Hong Kong and Singapore have experienced a low degree of government intervention overall, while the Taiwan and South Korea governments intervened more. Hong Kong has traditionally been regarded as the *laissez-faire* economy with a high degree of freedom. *Laissez-faire* implies a policy of economic liberalism and little intervention by the government; *laissez-faire* capitalism in Hong Kong imposes no restriction on the scope of private ownership and public enterprises play a very minor economic role. In Hong Kong, there are no tariffs, no control on capital movement, and no minimum wage legislation for workers. The government regulates only when needed, and a stable and low tax structure is maintained (Riedel 1974; Chen 1980; Chow and Papanek 1981; Milton Friedman 1981; Sung1982; Schiffer 1983; Lau and Kuan 1990).

Singapore basically enjoys a high degree of market freedom, especially in private consumables. A more active interventionist approach is thought to be necessary because "the *laissez-faire* policies of the colonial era had led Singapore to a dead-end, with little economic growth, massive unemployment, wretched housing and inadequate education" (Goh 1976: 84). Similarly, the Singapore government is not prepared to allow complete free play of market forces without intervention. The role of government in Singapore has been a "goal setter, producer, regulator and fiscal agent" (Ow 1986: 233–6).

In the case of Taiwan, there is very little mention of a free market or *laissez-faire*. Although the market forces of supply and demand largely determine the market prices of consumables, the government or the state has been involved considerably since the 1950s. Probably as a result of post-war rehabilitation and the new government under Kuomingtang, the Nationalist Party, Taiwan is a "statist economy", characterized by the destruction of old establishments and formation of new ones during the developments of the 1950s (Winckler 1988: 162). Taiwan's industrial experience has not exhibited the "efficacy of a *laissez-faire* strategy" (Amsden 1985: 88).

The relatively backward state of the economy immediately after the Korean War (1950–53) did not permit a full functioning of a *laissez-faire* economy in South Korea. Economic activities began to take shape after Park Chung-kee established the Economic Planning Board in 1961. The first five-year economic development plan was based on the idea of a mixed economy but observed the basic principles of free enterprise and encouraged the initiative of private enterprise. The government rendered guidance to the basic industries and related areas. In the subsequent economic development plans, the government has intervened in order to maintain economic efficiency through the national budget, the establishment of public enterprises, and the use of regulations and inducements. Economic intervention has been strengthened by the establishment of various specialized policy research institutes, such as the Korea Development Institute under the Economic Planning Board and the Korea Institute for Industrial Economics and Technology under the Ministry of Trade and Industry (Whang 1991: 87).

Hong Kong

Beginning in the early 1970s, government intervention was required in three major economic areas: the development of new towns, the protection of exports, and the crisis in the international monetary system (Sung 1986: 122). The then financial secretary, Sir Haddon-Cave, used "positive non-interventionism" as a framework for the government to coordinate economic policies. "Non-interventionism" suggested that *laissez-faire* capitalism would remain, while "positive" suggested that economic policies would be coordinated positively in the provision of infrastructures and the maintenance of macroeconomic stability.

"Positive non-interventionism", however, did not have a strong conceptual support. It can equally be argued that Hong Kong's government had practiced "positive interventionism" since World War II. The Hong Kong government had, on various occasions, intervened positively in the economic decision process so that *laissez-faire*, market liberalism, and other aspects of economic freedom were maintained. There are various examples of positive government intervention in Hong Kong. Since World War II, the government has regulated the price of rice. The large influx of refugees in the early 1950s forced the government to intervene in housing and education. Following the oil crisis of 1973, the government floated the Hong Kong currency in 1974, and engaged in the buying and selling of foreign exchange in order to avoid erratic fluctuations in the exchange rate (Sung 1986: 123). The government also intervened when there were bank runs (whereby too many deposits were withdrawn in a short period of time which led to cash shortages) in 1983 by temporarily acquiring three banks (Hang Lung Bank, Overseas Trust Bank, and Hong Kong Industrial and Commercial Bank) but it later returned their ownership to private corporations (Jao 1988). In the 1970s when the export markets of Hong Kong were threatened by protectionism, the government promoted economic diversification. It is more accurate to argue, therefore, that the Hong Kong government has positively intervened in the economy to ensure a fair play in the market and maintain macroeconomic stability on a number of occasions.

Singapore

There are five groups of policies that are vital to Singapore's growth: industrial and trade policy; infrastructure policy; human resources development policy; labor and wage policy; and macroeconomic policy (Soon and Tan 1993: 300). The Singapore government has turned the economy into a corporate-state. There are two elements in the corporate-state. First of all, the three first-generation leaders, or the founding fathers, Lee Kuan Yew, Goh Keng Swee, and S. Rajaratnam, have shaped Singapore's economic success with little input from others (Vogel 1991; Somjee and Somjee 1995). The second element in Singapore's corporate-state is the large number of statutory boards and state-owned enterprises or government-linked corporations, in addition to the civil service. There is a statutory board in almost every important socio-economic aspect of Singapore, for example, industrialization and investment, savings, infrastructure and essential services, trade, banking and finance, tourism, radio and television, housing, education and training, transport, promotion of science and technology, and taxation (Ow 1986; Soon and Tan 1993). Some of the statutory boards provide services that could equally be provided by private businesses. However, the boards have been profitable, and since 1987 they have been required to give 33% of their operating surplus to the government, an income tax rate similar to that of private enterprises.

Statutory boards and government-linked corporations together accounted

for 18% of total employment in 1990 (Goh 1992). In the case of the Housing Development Board and the Urban Redevelopment Authority, the number of people living in owner-occupied public apartments rose from 9% of the population in 1970 to 92% in 1990 (Soon and Tan 1993: 2). In terms of retirement pensions, the CPF provides a financial net for retirement as well as capital for home purchase before retirement.

The government-linked corporations operate like private enterprises, except that the government, through different holding companies, either wholly or partly owns them. There are several reasons for the government's participation in directly productive activities. One of the most important is that the government can commit its capital when private investors are being overcautious. Some public enterprises are set up for such special purposes as the breakdown of monopolies, while others are developed out of the reorganization of existing institutions. While it can be argued that the Singapore government has deliberately aided the successful operation of the market, criticism on its extensive interference has also been raised (Ow 1976; 1986). In short, the Singapore government has participated extensively in the economy.

Taiwan

The need for government involvement and guidance was vital in agriculture, and the subsequent agricultural reform reallocated land to peasants while previous landlords were encouraged to become industrialists in the urban areas. Positive outcomes of the land reform included a new arrangement for the peasants and the clarification of property rights, a transfer of income from those who were neither involved nor interested in agriculture to those who use the land productively, and the regular and effective collection of the land tax (Ho 1978: 44).

The first economic plan for the period 1953–56, the plan for economic rehabilitation, consisted of a collection of projects and the main focus was to attract foreign exchange through foreign or mainland Chinese investment. The second five-year economic plan for 1958–61 targeted the growth of income and the investment shares going to various sectors. Subsequently, half of the gross capital formation in the 1958–61 plan was carried out either by the government or by public enterprises (Wade 1990: 81–2). Over the years, public ownership declined. The share of public ownership in total industrial production which was 57% in 1952, had declined to 46% by 1962, and only 18% by 1980 (Amsden 1985: 92). Similarly, the share of public enterprise in value-added in manufacturing was 56.2% in 1952, but dropped gradually to 48.7% in 1957, 20.6% in 1970, 14.5% in 1980, and 11.1% in 1988 (Pack 1992: 95).

K.T. Li (1988: 102–3) argued that Taiwan "relies basically on private enterprises based on individual initiatives coordinated by a market mechanism, although it is tolerant of government interventions through a

host of policy instruments". A mixed and idealized market economy, according to K. T. Li, is one in which "through the rivalry of competition, the production potential of all market participants is fully unleashed while their greed and aggressiveness are curbed. They are all disciplined by market forces rather than overtly by personalized political forces." K.T. Li outlined five major features of a mixed and idealized economy:

1 a depoliticized system of organization and competition that would lead to an absence of any form of broadly defined collectivism;
2 an intrinsic welfare system based on the cardinal principle of "to each according to his production contribution" under "equality of opportunity;"
3 the existence of private property rights;
4 prices acting as market signals linking producers and consumers;
5 a cumulative process of economic liberalization, which can eliminate market price distortions due to political intervention.

South Korea

Foreign ideas were incorporated into Korea's first development plan and national capitalism was established through the activities of the industrialists, while the government ensured that economic power was not abused. The Korean government intervened and mediated the market forces between the savers and investors, and the exporters and importers. A multiple price system, including different interest rates and foreign exchange rates, was adopted, though it was sometimes argued that Korea deliberately set a "wrong" price in order to create profitable investment opportunities. For example, throughout the period of President Park's government, domestic interest rates were kept artificially low and were negative in several years (Amsden 1989: 13–14; Koo and Kim 1992: 128).

The government created large state corporations, known as *chaebols*, and performance-based incentives were set. If national targets were met in areas such as exports, R & D, and new products, the *chaebols* were rewarded with further licenses to expand. This permitted not only the possibility of securing loans, but also access to state power. Five conditions were set in order to lure ambitious *chaebols*: (1) all commercial banks were nationalized, so that funds came from the government's purse; (2) a limited number of firms were allowed to enter new industries; (3) prices were negotiated to avoid monopoly power; (4) restrictions were imposed on movement of capital; and (5) a persistent deficit was created in the government fiscal account to reflect long-term investments (Amsden 1989: 16).

Firms in Korea face keen competition for domestic licenses, foreign technical licenses, and skilled workers, and on price, quality, and delivery. The intense competition in Korea has resulted in a high level of economic concentration of industries, which is even more so than in Japan and Taiwan. A major success of President Park's era in the 1960s was the transformation

of merchant capital into industrial capital, which changed the accumulation process, though the rapid rise in land prices and the controls on the money market soon led the Korean economy into difficulties in the early 1970s (Amsden 1989: 120; Koo and Kim 1992: 128). The large *chaebols* could easily secure loans from national banks, but small businesses were not assisted in this way. An extreme situation developed where large *chaebols*, which were supposed to be profitable and successful, could obtain large investments at below market interest rates, while small businesses, which were less profitable, had to borrow from the controlled market at a much higher interest rate. The government's protection of *chaebols* deprived Korea of the natural development of small businesses, and distorted the free market price structure.

4.3 The government and industrialization

The four East Asian economies have successfully undergone a process of industrialization since the 1950s. These economies began to attract foreign investment initially mainly due to their low labor cost. Labor-intensive manufacturing developed quickly to cater for the export market. Beginning in the mid-1960s, some economies began to diversify their industrial development by adopting an interventionist policy. In the case of Korea and Taiwan, for example, their governments actively promoted the development of heavy industries (Caiden and Kim 1991; Appelbaum and Henderson 1992). By the late 1970s, a "pick-winner" strategy was being employed to promote such popular industries as electronics and electrical appliances (Yang 1994). Trade protectionism gathered momentum in the 1970s, urging these economies to diversify their markets and products. By the early 1980s, the high domestic labor cost had pushed many of the labor-intensive manufacturing plants to such neighboring economies as southern China, Malaysia, Thailand, and Indonesia. The industrial pattern of the four East Asian economies shifted to either added-value exports, high-technology products, or capital-intensive industries (Hughes 1988). Following the migration of labor-intensive manufacturing to their neighboring economies, the four East Asian economies have now become major foreign investors in the region (Chen 1990; 1993).

There are theoretical advantages in the two strategies of industrialization, namely, import- substitution and export-led. Both can lead to a virtuous circle of development. Import substitution is usually advocated by developing economies with a large domestic market, which replaces imports, saves foreign exchange and generates domestic investment. At a later stage when the industries are fully developed, exports generate foreign exchange. The virtuous circle begins from expansion in domestic industries, to saving of foreign exchange, to expansion of local employment and the local industrial market, and finally to exports and technological development in industry. The multiplier effect of income–consumption will lead to economic prosperity.

Unfortunately, experience from Latin American and other developing countries (Burton 1968; 1970; Ahmad 1978; Krugman 1984) has shown that problems arise when the government intervenes by subsidizing "infant" industries. Because of its large fixed cost, the provision of subsidy is intended to be temporary; as the "infant" industries grow, they become "mature" and can stand on their own feet, and subsidies can then be withdrawn. However, problems emerge as soon as subsidies are given. Firstly, "infant" firms tend to regard subsidies as "cushions" if they are not tied to efficient performance. Inefficiencies lead to wastage and soon a "subsidy breeds subsidy" vicious circle develops. Secondly, protected by subsidies, "infant" firms may remain at the infant stage and become dependent on the subsidies. The government may end up with a prolonged period of fiscal deficit. Thirdly, since the quality of industrial output is poor, local demand will turn to imports, putting extra pressure on foreign exchange. In the end, the import substitution strategy often ends up with the worst of two worlds: the government faces a fiscal deficit and pressure on the foreign exchange rate. The outcome of the strategy can turn out to be the opposite of the original intention.

An export-led strategy, in contrast, is usually advocated by economies with a small domestic market. The initial step begins with inward investment because of the rising labor cost in advanced countries. By making use of the low-cost labor in the host economy, foreign investors can export the finished products back to their home market. The economic advantages of an export-led strategy include an increase in domestic income, consumption, employment, and foreign exchange. The rise in foreign exchange earnings, in turn, increases imports of both consumer and capital goods. Since foreign investors bring with them their patterns of foreign demand and markets, the manufactured exports are bound to be competitive. Economies that practice an export-led industrial strategy tend to experience a "dynamic" comparative advantage since their exports satisfy foreign markets' changing demands. However, a common disadvantage of an export-led strategy is the lack of indigenous development of technology, and the dependent nature of R&D on foreign investors.

Governments' involvement and intervention in industrialization vary significantly from none to full control in the form of nationalized industries. The experiences of Japan and the US are used as an illustration of two extremes. The Japanese government intervenes significantly through the Ministry of International Trade and Industry (MITI), which acts as the government's think-tank, and is run by a council of advisors composed of industrialists, labor unionists, academics, and other relevant professional representatives. The fostering of a close government–business relationship generates several advantages. Common national goals can be carried out with little opposition. Private sector industrial ventures can be assured of government support and "industrial winners" can be identified and promoted. R&D activities can be conducted and supported by both the government and business, which, in turn, facilitates the commercialization of hi-tech products.

Conversely, the US model of government involvement demonstrates a well-developed capital market and strong support from the highly developed education system. The government formulates policies that affect industries indirectly through interest rate policies or fiscal concessions and the bulk of industrial development is conducted in the private sector(Chen and Li 1991).

The classical examples of technology commercialization are Japan's Walkman cassette and radio, on the one hand, and France's supersonic Concorde, on the other. The Concorde supersonic jet is a masterpiece of technological innovation, but it has low marketability. On the contrary, Japan's Walkman was developed from an existing technology, achieved a large world market, and quickly became a personal item in many households (Chen and Li 1991: 39).

Among the four East Asian economies, Hong Kong practiced an export-led industrial strategy almost from the very beginning. Singapore, Taiwan, and South Korea switched from an import-substitution to an export-led strategy only in the 1960s. While both Hong Kong and Singapore concentrated mainly on light-manufacturing industries, Taiwan and South Korea indulged in heavy industries (Krause 1987). Singapore adopted a "pick-winner" strategy in the 1970s and economic plans, such as the *Next Lap* in 1990, which aimed to boost its strategic position. Taiwan established the export processing zone in the 1960s and identified a number of strategic industries in the 1980s. Since the mid-1990s, however, both the Taiwan and South Korean governments have encouraged the private sector to play a more important role.

Hong Kong

The basic features of Hong Kong's industrialization process are (Riedel 1973; 1974):

1 the manufacture of standardized consumer goods;
2 export to high-income countries in the West;
3 reliance on other Asian countries for raw materials and western countries for capital.

The traditional industrial outputs include textiles and clothing, plastic and toys, electrical appliances and electronics, wigs, leather products, watches and clocks, paper products and print, machinery, and others. The majority of industrial plants are small scale and employ less than twenty workers. Rather than follow a "mission-oriented" industrial policy, the Hong Kong government has concentrated on a "diffusion-oriented" strategy. Industrialization has been driven almost entirely by the private sector. There are no strategic industries but techno-economic studies are undertaken by various organizations. There is little publicly funded R&D or fiscal incentives. No subsidies are provided and organizations operate on a cost-recovery basis. The government has aimed

to maintain Hong Kong's locational attractions, including political stability, simple regulations, a trained work force, and a good infrastructure. Its industrial policy is based on three "I's": investment in human capital through education, and industrial and vocational training and retraining; infrastructure provision in the form of good communications networks, an efficient banking and financial structure, and low-cost industrial land; and institutions that assist firms and industries to promote their exports, upgrade their technology, obtain short terms loans, and so on (Chen and Li 1997: 94).

At the peak of the operation of the trade protection policy in the 1970s, the Hong Kong Government (1979) initiated a study on economic diversification and the *Report of the Advisory Committee on Diversification* was published in 1979. Its recommendations were grouped into two types: institution-oriented and policy-oriented. On policy, the report suggested that the Hong Kong Government should evaluate the feasibility of different ways of improving Hong Kong's marketing capability, ability to provide logistic support to exports, and so on (Chen and Li 1991: 32–3). Since the early 1980s, there has been pressure on the government to increase its involvement in industry and technology, particularly in view of the participation of the governments of other East Asian economies in targeting the development of specific industries such as electronics. However, the Hong Kong government has asserted repeatedly that it will continue to play a secondary and indirect role. The following statement summarizes Hong Kong's industrial policy: "The government's industrial policies aim at maintaining an infrastructure which enables manufacturing businesses to function efficiently and providing services which enable industry to become more competitive through productivity growth, quality improvement, and product innovation, and the government encourages technology transfer through an inward investment promotion programme" (Hong Kong Government 1991). A similar statement was made following renewed pressure for the revitalization of Hong Kong's industrial sector in the early 1990s (Hong Kong Government 1994: 85).

As a consequence of rising costs in Hong Kong and the rapid migration of industries to southern China, an "office–factory" relationship between Hong Kong and the mainland was thought to be more appropriate. Re-exports expanded tremendously in the 1980s as China opened its trade and investment channels. Together with the internationally recognized banking and finance sector, Hong Kong now relies mostly on the tertiary sector. The long-standing free market attitude of government, however, has been reiterated by the post-1997 government. An independent task-force composed of academics, entrepreneurs, and professionals was established early in 1998 to examine the entire issue of industry and technology in view of maintaining the long-term economic advantage of Hong Kong, and including the development of complementarities between Hong Kong and mainland scientists, the redevelopment of industries in the light of the "office–factory" relationship, and the costs and benefits of going hi-tech. The focus of the remit of the task-force highlights the differences between a "diffusion-oriented" and a "mission-oriented" industrial policy.

Singapore

The Singapore government intervenes in the establishment of state-owned enterprises, the land market, and the capital market. Indeed, Singapore's success is a result of "not the invisible hand of the free market, but rather the very visible hand, or even the long arm, of the state" (Lim 1983). In the early years, Singapore's industrial policy aimed to find effective ways of helping the private sector by providing physical infrastructure, industrial parks, manpower, a legal framework for industrial promotion, and fiscal incentives for export-led industries (Somjee and Somjee 1995: 29). There were five phases in industrial policy between 1959 and 1990 (Deyo 1981; Soon and Tan 1993):

1 labor-intensive import substitution, 1959–63;
2 labor-intensive, export-oriented manufacturing, 1966–73;
3 first attempt to upgrade, 1973–78;
4 economic restructuring, 1979–84;
5 retrenchment and further diversification, 1985–90.

Manufacturing accounted for 13% of Singapore's total real GDP in 1960, rose to 20% in 1970, and peaked in 1981 at 24% because of the rising importance of the service sector. The manufacturing sector has developed from traditional labor-intensive industries, such as food and beverages, and textiles and garments, to capital-intensive activities such as petroleum refining.

In 1979, the Singapore government introduced the "second industrial revolution", which had three main features. Firstly, a "wage correction policy" was imposed, which led to wage increases averaging 20% a year for a three-year period. Secondly, a specific industrial incentive system relating to plant expansion, automation, R&D expenditure, and computerization was developed. And, thirdly, a program of labor training and skills development was introduced. Wages, however, increased more quickly than developments in technology or skills, resulting in a rapid rise in costs and decline in competitiveness, which eventually contributed to the economic setback in 1985 (Wong 1986).

The "pick-winner" strategy of the 1970s led to the rapid growth of electronics, which overtook petroleum. In 1984, for example, the percentages of total manufacturing output occupied by petroleum refineries and products and electronic products and components were 30% and 23% respectively. By 1995, petroleum accounted for only 11% of total manufacturing output, whereas the share taken by electronics had increased to 49%. In terms of investment commitments in manufacturing industries, electronics had the highest shares of 32% and 26.3% in 1984 and 1994 respectively.

A new strategic economic plan, known as the Next Lap, was released soon after Goh took up the post of prime minister in 1990. It comprised eight strategic objectives in the areas of: enhancing human resources; promoting

national teamwork; becoming internationally oriented; creating a conducive climate for innovation; developing manufacturing and service clusters; spearheading economic redevelopment; maintaining international competitiveness; and reducing vulnerability. Major industrial investments have concentrated on the electronics and chemical industries. The Manufacturing 2000 (M2000) program, which formed part of the Next Lap, was intended to keep the proportion of GDP occupied by manufacturing at more than 25% in the medium to long term. In the area of technology, the target was to achieve an investment in R&D of 2% of GDP in the 1990s (Wong 1996; Wong and Ng 1997). And finally, to reduce labor costs, a "growth triangle" that includes Malaysia's Johor district and a number of Indonesian islands was designated and promoted as a single economic unit. For example, two agreements were signed with the Indonesian government in 1990, which allowed Singapore investors to establish firms in the Batam Industrial Park and other locations (*Country Profile - Singapore 1993/94,* Economist Intelligence Unit 1993: 21).

Taiwan

Taiwan started its import-substitution strategy in the 1950s when multiple exchange rates were applied to different types of imports. The small size of the domestic market and the need for foreign exchange earnings drove Taiwan to adopt an export-led strategy in 1959 with the announcement of the nineteen-point economic and financial reform program. This program comprised five key directions (Ranis 1979; Kuo 1983; Wu 1986; Hwang 1991):

1 liberalizing the various control measures;
2 giving preferential treatments to private businesses;
3 enhancing capital formation through tax reform;
4 liberalizing trade and unifying exchange rates;
5 encouraging exports and increasing foreign business contacts.

The statute for encouragement of investment facilitated the acquisition of plant sites and provided tax exemptions and deductions (Kuo 1983: 302). The establishment of the Kaohsiung export processing zone in 1965 strengthened the export-led strategy; as part of this, favorable interest rates were given to export loans.

Taiwan's post-war reconstruction was short-lived as a result of a shortage of capital and human resources, though economic plans were adopted to replace import items. Import-substitution encouraged the growth of new industries. The government imposed tight restrictions on import quotas and high exchange rates on imports, but a lower exchange rate on imports of materials for the import-substitution industries. The export-led strategy was the result of a nineteen-point program, which was designed to induce saving, investment, and export through favorable tax exemptions. Soon, labor-

intensive industries such as textiles, plastic products, plywood, and electronic products dominated Taiwan's exports (Hwang 1991).

Although the oil crisis had a serious effect on Taiwan's economy, reducing its annual economic growth rate to only 1.1% in 1974, it also led Taiwan to pursue a more ambitious industrial plan: the development of heavy and chemical industries. The primary aim was to improve the supply of intermediate materials, such as steel, copper, and aluminum, and to develop transportation industries such as automobile manufacture and shipbuilding. In addition, the Taiwan government launched ten mass public construction projects to boost industrial growth, but the second oil crisis in 1979 drove up the cost, resulted in a loss of competitiveness, and led to a fall in industrial growth that averaged 3.2% between 1979 and 1982.

In the 1980s, the Taiwan government decided to develop "strategic industries," which were defined as industries that were "expected to generate a series of backward supply chain reactions that will create a new wave of growth of value-added industries in Taiwan" (Hwang 1991: 77). This necessarily meant the development of high-technology industries that met the following criteria:

1 international market;
2 the potential to generate backward and forward supply chain-reactions in industries;
3 high value-added but low energy consumption.

A total of eight high-technology industries were selected for intensive development in the 1980s. The two favored industries were mechanical engineering and computer electronics, while the others included energy, metallurgy, information technology, and automation. An entirely government-funded research institute, the Industrial Technology Research Institute, was established in 1973. Subsequently, a number of research divisions and centers have been established under the Industrial Technology Research Institute in the areas of chemicals, electronics, materials, mechanics, energy, mining, and so on. The electronics research division developed the integrated circuit (IC) industry, which assisted technology transfer.

Government intervention took the form of venture capital, provision of funds, and financing high-level R&D projects. Positive results began to emerge as early as 1982 when backward supply linkages and demand for materials and parts were generated. In addition, a huge science park in Sintsu was established, and low interest rates and various tax concessions were offered to suitable industries. Four obstacles were identified in the development of high-technology industries in Taiwan (Hwang 1991: 83):

1 limited access to high-technology information;
2 relatively small domestic market size and firms' ignorance of the products;
3 restricted trade quota;
4 difficulty in servicing foreign customers.

The Taiwan government intervened in the form of the introduction of a series of four-year economic plans (1953–56, 1958–61, 1961–64, and 1965–68), the deliberate switch from an import-substitution to an export-led strategy, the establishment of public enterprises in various industries, the pursuit of capital- and technology-intensive industries, and the public ownership of research organizations. It is argued that Taiwan's campaign of industrial development was "state-led" and not "market-led." The government intervened in the textile and consumer electronic industries in the 1950s, and from then until the early 1970s, the production of plastics, automobiles, and artificial fibers received the government's attention. From the mid-1970s to mid-1980s, it was the turn of the metal, shipbuilding, semiconductor, and machine tool industries (Wade 1990: 73 and 111).

Since the mid-1980s, the economy of Taiwan has been faced with a labor shortage and rising domestic costs. Leading firms have relocated their plants to mainland China and South-East Asia. A persistent trade surplus has led to increases in the exchange rate and higher levels of protectionism against Taiwan's exports. The "Super 301" clause in the US Trade Act of 1988 forced Taiwan to liberalize its trade and diversify into new markets (Wang 1997: 72 and 85). Despite the various aspects in which the government is still involved in industry, Wang (1997: 85) concludes that the trend in the 1990s was away from government intervention, and, increasingly, toward international disciplines and a free economy philosophy.

South Korea

South Korea has passed through four stages of industrialization. The import substitution strategy was based on US economic aid in the 1950s, while the export-led strategy was based on labor-intensive, light manufacturing in the 1960s. Industrial expansion occurred with a combination of the two strategies in the 1970s, followed by economic liberalization and internationalization in the 1980s. State intervention in industrial development is so extensive that Korea has often been labeled as "Korea Incorporated," meaning that the Korean economy appears to be run by a board of directors (Koo and Kim 1992: 122).

Different political regimes have exerted different industrial policies in South Korea. In the 1950s, the Rhee regime redistributed Japanese-owned properties and privatized state-owned enterprises and banks, but its downfall in 1960 was partly caused by the limits of the import-substitution strategy and the spiraling rates of high inflation and unemployment. The Park Chung-kee regime in the early 1960s overhauled the bureaucracy, created the economic planning board, and reorganized the economy into a state in which development could take place. This is defined as "a state that has a considerable amount of autonomy to adopt policies without interference from class interests" (Koo and Kim 1992: 126). Throughout the Park regime, domestic interest rates were kept below real market prices, and loans were

subsidized. The plan for the development of heavy and chemical industries was announced in 1973, and mobilized all the institutional and material resources. Six industries were targeted for promotion: steel, electronics, petrochemicals, shipbuilding, machinery, and non-ferrous metals.

Major economic restructuring took place when General Chun Doo Hwan elected himself to the presidency in 1981. The military government faced pressures from both international and domestic investors. The keystone of the reform was liberalization, which reduced government intervention, promoted the market mechanism, opened the domestic market, and encouraged foreign direct investment (Koo and Kim 1992: 140). The strong partnership between the government and the private sector was thought to have been a positive factor, but a number of measures have been applied since the 1980s to liberalize the economy and its industries. The Foreign Capital Inducement Law, introduced in July 1984, increased the share of manufacturing industries open to foreign investments to 92.5%. A measure to rationalize corporate structure was introduced in September 1980. This forced twenty-six *chaebols* to reorganize their structure, relinquish their sideline businesses, sell non-business-related real estate, offer their stocks on the stock market, and improve their financial structures. It was not, however, a successful exercise since many *chaebols* gave up some of their firms, though they bought almost the same number of new firms.

Studies (Franco *et al.* 1988; Choi and Lee 1990; Westphal 1990; Pae 1992; Haggard 1994) suggest that the Korean industrial policy can be divided into the take-off period (1962–72), the drive to heavy industry period (1973–80), and the structural adjustment and liberalization period (1980–85). In output terms, the percentage shares between heavy and light industries show a change in industrial structure over the years. In 1962, the shares of total industrial output of heavy and light industries were 25.8% and 74.2% respectively. In 1985, the shares were more balanced at 54.4% and 45.6% respectively (Choi and Lee 1990: 60). Soon after Kim Young Sam came into power in 1993, he delivered a special announcement on a "new leap toward a new economy," which aimed to ease regulation and promote competition. It consisted of three stages:

1 lowered interest rates and increased supply of funds;
2 reduced government control over the economy;
3 shared economic burdens.

The overall economic turnout, however, has not been favorable since 1993. The economy has experienced a fall in consumption, a rise in unemployment to 3.2% (the highest since 1987), and a growth rate of only 3.8% in the first half of 1993 (the lowest since 1981), while the manufacturing sector has become uncompetitive with rising wages and inflation (Lee and Sohn 1994). There is, however, a high degree of market concentration due to the large number of *chaebols*. Public enterprises have played an important role in Korea's

industrialization. In 1986, for example, the value-added of the public enterprise sector comprised 9.1% of GDP, 2% of employment, and 15.6% of total investment. Since the 1990s, however, the heavy and chemical industries have begun to enjoy an expansionary phase, while light industries have been suffering a decline. Such a dichotomy is due to the large amount of investment in R&D in the heavy and chemical industries. Spending on R&D as a proportion of GNP has increased from 0.77% in 1980 to 2.61% in 1994 (Mukerjee 1986: 18; Song 1990: 117; Seong 1997: 58).

The role of the Korean government is expected to be more multi-dimensional in future, putting equal emphasis on economic growth and quality of life. From 1994, Korea's industrial policy has been "technology-driven" rather than "export-led," and in 1995 two five-year plans of industrial technology development and technological infrastructure development were devised. It is expected that the private sector will play a more prominent role, while many deregulations have eliminated red tape and simplified administrative procedures (Seong 1997).

4.4 The government and fiscal policy

Although fiscal policy itself is an interventionist instrument, macroeconomic stability and "investing in the future" are the two major fiscal features of the four East Asian economies. In general, the fiscal framework of Taiwan and South Korea is more interventionist than that of Hong Kong and Singapore.

In Hong Kong, the various post-war financial secretaries have shaped a fiscal philosophy that includes the guarantee of a free flow of capital, the shaping of the economy by market forces, government provisioning to be conducted at cost and extended when needed, the cost of public services to be met by tax-payers, and the maintenance of a balanced budget (Rabushka 1976). Hong Kong's fiscal philosophy was consolidated into "seven heavenly virtues" in the 1996–97 budget:

1 Retain a low, simple, and predictable tax regime.
2 Raise sufficient revenue to meet known spending commitments.
3 Maintain a vigorous "user pays" system for setting fees and charges to keep taxes low.
4 Maintain an adequate fiscal reserve to provide a cushion against future uncertainties.
5 Combat tax avoidance and evasion.
6 Provide concessions where most needed.
7 Minimize the inflationary impact.

The primary role of the fiscal policy in Singapore is twofold. It acts as a tool for stabilizing the economy and it promotes economic growth through economic and social infrastructure development. A major feature is the emphasis on inter-generation transfer through the government's involvement

and investment in education, infrastructure development, and the provision of public housing. The fiscal philosophy of the Singapore government consists of:

1 relying on the expansion of economic activities to generate revenue;
2 providing a conducive industrial and commercial environment for economic activities;
3 effective implementation of sound economic strategies;
4 a thrifty and conservative practice.

Taiwan's fiscal policy has different focal points in different decades, but overall it has focused on three major functions:

1 effective resource allocation;
2 equalizing income distribution;
3 ensuring economic stability and growth.

In the 1950s, balancing the budget was the primary concern, whereas in the 1960s tax deduction was used to encourage saving and investment. Taiwan's fiscal policy has also been used to complement monetary policy and the high interest rate policies of the 1950s and 1960s (Lundberg 1979; Hwang 1991). Fiscal policy in Taiwan has also assisted national saving, capital formation, and the development of human capital.

South Korea's fiscal structure reflects the macroeconomic characteristics of the economy. The South Korean budget has been used as a stabilization instrument only occasionally, it does not give much scope for economic fine-tuning, and there are supplementary budgets in many years (Cooper 1994: 129–31). Although a series of tax reforms were carried out in the 1960s and 1970s, South Korea has a relatively low level of governmental activity (government expenditure is less than 20% of GNP). However, it does have a larger than average share of military expenditure, amounting to around 5% of GNP. The South Korean government, in general, does not exercise tight budgetary control and behaves more like an entrepreneur, spending far more than it has collected. Borrowing finances the deficit, either in the form of foreign loans or public loans. South Korea's large public expenditure has been geared to build up its long-term investment, not short-term social welfare consumption. Compared with other Asian and Latin American economies in the 1970s, the Korean government had a smaller expenditure and a higher fixed investment (Cole and Lyman 1971; Amsden 1989: 90–3; Cooper 1994: 139).

Of the four East Asian economies, Hong Kong has the lowest tax rate of 15%, compared with 30% in Singapore and 40% in both Taiwan and South Korea in the 1996–97 fiscal year. For comparison, the highest income tax rates in Australia, Indonesia, and the Philippines were 47%, 30%, and 35% respectively in 1994–95. The difference in corporate tax rates among the

East Asian economies is not as wide In 1996–97, the highest corporate tax rate in Hong Kong was 16.5%, while in Singapore and Taiwan it was 27% and 25% respectively. South Korea's corporate tax rate was the highest at 33% in the 1990–91 fiscal year. There has been, however, a falling trend in both the income tax rates and the corporate tax rates in these four economies since the 1980s.

Hong Kong

Public expenditure in Hong Kong is divided into nine categories: community and external affairs; economic; education; environment; health; housing; infrastructure; security; and social welfare and support. The area that received the highest percentage share in total public expenditure in 1996–97 was education (17.9%), followed by health, housing, infrastructure, and security, each with a share of about 11–12%. Social welfare has a share of 8.5% (*The 1998–99 Budget*, Hong Kong Government, 1998). The percentage shares have been quite steady over the years, though the Hong Kong government may give more emphasis to a particular area in any particular year.

Through the budgetary policy, the Hong Kong Government intervenes in such areas as the provision of water, land ownership and public housing, and provision of infrastructure, and regulates banks, rents, pollution, labor conditions, the rice trade, and the fish and poultry supply. The public works program and other capital investments are financed from recurrent revenue and borrowing is avoided. There are five financial guidelines in Hong Kong's fiscal policy (Lau 1997: 275). Recurrent expenditure over recurrent revenue should be no more than 80%, while recurrent expenditure over total expenditure should be no more than 70%. The surplus on current account over capital account must be at least 60%, and recurrent revenue over total expenditure at least 88%. Lastly, capital revenue should be at least 20% of capital expenditure.

Hong Kong's post-1997 fiscal budget is governed by Article 107 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (1991: 56): "The Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget. It shall strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its Gross Domestic Product." Budget deficits are rare in Hong Kong and it is common for the Hong Kong government to make a conservative budget. In the mid-1980s it was agreed that, after the Joint Declaration on the Future of Hong Kong had been signed by the UK and the People's Republic of China, half of the land sale revenue should be deposited in the land fund that would form part of the reserve in the post-1997 government (Tang 1996). The sale of land has provided the Hong Kong government with a steady source of revenue.

Singapore

There are two types of government expenditures:

1 operating expenditure, which is larger and refers to expenditure on manpower, other operating expenditure, grants-in-aid, and pensions;
2 development expenditure, which is smaller and excludes loans to statutory boards, industrial, and commercial enterprises.

Government expenditures are grouped into four large categories in Singapore. The first is security and general services. Secondly, social and community services comprise education, health, environment, public housing, and others. And thirdly, economic services consist of national development, communication, trade and industry, labor, and research and development. In 1996, public housing (14.8%) was the largest item in government development expenditure, followed by communication (11.4%), security (11.36%), education (9.3%), and research and development (7.5%) (*Economic Survey of Singapore 1996*, Ministry of Trade and Industry 1997: 38).

One interesting item of tax rebate is the program on enhanced child relief for qualified working wives, which was introduced in 1974. It is believed that the offspring of educated women will develop a higher level of personal endowment. Despite the rarity of fiscal deficits, government debt has been expanding, though domestic debt holds the lion's share. Between 1984 and 1994, for example, government debt increased by 168% from $28,077 million to $75,344 million. In 1966, the size of the government debt was only $690.2 million. The effectiveness of fiscal policies as a stabilization tool in Singapore has been limited by two factors. Firstly, a considerable amount of wealth has been accumulated in the central provident fund (CPF), which results in an artificially low level of demand for money. The CPF is a compulsory pension fund for all workers, though they can also use the fund for home purchasing. Secondly, a fiscal surplus does not lead to a fall in the amount of bonds outstanding, or a fall in the supply of money. The combined result is a weak government expenditure multiplier (Lim *et al.* 1988: 361–2).

Taiwan

Total government expenditure is grouped under six categories: general administration and defense, education (including science and culture), economic development, social security or welfare, debts, and others. Social expenditure refers to government expenditure on social security and education. Economic development and social security are the largest items of net expenditure; each occupied about 20% of total government expenditure in 1995. The second largest item is education, science and culture, occupying about 17% of total in 1995 (Ku 1995: 353).

Between 1964 and 1986, a fiscal surplus was experienced in most years due to the rapid growth of the economy. However, when the capital account is included, the budget shows a deficit almost every year. A persistent budget surplus, however, would lead to a decline in public investment, and a large surplus in the central government at the same time as a deficit in the sub-national governments could lead to political uncertainty. For example, the central government squanders taxpayers' money on "buying" relationships with some countries with which Taiwan has no formal relations, while local governments have to rely on central aid to keep up with their operations (Chang 1992). Data from 1951 to 1988 show that fiscal policy variables displayed an "excess sensitivity" to changes in GDP, meaning that fiscal policy in Taiwan reacted well to "surprises" generated by changes in GDP, but not to "surprises" arising from changes in the tax rate (Tseng and Mao 1994: 260).

Three tax reforms were introduced between 1950 and 1968. A unified tax collection law on central and local taxes was passed in 1951, while in 1955 an income tax reform was introduced to synchronize different tax items. In 1968, a government tax reform committee was established and recommended a new tax ceiling (Hwang 1991: 106). Tax revenue is the single largest item, accounting for over 50% of government revenue in most years. Among all the tax items, income tax is the largest, followed by business tax, and land tax, accounting for 25.9%, 17.4%, and 15.7% of total tax respectively in 1995 (*Taiwan Statistical Data Book 1996,* Council for Economic Planning and Development 1996).

South Korea

The proportion of government spending relative to GNP has increased from less than 11% in 1953 to 20% in 1986, with an average annual real growth rate of 9%, while the growth rate of real GNP was 7.6% in the same period. Since the 1970s, there has been a shift from "investment-oriented" toward "consumption-oriented" government spending. Defense (ranged from 21.6% to 27.1 % between 1971 and 1987), education (ranged from 13.6% to 17.7%), and economic services (ranged from 23.1% to 33.9%) have been the three largest items. Central government spending is about four times greater than local government spending. The other three main items of government expenditure are health, welfare, and housing. Taking the period between 1953 and 1986 as an indicator, Lee (1990: 288) concluded that the impact of economic growth depends on the composition of government expenditure. If additional government expenditure were used on public consumption, a 1% increase of such government expenditure would lead to a drop of 6.13% in the growth rate. On the contrary, for every additional 1% increase in government expenditure on public investment, the growth rate would increase by 7.56%. Private capital is about ten times more productive than public capital, and thus the accumulation of private capital is important for Korea's rapid economic growth.

The Korean government has used taxation policy to influence growth, industrialization, and sectoral developments (Choi and Lee 1990; Choi and Kwack 1990; Lee 1990; Abizadeh and Yousefi 1994; Park 1994; Roh 1994; Whalley 1994). The primary objective of the tax policy was to "mobilize resources for capital formation in the public sector, while not discouraging investments in the private sector." An office of national tax administration was established in 1966, but tax exemptions to favorable businesses had started as early as 1956, while investment tax credits were introduced in 1956 and 1971, and tax rates were lowered in 1961, 1971, 1974, and 1982. Changes in major tax rates and tax laws were introduced between the 1960s and 1980s (Choi and Lee 1990; Park 1994). The Korean tax system is complicated by the existence of two levels of tax: national and local.

There have been three periods of evolution in Korea's tax system. The first was the decade of the 1960s with two epoch-making tax reforms. The second was the decade of the 1970s, which was characterized by economic adjustments and emergency measures resulting from the oil crisis. Finally, the limited tax reform of the 1980s led to economic restructuring and stabilization. Tax revenue as a percentage of GNP increased from 5.2% in 1965 to 10.5% in 1969, 15% in 1971, and 15.8% in 1975. Tax incentives have been given to export promotion, key industries, small and medium-sized firms, local industrial development, technical innovations, foreign investment, counter-cyclical investment, energy conservation and environmental protection, and resource development. However, the main focus of tax incentives has been in the areas of export promotion, key industries, and small and medium-sized firms. The statutory maximum tax rate was 40% in 1973, lowered to 33% in 1983, but the effective marginal tax rates have varied between products and sectors. For example, processed food and beverage has paid the highest marginal tax rates of 50.6% in 1973, and 39.5% in 1983 (Choi and Kwack 1990: 255). The total tax to GNP ratio has increased from 9.1 in 1962–66 to 18.9 in 1982–85, while the central government expenditure to GNP ratio has decreased from 22.8 to 21.7. Consequently, the ratio of government savings to GNP has increased from 0.3 to 6.7 in the same periods (Choi and Lee 1990: 62). Many have argued that the high tax rates in Korea have led to distortions in the cost of capital, weakened the distributive role of direct taxes, and restricted the build-up of growth potential and the liberalization of the Korean economy (Choi and Kwack 1990; Park 1994).

4.5 Public utilities and infrastructure

The governments of the four East Asian economies have intervened considerably in the provision of public utilities and infrastructure. In general, public utilities are goods and services that require large initial capital investment, such as medical services, hospitals, electricity, transport, public libraries, postal services, and so on. Infrastructure includes large public works and various public construction projects, such as airports, roads and highways, sewerage, and public parks.

There are economic advantages in the government provision of public utilities and infrastructure. First of all, there are the implications for equality, survival cost, and the likelihood of market failures. The provision of public utilities ensures that low earners are provided with basic necessities to achieve a reasonable living standard. Public utilities require huge investment, which could not be afforded by the individual consumer. The marginal cost of the supply of public utilities is usually low, or even non-existent. Equating the market price with the marginal cost does not produce a viable return for the investors, at least in the short term. The provision of infrastructure opens up economic potential to businesses by allowing additional business opportunities and lowering the transaction costs. Seen as a pre-condition to growth and development, infrastructure provision encourages investors to venture into new territory, and it makes a long-term contribution to the region.

Hong Kong differs from the other three economies in the government's commitment to R&D. The free market ethos of its government means that it is very reluctant to support R&D activities openly, whereas the other three economies are committing around 2% of their GDP to R&D expenditure. The Hong Kong government takes a narrow view and considers that R&D expenditure is a "subsidy" to industry. The governments of the other three East Asian economies, however, consider R&D expenditure in the same way as other infrastructure that benefits society, especially industry.

Hong Kong

Public utilities and infrastructure are provided under a mixed system in Hong Kong. Some public utilities are completely run by the government, for example, water supply, street lighting, sewerage, and the postal service. Others are "natural monopolies," and are supplied by private companies under a franchise system monitored by the government, for example public transport, electricity, and gas. There are also other public utilities that the government operates in parallel with private suppliers; medical services and hospitals, and schools are good examples. Though there is clearly a price differential, individual consumers can choose to patronize either private suppliers or government-run services (Mak 1996; Hung 1997; Yuen 1997). In the cases of the underground urban railway (mass transit railway), the train network in the New Territories, and the various cross-harbor and other tunnels, the Hong Kong government has permitted private sector involvement. There are other cases in which the government ensures that there is sufficient competition among the potential suppliers, for example, telecommunication and port facilities, and container handling services (Cheng and Wong 1997).

Singapore

The Singapore government have provided guidelines for the development of infrastructure and the provision of public utilities and amenities, such as

schools and recreational facilities. The main functions of Singapore's transportation network include (Soon and Tan 1993: 32):

1 the provision of more jobs for women;
2 the provision of domestic transportation for the workers;
3 bringing about a reduction in pollution;
4 an improved quality of life.

In addition, the development of an "institutional infrastructure" has been considered to be essential because of the rise in economic complexity and the need for government bodies to improve their management. The transport and communication sector has outperformed the rest of the economy since 1991. This sector grew by an average of 14.8 % and 10.9% in real terms between 1969–79 and 1980–84 respectively. Despite the economic setback in 1985, the sector enjoyed rapid growth in the remainder of the 1980s, and steady growth continued into the 1990s (9.2% in 1991, 11% in 1995, and 8.1% in 1996; *Country Profile Singapore 1993/94* (Economist Intelligence Unit 1993: 26); *Economic Survey of Singapore 1996* (Ministry of Trade and Industry 1997: 82)).

Taiwan

Government investment has been the major source of funding for infrastructure projects in Taiwan. Infrastructure development in Taiwan began in 1973 with the announcement of ten major development projects with a total price of $8 billion. These included: a north–south freeway, electrification of the west coast trunk-line tramway, an east coast railway, an international airport, a commercial harbor and an auxiliary harbor, a steel mill, a petrochemical complex, a shipyard, and three nuclear power plants (Pang 1992: 221). The government provided 60% of the funding, and the rest came from foreign lenders. Investment in the ten major projects comprised 4.5% of total government investment in 1973–74, and about 20% in 1975–76 (Kuo 1983: 216). The shipyard and the steel mill were originally owned jointly by the state and the private sector, but the private sector dropped out later, because it was involved in national defense and suffered huge losses. In 1979, another twelve new projects were announced, including five in transportation and one in nuclear power. This was followed by the announcement in 1985 of the fourteen development projects, which included the development of high-technology industry. A technology-based industrial park was first established in 1980 to cater for the needs of the high-technology industries. Discussions have also concentrated on the extent of technical change and its impact on industries and human capital (Liu 1992; Kuo 1983).

A more recent drive to expand Taiwan's infrastructure is the six-year national development plan, which was launched in 1991 and aims to provide infrastructural software and hardware. This plan consists of a series of public construction projects on: transportation and communications; public utilities; urban construction and housing; manufacturing industries; environment

protection; and health care. The ultimate aim is to improve the quality of life and increase overall productivity. The development of services is another focus of the 1991 plan, since high-quality services are required by the legal profession, and in manpower planning and service distribution (Schive 1996).

South Korea

In the case of Korea, a considerable proportion (over 35%) of government expenditure is committed to investment in human and material resources, facilities and machines, and R&D (Pae 1992). Housing is the most serious concern of the government, especially in the urban areas. Land speculation has enabled a minority of Koreans to control the supply of land. A five-year housing construction plan, which permitted private sector participation, was announced in 1988. The Korean government planned to spend 10 trillion won ($14.3 billion) and President Roh Tae Woo pledged to supply a total of 250,000 housing units for the low earners.

The expansion of scientific and technological capabilities and infrastructure has been a major concern in Korea. The emphasis on technology-intensive industries, the rapid rise in labor costs and Korea's drive toward self-reliance are the major reasons for building infrastructure and developing technology. Other than technology import, R&D investment as a proportion of GNP had already reached 2% in 1986. By 1993, Korea's R&D expenditure had reached 2.33% of GDP, which is comparable to the industrialized countries (for example, the UK at 2.19%, France at 2.41%, the US at 2.72%, and Japan at 2.68%; *Taiwan Statistical Data Book 1996*: 106). The private sector has been given a large role in the development of R&D since the early 1980s. For example, the private sector share of R&D expenditure increased from 32% in 1980 to 55% in 1986. The tax system also provides considerable incentive for expenditure on R&D.

4.6 The metaphor of fertilizers, pillars and carpets

The discussion on the role of the government and the experience of the four East Asian economies shows that their governments have intervened in a range of economic activities. The *laissez-faire* argument which advocates a free market economy and government non-intervention is rather simple and narrow. On the contrary, it would be unwise to conclude that the governments of Singapore, Taiwan, and South Korea are interventionist. Some studies suggest that these governments are "market-friendly." Others use the phrases "capitalist-guided market economies" and "state-led changes" to describe the role of the government (White and Wade 1988). An analysis should begin at the conceptual level. The government oversees various activities in a society, including economic activities. In a sense, the government has to survive economically too, meaning that it has to earn so that it can spend. The

government has to ensure that the channels of wealth creation are not restricted.

Conceptually, the government in these four economies performs three basic functions. Firstly, in order to ensure and expand its future source of revenue and minimize its current and future financial burdens, it is desirable to provide economic agents with incentives. With these incentives, the private agents can progress economically, and consequently either contribute more to or require less from the government in the future. Metaphorically, these institutional incentives are known as "economic fertilizers".

Fertilizers

Consider the economy as a piece of agricultural land and citizens as farmers with each farmer trying to work for a better harvest. There are, however, exogenous factors that are beyond the control of the farmer, such as weather, soil fertility and erosion, and damage done by pests and diseases. If the farmer were provided with a certain amount of fertilizer, for the same effort he would gain a better harvest in terms of a higher crop yield, which, in turn, would mean that the farmer was better off economically and would be able to contribute more taxes to the state. At the same time, he would be unlikely to seek financial aid from the government, thus reducing the financial burden on the state. Thus the provision of fertilizer is "the stone that kills two birds": both enlarging the state's purse and reducing the expenditure on welfare.

Economic "fertilizers" are instruments the government provides to economic agents for use in economic activities. There are a number of institutional facilities which are established by the government, for example: trade development offices to provide exporters with better information on the foreign markets; favorable bank credit facilities extended to industrialists and exporters; low cost industrial land made available to facilitate industrial development; and technological institutes, which assist automation in industries and enterprises. These are good examples of economic fertilizers commonly used by the governments of the four East Asian economies. The government does not provide subsidies, so it is not left in a financially difficult situation.

There are several advantages of providing economic fertilizers. Firstly, it is indirect, and the benefits will not accrue if the recipients do not make sufficient effort. Secondly, economic fertilizers are operation-oriented, i.e. the recipients can do without them, but equally cannot use them for anything else. They help the recipients by reducing various transaction or information costs, but the government can monitor the process so that the fertilizers are not misused. Thirdly, the commitment on the part of the government is limited, and so there is not a lot of intervention. Flexibility is a fourth advantage; when the need arises, the government can switch economic fertilizers from one area to another where the need is greater. Most importantly, the free market, capitalistic system is preserved. With the

provision of economic fertilizers, business is conducted openly in the free market, while the government takes a "back seat." Different economic scenarios and processes require different fertilizers, and there may be variation even though the scenarios are the same in different economies. For example, in the pursuit of an industrial policy in the 1970s and 1980s, the Hong Kong government insisted on a "free market" approach with no fiscal assistance, while the governments of Singapore and Taiwan picked the electronic industry as their "winner" and provided tax inducements. As it turned out, all these economies have been successful in achieving industrial growth and generating income, though their technological progress has differed.

The concept of economic fertilizers is useful to explain both the role of the government and the pace of economic growth. Growth results from the increase in income and earning power, while the industrialization process and economic diversification promote growth. Similarly, an improvement in individual well-being results in a fall in demand for welfare provision. A virtuous circle is created as sustainable growth is maintained, leading eventually to the emergence of a "miracle" economy.

Pillars

Each government has, to a large extent, to chart an economic path that focuses on one or two "economic pillars," which are industries (manufacturing, financial, or service) that will provide major employment and a reliable source of income. The identification of these economic pillars helps to establish comparative advantages in the economy. Economic pillars are created as a means of maintaining and sustaining growth, encouraging expansion of a particular industry and market, and maintaining a special area of expertise, and they act as a focal point for income generation and employment. Once established, they form the society's support system, and can provide a stable source of employment and output, and create linkage and cluster effects with related industries and future developments.

The establishment of economic pillars can be initiated or encouraged either by the government or by a joint effort between the government and the private sector. A good example of an economic pillar would be the efforts made to establish a popular or highly valued industry, or to create a niche in a particular market. In short, economic pillars represent the strategic base of a society. One major disadvantage is their inflexibility once established. If export demand for that particular product has fallen, there may be excess capacity, leading to unemployment, a fall in income and other negative knock-on effects. To take account of dynamic markets, new pillars should be established as the pattern of demand changes, to take the place of the old pillars when they fall.

Carpets

On the input side, the government must ensure an adequate level of education and training, R&D development in some cases, and social infrastructure and public services to reduce the survival cost. Welfare assistance is provided to ensure a minimum standard of living. Such provisions are, metaphorically speaking, "carpets" that help to maintain the economic well-being of society. A "wall-to-wall economic carpet" ensures that every agent will enjoy a certain level of economic well-being. Once the government has ensured the economic minimum, the maximum level of economic achievement, however, is left to the private sector.

The provision of education, old age pensions, public housing, a minimum level of social welfare, public transportation, infrastructure developments, and so on are the "wall-to-wall economic carpets" that the government has laid. Once the government has provided the minimum, the free market, capitalistic system and an efficient economic framework will encourage individuals to proceed and conduct their private business affairs. More importantly, economic carpets usually last for a long time, suggesting that government provisions will remain unchanged, so that a consistent policy framework can be maintained. It is important for investors, particularly foreign investors, to see a long-term prospect for their investment returns. On the contrary, an inconsistent, or ever-changing policy will produce an unstable and unpredictable situation and investors will discouraged if there are other stable and predictable investment markets elsewhere.

Capital is the most mobile form of resource. The owners of capital naturally make comparisons before deciding on the most attractive, that is, profitable, reliable, and predictable, place to invest. The success of private economic and business activities depends on the availability of capital. Attracting capital, especially foreign investment, however, is the first step. If output and productivity then expand, it is important to ensure that all investments enjoy a good return so that they are encouraged to "stay" and further improve productivity.

The focus of the debate in contemporary development should not be on the two extremes of *laissez-faire* or government intervention. It should instead concentrate on the kinds of government involvement that will facilitate the activities of the private sector and maintain a sustainable level of economic growth. While the ownership of resources will be in the hands of the private sector, the government is responsible for ensuring that the potential for generating wealth, income, and productivity is maximized. Thus, the government, on the one hand, operates policies to provide as much incentive as possible to economic agents, while, on the other hand, its financial burden is reduced. These are really the two sides of the same coin.

The experience of the four East Asian economies over the last three to four decades confirms that government involvement has been beneficial, the only difference between the four economies being the form and extent of

intervention. In most cases, the role of government has remained secondary to and supportive of the private sector, and the provision of economic fertilizers demonstrates that the government has maintained a supportive role without direct intervention in the form of subsidies or outright ownership. A major criterion for an economic fertilizer is its non-discriminatory nature, in that every economic agent has an equal opportunity to obtain government support. Furthermore, the economic return is for the sole benefit of the agent, though the amount will differ between agents. Economic pillars are designated "winner" industries that generate a major portion of the economy's total output and employment. Together, they lead to an economically strong and financially healthy government.

4.7 Tax incentives versus credit provisions

Where should one draw the line on government involvement in the economy? When does a government's involvement change from one of simply providing incentives (fertilizer) to one of direct intervention? This section considers the three types of government involvement: providing a low tax regime, providing "tax heavens," and making credit provision through banking institutions. Hong Kong is popular because of its low and straightforward tax regime, while Singapore, and to some extent Taiwan, provided tax heavens to attract foreign capital. South Korea, and to a large extent Taiwan, have concentrated on credit provision.

A low tax regime means that low standard income and corporate tax ceilings are imposed on all local and foreign residents and firms. This has several advantages. It imposes no disincentives on business or individual productivity. Businesses and investors can predict their likely profits and costs from the tax rates. It thus reduces risk and uncertainty considerably, especially for long-term investments. A low tax regime also attracts businesses, leads to a rise in income and employment, and consequently creates a larger revenue pie for the government.

A tax heaven, or a tax holiday, is a strategy that is used to attract foreign investment. A period of, say, ten to fifteen years of tax exemption is given to a foreign investor. The investor will then enjoy tax-free profits during this period. Usually, such investments are considered as strategic to the economy. Once the holiday is over, the firm will either have to renegotiate, or pay corporate tax. The clear advantage is the holiday period when the investor does not need to worry about the difference between gross and net profit. The disadvantage for the host economy is that the firm may withdraw once the holiday is over.

Whether a low-tax regime or a tax holiday strategy is more attractive to foreign investment depends on a number of factors. Assuming that there is no change in the tax system over the years, a low-tax regime will attract investments that yield a higher level of profit in the long term. In contrast, investments that will yield profit in the long term may have to face higher

business tax once a tax holiday period is over. A tax holiday strategy, in theory, will, therefore, attract investments that will have completed their profit cycle by the end of the holiday period. Other considerations include whether the product will be for export or the local market. The size and income level of the local population will be another decisive factor if the foreign investor is to target the local market.

Credit provision is usually applied to local industries with the aim of helping them to "catch up" with foreign firms. In the "pick winner" strategy, government banks are instructed to lend to these industries at favorable, probably below-market, interest rates. The advantage of credit provision is that these industries will grow rapidly, and become competitive in the world market. These "pick winner" industries are intended to widen the economy's comparative advantage. Credit provision to "pick winner" industries has certain disadvantages. Firstly, these industries will grow at the expense of other not favored by the government. Non-favored industries will then have difficulty in raising loans from financial institutions. As a result of the mass attention and development opportunities given to the target (favored) industries, the economy may end up with a rigid industrial structure. Should demand fall, the economy will have excess capacity, and that in turn creates a "snowball" effect. In the case of South Korea, the large conglomerates (*chaebol*) were the firms that benefited from the government's favored credit provision, thereby leaving little chance for smaller companies to compete and survive. Consequentially, the economy's industrial structure became skewed toward large firms. The typical argument against import substitution can also be applied to the promotion of "pick winner" industries in that once they are considered to be "winners", they can no longer be "losers," and thus they can survive only with the government's continued support and provision of cheap credit. And because of the government's continued support, the industries become protected and uncompetitive and internal conflicts may develop at the management level. These problems may not emerge when the economy is growing rapidly, but could pose problems for structural rigidity should there be a sudden fall in demand.

The difference between a low tax regime and tax holidays, on the one hand, and credit provision, on the other, lies in the way in which they are applied. The former is exercised within the fiscal policy framework while the latter is a monetary policy tool. There is, however, a major conceptual difference. Fiscal policy instruments concentrate on the "fruits" or the outcome of investment; the incentive is that less of the profit will be taxed. Monetary policy instruments, however, concentrate on the input end of investment in that capital availability is assured from the very beginning. To sum up, the emphasis of the fiscal tool is put at the end of the investment process, while the beginning of the investment process is the emphasis of the monetary tool. Clearly, it is more efficient to reward the business' achievement at the end of the investment process than to supply funds to encourage investments that may turn out to be uncompetitive and burdensome. Credit

provisions are actually indirect fiscal subsidies that are provided via the banking sector. Default credits become non-performing loans that present serious risks for the financial sector. A short-term increase in the money supply through provision of credit could also have adverse consequences for the monetary policy.

4.8 Conclusion

A scale showing the extent of government involvement can be drawn for the four East Asian economies. The straightforward low tax regime in Hong Kong is considered to be least interventionist and has been an attractive feature for investors. The Singapore government has intervened considerably in the promotion of industries, and a tax holiday strategy is used to attract foreign investors. Taiwan has targeted the development of large and heavy industries, but the manufacturing sector is decentralized and composed largely of small and medium-sized enterprises. The South Korean government is considered to be most interventionist. It actively promotes industries, and development has been concentrated in a number of conglomerates that have become so big that they have deprived non-targeted and small and medium-sized industries of development opportunities.

Other than the provision of social capital and infrastructure, the governments of the four East Asian economies leave the activity of production largely in the hands of private economic agents. With few exceptions, governments do not own productive resources but they exercise various economic policies. Government expenditure is complicated by the various social priorities: a minimum survival social net; long-term output-generating public expenditure; and temporary short-term welfare provision. With the exception of Hong Kong, national security and military expenditure has often competed with other items and imposed a high opportunity cost on total government expenditure; political stability and peace ease the pressure on military expenditure.

There are traditionally two debates on the economic role of government. The first is whether the government should follow a central economic planning strategy or pursue a free market system. The second is whether the government should intervene through direct expenditure or rely on the private sector to stimulate growth. The economic success of the four East Asian economies suggests that a free market system is definitely the preferred option. Equally, their governments have intervened on certain occasions, more because of the lack of markets and the need to create more opportunities than because of market failure.

The government intervenes in three ways, metaphorically speaking. One is the provision of economic "fertilizers" as an indirect incentive to encourage firms and households to maximize their economic gains. The setting up of economic "pillars" is another measure, which gives a strong absolute advantage to industries and provides a new comparative advantage for

exports. Various economic mechanisms can be put in place to ensure a minimum level of economic survival, and this can be likened to the provision of an economic "carpet." The Hong Kong government has made extensive use of economic fertilizers as an indirect instrument to encourage the free market. Singapore, Taiwan, and Korea have put more emphasis on the construction of economic pillars to build up their industrial base and strength. Economic pillars create niche markets for the economy, but may make the economy less flexible since resources tied to a particular industry cannot be transferred to others should that industry experience a decline.

There is a government in every society. One cannot simply argue that whatever the government does is intervention, and, similarly, non-intervention does not mean that the government does nothing. It is more appropriate to argue that a judicious government is the ideal. What is equally true, however, is that the private sector cannot survive on its own without support from the government. The debate, therefore, is not whether or not there should be government intervention, but how strategic the government is in directing economic growth by creating more markets, while at the same time preserving a free market principle and maintaining the dominance of the private sector. The role of the government is to support the private sector. Metaphorically speaking, "economic fertilizers, pillars and carpets" prepare and maintain the ground for private sector activities, and their success and expansion ensures economic growth.

5 The external dimension

A necessary condition

5.1 The role of the external sector

Few would disagree with the positive economic effect that trade and foreign direct investment has had on the development of the four East Asian economies. The expansion in trade has largely been facilitated by the constant inflow of foreign direct investment. Exports, especially industrial exports, have often been explained by these economies' comparative advantage. Judging from the export performance of the four East Asian economies, it can be concluded that their comparative advantage has changed over the decades, and export expansion has been supported by different manufactured exports. This chapter focuses on the role of trade and foreign direct investment in the growth of the four East Asian economies. One of the roles they have played is in the changing nature of comparative advantage. It has also been argued that the external sector supplements domestic growth. As such, it forms a necessary condition for growth, while domestic prerequisites are both necessary and sufficient conditions.

The pure theory of comparative advantage argues that trade becomes feasible when nations specialize in products which have the lowest marginal cost of production for them. This necessarily means that resources are channeled from lines of production with comparative advantage to those with comparative disadvantage. If an economy has more than one product with comparative advantage, a "chain of comparative advantage" will emerge, with goods listed in descending order in terms of relative efficiency of production. The development experience of the four East Asian economies, however, has shown that there is a "dynamic" aspect to comparative advantage. Over the years, new export products with comparative advantage have emerged, developed, and expanded and then replaced exports on the existing list. There are various reasons for, and channels of, developing new export items with comparative advantage. One is changes in global demand, which gives rise to new investments. Secondly, new developments in production techniques, including automation and technological applications and innovations, discovery and designs can give rise to new industries that lead to new comparative advantages in exports. An increase in the value-added and product diversification can also contribute to changes in the comparative

advantage of exports. The third factor is the government's policy on picking "winners", so that new export items can gain comparative advantage. In short, a "dynamic comparative advantage" evolves, with new opportunities arising from capital accumulation, technological change that leads to capacity change, and changing world demand. Changes in comparative advantage allow an economy to float and follow close to international trends in growth and development. This is particularly true if the domestic economy is small and open.

To a large extent, trade and foreign direct investment depend very much on the strength of the domestic economy. Given that financial capital is the most mobile form of resource, foreign direct investment is attracted to an economy only when investors feel that their likely return on investment is promising. Similarly, trade is feasible only if the exported products are acceptable to the importing countries. Domestic conditions form the basic prerequisite for a successful export and foreign direct investment regime. Conceptually, for the domestic economy to benefit from the world economy, trade and foreign direct investment constitute necessary conditions. In other words, the domestic economy has to make itself attractive to inward investment. A domestic economy suited to external conditions is, therefore, both a necessary and sufficient condition for growth and development.

This chapter uses the development experience of the four East Asian economies to distinguish between necessary and sufficient conditions in trade and foreign investment on the one hand and domestic prerequisites on the other. Their strong positions in trade and foreign direct investment are based on a number of prerequisite domestic conditions that have been cultivated over the decades by their governments, the private sector, the labor force, and the public at large. Section 5.2 considers the experience of the four East Asian economies, while section 5.3 presents the argument that it is "dynamic comparative advantage" that has maintained, and even expanded, their growth over the decades. Here the special features of each of the four East Asian economies will be examined. Section 5.4 puts forward the hypothesis that external favors are a necessary condition, while domestic strength is both a necessary and sufficient condition for successful growth and development. The last section provides a conclusion to this chapter.

5.2 Trade and foreign direct investment

The problem of economic development, according to Lucas (1988), is "the problem of accounting for the observed pattern, across countries and across time, in levels and rates of growth of per capita income." Growth rates tend to be stable over long periods of time in developed countries, whereas poor countries tend to experience sudden changes in growth rate. In contrast, the four East Asian "miracle" economies of Hong Kong, Singapore, Taiwan, and South Korea experienced sharp growth rates. Over the period 1960–80, their per capita income grew at an average annual rate of 6.95%.

Trade and foreign direct investment is the area that has attracted least controversy over its contribution to income growth in the post-war economic development of these economies. Numerous studies have shown a strong link between export growth and growth of real GDP among the Asian economies (Balassa 1978; 1981; Batchelor 1980; Naya 1983; 1988; Page 1991). Given the open and externally oriented nature of these economies, foreign direct investment was attracted by their low costs of industrial production in the 1950s and 1960s. And because of the relatively small domestic market, most foreign direct investment was intended for the export market. Therefore, economic growth was simply the outcome of both external trade and inward foreign direct investment. At the same time, these economies also experienced a process of industrialization. Manufactured goods soon occupied an increasing share of domestic output. The growth of export industries, in turn, expanded their economic base. The success of industrialization promoted productivity and led to sustained development and growth.

Exports from the four economies have been favored by the various preferential trade agreements they received from developed countries, and there has been a general absence of international hostility. Although trade protectionism was imposed on their textile and clothing exports, their economic liberalism continued to foster trade and absorb large amounts of inward direct and portfolio investments. Their economic stability, coupled with consistent economic policies, meant that foreign investors could predict their investment returns easily. In turn, this encouraged foreign investment to stay and become rooted in these economies.

While Hong Kong and Singapore have claimed to be export-led growth economies, Korea and Taiwan switched from import substitution to export promotion in the 1960s. Beginning in the 1960s and 1970s, for example, the export–GDP ratio was higher for Hong Kong (0.99 in 1963–78) and Singapore (1.87 in 1965–78) than for Taiwan (0.47 in 1960–76) and South Korea (0.29 in 1960–78) (Krueger 1990: 52). Eight prerequisites were identified for an export-oriented strategy: an explicit government policy, a clear government commitment, a realistic exchange rate, no quantitative restrictions on trade, ready access to the international market, a good communication and transport infrastructure, labor markets functioning according to market forces, and policies to assist export industries (Krueger 1985: 207–8). The intensity of trade can be seen by calculating the ratios of import to consumption of raw material and of export to production of manufactured goods. These two ratios have remained high for both Singapore and Hong Kong since the early 1960s, but both Taiwan and South Korea caught up in the 1970s.

There are four aspects to trade or export competitiveness, namely the effects of world trade, commodity composition, market distribution, and competitiveness. Between the 1960s and early 1980s, the four East Asian economies showed strong growth in terms of world trade and competitiveness. Hong Kong was weak in terms of its market distribution, implying a heavy concentration on a few major trade partners. South Korea was weak in both

commodity composition and market distribution, suggesting a lack of diversification in its exports in these two decades (Chen and Li 1994a: 116).

Foreign direct investment is a potent factor in promoting growth, as it provides not only financial capital, but also a source of technology, know-how, and managerial skills. Export-promoting economies attract a greater volume of foreign direct investment than economies that practice import substitution (Bhagwati 1994). Export promotion is more suited to the efficient function of foreign direct investment because it allows a free play of market forces. Resources are allocated on the basis of comparative advantage, which, in turn, promotes specialization and economies of scale (Pack 1994). Empirical work on output elasticity for the period 1970–85 shows that foreign-owned capital is the most effective in promoting growth, followed by growth in labor force, increased exports, and the stock of domestic capital (Balasubramanyam *et al* 1996).

The rising costs in most of the post-war economies in the West led to new trade and investment opportunities elsewhere, and this allowed the East Asian economies to become the "workshop of the world." Vernon's (1966) "product life cycle" theory of trade and foreign direct investment suggested that foreign direct investment occurs when domestic production and supplies face severe competition and rising costs. It then becomes cheaper to invest abroad, and export back the manufactured products to the parent country. The rapid growth of Japan in the 1960s and 1970s allowed it to experience a prolonged period of trade surplus that enabled Japanese firms to invest abroad. The four East Asian economies have become the natural destinations of Japanese investment, probably as a result of their economic and political stability, and geographical proximity.

Furthermore, the provision of the generalized system of preference (GSP) treatment by developed countries of a number of Asian economies on a most favored trade status encouraged Japanese firms to invest in other Asian economies. Between 1951 and 1989, Japan invested a total of US$19,919 million in the four newly industrializing economies (NIEs) of Hong Kong, Singapore, Taiwan, and South Korea compared with US$17,531 million in the ASEAN economies. Manufacturing accounted for 34.6% and 44.6% of investment respectively in the two groups of economies. Japanese investment in commerce, finance, and services accounted for 43.9% in the NIEs, compared with 8.5% in the ASEAN countries (Urata 1993). The "flying geese" model suggested that growth in Japan "trickled down" to the four East Asian economies, and then, in turn, "trickled down" to other Asian economies, such as Malaysia and Thailand (Gangopadhyay 1998: 37).

The statistics in Table 5.1 show that in 1998, for example, the four East Asian economies were ranked within the top fifteen largest world exporters and the top sixteen largest world importers. Increases in exports and foreign direct investment can easily be detected from national statistics. Exports from the four East Asian economies have increased considerably, as Table 5.2 shows. The percentage share of exports to North America declined

Table 5.1 Rankings of major Asia–Pacific economies in trade, 1998

Rank	*Economy*	*Value (US$ billion)*	*Share (%)*
Exports			
1	United States	683.0	12.7
3	Japan	388.0	7.2
7	Canada	214.3	4.0
9	PRC	183.8	3.4
10	**Hong Kong**	**174.1**	**3.2**
12	**South Korea**	**133.2**	**2.5**
13	Mexico	117.5	2.2
14	**Taiwan**	**109.9**	**2.0**
15	**Singapore**	**109.8**	**2.0**
19	Malaysia	73.3	1.4
22	Russia	56.2	1.0
23	Australia	55.9	1.0
24	Thailand	53.6	1.0
26	Indonesia	48.8	0.9
	World	5,375.0	100.0
Imports			
1	United States	944.6	17.0
5	Japan	280.5	5.0
7	Canada	205.0	3.7
8	**Hong Kong**	**188.7**	**3.4**
11	China	140.2	2.5
13	Mexico	128.9	2.3
14	**Taiwan**	**104.2**	**1.9**
15	**Singapore**	**101.5**	**1.7**
16	**South Korea**	**93.3**	**1.6**
20	Australia	64.7	1.2
22	Malaysia	58.5	1.1
26	Russia	44.7	0.8
29	Thailand	41.8	0.8
	World	5,560.0	100.0

Source: World Trade Organization. http://www/wto.org/wto/intltrad/998appl.htm, March 2000.

between 1981 and 1992 for Hong Kong (dropped from 36% to 23%), Taiwan (dropped from 36% to 29%), and South Korea (dropped from 27% to 21%). Singapore was the only economy to increase its export value to the US (from 13% to 17%) (Alvstam 1995: 110). In the case of Hong Kong, exports to North America experienced a slower growth in the 1980s, suggesting that exports were diversified to Asia and Europe. The situation was reversed in the 1990s and North America has become Hong Kong's largest export market. In contrast, Asia has been the major export market of Singapore, Taiwan, and South Korea, especially in the 1990s.

The ranking of Hong Kong in terms of world trade is higher than the other three economies. This is because Hong Kong's total exports include

domestic export and re-export, but re-export has increasingly become the dominant element. In the 1950s, exports from South Korea and Taiwan were lower than those from Hong Kong and Singapore, probably because of the latter's import substitution policy. Singapore was the only economy that experienced a reduction in exports in the 1960s to all of its major trade partners, except Asia. All four economies experienced their highest growth in exports in the 1990s. As a result of the 1997 Asian financial crisis, exports to other countries declined considerably in all four economies in 1998. The export trade among the four East Asian economies picked up in the second half of the 1970s, and expanded significantly in the 1980s, as Table 5.3 shows. Hong Kong has absorbed the greatest amount of exports from the other three economies. Trade between Taiwan and South Korea has been lower than between Singapore and Hong Kong. South Korea's exports to the other three economies was insignificant until the 1970s, and remained low throughout the 1970s and 1980s.

Inward foreign direct investment to Hong Kong and Singapore has far exceeded that to South Korea and Taiwan. The latter received a great deal of official aid, especially from the US, in the 1950s and 1960s, which crowded out private foreign direct investment. Both Hong Kong and Singapore play a pivotal role in their immediate neighbors' economies. Foreign businesses use Singapore as the headquarters for their businesses in the ASEAN economies of Malaysia, Thailand, the Philippines, Indonesia, Brunei, and Vietnam. Hong Kong has been serving foreign businesses as a base for their activities in the People's Republic of China, particularly since its adoption of economic reform in 1978.

The economic maturity of the four East Asian economies has brought changes in their trading status and financial flows. These four economies graduated from the GSP treatment in 1989 (Kwok and Li 1991; United Nations 1992). As a result, from 1990 onwards, exports to the US and major European countries were not exempt from relevant import tariffs. In the early years after their GSP graduation, the export pattern of the four economies remained largely unchanged. Rather, it was other factors that altered their comparative advantage and quantity of exports in the 1990s. In the longer term, the ASEAN countries and the People's Republic of China will be favorable destinations for outward foreign direct investment from the four East Asian economies. The most favored nation status and the low cost of labor-intensive manufacturing in ASEAN countries and in mainland China will pull investments from the four East Asian economies, thereby activating financial flows in the region.

By the early 1980s, the comparative advantage of the four East Asian economies had switched from export of manufactured goods to export of financial capital, mainly to ASEAN countries and to mainland China (Chen 1993; Ramstetter 1993). Among the ASEAN-4 (Malaysia, Thailand, Indonesia, and the Philippines), Malaysia has been the largest recipient (Chia 1993: 73). Thus, while both Hong Kong and Singapore have become major financial

Table 5.2 Domestic exports of the four east Asian economies (US$ million).

From/to	*Asia*	*North America*	*Europe*	*Australia*
Hong Kong				
1950	155.3	55.8	40.2	6.9
1955	91.3	20.4	53.1	9.4
1960	63.2	144.2	122.5	15.2
1965	50.7	319.6	216.0	23.1
1970	296.0	965.4	434.3	69.9
1975	920.0	1,730.5	1,214.1	239.4
1980	1,983.0	464.0	3,368.2	461.6
1985	3,375.9	989.9	2,782.2	901.5
1990	3,563.7	9,316.3	4,560.1	458.1
1995	6,971.2	8,461.2	3,414.7	337.3
2000	2,251.0	7,384.6	2,914.1	190.4
Singapore				
1950	104.0	374.5	288.4	46.1
1955	115.2	266.5	400.7	58.1
1960	81.4	95.2	149.3	44.3
1965	85.1	49.5	96.8	30.6
1970	192.8	190.8	181.6	52.3
1975	1,046.1	801.1	525.2	94.7
1980	4,074.6	2,657.9	1,541.8	813.2
1985	4,484.6	5,202.3	1,547.7	783.0
1990	11,504.3	12,105.3	4,834.4	1,242.0
1995	25,891.5	20,904.4	8,580.1	2,449.3
1999	15,171.1	17,132.7	7,123.9	1,814.7
South Korea				
1955	10.8	8.9	0.1	
1960	24.6	5.3	2.5	
1965	59.0	64.2	7.3	1.2
1970	272.9	410.1	41.9	2.9
1975	1,596.1	1,733.6	514.1	63.1
1980	4,345.3	5,293.4	1,739.1	230.4
1985	6,795.1	11,982.8	2,208.5	368.8
1990	19,471.0	21,090.8	5,718.5	956.0
1995	38,330.9	25,921.9	10,306.1	1,569.3
1999	36,177.9	31,113.2	10,615.1	2,426.0
Taiwan				
1955	90.5	5.5	5.3	0.1
1960	92.3	20.1	7.0	0.3
1965	181.0	104.8	33.8	4.3
1970	415.3	615.1	88.3	20.4
1975	1,317.5	2,004.4	491.3	125.6
1980	4,535.7	7,220.0	1,813.1	539.4
1985	16,144.0	15,718.3	1,683.1	747.3
1990	20,310.4	23,303.0	6,308.8	1,279.2
1995	46,239.1	27,836.8	7,451.4	1,755.6
1999	44,335.6	32,652.1	9,491.0	1,847.3

Sources: *Taiwan Economic Statistics*; *Domestic and Foreign Express Report of Economic Statistics Indicators*; *Economic Statistics Annual Taiwan Area*; *Hong Kong Statistics*; *Hong Kong Trade Statistics*; *Monthly Statistical Bulletin, Bank of Korea*; *Economic Survey of Singapore*.

Notes
Asia = Hong Kong, Singapore, South Korea, Japan, and Taiwan. North America = USA and Canada. Europe = West Germany, France, and United Kingdom.

Table 5.3 Domestic export trade among the four East Asian economies (US$ million)

From/to	*Hong Kong*	*Singapore*	*South Korea*	*Taiwan*
Hong Kong				
1950		95.0	4.0	35.2
1955		62.5	3.3	6.5
1960		42.6	0.3	2.5
1965		24.7	0.2	3.0
1970		108.3	17.6	58.0
1975		307.9	65.1	166.0
1980		836.8	219.8	596.3
1985		1,407.7	1,036.9	1,266.1
1990		1,012.4	239.8	742.8
1995		1,589.1	2,821.1	1,028.5
2000		604.6	212.1	782.6
Singapore				
1950	66.3			
1955	18.3			2.7
1960	19.6		8.1	2.5
1965	43.4		1.2	3.8
1970	63.4		11.3	
1975	78.8		45.0	
1980	1,259.1		296.0	336.0
1985	1,515.4		293.6	405.3
1990	3,555.2		1,211.6	1,966.6
1995	10,132.5		3,245.1	4,873.0
1999	8,836.0		2,934.0	4,956.0
South Korea				
1955	2.4	1.0		0.1
1960	2.7			0.4
1965	10.8	2.2		1.9
1970	27.6	11.0		
1975	182.0	58.3		62.9
1980	823.3	266.3		216.3
1985	1,565.5	490.1		196.1
1990	3,779.9	1,804.6		1,248.6
1995	10,682.0	6,689.4		3,881.5
1999	9,048.2	4,921.8		6,345.5
Taiwan				
1955	6.8		3.5	
1960	20.7	6.8	6.1	
1965	27.9	3.7	6.2	
1970	135.9	9.2	27.9	
1975	363.0	25.9	119.5	
1980	1,550.6	140.7	266.5	
1985	2,539.7	885.2	253.8	
1990	1,445.9	1,406.0	1,343.6	
1995	26,105.9	2,203.7	2,571.8	
1999	26,012.1	2,604.9	3,818.3	

Source: same as Table 5.2.

centers in the region, mainland China and Malaysia have absorbed a large portion of low-cost, labor-intensive manufacturing investment. Between 1990 and 1996, the average growth rate of total trade (exports plus imports) of the four East Asdian economies was strongest with the People's Republic of China (20%), followed by the ASEAN-4 (19%). The average growth rate with the US increased by 9 %. Both the ASEAN-4 and the People's Republic of China, however, have achieved higher average growth rates in total trade than the four East Asian economies, as Table 5.4 shows. Table 5.5 shows the net foreign direct investments (inward less outward) for the period 1989–97. Among the four NIEs, Singapore is the only economy with a positive net foreign direct investment during this period. Hong Kong, South Korea, and Taiwan have been more active in their outward than inward foreign direct investments.

5.3 Changing comparative advantage

The theory of comparative advantage provides an explanation for economic development in many developing countries, and the four East Asian economies are no exception. Indeed, their cheap labor force was their comparative advantage in the 1950s. Given the open nature of these economies, and changing world demand, trade and foreign direct investments shifted from one type of industrial product to another. The economic success of the East Asian economies has demonstrated that the changing or dynamic nature of comparative advantage is equally as important as its discrete or static nature. The essence of comparative advantage permitted these economies to float along with changes in the world economy. Economic structures changed in accordance with the emergence of new comparative advantages, from a source of cheap labor in the 1950s and 1960s, to service-based economies in the 1970s and 1980s, and to information-based and capital-intensive industries in the 1980s and 1990s. Indeed, since the early 1980s, the four East Asian

Table 5.4 Total trade matrix: average percentage growth 1990–96

From/to	*NIEs*	*ASEAN-4*	*Aus+NZ*	*Canada*	*PRC*	*Japan*	*USA*
NIEs	16	19	11	4	20	10	9
ASEAN-4	4	19	23	14	16	18	14
Aus+NZ	10	15	10	6	19	2	5
Canada	3	13	3	–	17	1	8
PRC	14	20	15	17	–	19	21
Japan	8	13	1	2	18	–	4
USA	7	17	4	8	20	4	–

Source: *International Trade Statistics Yearbook*, The United Nations, various years.

Notes
NIEs = Hong Kong, Singapore, Taiwan, and South Korea. ASEAN-4 = Malaysia, Thailand, Indonesia, and Philippines. Aus+NZ = Australia and New Zealand.

Table 5.5 Net foreign direct investment (US$ million)

Year	*HK*	*Singapore*	*Taiwan*	*Korea*	*ASEAN-4*	*PRC*	*Japan*	*USA*
1976	–	722	65	99	–	–	–1,786	–7,335
1977	–	343	42	120	1,043	–	–1,622	–8,878
1978	–	422	107	130	1,084	–	–2,341	–10,404
1979	–	815	122	153	1,226	99	–2,662	–14,638
1980	–	1,454	124	1	1,338	165	–2,121	–7,757
1981	–	1,797	91	103	2,144	428	–4,728	12,875
1982	–	2,093	71	–27	1,801	424	–4,085	13,491
1983	–	1,389	130	–7	2,111	626	–3,196	6,382
1984	–1,590	1,458	131	74	1,542	1,180	–5,955	17,948
1985	–1,937	1,076	260	188	1,102	1,610	–5,810	–900
1986	–961	582	260	279	1,175	1,799	–14,250	–3,000
1987	321	982	11	269	1,456	2,031	–18,330	–2,470
1988	–1,203	1,066	–3,161	648	3,270	2,344	–34,710	40,920
1989	–1,854	2,005	–5,347	453	4,333	2,613	–43,076	42,058
1990	–649	4,005	–3,913	–105	5,709	2,657	–46,271	20,740
1991	–2,526	4,444	–583	–241	7,413	3,453	–29,358	–11,452
1992	–6,203	887	–1,088	–481	8,584	7,156	–14,634	–20,093
1993	–16,049	2,665	–1,694	–752	7,764	23,115	–13,620	–31,303
1994	–19,437	4,622	–1,229	–1,652	6,143	31,787	–17,202	–28,157
1995	–22,900	4,222	–1,424	–1,776	7,779	33,849	–22,467	–33,302
1996	–23,856	4,635	–1,979	–2,345	9,329	38,686	–23,200	1,620
1997	–23,400	4,100	–2,952	–1,946	7,821	42,800	–22,769	–23,789

Source: *World Development Report*, and *World Investment Report*, The United Nations, various years; *International Financial Statistics*, International Monetary Fund, various years; Central Bank of China, Taipei.

economies have, in turn, provided major import markets for nearby economies and become key players in foreign investment in the region.

Dynamic comparative advantage was first noted in South Korea (Amsden 1989). Experiences from the four economies suggest that the dynamic nature of comparative advantage led to change at two levels. The first took place within the manufacturing sector in the form of industry and product diversification (Balassa 1979). In the case of Korea, for example, the development of heavy industry broadened its base of comparative advantage, thereby adding new export items. The second level of change was the development of new economic sectors, probably from manufacturing to non-manufacturing industries. Hong Kong and Singapore are typical examples. The rapid development of the financial and service sector has promoted new areas of comparative advantage.

Changes in comparative advantage in these four East Asian economies have been conducted through two major instruments. The first was related to the active role of the government. The Taiwan and Korean governments, and the government of Singapore to some extent, have assisted and promoted new industries for the export market. The Singapore government aimed to create a market-friendly environment, while the Hong Kong government preferred a free market and indirect approach to trade. The second instrument of change was the use of foreign direct investment to widen comparative advantage. By supplementing the use of local resources, such as labor and raw materials, foreign investors injected capital to manufacture goods needed in the rest of the world. In many ways, foreign investment goes beyond simply supplementing domestic savings and provides the economy with new comparative advantages in exports.

Typically, dynamic comparative advantage has followed one of the following two patterns. Both began with a comparative advantage in labor-intensive industries and/or light-industry manufacturing. The economies of Hong Kong and Singapore then diversified into such export-related services as banking and insurance. On the other hand, Taiwan and South Korea developed heavy industries. Trade protectionism on textiles and clothing in the 1960s to 1980s stimulated all four economies to diversify into other lines of light industry. A "pick winner" strategy then enabled economies like Taiwan and Singapore to concentrate on electronic products. From trade-related services, the economies of Hong Kong and Singapore soon developed into financial centers in the region, leading to the rise of various tertiary industries. Capital-intensive or high-technology industries have also been targeted for development in South Korea and Taiwan. Thus, at the one extreme, Hong Kong has concentrated its new comparative advantage in services and the tertiary sector, while, at the other extreme, both South Korea and Taiwan have focused on various types of industries. Finally, Hong Kong and Singapore developed into regional hubs or headquarters serving their neighboring economies, but all four become active in regional investment, supplying capital goods in the Asian region. The sequence of these two patterns can be summarized as follows:

Light manufacturing/labor-intensive exports – export-related services – heavy industries/technology-related/capital-intensive industries – tertiary industries/regional headquarter – regional investors

Hong Kong: from exports to services

Hong Kong is a classic example of a free port with virtually no restrictions on legal trade and finance. Before the end of World War II, the entrepôt business was the major form of trade. However, the influx of refugees and capital from mainland China in the early 1950s forced the government to react, and the inflow of capital provided additional resources for investment. The low labor costs attracted investments in the labor-intensive manufacturing of goods, such as transistor radios, shoes, textiles, and plastic. This expansion of labor-intensive manufacturing led to the process of industrialization (Szczepanik 1958; Riedel 1974).

The small domestic market in the 1950s and 1960s meant that manufactured outputs originating from foreign direct investment were geared to the export market, and capital, technology know-how, design, and materials requirements were all imported. Hong Kong was granted free-trade status by major importers. By the 1960s, the intensity of export was high, and the range of export items was enlarged to include clothing, wigs, toys, machinery, personal accessories and jewelry, and a miscellaneous range of consumer products (Lin and Mok 1980). In the 1960s and 1970s, miscellaneous manufactured articles (SITC-8) occupied the largest share of domestic exports, followed by machinery and transport equipment (SITC-7). Although in nominal terms it was still increasing, the export group that experienced a large drop in its percentage share was manufactured goods, classified under materials (SITC-6). Since the mid-1980s, the major items of domestic export have been textiles and clothing, electronic products, watches and clocks, plastic products, jewelry, including goldsmiths' and silversmiths' wares, manufactured metals, printed matter, toys and dolls, and electrical appliances. These categories accounted for 79% of total domestic exports in 1991. In 1998, the top five domestic export items were articles of apparel and clothing accessories (39.7%); electrical machinery, apparatus and appliances, and electrical parts thereof (14.2%); textile yarns, fabrics, assembled articles, and related products (5.7%); watches and clocks (4.7%); and office machines and automatic data processing machines (4.7%).

Developed countries have been the major recipients of Hong Kong's manufactured exports. Their percentage share in exports received increased from 65.8% in 1960 to 84% in 1972, then leveled off to 81.9% in 1975. Since the late 1970s, Japan and other Asian economies have increasingly become Hong Kong's major trading partners. By 1990, mainland China was Hong Kong's largest trade partner. In 1993, for example, mainland China absorbed 28.4% of domestic export, 37.5% of imports, and 33.4% of re-exports. In 1998, the destinations of Hong Kong's domestic exports were mainland China

(29.8%), the US (29.1%), the UK (5.3%), Germany (5.2%), Taiwan (3.5%), Japan (3.4%), and Singapore (2.7%). Hong Kong's top ten trading partners in 1998 were mainland China (37%), the US (15%), Japan (9%), Taiwan (5%), South Korea, Germany, Singapore, and the UK (3% each), and France and Malaysia (2% each).

Hong Kong's growth in manufactured exports has been consistent with the Heckscher–Olin trade theory, which argues that a labor-abundant economy will specialize in the export of labor-intensive manufactures (Lin and Mok 1980: 21). As Table 5.6 shows, although domestic exports have experienced positive growth in most years, domestic trade has showed signs of declining, probably as a result of the decrease in the manufacturing sector since the late 1980s. The growth of re-exports has remained strong, but Hong Kong has had a merchandise trade deficit for a number of years. Large surpluses in the net export of services, however, have reduced its trade deficit considerably. Nonetheless, Hong Kong's total exports have exceeded its GDP since 1988.

Trade protectionism on Hong Kong's export of textiles began in 1959 with the Lancashire Pact, which was imposed by the UK. There were three further extensions of the Lancashire Pact, which lasted until 1974. Bilateral trade agreements between Hong Kong and the US and different individual European Economic Community (EEC)countries were negotiated under the three phases of the Multi-Fiber Agreement (MFA) between 1974 and 1986. These were concluded on "mutually acceptable terms" and annual growth rates were imposed. The 1985–87 Textile and Apparel Trade Enforcement Act (popularly known as the Jenkins Bill), followed by the Hong Kong–US and Hong Kong–EEC Textile Agreements between 1986 and 1991, further restricted Hong Kong's textile and clothing exports (Li 1991: 200–1). However, on the brighter side, the various quotas and their restricted growth rates have protected and guaranteed Hong Kong's exports and allowed it to avoid competition from latecomers. Furthermore, Hong Kong's exports of textiles and clothing continued to grow despite the imposition of trade protection policies. Between 1980 and 1990, its average utilization of export quota to the US was 91.9%, to the UK was 86.1%, and to Germany was 73.8% (Li 1991: 203). This suggests that the quota system was a realistic reflection of Hong Kong's export ability.

The Country of Origin Rule imposed by the US in 1983 meant that the entire package of export goods must be produced locally. Rising labor costs in the 1980s effectively pushed manufacturing investors to southern China, although many responded by going hi-tech in their production by importing new machinery from Japan and Germany. In the case of the quota system, there was another aspect of increases in costs that reduced Hong Kong's competitiveness. The allocation of quota on textile and clothing exports was proportional to the share of total exports, so larger exporters could secure quota easily. Unfortunately, this led to the development of a speculative quota market among the manufacturers, which resulted in price distortions. In

Table 5.6 Hong Kong's trade (HK$ billion at current market prices)

Year	*Domestic exports*		*Re-exports*		*Net export of services*	*Trade balance*	*Total export/ GDP*
1961	2.9	(–)	1.0	(–)	1.5	–2.0	52.9
1962	3.3	(12.9)	1.2	(8.0)	1.5	–2.3	50.7
1963	3.8	(15.5)	1.2	(8.4)	1.7	–2.4	48.0
1964	4.4	(15.6)	1.4	(16.9)	1.9	–2.8	48.8
1965	5.0	(13.5)	1.5	(10.8)	2.0	–2.4	46.9
1966	5.7	(14.0)	1.8	(22.0)	2.0	–2.5	53.1
1967	6.7	(16.9)	2.1	(13.5)	2.4	–1.7	56.9
1968	8.4	(25.8)	2.1	(2.9)	2.8	–1.9	64.2
1969	10.5	(24.8)	2.7	(25.1)	3.4	–1.7	68.2
1970	12.3	(17.4)	2.9	8.0)	4.2	–2.4	66.2
1971	13.8	(11.4)	3.4	(18.0)	4.2	–3.1	64.7
1972	15.2	(10.9)	4.2	(21.7)	4.9	–2.4	60.7
1973	19.4	(27.7)	6.5	(57.1)	5.6	–3.1	63.3
1974	22.9	(17.6)	7.1	(9.2)	6.3	–4.1	64.0
1975	22.9	(–2.2)	7.0	(–2.1)	6.4	–3.7	60.6
1976	32.6	(42.7)	8.9	(28.0)	8.6	–2.0	66.2
1977	35.0	(7.3)	9.8	(10.1)	8.6	–4.0	61.6
1978	40.7	(16.3)	13.2	(34.3)	10.0	–9.4	63.3
1979	55.9	(37.3)	20.0	(51.7)	11.5	–10.4	68.0
1980	68.2	(21.9)	30.1	(50.2)	12.2	–13.6	69.3
1981	80.4	(18.0)	41.7	(38.8)	13.5	–17.1	71.5
1982	83.0	(3.2)	44.4	(6.3)	16.2	–16.3	66.2
1983	104.4	(25.7)	56.3	(26.9)	18.1	–15.9	75.6
1984	137.9	(32.1)	83.5	(48.3)	22.4	–3.4	86.3
1985	129.8	(–5.8)	105.3	(26.1)	23.1	2.5	86.6
1986	154.0	(18.6)	122.5	(16.4)	27.5	–1.0	88.5
1987	195.3	(26.8)	182.8	(49.2)	39.9	–2.0	98.3
1988	217.7	(11.5)	275.4	(50.7)	48.2	–8.1	108.4
1989	224.1	(3.0)	346.4	(25.8)	55.0	7.7	108.9
1990	225.9	(0.8)	414.0	(19.5)	54.6	–2.7	109.8
1991	231.0	(2.3)	534.8	(29.2)	60.2	–13.1	114.6
1992	234.1	(1.3)	690.8	(29.2)	75.1	–30.3	118.7
1993	223.0	(–4.7)	823.2	(19.2)	92.6	–26.3	116.6
1994	222.1	(–0.4)	947.9	(15.1)	96.6	–80.7	115.7
1995	231.7	(4.3)	1,112.5	(17.4)	104.8	–147.0	124.8
1996	212.2	(–8.4)	1,185.8	(6.6)	125.3	–137.7	117.2
1997	211.4	(–0.3)	1,244.5	(5.0)	117.9	–159.1	109.7
1998	188.5	(–10.9)	1,159.1	(–6.9)	90.9	–81.4	107.0

Source: Census and Statistics Department, Government of the Hong Kong Special Administrative Region.

Notes
Figures in brackets are percentage changes over the preceding year. Total export = domestic export + re–export. Trade balance = total exports – imports of goods. Net export of services = export of services – import of services.

combination with increasing labor costs, this increased the price of exports from Hong Kong.

Increasing protectionism in the 1970s, coupled with world economic recession in 1974–75, attracted government attention. Economic and trade diversification was the theme of the 1979 government's *Report of the Advisory Committee on Diversification*. The 1979 report examined the Hong Kong economy in detail and made a total of forty-seven recommendations on its economic relationship with mainland China; land, financial, and related activities; education and training; industrial development; trade and industrial investment promotion; external commercial relations; and miscellaneous issues. Many of these recommendations served as guidelines to industries and businesses. However, the report was outdated soon after its publication, as economic reform in China in 1978 provided Hong Kong with new economic and trade opportunities and new comparative advantages.

Since the late 1970s, Hong Kong has gained a new area of comparative advantage. In additional to commercial banking and stock market activities, the tertiary sector has grown rapidly. First, the re-export trade was revitalized as a result of the open-door economic reform policy in mainland China (Li 1987a). With the exception of 1982, as Table 5.6 shows, re-exports grew at an extraordinary rate – close to 50% in 1979, 1980, 1984, 1987, and 1988 – and their growth remained at a double-digit level until 1996. Other than re-exports, there is also trans-shipment trade taking place in Hong Kong waters. Trans-shipment trade refers to "cargo that is consigned on a through bill of landing from a place outside Hong Kong to another place outside Hong Kong but is or is not to be removed from one vessel (ship, vehicle, train or aircraft) and either returned to the same vessel or transferred to another vessel within Hong Kong waters" (Chen and Kan 1997: 122–3). Trans-shipment trade mainly deals with trade between mainland China and Taiwan. Hong Kong's re-exports, however, face two types of challenge. One is the growing tertiary sector in mainland China's coastal region. The lower level of wages there will definitely make China's port services very competitive with Hong Kong. Another relates to China's accession to the World Trade Organization, which has been under negotiation since 1986 (Tait and Li 1997). Upon accession, mainland China could conduct direct trade to all countries, and the need for the Hong Kong's re-export service will decline.

Development in the tertiary sector has been rapid, and employment has shifted from manufacturing (9.8% in 1997) to services (79.3% in 1997). Support has been given to this sector at the institutional level. The Business and Services Promotion Unit was set up in the Financial Secretary's Office in May 1997, with the task of maintaining Hong Kong as the best place in the world for business, and a major service center in the region through the Helping Business and Service Promotion Programs. Another institution that assists the service sector is the Hong Kong Coalition of Service Industries (HKCSI), which was established in 1990 within the Hong Kong General Chamber of Commerce. The HKCSI represents more than fifty service

industries, including infrastructure industries, such as telecommunications and transport. There are five major categories of service industries. Professional services include legal, accounting, design, management consultancy, architecture, building and construction, and engineering and surveying. Communications and media services comprise telecommunications, convention and exhibition, film, advertising and market research, information technology services, and publishing. Financial services include banking, securities, insurance, venture capital, and debt market and fund management. Trade-related services consist of import and export trade, air and sea transport, freight forwarding, express cargo, industrial testing and inspection, and arbitration and mediation. Commercial services incorporate wholesale and retail, restaurants, hotels, real estate, storage, and tourism.

Hong Kong's dynamic comparative advantage began with the expansion in labor-intensive manufacturing industries. Diversification in manufactured products widened Hong Kong's export base. Rising trade and further income expansion led to changes in the commercial and financial sectors, followed by the gradual expansion in communication-related and professional services. Economic reform in the People's Republic of China moved Hong Kong toward new economic horizons. Migration of light industries to southern China, in turn, encouraged the expansion of the tertiary sector in Hong Kong.

Despite the prominence and maturity of the service sector, foreign direct investment in the manufacturing sector has continued to enter Hong Kong, as Table 5.7 shows. Hong Kong's inward foreign direct investment can be in the form of entirely foreign ownership, joint ventures without local interest, and joint ventures with local interest. In nominal terms, the amount of foreign direct investment has increased considerably, but the average annual increase has fallen below 10% since the mid-1990s. The number of foreign companies has also declined. The four largest foreign investors in Hong Kong are Japan, the US, mainland China, and the UK. Electronics and electrical products are the main recipients of foreign direct investment. Textiles and clothing, however, have given way to other industries, such as chemical products, printing and publishing, and food and beverage. Fixed assets are the major item of foreign investment. Hong Kong Industry Department surveys show that there is a significant number of companies receiving various forms of advanced technology transfer from external investors.

Foreign investment in Hong Kong's non-manufacturing sector is, however, greater than that in the manufacturing sector. Stocks of inward direct investments in the non-manufacturing sector are classified under holding companies; construction; wholesale; retail and import/export; restaurants and hotels; transport and related services; communication; banks and deposit-taking companies; other financial institutions; insurance; real estate; and other business services. Table 5.8 shows the foreign inward investment in Hong Kong's non-manufacturing sector in the period 1994–97. The UK is Hong Kong's largest foreign investor in the non-manufacturing sector, followed by mainland China, Japan, and the US. Banks and deposit-taking

Table 5.7 Inward foreign direct investment to Hong Kong (US$ million)

Year	*Amount**	*Number of companies*	*Major sources*	*Industry recipients*
1985	2,006.1 [6]	577	US(36), Ja(21), Ch(18), UK(7), Ne(3)	El(32), NM(12), TC(9), PP(7), EP(6)
1989	3,841.6 [14]	589	US(31), Ja(29), Ch(11), UK(7), Ne(4)	El(29), EP(12), TC(9), Cm(8), PP(8)
1990	3996.5 [4]	545	Ja(32), US(31), Ch(11), UK(7), Ne(4)	El(30), EP(11), TC(11), Cm(8), WC(6)
1991	4,444.3 [11]	536	Ja(32), US(28), Ch(11), Au(6), UK(6)), Cm(5)	El(32), EP(13), TC(9), Tob(5), Cm(5)
1992	4,818.7 [8]	472	Ja(33), US(27), Ch(11), UK(5), Ne(5)	El(31), EP(11), TC(11), FB(7), Cm(6)
1993	5,284.1 [10]	433	Ja(34), US(28), Ch(11), UK(4), Ne(4)	El(30), TC(10), EP(9), Cm(9), FB(7)
1994	5,118.5 [8]	424	Ja(34), US(29), Ch(9), UK(7), Ne(4)	El(32), EP(10), FB(8), TC(8), Cm(6)
1995	5,858.3 [14]	430	Ja(39), US(28), Ch(6), UK(5), Ne(4)	El(33), EP(9), TC(9), Cm(7), FB(5)
1996	6,197.4 [6]	403	Ja(38), US(27), Ch(5), UK(5), Ne(5)	El(34), EP(11), Cm(8), FB(6), TC(6)
1997	6,538.1 [5]	364	Ja(41), US(21), Ch(7), UK(6), Ne(6)	El(40), EP(10), FB(8), PP(6), Cm(5)

Sources: *Survey of External Investment in Hong Kong's Manufacturing Industries*, Industry Department, Hong Kong Special Administrative Region, People's Republic of China, various issues.

Notes

*Figures before 1994 were total foreign direct investment at original cost, whereas figures since 1994 were year-end total value of the stock of inward direct investment measured at historical cost. The new measurement refers to the value of the stock of fixed assets at historical cost, plus working capital, and minus long-term loans from third parties including banks at the end of the reporting period. The old measurement refers to the net assets attributable to inward direct investment and does not include the deduction of long-term loans. An exchange rate of US$1=HK$7.74 was used to convert figures. Figures in square brackets denote the percentage growth over the preceding year. Figures in brackets denote the percentage share of total. US, USA; Ja, Japan; Ch, Mainland China; UK, United Kingdom; Ne, Netherlands; Au, Australia. El, electronics; EP, electrical products; TC, textile and clothing; Tob, tobacco; Cm, chemical products; FB, food and beverage; NM, non-metallic mineral products; WC, watches and clocks; PP, printing and publishing.

companies are the largest recipient sector, followed by holding companies, wholesale, retail and import/export, other financial institutions, and communications.

Typical examples of inward investment in the non-manufacturing sector are the branches and subsidiaries of multinational corporations' operating in Hong Kong. The stock figures at historical cost are usually larger than the

Table 5.8 Stocks of inward direct investment in Hong Kong's non-manufacturing sector (US$ billion)

Year	*Amount**	*Major sources*	*Industry recipients*
1994	59.4	UK(31), Ch(20), Ja(16), US(12)	BK(40), Hold(22), WRIE(15), OFI(6), Ins(5)
1995	63.0 [6]	UK(29), Ch(21), Ja(14), US(12)	BK(41), Hold(23), WRIE(15), OFI(6), Ins(5)
1996	72.5 [15]	UK(30), Ch(20), US(17), Ja(14)	BK(39), Hold(23), WRIE(17), Com(5), OFI(5)
1997	88.1 [18]	UK(27), Ch(20), US(17), Ja(11)	BK(33), Hold(27), WRIE(19), OFI(6), Com(5)

Source: *External Investments in Hong Kong's Non-Manufacturing Sectors 1995, 1996, 1997*, Census and Statistics Department, Hong Kong Special Administration Region, People's Republic of China.

Notes
*Measured in historical cost at an exchange rate of US$1=HK$7.74. Figures in square brackets denote the percentage change over the preceding year. Figures in brackets denote the percentage share of total. US, USA; UK, United Kingdom; Ch, Mainland China; Ja, Japan. BK, banks and deposit-taking companies; Hold, holding companies; WRIE, wholesale, retail, import/export; OFI, other financial institutions; Com, communication.

net book value but smaller than the value of net asset attributable to inward investment. In 1997, these three values were US$88.1 billion, US$77.5 billion and US$164.4 billion respectively. The service industries have become Hong Kong's largest sector. Its share of GDP has increased from 69.2% in 1986 to 84.4% in 1996, while the manufacturing sector has declined from 22.6% to 7.2% over the same period. The largest service industries are wholesale, the retail and import/export trades, and restaurants and hotels (together 25.4% of GDP in 1996), followed by finance, insurance, real estate, and business services (24.9%). Community and social and personal services (17.9%) and transport, storage, and communications (10.2%) are the third and fourth largest respectively.

The Hong Kong economy has come a long way and has gone from strength to strength over the decades, as reflected in the dynamic aspect of comparative advantage. The open and free market nature of the economy allows maximum utilization of existing comparative advantage and, at the same time, promotion of new areas of comparative advantage. Its changing and dynamic pattern of comparative advantage has enabled Hong Kong to float on top of the world economy. Table 5.9 summarizes the position of the Hong Kong economy in relation to the region and the rest of the world.

Singapore: trade and foreign investment dependent

The developments in Singapore's trade are similar in many ways to those of Hong Kong. After its independence in 1965, the Singapore authority developed

Table 5.9 Position of Hong Kong in the world economy

General

- The world's freest economy
- The world's most service-oriented economy
- Asia's highest per capital income (in terms of domestic purchasing power)
- The world's second most competitive economy
- The world's second highest per capita holding of foreign exchange
- Asia's second least corrupted economy
- The world's fourth largest source of foreign direct investment
- The world's ninth largest trading economy (fifth if the EU is regarded as one entity)
- The world's tenth largest exporter of services

Merchandise trade

- The world's largest exporter of clocks, toys and games, calculators, radios, electric hairdressing/hand-drying apparatus, imitation jewelry, travel goods and handbags, umbrellas and sunshades, artificial flowers, fur clothing, textiles, telephone sets, electric food grinders, mixers and juicers
- The world's second largest exporter of watches, footwear, and clothing
- The world's fourth largest exporter of precious jewelry

Finance

- Asia's highest concentration of fund managers
- Asia's largest number of authorized insurance companies
- Asia's largest loan syndication center and venture capital center
- The world's fourth largest gold bullion market
- The world's seventh largest foreign exchange market
- The world's eighth largest banking center for external financial transactions
- The world's eleventh largest stockmarket

Communications and media

- The world's first major city to have fully digitized telephone network
- Asia's busiest international telephone traffi.
- Asia's highest rate of telephone penetration
- Asia's highest connection to optical fiber cables
- The world's largest film producer (in terms of per capita production)
- The world's second highest usage rate of facsimile
- The world's fourth largest printing center

Transportation

- The world's busiest airport in terms of international cargoes.
- The world's second busiest container port.
- The world's third busiest speedpost traffic.
- The world's fifth busiest airport in terms of international passengers.

Source: Website of Hong Kong Trade Development Council, April 23, 1999.

an export-led strategy in 1967. Singapore's entrepôt trade served mainly ASEAN countries, especially Malaysia and Indonesia (Huff 1994). The Singapore authority imposes no taxes on exports. The 1967 Economic Expansion Incentive Act provided concessions to foreign businesses engaged in the export trade. There is no price distortion on internationally tradable commodities; manufactured goods form the largest component of exports, and a high degree of foreign participation in trade. Singapore experiences a constant trade deficit and a large total export–GDP ratio, which consistently exceeds unity. Singapore exports and imports a lot of similar items; a large portion of its export is petroleum. Prior to its graduation from the GSP in 1989, Singapore also benefited from the preferential treatment of the developed countries.

The Singapore government basically adopts a "market-friendly" attitude toward foreign direct investment, and has played a supportive role in the provision of physical infrastructure, fiscal incentives, and human resources development (Chia 1985: 272; Lloyd and Sandiland 1986: 182; Ngiam 1994: 471). As Table 5.10 shows, non-oil exports have increased rapidly since the mid-1980s. Re-exports, however, have caught up, and their value is greater than oil exports but less than non-oil exports. Over the years, the annual growth rates of different export groups have been uneven. The growth rates of oil exports have been low and negative growth rates have been experienced more often. Trade deficits have been either close to or over S$10 billion. The open nature of the Singapore economy is confirmed by the high total export–GDP ratio.

A large portion of industrial output is exported. Since the 1970s, exports have accounted for about 60–70% of domestic manufacturing. The average direct export to manufactured output ratio was 63.6 between 1984 and 1994. Out of a total of thirty manufacturing output items, electronic products and components alone accounted for 49% of total manufactured output in 1994, followed by petroleum refineries and petroleum products at 11% (*Yearbook of Statistics, Singapore, 1994,* Ministry of Trade and Industry 1994: 108–9). The products accounting for most of Singapore's exports have remained the same since the 1970s, though the increase in value-added has been greater for some items, such as electronic products and components, than for other manufactured items. For example, between 1984 and 1994, the value added to exports of electronic products and components increased by 361.8%, while that of petroleum refineries and petroleum products increased by 88%. The US, Malaysia, Hong Kong, and Japan are Singapore's largest export partners. Their 1997 percentage shares of Singapore's exports were 18%, 17%, 10%, and 7% respectively. Europe as a whole absorbed only 15% of Singapore's exports in 1997 (Fong and Lim 1985: 87).

Re-exports are closely associated with trade in services. The commerce sector includes wholesale, retail, and hotels and catering. Its value-added increased by 53.3% between 1989 and 1993. The service sector comprises transport, storage and communication services, financial and insurance

Table 5.10 Singapore's external trade (S$ billion)

Year	Domestic exports: Non-oil		Domestic exports: Oil		Re-exports		Trade balance	Total exports/ GDP
1960	*0.2				3.3		–0.6	1.64
1970	*1.8				2.9		–2.8	0.89
1975	*7.5				5.2		–6.5	0.95
1976	*9.4	(25.3)			6.9	(31.7)	–6.1	1.12
1977	*11.7	(24.5)			8.4	(22.9)	–5.4	1.26
1978	*13.2	(12.8)			9.8	(15.7)	–6.6	1.68
1979	*18.2	(37.9)			12.7	(30.5)	–7.4	1.54
1980	*25.8	(41.8)			15.6	(22.8)	–9.9	1.15
1981	*29.5	(14.3)			14.8	(–5.2)	–14.0	1.27
1982	*29.2	(–1.0)			15.3	(3.2)	–15.8	1.30
1983	*29.2	(0)			16.9	(10.7)	–13.3	1.29
1984	17.3		15.7		18.3	(7.9)	–9.8	1.23
1985	16.7	(–3.3)	15.8	(0.6)	17.6	(–3.7)	–7.6	1.39
1986	20.1	(0.2)	12.0	(–24.4)	16.9	(–3.9)	–6.6	1.64
1987	27.3	(36.0)	11.7	(–1.9)	21.2	(25.2)	–8.1	1.65
1988	38.2	(39.9)	11.3	(–3.5)	29.5	(39.2)	–9.1	1.66
1989	42.0	(10.0)	13.2	(16.6)	31.9	(8.3)	–9.7	1.66
1990	45.6	(8.5)	17.1	(29.6)	32.5	(1.8)	–14.6	1.59
1991	48.8	(7.0)	17.2	(0.4)	35.8	(10.5)	–12.3	1.67
1992	52.9	(8.4)	13.4	(–22.0)	37.0	(3.2)	–14.2	1.87
1993	60.8	(14.9)	14.6	(8.6)	44.1	(19.1)	–18.1	1.38
1994	74.5	(22.5)	14.0	(–3.9)	58.8	(33.3)	–9.1	1.33
1995	84.8	(13.7)	13.7	(–1.9)	69.0	(17.4)	–8.8	1.39
1996	87.0	(2.7)	16.6	(20.6)	72.7	(5.2)	–8.9	1.35
1997	91.6	(5.3)	15.9	(–4.2)	78.1	(7.4)	–11.0	1.27
1998	92.4	(0.9)	13.5	(–15.1)	77.8	(–0.3)	13.9	1.35
1999	101.2	(9.5)	15.1	(11.9)	77.9	(0.2)	6.2	1.29

Source: *Yearbook of Statistics, Singapore*, and *Economic Survey of Singapore*, various issues.

Notes
*Figures represent the sum of non-oil and oil exports. Figures in parenthesis are percentage change over previous years.

services, real estate and business services, community, social and personal services, and non-profit organizations. Between 1989 and 1993, the average value-added in the service sector increased by 62.2%. Community, social and personal services saw the highest increase, at 86.7%, followed by real estate and business services (84.3%), non-profit organizations (56.5%), financial and insurance services (44%, excluding establishments within the purview of the monetary authority of Singapore), and transport, storage and communication services (39.5%).

A high percentage of Singapore's exports are dependent on foreign direct investment. There are three features that characterize its official policy toward this type of investment: the presence of liberal incentives, the absence

of restrictions, and a pattern of consistency (Chia 1985: 281). The Economic Development Board acts as an efficient investment center and promotes foreign investment in manufacturing through tax incentives. These include various kinds of profit tax exemptions, tax deductions on export promotion, R&D, accelerated depreciation allowances, tax concessions on export income, and so on (Lim 1988: 258).

Tables 5.11 and 5.12 summarize Singapore's two-way foreign direct investment. Both portfolio and direct inward investment increased significantly between the 1980s and 1990s, achieving double-digit annual growth rates in most years. Recipients of foreign direct investment used to be concentrated in manufacturing, but since the mid-1980s, financial and business services have taken the lion's share of direct foreign investment (from 29% in 1982 to 46% in 1992). The US, the UK, and Japan are consistently the largest three foreign investors in Singapore. For example, between 1982 and 1989, Japan moved from the fourth to the largest foreign investor in Singapore.

Singapore's outward portfolio investment has increased at a slower pace than direct investment. The two years of 1989 and 1990 saw a particularly rapid increase in direct investment. Financial services is the major sector in

Table 5.11 Singapore's inward foreign investment (S$ billion)

	Portfolio	*Direct investment*		
Year	*and other*	*Amount*	*By industry*	*By economy*
1982			M(49),F(29),C(16)	US(24),UK(23),HK(12),Ja(11)
1983	2.9 [0.6]	19.3 [10.0]	M(51),F(30),C(16)	US(26),UK(20), Ja(11),HK(11)
1984	3.2 [10.6]	21.6 [12.3]	M(50),F(33),C(14)	US(24),UK(18), Ja(13),HK(10)
1985	3.1 [–0.3]	22.4 [3.3]	M(50),F(35),C(13)	US(27),UK(16), Ja(14),HK(8)
1986	3.9 [23.3]	24.7 [10.5]	M(40),F(38),C(11)	US(28), Ja(15),UK(15),Sw(6)
1987	4.6 [18.3]	29.9 [21.2]	M(49),F(40),C(10)	US(28), Ja(15),UK(12),HK(6)
1988	5.5 [19.3]	35.8 [19.5]	M(44),F(42),C(11)	US(21), Ja(18),UK(11),Au(9)
1989	6.0 [8.9]	41.1 [14.7]	M(43),F(41),C(11)	Ja(21),US(20),Ge(9),Au(7)
1990	8.1 [35.8]	49.8 [21.4]	M(40),F(43),C(13)	Ja(21),US(17),UK(9),Ne(8)
1991	8.3 [3.0]	54.6 [9.5]	M(38),F(42),C(16)	Ja(21),US(17),UK(11),Ne(8)
1992	8.7 [4.1]	56.7 [3.8]	M(35),F(46),C(14)	Ja(23),US(17),UK(11),Ne(7)
1993	10.5 [20.7]	62.8 [10.7]	M(36),F(46),C(15)	Ja(21),US(17),UK(10),Ne(6)
1994	12.1 [16.0]	74.6 [18.9]	M(36),F(45),C(15)	Ja(21),US(16),UK(9),Sw(8)
1995	14.9 [22.5]	84.3 [13.0]	M(36),F(45),C(14)	Ja(20),US(17),Sw(8),UK(8)
1996	21.6 [–4.0]	94.0 [11.5]	M(35),F(46),C(14)	Ja(20),US(17),Sw(9),UK(7)
1997	26.8 [24.1]	112.1 [19.3]	M(35),F(48),C(13)	US(20), Ja(20),Sw(7),UK(6)

Source: *Yearbook of Statistics, Singapore*, various years.

Notes
Figures in square brackets are percentage change over previous years. Figures in parenthesis are percentage share of total. M, manufacturing; F, financial/business services; C, commerce. US, United States. UK, United Kingdom; Ja, Japan; HK, Hong Kong; Sw, Switzerland; Au, Australia; Ge, Germany; Ne, Netherlands.

Table 5.12 Singapore's outward investment (S$ billion)

Year	*Portfolio investment*	*Direct investment*			
		Amount		*By industry*	*By economy*
1983					Ma(52),HK(16),Au(5),US(2)
1984	1.4 [–2.7]	2.4	[7.4]		Ma(50),HK(16),Au(6),Io(2)
1985	1.8 [34.5]	2.3	[–5.9]		Ma(43),HK(20),Au(8),US(3)
1986	1.9 [6.2]	2.6	[15.1]		Ma(38),HK(19),Au(7),Ch(4)
1987	2.0 [1.0]	3.0	[14.0]		Ma(34),HK(18),Au(7),Ch(3)
1988	2.3 [14.8]	3.0	[1.0]		Ma(34),HK(18),Au(6), Ne(4)
1989	3.3 [47.2]	5.3	[76.7]		Ma(27),HK(16),Au(6),US(6)
1990	1.0 [21.6]	13.6	[157.6]	F(54),M(18),C(11)	Ma(20),HK(17),US(5),Ne(5)
1991	4.4 [9.3]	15.2	[11.5]	F(57),M(19),C(11)	Ma(21),HK(16),US(9),Au(4)
1992	5.0 [14.6]	17.7	[16.8]	F(55),M(21),C(11)	Ma(22),HK(17),US(9),Au(4)
1993	5.6 [10.5]	21.2	[19.7]	F(55),M(22),C(10)	Ma(22),HK(19),US(8),Io(2)
1994	7.3 [27.0]	29.8	[34.0]	F(52),M(24),C(9)	Ma(22),HK(17),Io(7),US(6)
1995	10.9 [59.0]	39.1	[24.0]	F(52),M(26),C(9)	Ma(20),HK(14),Io(9),Ch(7)
1996	15.6 [43.1]	42.2	[7.9]	F(57),M(21),C(9)	Ma(16),Ch(12),HK(11),UK(9)
1997	13.7 [–12.2]	53.5	[26.8]	F(60),M(19),C(7)	Ch(13),Ma(12),UK(11),HK(11)

Source: *Yearbook of Statistics, Singapore*, various years.

Notes
Figures in square brackets are percentage change over previous years. Figures in parenthesis are percentage share of total. F, Financial; M, Manufacturing; C, Commerce. Ma, Malaysia; HK, Hong Kong; Au, Australia; US, United States; Io, Indonesia; Ch, China; Ne, Netherlands.

Singapore's outward investment and Malaysia has been the largest recipient, though its percentage share has declined since the late 1980s, suggesting that Singapore's outward investment has become more diversified. Hong Kong is the second largest recipient of investment from Singapore, and the US has risen to become the third since the early 1990s.

Among the four NIEs, Singapore is the most heavily dependent on foreign direct investment since it prefers foreign direct investment as the means of securing foreign resources to promote domestic economic development, while South Korea, for example, prefers foreign borrowing. Emphasis on cost competitiveness and the liberal use of tax incentives are Singapore's major attractions to foreign direct investment. In the service sector, the Singapore authority is actively promoting Singapore as a financial and service center, a regional headquarter for multinationals, and a "total business" center in which multidimensional business services are provided. The benefits of foreign direct investment include its contribution to the quantity and quality of economic resources; the way in which it acts as a supplement to domestic resources; its contribution to industrialization; and its positive impact on the balance of payment. The two criticisms of heavy dependence on foreign direct investment are the "crowding out" of domestic investment, and the lack of development of domestic entrepreneurship (Lim 1988: 263–8).

Singapore is conscious of economic and cost competitiveness. There are

five measures of export competitiveness. They are the real effective exchange rate (REER), the export price index (EPI), the unit labor cost (ULC), the unit business cost (UBC) and the relative unit labor cost (RULC) (Ngiam 1994). Empirical studies based on the period 1980–92 have shown that the rising unit labor and unit business costs accounted for the loss of export competitiveness in the early 1980s and contributed to the 1985 recession. Competitiveness, however, was recovered soon after the 1995 recession as deflation occurred. A new committee on Singapore's competitiveness, established in May 1997, has constructed strategies for the post-Asian financial crisis economy in Singapore in the next two to three decades. The Singapore authority has recognized that open competition occurs among domestic firms as well as with foreign firms. It is important that companies in Singapore remain competitive to ensure its economic survival and prosperity.

Singapore's competitiveness has gained global recognition. Out of a total of forty-nine economies, the Swiss-based International Institute for Management Development (IMD) has ranked Singapore second to the US on the world competitiveness scoreboard in both 2000 and 2001, while Hong Kong, Taiwan, and South Korea ranked at sixth, eighteenth, and twenty-eighth, respectively, in 2001. The scoreboard is based on 286 criteria grouped under economic performance (domestic economy, international trade, international investment, employment, and prices), government efficiency (public finance, fiscal policy, institutional framework, business framework, and education), business efficiency (productivity, labor market, financial markets, management practices, impact of globalization), and infrastructure (basic infrastructure, technological infrastructure, scientific infrastructure, health, and environment and value system). It was pointed out in the *World Competitiveness Yearbook 2001* (IMD International 2001) that many of the criteria used are structural factors that have evolved slowly over time. Technological infrastructure and government efficiency are typical examples. The yearbook also warned of the fragility of the information technology and telecommunications sector. Rapid development is not enough; sustainability is a more challenging issue for a number of economies, including the four East Asian economies.

Taiwan: a narrow externally oriented economy

Between the 1950s and the 1980s, as Table 5.13 shows, Taiwan's exports experienced a double-digit growth rate in most years but, since 1990, a single-digit growth rate has become common. Despite its substantial export growth rates, Taiwan has had a large trade surplus since the mid-1970s. Taiwan's export orientation is lower than that of both Hong Kong and Singapore, as exports reached their highest proportion of GDP at 52% in 1987. This figure was less than 10% in most years before 1960, but has been more than 40% in most years since the mid-1970s. This suggests that Taiwan achieves a balance

Table 5.13 Taiwan's foreign trade (US$ million)

Year	*Exports (% growth)*		*Balance*	*Export/GNP*
1952	119	(16.7)	–86	7.1
1953	128	(7.6)	–64	8.7
1954	93	(–27.3)	–118	5.7
1955	123	(32.3)	–78	6.4
1956	118	(–4.1)	–75	8.5
1957	148	(25.4)	–64	9.1
1958	156	(5.4)	–70	8.6
1959	157	(0.6)	–74	11.0
1960	164	(4.5)	–133	9.6
1961	195	(18.9)	–127	11.1
1962	218	(11.8)	–86	11.3
1963	332	(52.3)	–30	15.2
1964	433	(30.4)	5	17.0
1965	450	(3.9)	–105	16.0
1966	536	(19.1)	–86	17.0
1967	641	(19.9)	–165	17.6
1968	789	(23.1)	–114	18.6
1969	1,049	(33.0)	–163	21.3
1970	1,481	(41.2)	–43	26.2
1971	2,060	(39.1)	216	31.2
1972	2,988	(45.0)	475	37.8
1973	4,483	(50.0)	691	41.8
1974	5,639	(25.8)	–1,327	39.0
1975	5,309	(–5.9)	–643	34.4
1976	8,166	(53.8)	567	44.2
1977	9,361	(14.6)	0	43.2
1978	12,687	(35.5)	1,660	47.4
1979	16,103	(26.9)	1,329	48.5
1980	19,811	(23.0)	78	47.9
1981	22,611	(14.1)	1,412	47.2
1982	22,204	(–1.8)	3,316	45.7
1983	25,123	(13.1)	4,836	47.9
1984	30,456	(21.2)	8,497	50.9
1985	30,726	(0.9)	10,624	48.7
1986	39,862	(29.7)	15,680	51.6
1987	53,679	(34.7)	18,695	52.0
1988	60,667	(13.0)	10,994	48.4
1989	66,304	(9.3)	14,039	44.1
1990	67,214	(1.4)	12,498	41.8
1991	76,178	(13.3)	13,317	42.4
1992	81,470	(6.9)	9,463	37.7
1993	85,091	(4.4)	8,030	37.6
1994	93,049	(9.4)	7,700	38.1
1995	111,659	(20.0)	8,109	42.4
1996	115,942	(3.8)	13,572	42.6
1997	122,081	(5.3)	7,656	43.0
1998	110,582	(–9.4)	5,917	41.4
1999	121,591	(10.0)	10,901	42.2

Source: *Taiwan Statistical Data Book*, Council for Economic Planning and Development, Taipei, various years.

between its external trade and the domestic economy. Indeed, Taiwan's relatively large domestic market can serve as an economic cushion in difficult times.

In the initial post-war years, Taiwan received economic aid from the US. On top of the large balance of payment deficit that constrained government reserves, strict controls were imposed on imports before 1957. Strong financial inducement was given to import substitution, and an export tax, in the form of an unfavorable exchange rate, was imposed on such exports as sugar and rice. Initial success was recorded in a twofold increase in manufacturing production between 1952 and 1958. Industries such as textiles, plastics, artificial fibers, glass, cement, and plywood benefited from the import substitution strategy. There were, however, three major problems. Firstly, substitutes depended on imported raw materials. Secondly, inefficient and costly industries were maintained and kept away from foreign competition. And, thirdly, monopolistic agreements were made among profitable enterprises in order to secure a higher level of profit (Scott 1979; Haggard and Pang 1994).

Partly in an attempt to compete with Hong Kong's export-led strategy, the establishment of an export processing zone (EPZ) in 1965 marked the beginning of Taiwan's export-oriented growth strategy. By 1971, there were a total of three EPZs established in Kaohsiung, Nantze, and Taichung (Li 1995: 164). The EPZs combined the components of free trade, foreign investment, industrial development, employment, and relevant government administrative support. Major industries attracted to these EPZs included electronics, garments, plastic, leather, knitted and woven goods, metal, and handicrafts. The cumulative export and total investment of these three EPZs in September 1966 and August 1976 amounted to US$2,349 million and US$134.8 million respectively. Foreign capital came mainly from Japan, the US, Hong Kong, Europe, and expatriate Chinese (Scott 1979: 337). Between 1966 and 1974, Taiwan experienced a continuous, double-digit growth in exports which averaged 33%. The agriculture-dominated exports of the 1950s were overtaken by exports of industrial products, such as textiles and garments, and plywood in the 1960s, and electrical products and electronics in the 1970s. Exports of manufactured products soon diversified into metals and metal products, transportation equipment, and machinery in the 1980s (Lee and Wang 1986).

Growth in exports led to growth in output and income, a change in the economic structure and raised total factor productivity (Riedel 1992; Dollar and Sokoloff 1994; Liang 1994; Okuda 1994). For example, Kuo *et al.* (1981: 110) found that output expansion due to export expansion increased from 35% in 1961–66 to 67.7% in 1971–76. Since 1975, however, Taiwan's export growth has slowed down, probably as a result of the harsh environment of trade protectionism and its exclusion from the GSP in 1988, and the appreciation of the Taiwan currency. For example, growth in exports fell below 10% in 1989 and stabilized at a single-digit growth rate throughout most of the 1990s.

The Taiwan authority responded with a twofold strategy. One the one hand, various export promotion schemes were phased out and a policy of trade and financial liberalization was pursued. On the other hand, the Taiwan authority turned to the promotion of capital- and technology-intensive industries. The Hsinchu Scientific Park, for example, was subsequently established in 1980, and such capital- and technology-intensive industries as electronics, machinery, and automobile parts were classified as strategic industries in the eighth four-year development plan of 1982–86. This was clearly a move by the authority to change Taiwan's comparative advantage (Okuda 1994: 425–6). Another trend in the 1980s was the focus on Taiwan as a regional operation center and the globalization of corporate businesses. This included an intensive effort to establish close economic ties with other Asian economies and close links with the developed countries, and to pursue a resilient domestic economy. Infrastructure hardware and software was further promoted in the six-year national development plan launched in 1991 (Schive 1996: 570).

Taiwan maintains a steady relationship with its key trading partners. The US has remained Taiwan's largest export market since the 1960s. Its percentage share increased from 11.5% in 1960 to a peak of 48.8% in 1984, and then gradually fell to 24.2% in 1997. Japan used to be the largest recipient of Taiwan's exports in the 1950s and early 1960s, but its share has declined considerably from 59.5% in 1955 to less than 15% since 1970. Japan took 9.6% of Taiwan's export in 1997, occupying third place. Hong Kong used to account for less than 10% of Taiwan's exports before 1988, but this has risen to 23.5% in 1997, in second place to the US. Singapore, Germany, Thailand, the Netherlands, Malaysia, and the UK are also important export partners; each received more than 2% of Taiwan's exports in 1997.

Japan has been Taiwan's major import supplier since the 1960s, though its percentage share has declined from a peak of 44.9% in 1971 to a trough of 25.4% in 1997. The US is the second largest import supplier with a share of over 20% in most years since the 1970s and amounting to 20.3% in 1997. Germany and South Korea are Taiwan's third and fourth import partners, with shares of 4.7% and 4.4%, respectively, in 1997. Malaysia, Singapore, Australia, and Hong Kong are its remaining import partners.

Taiwan's trading partners are concentrated in fewer countries. In 1997, for example, its largest export (the US and Hong Kong) and import (Japan and the US) partners accounted for 47.7% and 45.7% of Taiwan's exports and imports respectively. Manufactured export items are equally concentrated in a few areas. Industrial products accounted for only 8.1% of total exports in 1952, increased to over 70% in 1970, and reached 97.9% in 1997. The four industrial exports each worth more than US$10,000 million in 1997 were electronics, information and communications products, textile products, and basic metals and articles. Their export concentration ratio in 1997 was 47.7% compared with 45.9% in 1990 (includes machinery exports). Electronics has replaced garments as the dominant industrial export. Other export items that have been replaced by capital- and technology-intensive items include

footwear, toys, games, and sports items. Exports of machinery, plastic, transportation equipment, electrical machinery products, chemicals, and precision instruments have expanded considerably. Like Singapore, Taiwan exports and imports similar items. The three largest industrial imports are electronic products, machinery, and basic metals and articles.

The change in industrial export items can also be seen from the labor, capital, and technology intensities. Between 1982 and 1997, labor intensity declined from 47.2% to 34.9%, while capital intensity increased from 26.9% to 30.3%, and technology intensity increased from 18.3% to 39.7%. The reverse took place in imports, with an increase in labor intensity and a decline in capital and technology intensity. Thus, Taiwan has successfully switched its comparative advantage to capital- and technology-intensive industrial exports.

In the case of foreign direct investments (shown in Table 5.14), Taiwan has experienced a rather unsteady pattern of growth, with an increase in one or two years followed by a decrease. In the 1950s, overseas Chinese investment accounted for the lion's share, but the situation has been reversed since the 1960s. By the 1980s, foreign investment accounted for over 80% of total, while overseas Chinese investment had declined to less than 10% in many years. Expatriate Chinese from Hong Kong and Japan are the major suppliers of overseas Chinese investment in Taiwan. In the entire post-war period of 1952–77, Japan and the US had invested the most in Taiwan with a total share of 28.4% and 26.5% respectively. Europe as a whole contributed 12.9% of the total.

Between 1952 and 1997, Taiwan's approved foreign investment amounted to US$28,988 million. Overseas Chinese investment amounted to 11.9%, while private foreign investment amounted to 88.1% of the total. Banking and insurance has been the largest item of overseas Chinese investment, accounting for 31.4% of the total in the 1952–97 period. Private foreign investments in the same period were more diversified between electronic and electrical products (27.4%), chemicals (13.1%), services (9.7%), basic metal and metal products (7.7%), and banking and insurance (occupying only 5.8 %). The economic effects that trade and foreign direct investment have on the domestic economy in terms of employment and technology transfer has been debated. Kojima (1977) draws the distinction between Japanese and US foreign investment and argues that Japanese firms concentrate more on such labor-intensive businesses as assembly, processing, and maintenance, while US firms are keen on earning rents from "non-competitive" inputs derived from trademarks, patents, market power, and so on. Taiwan's inward investment has contributed to employment and exports, though there has been variation between industries. Since 1976, for example, foreign investment has concentrated heavily on electronics, textiles, and chemicals. Japanese direct investment in Taiwan in the 1970s was concentrated on more homogeneous-product and price-competitive areas than US investment. This could be because Japanese investors started later than US investors in some areas. Nonetheless, both Japanese and US foreign investment has changed Taiwan's course of economic development (Ranis and Schive 1985: 116).

Table 5.14 Taiwan's foreign and overseas Chinese investment in approval

Year	*Total (US$1,000)*	*Overseas Chinese (% share)*	*Foreign (% share)*
1952	1,067	100.0	0.0
1953	3,695	44.8	55.2
1954	2,220	5.8	94.2
1955	4,599	3.8	96.2
1956	3,493	71.1	28.9
1957	1,622	97.0	3.0
1958	2,518	55.7	44.3
1959	965	85.0	15.0
1960	15,473	7.3	92.7
1961	14,304	58.3	41.7
1962	5,203	31.9	68.1
1963	18,050	42.7	57.3
1964	19,897	40.2	59.8
1965	41,610	15.5	84.5
1966	29,281	28.6	71.4
1967	57,006	32.2	67.8
1968	89,894	40.5	59.5
1969	109,437	25.1	74.9
1970	138,896	21.4	78.6
1971	162,956	23.2	76.8
1972	126,656	20.9	79.1
1973	248,854	22.2	77.8
1974	189,376	42.6	57.4
1975	118,175	40.0	60.0
1976	141,519	27.9	72.1
1977	163,909	41.9	58.1
1978	212,929	35.8	64.2
1979	328,835	44.8	55.2
1980	465,964	47.8	52.2
1981	395,757	10.0	90.0
1982	380,006	15.7	84.3
1983	404,468	7.2	92.8
1984	558,741	7.1	92.9
1985	702,460	5.9	94.1
1986	770,380	8.4	91.6
1987	1,418,796	13.8	86.2
1988	1,182,538	10.3	89.7
1989	2,418,299	7.3	92.7
1990	2,301,772	9.6	90.4
1991	1,778,419	12.3	87.7
1992	1,461,374	21.4	78.6
1993	1,213,476	10.2	89.8
1994	1,630,717	6.5	93.5
1995	2,925,340	5.8	94.2
1996	2,460,836	6.9	93.1
1997	4,266,629	9.1	90.9
1998	3,738,760	4.9	95.1
1999	4,231,400	3.1	96.9
2000	7,607,760	0.7	99.3

Source: *Taiwan Statistical Data Book*, Council for Economic Planning and Development, Taipei, various years.

Taiwan has changed from an importer of foreign investment to a supplier of capital to the global economy. Table 5.15 shows Taiwan's outward investment by area. North America absorbed 66.2% of Taiwan's outward investment in the period 1952–97, while Asian countries and Europe absorbed 28.3% and 2.0% respectively. Taiwan's growth in outward investment has been characterized by huge jumps in different years. There were large jumps in investment to North America in 1984, 1989, and 1996. The period 1987–89 saw large increases in investment in Asian countries, and investment was maintained at a high level throughout the 1990s. On an industry basis, the largest five industries in Taiwan's approved outward investment for the period 1952–97 were banking and insurance (31.6%), electronic and electrical products (15.8%), foreign trade (8.2%), chemicals (7.7%), and services (6.4%). Together, they accounted for 69.7% of the total. Other significant industries included basic metals and metal products, textiles, transportation, and non-metallic mineral products.

Taiwan has also been active in her outward investment to mainland China via third countries. A total of US$11,208 million direct investment to mainland China via third countries was approved for the period 1991–97, spread across nine major industries. These were electronic and electrical products (18.2%), food and beverage processing (9.9%), basic metals and metal products (9%), plastic products (8.9%), textiles (7.8%), non-metallic minerals (6.6%), chemicals (6.4%), precision instruments (6%), and transport equipment (4.9%). Cultural factors and economic complementarity have been the major motivation for Taiwan's outward investment (Schive 1996: 558). By the early 1990s, Taiwan was Vietnam's largest foreign investor, Malaysia's second, Indonesia's and the Philippines' third, and Thailand's fourth. Light industries received most of Taiwan's investment in South-East Asian countries, while its major investment in Hong Kong and Singapore has been in services.

Korea: emphasis on heavy industry and domestic capacity

Historically, Korea has had strong economic ties with Japan, as it was a Japanese colony for the period between 1910 and 1945, and its trade with the outside world was limited (Balassa 1985: 142). In the immediate post-Korean War period, import substitution accounted for 24% of industrial growth. At this time, the overvalued exchange rates, high tariffs, quantitative restrictions, and influx of foreign aid were unfavorable to exports. In 1960, for example, exports of goods and services accounted for only 3% of GDP. The Korean economy was largely characterized by an inward-looking economic strategy between 1953 and 1960. A series of exchange rate devaluations between 1961 and 1965 were the first steps of a transition to an export-oriented strategy. From a rate of 65 won per US dollar in 1961, the foreign exchange rate was devalued to 256 won per US dollar in May 1964, followed by the introduction of a unitary exchange-rate system in March 1965 (Song 1990: xiv–xvii). Quantitative controls on imports were gradually replaced by

Table 5.15 Taiwan's approved outward investment (US$1,000)

Year	*Total*	*North America*	*Asian countries*	*Europe*	*Others*
1959	100		100		
1965	971		971		
1969	122	100		22	
1970	527		527		
1971	1,212	100	1,112		
1972	4,124	465	2,322		1,337
1973	3,210	770	2,291	13	136
1974	7,371	2,504	4,867		
1975	2,419	854	1,565		
1976	4,460	2,210	2,250		
1977	13,789	1,650	12,139		
1978	5,196	3,303	1,680	97	116
1979	9,364	1,620	7,734	10	
1980	42,105	35,130	3,170	1,000	2,805
1981	10,764	1,795	6,738	2,231	
1982	11,632	2,500	9,132		
1983	10,563	2,858	6,561		1,144
1984	39,263	32,178	6,551		534
1985	41,334	35,830	4,206	891	407
1986	56,911	46,738	8,412	194	1,567
1987	102,751	80,250	21,302	199	1,000
1988	218,736	130,335	69,299	12,005	7,097
1989	930,968	624,431	296,372	2,333	7,850
1990	1,552,206	838,711	602,910	96,176	14,409
1991	1,656,030	658,958	929,819	60,289	6,964
1992	887,259	449,096	369,929	45,933	22,301
1993	1,660,935	740,110	663,514	255,913	1,398
1994	1,616,764	988,336	559,471	22,209	46,748
1995	1,356,878	787,105	467,743	59,868	42,162
1996	2,165,404	1,442,953	661,717	11,875	48,859
1997	2,893,826	1,915,948	818,743	58,508	100,627
1998	3,296,302	2,637,021	580,819	33,828	44,634
1999	3,269,013	2,267,710	836,378	60,981	103,943
2000	5,077,062				

Source: *Taiwan Statistical Data Book*, various years.

export incentives after General Park Chung-kee took over the government in May 1961. Export incentives included tariff exemptions on raw materials imports for export production, indirect tax exemption on intermediate imports, tax reductions on export earnings, a preferential export credit rate, import businesses linked to export performance, and tariff and tax exemption for domestic suppliers of intermediate goods (Mason *et al.* 1980: 127–9).

Along with the construction of the first five-year economic development plan in 1962–66, relevant institutions (for example, the Economic Planning Board in July 1961 and the Korea Trade Promotion Corporation in May 1962) were established with the aim of providing support for the development of

the export market. However, national security has been a major consideration in many of Korea's economic decisions. The threat of war and endangered survival urged Koreans and the Korean government to recognize that improvements in the living standard were needed. "Loyalty to the country through export" was a maxim popularized by President Park Chung-kee. The intention of the export-oriented strategy was to promote growth rather than equity, and expansion of manufacturing industry was given higher priority than resource or service industries. Export maximization, rather than profit maximization, became the primary objective of Korean businesses (Song 1990: 87, 101 and 203).

The favorable official policy environment on external trade can be summed up into four areas (Mukerjee 1986: 29): exchange rate devaluation, incentives, and financing of export production were geared to all export activities; favorable loans were given to firms selected to set up export businesses; periodic changes in incentives were intended to maintain the profitability of exports; and imported inputs were available to all exporters on an automatic and non-discretionary basis. Before the mid-1980s, rapid export expansion was further supported by the "golden opportunity of three lows" – low foreign exchange rates, low costs, and low taxes (Kim 1994: 539).

Another feature of Korea's export-oriented strategy, which is similar to the Japanese policy, is the role of large corporations (Mukerjee 1986: 30; Fields 1989: 1075; Suh 1996: 593). The so-called *chaebols* were relatively small in size in the 1960s, but they they grew rapidly in the 1970s and became giant corporations in the 1980s. These *chaebols* dominated the export market and pushed the economy into the development of heavy industries, such as shipbuilding and chemical industries. In 1975, five other general trading companies (GTCs), known as *chonghap sangsa* (translated from *sogo shosha*) were established. Their continuing operation depended on their performance and the satisfaction of various criteria set by the government. For example, their total exports had to cover seven products and ten markets, maintain a minimum of ten overseas branches and have a minimum capital of at least one billion won (about US$2 million) (Mukerjee 1986: 30).

Economic and industrial structural change followed trade expansion. Based mainly on exports of silk, tungsten, fish and fish products, and animal oils and fats in 1962, the composition of export items had changed to clothing, electronics products, ships, and textiles and fabrics by 1974. In the 1980s, textiles and garments, ships, electronics products, steel products, footwear, and automobiles were the key export items. Since the 1980s, growth in high-technology and capital goods industries has been reflected in exports, which, in turn, have generated various linkage effects (Mukerjee 1986: 25; Song 1990: 103; Yoo 1994: 562). The changing nature of Korea's industrial export (from agriculture to light industries, and then to heavy, capital-intensive, and high-technology industries) has followed a pattern of dynamic comparative advantage (Amsden 1989; Dollar and Sokoloff 1990). Compared with the other three East Asian economies, which are very open, two features

specific to Korea are its close ties with the US, and the fact that it has followed Japanese companies closely in its conduct of foreign trade (Petri 1988; 1990).

Table 5.16 shows Korea's trade performance since the 1980s. With the exception of 1998, when Korea experienced a small negative growth in exports probably as a result of the Asian financial crisis, Korea's exports have been increasing steadily, though its growth rates have been uneven. A double-digit growth rate was recorded consecutively in three years of the mid-1980s, resulting in a balance of trade surplus. Since 1990, Korea's imports have exceeded exports. Since Korea graduated from the GSP scheme in 1989 (KTPC 1991), its export growth rate has fallen to single digits. In contrast to Singapore, Korea has focused more on its domestic economy, its export to GDP ratio is much lower, and has been declining – from over 30% in the 1980s to below 30% since 1989.

Korea's export pattern and partners are also straightforward, as shown in Table 5.17. The US and Japan have been Korea's major export destinations, though their shares have declined. The other three Asian NIEs of Hong Kong, Singapore, and Taiwan are also key export recipients. Since the mid-1990s, China has emerged to be Korea's third export partner. Heavy industry accounts for about two-thirds of Korea's exports, while light industry accounts for about one-quarter. Heavy industries include chemicals and chemical products, metal goods, machinery and equipment, electronic products, motor vehicles, and vessels. Light industries comprise textile products, clothing, and fibers. Semi-conductors, machinery and precision instruments, and metal

Table 5.16 Korea's exports (US$ million)

	Exports (% growth)		*Balance of trade*	*Export/GDP ratio*
1981	21,253.8		–4,877.6	31.7
1982	21,853.4	(2.8)	–2,397.4	30.5
1983	24,445.1	(11.9)	–1,747.1	30.6
1984	29,244.9	(19.6)	–1,386.5	33.2
1985	30,283.1	(3.6)	–852.6	33.2
1986	34,714.5	(14.6)	3,130.6	32.9
1987	47,280.9	(36.2)	6,261.1	35.4
1988	60,696.4	(28.4)	8,885.8	33.8
1989	62,377.0	(2.8)	912.0	28.3
1990	65,016.0	(4.2)	–4,828.0	25.8
1991	71,870.1	(10.5)	–9,654.8	24.6
1992	76,631.5	(6.6)	–5,143.8	25.1
1993	82,235.9	(7.3)	–1,564.2	24.9
1994	96,013.2	(16.8)	–6335.0	25.4
1995	125,058.0	(30.3)	–10,060.9	27.6
1996	129,715.1	(3.7)	–20,624.0	24.9
1997	136,164.2	(5.0)	–8,452.2	28.6
1998	132,313.1	(–2.8)	39,031.3	41.2
1999	143,686.0	(8.6)	23,933.0	29.7

Source: *Monthly Statistical Bulletin*, Bank of Korea, various issues.

goods have been the most important export items in Korea; their shares of total exports in 1998 were 12.8%, 7.6%, and 8.4% respectively. The item that has increased most in its share of Korean exports is electrical machinery and products; its share increased from 2.3% in 1967 to 22.2% in 1991. The share of other industrial items declined over the same period. For example, raw materials declined from 18.2% in 1967 to 0.8% in 1991 (Pilat 1994: 94).

Korea has been attractive to inward foreign direct investment. A series of laws was passed in the 1960s to encourage and consolidate inward foreign direct investment. The Foreign Capital Inducement Promotion Act initiated in January 1960 and revised in 1966, and, subsequently, the Comprehensive Measure for Rationalization of Foreign Capital Inducement Act passed in 1967, encouraged both foreign direct investment and foreign loans. In 1969, the "Measure to Promote the Inflow of Foreign Direct Investment and to Foster the Activities of Foreign Subsidiaries" was announced to improve the administrative procedures and reinforce the supporting system. The first Free Export Zone was established in Masan in 1970. The Korean government played a major role in stimulating inward foreign investment. The "open door" policy of unlimited approval of inward foreign investment in the early 1970s, however, was thought to increase economic vulnerability in case of unpredicted massive withdrawals. After 1973, priority was given to joint ventures rather than to wholly owned foreign investment. Criteria for non-eligible projects for foreign ownership were established. For example, projects that disrupted domestic demand and supply of raw materials, and projects that competed in overseas markets with domestic enterprises, were not eligible. In general, foreign participation was limited to 50% in a joint venture (Koo 1985: 177–8; Kwon 1990).

Table 5.17 Korea's export pattern and partners (percentage shares)

	Industries		
	Light	*Heavy*	*Trading partners*
1991			US(26), Ja(17), HK(7), Ger(4), Sing(4)
1992	32.4	60.4	US(24), Ja(15), HK(8), Sing(4), Ger(4)
1993	30.8	62.9	US(22), Ja(14), HK(8), Ch(6), Sing(4)
1994	27.8	65.8	US(21), Ja(14), HK(8), Ch(6), Sing(4)
1995	24.3	69.6	US(19), Ja(14), HK(9), Ch(7), Sing(5)
1996	25.2	67.7	US(17), Ja(12), Ch(9), HK(9), Sing(5)
1997	24.9	67.3	US(16), Ja(11), Ch(10), HK(9), Sing(4)
1998	24.6	67.8	US(17), Ja(9), Ch(9), HK(7), Tai(4)
1999	20.7	71.8	US(21), Ja(11), Ch(10), HK(6), Tai(4)

Source: *Monthly Statistical Bulletin*, Bank of Korea, April 1999.

Notes
Light industries = textile products, clothing, cloths, fibres, tyres and tubes and footwear. Heavy industries = chemicals and chemical products, metal goods, machinery equipment, electronic products, motor vehicles and vessels. US, United States of America; Ja, Japan; HK, Hong Kong; Ch, People's Republic of China; Sing, Singapore; Tai, Taiwan;Ger, Germany.

The huge inflow of foreign investment in the 1970s and early 1980s basically supplemented the lack of domestic savings, though the scale of annual inflow of investment fluctuated widely, depending on the economic conditions in investing countries. Japan has emerged as the largest foreign investor, followed by the US and Europe. The largest recipients of foreign investment are heavy industry and chemical industry. Korea's outward investment began in the early 1970s, but accelerated in the mid-1980s when a balance of payment surplus was experienced. South-East Asian countries are the traditional destinations of Korean investment, but since the 1980s, North America has been the largest recipient. Manufacturing occupies the largest portion of Korea's outward investment (Waitt 1993).

5.4 A necessary or sufficient condition?

The advantage of an open economy and a free market system is that the favorable external economic factors can be used to supplement the inadequacies of the domestic economy, thus making the overseas market part of the domestic market. In that sense, the domestic economy rides with the world economy. It supplies manufactured goods to the world market and attracts foreign investment so that the economy ultimately grows at a rate commensurate with foreign demand. As part of the world economy, industrial development and areas of industrial specialization depend a great deal on external demand. For example, the rise of the textile and clothing industry in the East Asian economies is largely a result of the high labor costs in developed countries. Similarly, the development of electronics was due to rising overseas demand that attracted foreign investment. Changes in world demand thus give rise to the emergence of new comparative advantage.

A more challenging question is whether the favorable trade position and the inflow of foreign direct investment is a necessary or sufficient condition for the economic success of the four East Asian economies. Whether the presence of such external factors as trade, foreign investment, and multinational activities aided domestic growth, or whether they are imperialistic instruments that exploited the domestic economy and deterred development and growth. This formed the basis for different schools of thought in the economic literature of underdevelopment. The classical and neo-classical schools (see, for example, Lewis 1954; Rostow 1956; Myint 1964; 1971; Herrick and Kindleberger 1983) argue that underdevelopment is caused by distortions in the domestic economy and that the external sector functions as a supplement to domestic capital, so removal of distortions and improvements in economic efficiency can ultimately promote growth. The thesis of unlimited supply of labor (Lewis 1954; Ranis and Fei 1961), for example, argues that labor resources from the backward sectors can be transferred to the advanced sectors and productivity can be raised, probably through a process of industrialization.

In contrast, the Marxist school (see, for example, Baran 1952; 1957; Frank

1969; 1981; Rhodes 1970; Amin 1976: Warren 1980) argues that trade and foreign investment are instruments used by imperialistic countries and institutions to exploit the underdeveloped economies. Unequal development between rich and poor countries is maintained and underdeveloped countries are turned into peripherals of the developed world. Foreign imperialists colonize and exploit local resources. Developing countries remain poor as exports of raw materials or semi-manufactured goods have low value-added content. The term of trade in developing countries remains weak because they tend to import high value-added manufactures from advanced countries. Similarly, the dependency theory (Furtado 1970) argues that poor countries remain underdeveloped and become dependent on advanced countries for markets and high value-added products, so developing countries are not given the opportunity to control their own domestic development. Imperialism is further perpetuated by the alliance between the government, local elite, and foreign multinationals. Foreign multinationals use the local elite as contacts, and the local elite in turn influence the government to pass favorable policies for foreign businesses.

The development experience of the four East Asian economies does not support the Marxist and dependency school of thought; instead, it shows that improvements in domestic conditions permit sustainable growth, which in turn attracts export-oriented foreign direct investment. The maintenance of a favorable domestic economy is the foremost factor, while trade and foreign investment are a result of this. The open-market system, the emphasis on efficiency, the provision of economic "fertilizer" by the government, an appropriate industrial policy, and a healthy social system are all domestic attributes that are necessary conditions for economic growth and development. The crucial point is not so much the degree of openness, or the involvement of the foreign sector, but the determination to set the domestic economy on a track that can lead to sustainable growth and development.

Trade is feasible only if there are exportable goods. If the domestic economy is poorly organized and output remains low, there will not be surplus goods for export. Foreign investment, similarly, is attracted because domestic investment opportunities provide a higher return to comparable investment overseas. Again, this depends on such attractive factors as low wages and economic stability. Since financial capital is the most mobile form of resource, foreign investment always ends up in places where returns will be maximized. If the domestic economy is not sufficiently attractive in terms of investment returns, foreign investment flows will soon be channeled to neighboring economies. The economy that suffers a loss of foreign capital inflow will experience both the "domestic loss" and the "competitive loss" effects. The "domestic loss" effect occurs when an economy fails to attract an inflow of capital, which directly affects the size of domestic investment and the subsequent impacts. In absolute terms, the economy is worse off. The "competitive loss" effect occurs when the capital flows to a neighboring economy and consequently enriched economic growth make that economy

more competitive. In relative terms, the economy that fails to attract an inflow of foreign capital suffers a loss in comparative advantage in the long run.

The prerequisite for foreign capital inflow, as the East Asian economies have demonstrated, is not so much the state of the world economy, but the domestic conditions of economic stability, openness, and consistent economic policies. Owners of capital resources face two choices. Firstly, unless there is a severe restriction on the movement of capital, the owners are bound to locate their capital resources in the most promising economies that will provide them with the highest return. This implies that capital will leave the country if domestic conditions become uncompetitive and returns become unattractive. Secondly, capital holders, at worst, can choose to do nothing and hold on to their resources in an "investment-hostile" situation. This implies that, even if the government restricts capital outflow, thinking that capital holders will have no choice but to invest domestically, investment can still decline because the alternative is for capital to be withheld.

The conceptual understanding is not whether foreign inflow of capital is available, but the suitability of domestic economic conditions for attracting an inflow of foreign capital. As capital can always travel to other more favorable economies, the inflow or outflow of capital, in fact, testifies to the attractiveness or otherwise of domestic conditions. As such, trade and foreign investment form only the "necessary" conditions for growth. They are "necessary" because they supplement domestic savings and capital and encourage domestic output to rise.

How much the domestic economy has had the groundwork prepared, and its strength in terms of attractive conditions for investment, are both "necessary" and "sufficient" conditions for capital inflow, and ultimately, for growth and development. Internal economic constraints are a more limiting factor than external constraints. The economic "law" that has been formulated from the experience of the development of the East Asian economies is that improvements in internal conditions or the easing of domestic rigidities will always be rewarded by improvements in external conditions.

5.5 Conclusion

There are two major arguments in this chapter. Comparative advantage in trade should not be considered on a static basis. It has a dynamic nature and changes over time as industries diversify and one export item overtakes another as a key earner of foreign currency. Exports continue to grow and expand as a result of the development of new products and new markets. The economy, therefore, becomes globalized, and floats with the trend of the international economic community. This globalization is maintained by a steady share of the world export market and a constant change in demand for manufactured goods, which, in turn, has positive repercussions on the

terms of trade and foreign exchange. Exports often come with foreign direct investments, as they usually provide a major source of finance.

In the literature on the political economy of development, there is a debate on the role of the external sector in fostering development. Many economists argue that domestic problems are the major obstacles to development. Improvements in economic efficiency produce a background suitable for sustainable growth. The radical economists, however, consider economic development from a political perspective, and argue that imperialism is the cause of underdevelopment. The development experiences of the four East Asian economies show that the prerequisite for exports and inflow of foreign capital is attractive and viable conditions in the recipient economy. Exports and an inflow of capital investment are necessary as they produce extra capital resources.

Improvements in the domestic economy are both a necessary and sufficient condition for growth. Trade, particularly exports of manufactured exports, becomes feasible when the economy has achieved a certain stage of industrialization. The external sector can supplement the deficiencies in domestic savings and capital. The lesson is that, although trade and foreign direct investment lead to economic growth, their presence requires a set of appropriate prerequisites in the domestic economy. The inflow of foreign direct investment stimulates exports and income growth, and a virtuous circle is then created.

6 The law of first opportunity in economic growth

6.1 Introduction

The conceptual contract between poverty and equality is that there must be a bottom line of economic survival, and that everyone should have an equal opportunity to progress upward from the bottom line. Governments maintain a rather small public sector, and provide incentives to various economic agents, who will exercise their choice and freedom in expanding economic welfare. A friendly international sector provides additional channels of economic support in the form of either exports or foreign direct investment. Another aspect of the economism paradigm is the viable domestic economic strength that attracts foreign investment and markets.

Partly because of the export-led nature and the relatively small size of the four East Asian economies, the emphasis of the domestic economic front has consistently been on output generation and the supply side. Although domestic consumption and expenditure have increased substantially, especially since the 1980s, during which time the per capita income of these four East Asian economies has caught up considerably with the rest of the developed world, output expansion has been regarded as the ultimate economic target. This suggests that the ability to earn is considered to be the most fundamental aspect of economic life. One's ability to spend, and possibly borrow, depends on one's ability to earn. At the economy-wide level, an increase in output generates higher earnings and incomes for households. The output–income–expenditure relationship in macroeconomics points squarely to the importance of output generation prior to expenditure.

Technology, labor, and capital are factors of economic growth. The more recent "new growth theory" advocates considering such concepts as human capital and culture as new endogenous factors in explaining economic growth (Jones 1998). Capital accumulation in the form of savings and domestic investment provides the necessary capital input. Equally important, however, is the quality of capital. The productivity of capital depends on the level of existing technology and technology transferred from abroad. Human capital can be discussed within the framework of labor quality, rather than simply the quantity of labor.

In addition to theories advocating growth in the real sector of the economy,

there are other theories that explain the relevance of the nominal sectors in influencing real economic variables. Typically, the stock and financial markets are additional channels of capital accumulation, and the size of the nominal sector relative to the real sector influences the rate of economic growth. For example, both Tobin's (1961; 1965; 1969) *q*-ratio and Goldsmith's (1969) financial inter-relationship ratio explained the importance of nominal variables relative to national wealth. In addition, financial institutions can influence the efficiency of capital use (McKinnon 1973; Shaw 1973). The divisions between bank and non-bank financial institutions and between private and public banks are crucial factors in determining the efficiency of capital use. Activities in the nominal sector, however, depend largely on growth in the real sector.

Although the four East Asian economies have experienced decades of rapid growth, their GDP growth rates have declined over the last three decades from an average of 9.5% in 1970–79, to 7.7% in 1980–89, and to 6.8% in 1990–96. Between 1960 and 1985, however, the average percentage GDP growth rates of the four East Asian economies were similar (Krueger 1995: 11; Fu *et al.* 1999: 5–7). The two causes of economic growth (factor accumulation and productivity) differed among the four economies in the 1960–85 period, as shown in Table 6.1. A general pattern can be identified, however. While factor accumulation was the principal reason for growth in Taiwan, Singapore, and Korea, productivity was the main growth factor in Hong Kong. The gap between the two factors was, however, smaller in Taiwan and Hong Kong than in Singapore and Korea.

This chapter focuses on two arguments in the paradigm of economism. The first concerns the output-led nature of growth in the domestic economy, which means that domestic resources are being deployed efficiently for the purpose of growth. In the four East Asian economies, growth in the real sector, typically in the form of industrial output, trade, and infrastructure construction, has preceded growth in services and the tertiary sector, typically in such industries as banking and finance, insurance, real estate, and personal service industries. Development in the "real economy" has served as a base for sustainable growth in the "nominal economy." The second argument concerns the source of growth, on which there are two debates. The first relates to exogenous versus endogenous growth factors. The advocates of exogenous growth concentrate on the availability of capital and labor, whereas the proponents of endogenous growth believe that the qualitative factors, such as education and environment, are equally important. The second debate concerns the source of growth in the four East Asian economies. Some argue that capital accumulation has been the major cause, whereas others argue that factor productivity has fueled growth in recent decades.

The bottom line, as advocated in economism, is that growth takes place, although the causes and the path will vary among different economies, probably as a result of different initial resource endowments. However, it is a common phenomenon in developing countries that economic growth proceeds

Table 6.1 GDP growth in the four East Asian economies

Economy	*1960–85 growth (%)*	*Percent of real per capita GDP growth accounted for by*	
		Factor accumulation	*Productivity growth*
Taiwan	6.38	58	42
Hong Kong	6.09	44	56
Singapore	6.03	65	35
Korea	5.89	63	37

Source: Fu *et al*. (1999: 5–7).

from whatever endowment is available. The "law of first opportunity" is familiar in economic activities. Typically, a highly populated economy will grow by developing labor-intensive industries. Conversely, a scarcely populated country will depend more on machinery to supplement the shortage of human labor. Thus, economic activities are conducted primarily with whatever resources are available in the first instance. It is to be expected, however, that development based initially on quantity will shift to the quality of resources as growth permits. So, it is conceptually correct to argue that economic growth is based on capital accumulation in the initial stage, while factor productivity contributes to growth in the later stage.

Section 6.2 elaborates on the issue of capital accumulation, making reference to the debate on exogenous versus endogenous growth. Section 6.3 summarizes the existing literature and discourses on total factor productivity, with reference to the empirical differences among the four East Asian economies. Section 6.4 argues that the two debates should be viewed more realistically by considering the "law of first opportunity", while section 6.5 raises a similarly important issue on the distinction between real and nominal sector development. Employing the endogenous growth concept, section 6.6 promotes the argument that endogenous growth leads to endogenous development, therefore developing countries and the four East Asian economies should pay more attention to the regeneration or redevelopment of consumed resources. The final section gives a brief conclusion.

6.2 Capital accumulation

According to Robinson (1958), capital accumulation is a succession of economic activities involving increase in income and wealth, increase in quantity and productivity of capital, and invention in the form of technical progress. In economic analysis, capital is regarded as a theoretical variable, but it may face a quantification or measurement problem. For example, the rate of depreciation is often an accounting estimate, and the inflow of foreign investment can complicate the measurement of capital. Investment is the expenditure side of the capital equation, whereas saving is the income size.

In a simple income identity equation, economists usually assume that aggregate saving (private and public) equals total investment (domestic and net foreign). There are three steps in the process of capital accumulation: the increase in real saving; the channeling of savings to the investors; and the transformation of savings into productive investment (James *et al.* 1989: 59).

The level of income, either past, current, or future, has often been used as the major determinant of saving. In developing countries, the availability of financial institutions and the informal credit market and their demographic structure influences the structure of saving (Deaton 1989). In these countries, foreign capital may displace domestic capital, and capital fleeing the country in times of uncertainty may distort the structure of savings (Srinivasan 1993). The political economy of saving has been discussed in the context of supply-side economics. For example, tax reduction on saving makes the rich richer since the rich, in general, save more than the poor (Canterbery 1993). Such arguments, however, may not hold in those economies where there is no capital gains tax.

It is argued in *The East Asian Miracle* (World Bank 1993: 221–3) that the interaction between high growth, savings, and investment can produce a virtuous circle. Two general conditions that facilitate investment are the security of property rights and complementary public investment in infrastructure. Some of the policies adopted by East Asian governments that encouraged investment include the existence of an efficient bond market, the creation of development banks, and the provision of mechanisms designed to increase the attractiveness of private investment. The causes of East Asia's high saving rates are listed as macroeconomic stability, regulatory supervision of banks, targeted intervention, the lack of a long-term fiscal deficit, restrained inflation, and a positive real interest rate in most cases. The report concludes: "East Asia's high saving rates since the 1960s are partially an outcome of high growth rates rather than a cause." The thriftiness of the Chinese and improvements in government budgeting have also been major causes of high saving rates (Szczepanik 1958; Lambert and Hoselitz 1963; Giovannini 1985). Fry (1984) surveyed fourteen Asian economies and found that, on average, a 1% increase in national income increased the savings rate by just over 1%. Chowdhury and Islam (1993: 130) pointed to the possible ambiguity between the income and substitution effects. An increase in interest rate encourages saving through the substitution effect because savers forgo present consumption for future consumption, but, at the same time, it discourages saving through the income effect because savers will spend more as they become better off with the rise in income from interest.

A positive real interest rate and an improved term of trade has increased the saving ratios of many Asian economies (Asian Development Bank 1984; 1985; *World Development Report 1990,* World Bank 1990). The private sector has been the most important source of saving (see, for example, United Nations 1985). Taiwan's growth in saving has been the most impressive, and

it remained fairly constant between the two decades of 1970–80 and 1980–90. Unlike Korea, where large corporations dominate industries, the encouragement of small enterprises in Taiwan has caused a rapid growth in personal savings (Scitovsky 1981; James *et al*. 1989). Taiwan's personal (household) savings rose from 3% of disposable income in 1952 to 21% in 1981, compared with Korea's, which rose from 1% to 15% between 1960 and 1970. Various reasons have been offered for the high saving rate. For example, the desire to set up one's own business is a major motivation to save and, because of the web-like business structure in Taiwan, small and entrepreneurial businesses can create both backward and forward linkages (Luo 1998). The speedy growth in income and the real high interest rate in the post-war period were also responsible for Taiwan's high saving rate (Kuo 1983: 15).

Korea experienced a lower growth rate in saving in the decade 1980–90 than in the previous one. Saving behavior in Korea differs from that of other East Asian economies. As the large *chaebols* control much of Korea's domestic business, small and entrepreneurial businesses are not popular, and so it is not common for households to save to establish their own business. Furthermore, urban and rural households save for different reasons in Korea. Housing is the major goal for many urban households, whereas rural families save for their children's education. Compared with Taiwan, Korean households save less because economic growth in Korea has been lower than in Taiwan. Bonus income forms a larger part of total income in Taiwan compared with Korea. Householders in Taiwan save more for their old age than Koreans, who rely greatly on family security, having adopted a strong family-centered ethnic system. Parents depend on their children in their old age, and investment in the children's education can increase their future earning ability. It has been argued that Korea's high growth rate in the mid-1980s was partly due to the massive investment in human capital in the previous decade (Song, 1990: 147–66).

The interest rate hypothesis is another explanation for high savings in Korea. Official interest rates have fluctuated greatly and have not kept up with the inflation rate. The rate of return in the unregulated, informal financial market has traditionally been higher, and this made the informal market very popular among Korean households, especially in the 1960s and 1970s. For example, unorganized money market lending in 1964–65 equated to 40% of total regular bank lending. In the 1970s, the size of the informal money market in terms of credit outstanding was about half that of the deposit-taking banks. It was not until the 1980s that a higher interest rate was offered by banking institutions in the organized sector, which succeeded in raising the level of national savings. Thus, the marginal private saving rate of 13.8% during 1960–74 in Korea was an underestimate if saving in the unregulated money market was excluded.

Singapore has the highest saving rate among the four NIEs, and rising income has been the traditional reason for this (Lim and Lloyd 1986). Between

1979 and 1983, for example, investment as a proportion of GDP in Singapore was 44.4%; the same figures for Hong Kong and Korea were 33.3% and 29.7% respectively (United Nations, 1985: 134). Two features are particularly relevant to the Singapore experience. One is the level of forced saving exercised through the CPF, which was established in 1965. It was set up to provide benefits for retired employees, and the contribution rate had increased considerably by the 1980s. Between 1974 and 1984, for example, savings in the CPF increased from S$643 million to S$3,849 million, an increase of nearly 500% (Lim and Lloyd 1986: 55).

The public sector in Singapore includes socio-economic infrastructure such as the Housing Development Board, the Public Utilities Board, and the Telecommunication Authority. Construction by the Housing Development Board, which houses over 70% of the population, provided by far the largest chunk of public sector saving of 86% in 1960, 78.2% in 1970, and 78.8% in 1980. Between 1974 and 1983, public sector saving increased from S$736 million to S$7,628 million, an increase of over 900% (Lim and Lloyd 1986: 51 and 55). Other reasons that account for Singapore's high saving rate include a sound fiscal and financial policy, the provision of financial institutions and instruments, and a positive interest rate over a long period of time. Empirical estimates have shown that Singapore's saving ratio rises rapidly with per capita income at low income levels and increases at a diminishing rate at high income levels. Appropriate interest rate policies are used to stimulate private voluntary saving, and policy on public sector savings is reviewed periodically to avoid large accumulations (Lim and Lloyd 1986: 62; Lim 1988: 235).

One similarity between Hong Kong and Singapore is their openness, which allows foreign investment to bridge the domestic saving–investment gap. This openness creates a measurement problem in compiling statistics on savings. In Hong Kong, for example, residents can save in local and foreign currencies, and there are local and foreign saving instruments, apart from deposits in licensed banks. A Hong Kong resident can hold a local saving deposit account, a foreign currency deposit account either in Hong Kong or in an overseas country, or foreign assets such as bonds and funds, or can invest in foreign property. Similarly, Hong Kong dollar deposits can also be held by non-Hong Kong residents. Overseas Chinese in other Asian countries have often chosen Hong Kong and Singapore as their financial centers for deposits. Total saving in Hong Kong increased continuously between 1952 and 1973. It was only the 1966–67 riots in Hong Kong that triggered a decline in the absolute amount of domestic savings, but they recovered quickly again in 1969 (Hsueh 1976). The increase in the 1970s was much higher than in the 1980s. This may have been the result not of a fall in savings deposits, but rather of the emergence of a more diverse portfolio of domestic savings as more channels of saving became available in the decade 1980–90.

In the 1970s and 1980s, the saving rate of the four NIEs was close to 30%; Singapore and Taiwan had a higher saving rate than Hong Kong and Korea

(Chandavarkar 1993). Between the mid-1950s and mid-1970s, the marginal propensity to save was higher in Taiwan (0.41) and Korea (0.352) than in Hong Kong (0.221) and Singapore (0.263), and the saving rate increased with per capital income at a decreasing rate (Chen 1979: 135–6). Despite the high saving–GDP ratio between 1960 and 1985, however, the four NIEs also faced a large demand for investment (James *et al.* 1989: 63–76; Krueger 1995). The average growth of gross domestic savings in the ASEAN economies during the period 1980–93 is shown in Table 6.2.[1]

Singapore's saving rate has shown a gradual increase over the years (see Table 6.3). Hong Kong saw a sharp drop in 1984, 1989, 1994, and 1997. Both Korea and Taiwan experienced their highest saving ratios in the late 1980s, but these have fallen gradually since the early 1990s. Investment ratios show a similar pattern, although their movements are more gradual. The saving ratios in Taiwan, Singapore, and Hong Kong exceeded the investment ratios in these countries in many years. Korea is the only economy that has frequently experienced an investment ratio higher than the saving ratio. This reflects Korea's weak formal sector and the popularity of the informal sector for household saving.

A high saving rate permits investment, which in turn increases income, and the rise in income further supports and reinforces a high saving rate. An economically open economy encourages capital flow, which increases the ability to invest. Although Hong Kong and Singapore have been traditionally more open than Korea and Taiwan, economic liberalization policies pursued since the 1980s have increased the latter's openness considerably. In short,

Table 6.2 Average percentage growth in gross domestic savings, 1980–93

Country/area	*Average percentage growth*	*Remarks*
Hong Kong	11.37	With the exception of a negative growth rate in 1983 and 1984, a two-digit growth rate in most years
Taiwan	10.23	Growth rates fluctuated over the years with a negative growth rate in 1988 and 1989
Singapore	14.08	Large two-digit growth rates in most years with a negative growth rate in 1985 and 1986
Korea	18.68	Large two-digit growth rates in most years but a growth rate below 5% in 1980 and 1989
China	14.54	Other than 1980, 1981, and 1991, a large two-digit growth rate experienced in all years
Indonesia	17.45	Growth rates fluctuated widely but since 1986 large two-digit growth rates have been experienced
Malaysia	10.52	Unsteady growth rates and a large negative growth rate in 1981, 1985, and 1986
Philippines	10.90	Unsteady growth rates with negative growth rate in 1985 and 1992
Thailand	16.25	A two-digit growth rate in all years except1983, when the growth rate was 3.85%

Table 6.3 Gross investment and savings ratios

	Gross investment ratio				*Gross saving ratio*			
Year	*Hong Kong*	*Singapore*	*Taiwan*	*Korea*	*Hong Kong*	*Singapore*	*Taiwan*	*Korea*
1975	21.6	37.7	30.5	28.6	26.0	28.5	26.7	18.1
1976	20.8	41.1	30.7	26.5	25.4	30.4	32.3	24.2
1977	24.4	36.6	28.3	28.3	28.5	30.7	32.6	27.5
1978	26.5	39.1	28.3	32.5	29.2	31.9	34.4	29.9
1979	30.0	43.5	33.1	35.8	29.8	35.0	33.6	28.5
1980	32.4	48.5	33.9	31.9	30.2	35.9	32.4	23.2
1981	33.0	48.8	30.1	29.9	31.0	38.6	31.4	22.9
1982	30.6	50.0	25.3	28.9	36.4	39.8	30.2	24.4
1983	24.9	48.7	23.5	29.4	33.5	44.1	32.2	27.6
1984	22.4	48.1	22.0	30.6	31.6	45.7	33.9	29.9
1985	21.1	41.5	18.8	30.3	36.4	42.0	33.7	29.8
1986	21.7	37.0	17.2	29.2	40.1	41.1	38.6	33.7
1987	23.9	38.2	20.3	30.0	47.1	40.1	38.8	37.3
1988	25.5	34.0	23.4	31.1	38.6	43.5	35.0	39.3
1989	26.0	34.5	23.2	33.8	36.9	45.9	31.5	36.2
1990	26.4	36.1	22.6	37.6	39.8	47.1	29.5	37.5
1991	26.6	34.6	22.8	39.8	47.0	45.3	29.4	37.3
1992	27.4	36.0	24.5	37.3	45.4	45.1	28.3	36.4
1993	27.3	38.6	24.9	35.4	47.1	45.7	27.9	36.2
1994	29.8	32.9	23.7	36.5	39.6	48.0	26.3	35.5
1995	30.6	33.7	23.7	37.3	40.8	50.4	25.6	35.5
1996	31.3	35.1	21.2	38.1	43.7	49.6	25.1	33.8
1997	33.9	36.8	22.0	34.4	36.5	50.7	24.7	33.4

Sources: *Monthly Statistical Bulletin*, The Bank of Korea, July 1999; *Hong Kong Monetary Authority Statistical Bulletin*, various issues; and *Estimates of Gross Domestic Product 1961–1997*, Government of Hong Kong Special Administrative Region.

Note
For Hong Kong, gross investment ratio equals to the ratio of gross domestic fixed capital formation to GDP, and the gross savings ratio equals to the ratio of saving deposits (all currency) with licensed banks to GDP.

the virtuous circle of high savings and the consequent income generation that, in turn, supports a high saving rate has worked well for the four Asian NIEs. Additional factors that have encouraged high savings include a pattern of restricted government expenditure or a high level of government saving; a high real interest rate in some years; the emergence of sound financial institutions; and the free flow of foreign capital.

6.3 Total factor productivity: the East Asian experience

Lewis (1955) recognized the need for capital in economic development, and the importance of the balance between saving and investment. Equally important, as Lewis argued (ibid.: 201), is the "fruitfulness" of capital. This relates to productivity, which concerns the quality of capital. It is often argued

that capital goods are not handled with sufficient care, which has often led to their inefficient use, in developing countries.

Defined as the ratio of real factor input to real product output, total factor productivity (TFP) is a concept that captures the degree of contribution by all factors of production. It is a catch-all concept embodying all changes in factor inputs. Empirical studies usually conclude that such change is due to technical progress. One common measure of TFP is the explicit use of an aggregate production function. An alternative method is the use of an implicit aggregate production function embodied in a national income accounting approach (Chen 1997: 20). Various production functions (Cobb–Douglas, constant elasticity of substitution, variable elasticity of substitution, and a translog production function) have been used in empirical studies. Consider a general production function that produces a single homogeneous output (Krueger 1980: 18):

$$Q_t = A_t f(X_1, \ldots X_j, \ldots X) \tag{6.1}$$

where Q_t is output at time t and X_j represents various factor inputs. A_t can be regarded as the Hicks neutral technology parameter, which can be defined as (Chen 1997: 20):

$$A_t = A_0 e^{\lambda t} \tag{6.2}$$

Technology is assumed to grow at a constant exponent rate of λ. TFP can be measured by taking the total derivative of equation (6.1):

$$\partial A_t/A_t = \partial Q/Q - \alpha_1 \partial X_1/X_1 - \ldots, - \alpha_j \partial X_j/X_j - \ldots, - \alpha_m \partial X_m/X_m \tag{6.3}$$

The αs denote the various output elasticities with respect to the factor inputs denoted by the subscript. These elasticity ratios sum to unity if a constant return to scale is assumed. Estimates of TFP provide an indication of the change in output per unit of input. Capital–output ratios and incremental capital–output ratios are commonly constructed as simple measures of factor productivity.

Structural factors, initial labor productivity, the degree of civil liberty, and the state of public health are additional factors affecting TFP (see, for example, Barro 1991). A Cobb–Douglas production function applied to the manufacturing sector of Japan and the four East Asian economies for the period between the mid-1950s and mid-1970s showed that Hong Kong and Singapore experienced a lower degree of technical progress than Taiwan and Japan. Total factor productivity accounted for about 50% of growth in the four NIEs, which was higher than in many other developing countries. Labor was more important than capital in the 1950s in Korea. The contributions of labor and capital were more or less equal in the case of Taiwan. Total factor productivity increased in Hong Kong at an average rate of 4.33% between

1955 and 1970. Singapore's highest total factor productivity was 5.1% in 1966–70, an increase from 3.62% in the period 1957–65 (Chen 1979: 64–71). Singapore's growth of total factor productivity, however, remained low, largely because foreign multinational firms have been the major investors, and their R&D activities are conducted in their parent country and transferred to Singapore (Peebles and Wilson 1996: 209).

In the case of Hong Kong, the foreign trade factor has contributed a lot to its productivity, followed by capital and labor. When the efficiency of capital and labor is divided into quantity and quality, the quantity of capital and labor becomes the second most important factor, while the quality component is the least important. In the entire period 1961–90, foreign trade contributed 45.5% of output growth, followed by the quantity of labor (22.8%) and capital (21.5%), and the quality of capital (8.7%) and labor (1.4%). The percentage shares of these components have differed in different periods. For example, the share of foreign trade was highest in 1986–90 (61%); the quantity of labor was highest in 1976–80 (30%); and the quantity of capital was highest in 1961–65 (25.8%). The quality of capital was also highest in 1961–65 (9.6%), while the quality of labor was highest in 1976–80 (2.7%). By including the foreign trade component in the calculation of TFP, the percentage share of output growth for the entire period 1961–90 that is due to TFP and its quantities is 55.6% and 44.4% respectively. TFP experienced its highest share of 70.9% in the 1986–90 period, while its quantities saw their highest share of 51.4% in 1961–65. When the share of TFP growth is broken down into trade and its quality in the 1991–90 period, trade accounted for 81.8%, while quality accounted for only 18.2%. Trade is considered to be the single dominant factor contributing to growth in Hong Kong (Gapinski and Western 1999: 158–61).

In the case of Taiwan, technical progress was responsible for economic growth in the 1950s. The situation changed in the 1960s, and in the 1970s capital accumulation and labor absorption were the major causes of growth. The rate of technical change has differed over the years; it accounted for about 50% of growth in the 1950s, about 20% in the 1960s, and only around 15% in the 1970s. A large amount of investment geared to infrastructure and heavy industry has contributed to growth since the 1970s (Kuo 1983: 225–7). Institutional developments, such as the China Productivity Center in Taiwan, have helped to promote productivity. Taiwan's total factor productivity growth rate has varied over the years (Liu 1980). It was at its highest (6.06%) in the period 1960–66, but dropped considerably to 1.82% in 1966–70, giving an average growth rate of 4.3% in the period 1955–70 (Chen 1979: 70).

The role of foreign trade in Taiwan has not been as significant as in Hong Kong. Instead, the import of technology and the removal of domestic distortions have been the more important factors in Taiwan's TFP growth over the years from 1951 to 1990. Export promotion has had only an indirect effect through its ability to finance imports. Adaptive educational policies and human capital accumulation have also contributed to TFP growth, which

averaged 3.16% over the period 1951–90 (Dessus 1999: 192). If the human capital element is removed, the TFP growth rate was only 2.33% (see also Young 1994; Bosworth and Collins 1996). The value-added TFP in Taiwan's manufacturing sector amounted to an average of 2.46% in the 1961–93 period. The total output TFP of the manufacturing sector as a whole showed an average growth rate of 0.32% per annum in the same period. From 1961 to 1982, the electrical machinery and electronics sector had the highest rate of total output TFP growth, followed by textiles and food. The pattern changed in the period 1982–93, when chemical materials recorded the highest growth rate in total output TFP, followed by beverages and tobacco, and plastics (Liang and Jorgenson 1999).

The promotion of comparative advantage and the desire to achieve self-reliance have been considered the major reasons for Korea's growth in productivity (Mukerjee 1986; Dollar and Sokoloff 1990). The Korean Ministry of Science and Technology was established in 1967 to raise the technological infrastructure of Korean manufactures and export. Among fourteen major manufacturing industries labor productivity rose rapidly at a weighted-average annual rate of 12.2% between 1963 and 1979, resulting in a significant change in labor costs. Both the light and medium industries experienced a higher total factor productivity growth than heavy industries. Capital deepening, that is the rise in capital–labor ratio, was the main cause of growth in the heavy industries. There is also a strong correlation between industries that experienced a rapid growth in both exports and labor productivity growth (Dollar and Sokoloff 1990: 136).

Korea's total factor productivity growth rate has ranged from a peak of 5.06% in 1966–70, to 4.8% in the 1972–78 period, down to –2.54% in 1978–81. Its industrial growth in the 1970s and 1980s has been attributed to the rapid growth of factor inputs and not to technological progress. The rapid growth of labor productivity was due to the high growth rate of capital coupled with large quantities of material inputs. The decrease in total factor productivity growth in the 1978–81 period was the result of the Korean government's pursuance of an ambitious investment policy and the economic recession in 1980. Ambitious investment plans, especially in heavy industries, coupled with investment subsidies in the form of low interest rate loans and other financial incentives, resulted in factor price distortions and inadequate demand. An economic slow-down and recession in 1980 was caused by the 1979 oil shock, political instability following the assassination of the president, and the policy shift that followed. Between 1963 and 1990, 42% of total productivity growth was attributed to the manufacturing sector, 14% to finance, insurance and real estate, 12% to the wholesale and retail trade, and 10% to construction (Chen 1979: 70; Kwon and Yuhn 1990: 154–6; Pilat 1994: 161).

Table 6.4 shows the performance of the four economies expressed as factor productivity ratios. Allowing for statistical, methodological, and periodical differences, direct comparison among the four economies is best made on

Table 6.4 Factor productivity ratios

	Labor	*Capital*	*Total factor productivity*	*Value-added*
Hong Kong				
Chen (1979: 70)				
1955–70	1.86	3.12	4.33	
Peebles (1988: 58)				
1971–76	1.68	3.80	1.82	
1976–84	2.76	4.40	1.74	
1971–84	2.40	4.24	2.46	
Young (1944: 16)				
1966–91	2.60	7.70	2.30	
Taiwan				
Kuo (1983: 227)				
1952–61	2.70	8.70		12.10
1961–80	6.60	14.80		14.40
Pack (1992: 78)				
1961–87	6.70	9.50	5.30	
Chen (1979: 70)				
1955–70	1.72	2.00	4.30	
Young (1990: 23)				
1966–90	5.90	12.80	1.50	
Korea				
Song (1990: 68)				
1963–73	3.24	2.17	4.13	
1973–86	2.16	1.91	3.75	
Chen (1979: 21)				
1955–70	1.73	2.12	4.99	
Young (1994: 21)				
1966–90	6.30	15.40	2.90	
Singapore				
Chen (1979: 70)				
1955–70	1.50	1.44	3.62	
Young (1994: 18)				
1970–90	5.40	10.70	–1.00	

the basis of trends. In the case of Hong Kong, capital has become more important since the 1980s (Young 1994). In Taiwan, labor productivity has increased considerably, and the value-added component has remained high. Manufacturing growth in the 1950s was largely due to technical progress, but in the 1971–80 period it was due more to the large amount of investment and rapid labor absorption than to technical change (Kuo 1983: 227). The results of Kuo (1983) and Young (1994) are similar in both labor and capital productivity ratios, and Young (1994) reported near-zero TFP in 1970–80. Capital has become an important factor since the 1970s.

Korea saw a decline in all productivity ratios in the two periods for which

results are available,and capital productivity has gained importance over labor since the 1970s (Song 1990). Young's (1994) findings differ considerably from those of both Song (1990) and Chen (1979) in the case of Korea, and from those of Chen (1979) in the case of Singapore. For Singapore, if the two results are seen as a continuation of the development in the 1970s to the 1980s, then both labor and capital productivity have increased considerably. Young (1992) concludes that economic growth in Singapore has been the result of an increase in inputs rather than of greater efficiency. In general, among the different factor productivity ratios, labor productivity is probably the most important in Hong Kong, capital productivity is high in Taiwan, whereas the total factor productivity ratio is higher in Korea. In all four economies, the productivity of capital has become more important than labor since the 1980s, suggesting a structural change in the manufacturing sector in these economies.

A "meta-production function" was used to compare the growth performance of the four Asian economies with that of four OECD countries. The study concluded that capital availability is a more important source of growth than technical progress in the four Asian economies and Japan, accounting for between 48% and 72% of the growth in real output. Conversely, technical progress is a more important source of growth than capital availability in the four Western countries studied (France, Germany, the UK, and the US), accounting for about 46–71% of economic growth. Labor accounts for 13–23% and less than 6% of the economic growth in the Asian economies and in the industrialized countries respectively. Finally, the average elasticity of capital for the four Asian economies is between 0.4 and 0.5, whereas for the four industrialized countries it is 0.2–0.3 (Kim and Lau 1994: 236 and 258).

In addition to high levels of saving and investment and high rates of growth in total factor productivity, *The East Asian Miracle* (World Bank 1993: 43–5) concluded that the quality of human capital is another key factor in the success of Asian economies. A high-quality education is ultimately reflected in a high level of labor productivity, which, in turn, is reflected in the wages of employees in different industries. Developments in the formal educational system have contributed greatly to growth in human capital. Improvements in human capital are the direct result of years of a governments' relatively large budgetary commitment to education. Other than the formal education system, government and quasi-government institutions have assisted the development of human capital through vocational training. In Hong Kong, the Vocational Training Council is responsible for job-based training in such areas as hotels and catering, construction, information technology, and so on. Retraining is also encouraged, especially for redundant factory workers. The idea is to ensure that workers can acquire new skills should they lose their jobs as a result of changes in the industrial structure. Vocational training in Taiwan has also been actively promoted. Classified under seven categories of vocational schools, the number of trainees increased from 40,092 in 1952–

53, to 117,246 in 1965–66, 295,762 in 1976–77, 436,276 in 1986–87, and to 507,447 in 1997–98.[2] In Singapore, the number of vocational trainees has also increased dramatically, for example, from 10,000 to 148,100 between 1980 and 1987.[3]

Improvements in human capital are reflected in increases in wages. Table 6.5 shows the average real monthly earnings of workers in the manufacturing, trade (wholesale, retail, restaurants, and hotels), and finance and business (financing, insurance, real estate, and business services) sectors. Earnings in all four NIEs have increased considerably, which mirrors their increase in productivity. A summary of the average annual growth and periodic growth of wages in each sector in the four economies between 1982 and 1996 is shown in Table 6.6.

In the manufacturing sector, Korea experienced the greatest increase in wages in the period 1982–96, followed by Taiwan, Singapore, and Hong Kong. Nominal wage increases in manufacturing in Hong Kong and Singapore were higher than in Taiwan and Korea until the late 1980s, but the situation has been more or less reversed since then. By the mid-1990s, the nominal wage in manufacturing in Korea and Taiwan was higher than in both Hong Kong and Singapore. With regard to wages in the trade sector, Taiwan experienced the highest growth rate of the four economies in 1982–96, followed by Hong Kong and Singapore. The last two had higher wages than Taiwan before the mid-1980s, but since then the average wage in the trade sector in Taiwan has overtaken that in both Hong Kong and Singapore. The situation in the finance and business sector is similar. Taiwan saw the greatest wage increases between 1982 and 1996, followed by Singapore and Hong Kong, and by the mid-1990s the real wage in both Taiwan and Korea was higher than in Hong Kong and Singapore. If wage earnings reflect labor productivity, one can conclude that labor is, in general, more productive in the larger NIEs of Taiwan and Korea than the city economies of Hong Kong and Singapore. An alternative explanation, however, is the rising power of the trades unions in both Taiwan and South Korea, leading to bigger increases in wages than in Hong Kong and Singapore. Real wages in 1997, however, fell considerably as a result of the Asian financial crisis.

Change in the industrial structure is another factor influencing growth and productivity. Factors such as new comparative advantage and increasing wages have been put forward as the cause of industrial structural change in the four NIEs. Rising labor costs is the most common factor in all four economies. For example, the wages of workers in the Chinese garment industry in the early 1980s were only 14% of those achieved by workers in the same industry in Hong Kong, 17% of those in Taiwan, and 24% of those in South Korea (Bauer 1992: 1013). A strong labor movement in Korea was responsible for a rapid rise in wages. The development of high-technology and heavy industries in Taiwan and Korea through deliberate government policies brought about a change in industrial structure (see, for example, Amsden 1989; Chu 1994; Meaney 1994; Kuo 1995). The existence of the

Table 6.5 Average real monthly earnings of employees by industry (US$)

	Manufacturing				*Trade*			*Finance and business*		
Year	*HK*	*Singapore*	*Taiwan*	*Korea*	*HK*	*Singapore*	*Taiwan*	*HK*	*Singapore*	*Taiwan*
1972		94				101			161	
1973		97				106			163	
1974		126				141			226	
1975		175	89			188	147		278	247
1976		175	102			196	152		284	253
1977		175	120			194	174		290	264
1978		218	139			244	203		356	286
1979		227	162	208		250	232		370	306
1980		268	182	173		314	249		432	327
1981		306	231	208		364	320		468	406
1982	358	359	256	252	375	426	353	483	566	458
1983	323	379	448	276	332	370	590	438	577	784
1984	351	406	304	300	359	406	391	456	632	528
1985	390	455	323	296	398	441	447	525	703	575
1986	421	455	384	333	425	440	512	573	703	652
1987	456	497	528	403	450	482	678	577	771	893
1988	515	547	599	537	528	513	763	689	826	1,023
1989	600	635	724	684	602	600	952	772	938	1,266
1990	672	771	782	760	674	721	1,027	892	1,103	1,313
1991	769	925	920	830	772	777	1,255	966	1,286	1,501
1992	873	1,007	1,027	954	867	848	1,332	1,082	1,342	1,734
1993	824	1,102	1,048	1,046	1,021	988	1,381	1,022	1,438	1,778
1994	1,060	1,324	1,141	1,221	1,117	1,170	1,504	1,220	1,681	2,024
1995	1,182	1,512	1,138	1,388	1,240	1,324	1,527	1,257	1,886	1,868
1996	1,292	1,624	1,198	1,424	1,309	1,396	1,619	1,244	1,980	1,977
1997	1,429	1,479	1,078	897	1,442	1,242		1,373	1,786	

Source: *Economic Statistics Yearbook* and *Monthly Statistical Bulletin*, Korea; *Social Indicators in Taiwan Area* and *Statistical Yearbook*, Taiwan; *Yearbook of Statistics Singapore*, Singapore; and *Annual Digest of Statistics*, Hong Kong.

Table 6.6 Real wage growth movements, 1982–96

Manufacturing				*Trade*			*Finance and business*		
HK	*Singapore*	*Taiwan*	*Korea*	*HK*	*Singapore*	*Taiwan*	*HK*	*Singapore*	*Taiwan*
Average annual growth of real wage (%)									
9.96	11.54	13.81	13.50	9.58	9.17	13.44	7.36	9.49	13.16
Periodical growth of real wage (%)									
261	352	368	465	249	228	358	158	250	332

chaebols in Korea facilitated a massive investment in high-technology industries as they have the ability to raise large amounts of capital. The relocation of industries from Hong Kong to mainland China and from Singapore to Malaysia has led the governments of the city economies to focus more on developments in business services and finance.

6.4 The two debates and the law of first opportunity

In the neo-classical growth model, production technology is assumed to follow a constant return to scale, and factor substitution along the same production isoquant is permitted. The assumption of a steady-state growth rate implies that output per worker is constant and labor becomes an exogenous factor (Srinivasan 1999: 7). The neo-classical growth models of capital accumulation and TFP, which are based mainly on labor and capital with technology as the exogenous factor, have been challenged theoretically. Firstly, if the neo-classical view that incremental contribution to output diminishes as physical and human capital are accumulated is correct, low-income economies would grow faster than high-income economies for the same level of investment, and would eventually catch up with rich economies (World Bank 1993: 49). Over the years, however, low-income economies have not caught up. Secondly, the assumption that technical change is exogenous is unconvincing. Technical change requires a huge amount of financial capital, which could only be afforded by high-income economies, and the dynamic economies of scale involved in technical change would enable the rich economies to grow at a faster pace than the poor economies.

The so-called "new growth theory," popularized by Romer (1986; 1990) and Lucas (1988), argues that factors that are considered to be exogenous in the neo-classical growth model should be included as endogenous factors. The assumption of a constant rate of progression of technology is thus relaxed. Lucas (1988) raised the importance of human capital and argued that the skill acquired by an individual worker increases his or her own productivity, as well as the average skill level of the economy as a whole. Similarly, Romer (1986) argued that technological progress of one firm has a positive spillover effect on the production of other firms. Thus, technological change and human capital become new endogenous factors.

The groups of endogenous growth models that do not assume either technology or employment as given are referred to as *AK* models. Based on the simple production function $Y = AK$, where Y is output, K is capital, and A is constant, various growth models can be constructed to incorporate systemic analysis of employment and/or technical progress (Aghion and Howitt 1998: 24). The general production function expressed in equation (6.1) can be conveniently specified to include the endogenous factors as follows (Srinivasan 1999: 10):

$$Q(t) = K(t)^a L(t)^b + cK(t) \tag{6.4}$$

In the neo-classical case, $c = 0$, and the two cases of $a + b = 1$ or $a + b > 1$ represent, respectively, constant return and increasing return to scale. The "new growth" theorists assume that $c > 0$, implying that output growth is endogenously determined. It is this endogenous factor that contributes to long-term economic growth independently of the economies of scale. In other words, output will grow at a minimum or base rate equal to c, and greater than this when there are economies of scale. This suggests that growth will converge into a steady state.

Indeed, neo-classical development economists also pointed out the importance of labor quality and technology improvement. Arthur Lewis (1955), for example, considered the growth of knowledge, the application of new ideas, and programs of R&D and training to be crucial to economic development. Endogenous growth theories basically complement the inadequacy of technological change analysis in terms of capital accumulation and growth by incorporating technological progress and innovation into the analysis of growth and capital accumulation (see, for example, Evenson and Westphal 1995).

The basic idea is to open up the production function to include variables other than the two primary variables of capital and labor. A basic inadequacy in the conventional Cobb–Douglas production function, for example, is its simplicity in its focus on capital and labor. It is widely believed that, through time, improvements in the quality of both capital and labor will contribute to growth. These qualitative improvements are endogenous, and are independent of the quantity of factors. Similarly, other quasi-economic factors, such as saving behavior, climatic differences, cultural practices, and so on, can also influence growth. Ignoring them does injustice to the explanation of growth, though these factors pose measurement problems and are difficult to quantify objectively. The authors of *The East Asian Miracle* (World Bank 1993: 50), however, agree that there is a distinction between technological change, which provides "the movements *in* international best practice," and technical efficiency change, which is "movements *toward* best practice." While the high-income economies exhibit technological change, growth in low-income economies proceeds with improvements in technical efficiency.

The second debate concerns the conventional and revisionist interpretations of factor productivity in the four NIEs (Fu *et al.* 1999). The conventional view, typically represented by the World Bank (1993), argues that the causes of rapid growth in the four NIEs, together with other Asian economies, were the increase in factor accumulation (high savings rates, heavy investment in education, and other private investment) and productivity growth. The revisionists, represented mainly by Young (1989; 1993; 1994) and Krugman (1994), argue that growth in the East Asian NIEs was due more to the increase in factor inputs than to productivity growth, especially in Singapore. Young (1994: 2), similar to other earlier studies (Tsao 1982; Kim and Park 1985; Lau and Kim 1992), observed that capital inputs have grown rapidly in Singapore, Taiwan, and Korea. For example, the constant price investment

to GDP ratio increased from 11% in 1960 to 47% in 1984 in Singapore, and increased from 5% in the early 1950s to 40% in 1991 in Korea. Hong Kong is the only economy that has experienced a roughly constant investment to GDP ratio in recent decades. The economy with the highest total factor growth rate was Taiwan (1966–90) with 2.4%, followed by Hong Kong (1966–91) with 2.3%, Korea (1966–90) with 1.6%, and lastly Singapore (1966–90) with –0.3%.

A more extreme study claimed that technical progress in the four East Asian NIEs from the mid-1960s to 1990 was zero. Lau (1999: 51–3) classified the sources of growth into tangible capital (measured as utilized capital), labor (the number of person hours worked), and intangible capital (human capital and R&D capital). Kim and Lau (1992; 1994) and Lau (1999) argued that, in contrast to other industrialized economies, there has been no measured improvement in technical progress, or total factor productivity, in the four East Asian economies in the period from the mid-1960s to 1990. The low level of investment in intangible capital and the bias in innovation rent distribution are two other problems associated with the lack of technical progress (Lau 1999). Tangible capital is by far the most important source of growth, as Table 6.7 shows.

These findings contrast sharply with those of Krueger (1995) and Fu *et al.* (1999). One possible reason for the disparity is in the methodology of calculating total factor productivity. Both Krueger (1980) and Chen (1997) agree that a measurement problem arises in the calculation of total factor productivity. The specification of the input–output relationship, the measurement of factor inputs, and the weight assigned to different inputs can lead to differences in the data collected and definitional problems (Chen 1997: 22). In capital inputs, for example, the level of aggregation, valuation, and choice of deflator and depreciation methods are clear measurement problems. Coupled with differences in the empirical construction of either the Cobb–Douglas production function or the constant-elasticity of substitution (CES) production function, total factor productivity estimates are subject to all kinds of conceptual and measurement errors. A number of studies have shown a range of different TFP growth rates in East Asia, even when the same time period was used. For example, Felipe (1999) concludes

Table 6.7 Growth attributable to investment in tangible capital, labor, and technical progress, mid-1960s to 1990

Economy	*Tangible capital (%)*	*Labor (%)*	*Technical progress (%)*
Hong Kong	74	26	0
Singapore	68	32	0
South Korea	80	20	0
Taiwan	85	15	0
Japan	56	5	39

Source: Lau (1999).

that analysis of the TFP growth rates in East Asia is an activity that yields diminishing returns, and argues that new avenues of research are needed.

The empirical debate on whether growth in East Asian NIEs has been the result more of growth in factor inputs than of growth in efficiency and productivity is important in identifying the source of growth, but it cannot hide the historical truth that these economies have experienced a rapid period of growth, which is unparalleled in recent history. Both capital accumulation and endogenous growth factors can promote growth, are not independent of each other, and can complement each other in the long run (Van Marrewijk 1999). A close look at the reality of the development of both the West and Asian NIEs would give a better understanding of the debate between factor accumulation and factor productivity. Economic growth in a country with virtually unlimited land supply but a small population size would have to depend more on machinery and technological improvement than on labor and human capital. Thus, it would concentrate on machinery manufacture, construction, R&D development, and advancements in technology in order to improve the quality of life. Economists term such activities technical progress.

In the East Asian experience, the situation in the post-war years of the 1950s was not one of an unlimited supply of land and a small population. Rather, the East Asian economies were faced with a large quantity of immigrants creating an "unlimited" supply of cheap labor, and a favorable overseas market (Fei and Ranis 1964). Economic aid and external capital investment enabled these economies to maintain economic stability and, together with their open and market-friendly business environment, capital accumulation lubricated the engine of growth. Thus, it would be fair to argue that growth owed more to the availability of factors than to the productivity of factors. The more important point is that the availability of various resources attracted investors and, together with improvements in productivity, economic growth proceeded. This should not be taken as a natural outcome, however, as a great number of developing economies that were blessed with natural resources, surplus labor, and available capital resources did not attract investors and did not grow in the same way.

Economic growth is limited by scarcity of resources and factors. A developing economy in the process of growth and development is often not given any choice on which are the leading growth factors, available resources, or technological innovation. All economies in their growth process experience the "law of first opportunity": development and growth is based on what is available initially. Economic growth is naturally the consequence of which factors are available in the input production process. If labor and foreign capital are the available resources, it will be natural for investors to engage in labor-intensive manufacturing. If the local market is small, it will be natural to export the outputs. On the contrary, it will be impossible to engage in capital- or technology-intensive production at the initial stage of development when the existing levels of production techniques and skills are low.

Differences in the economy's endowment makes it natural for one economy to achieve growth with capital accumulation, and another with advanced production techniques.

Capital accumulation is an important factor for growth in the early stages for developing countries. Gradual improvements in education and gradual advancements in technology efficiency, or even change, will usually proceed as income and demand increase. The work of the revisionists (Kim and Lau 1992; 1994; Lau 1999), however, basically suggests that improvements in factor productivity should become important at the second stage of development (factor productivity), though there may be a time lag from the first stage (resource accumulation). Over time, the contribution from factor productivity should increase relative to that from factor accumulation. There are, of course, a great number of other factors complicating the distinction between factor accumulation and factor productivity. The "law of first opportunity" argues that if there is a constant foreign supply of high technology and direct investment, it will make the development of home-grown technology a low priority. If the industrial structure is composed of a large number of small and medium-sized enterprises, firms may not have sufficient monopolistic profit to engage in R&D activities. Since technological progress takes a long time to mature, it may even be more economical for a wealthy economy to acquire the necessary technology through foreign imports. In economism, the priority is growth whereas the sources of economic growth can change over time.

6.5 The nominal versus the real economy

Trade, manufacturing, and growth are the primary components of the real sector of the economy. Two groups of financial development theories relate the real sector to the activities of the nominal sector. The first is the financial repression approach, pioneered by McKinnon (1973) and Shaw (1973), which basically argues that financial resources are the most powerful form of resources and can mobilize the activities of all other sectors. This approach repudiates the Keynesians' argument on the importance of the quantity of investment and focuses instead on the quality of investment. Shaw (1973: 5) defined "shallow finance" as a situation in which the distortion of financial prices, commonly through a government-imposed interest rate ceiling below the market equilibrium rate, would reduce real economic growth. Financial repression is a situation in which investment opportunities are lost and economic development cannot take place because of a weak and inefficient financial market.

The role of the government in the management of financial institutions is crucial in determining the extent of financial repression. In order to induce the public to hold more real balances, the real return on money must remain positive. The McKinnon–Shaw solution to financial repression is financial liberalization and deepening that will enable real saving to increase. As savings

are being transformed into productive investment, real income will rise. A process of liberalization and financial deepening requires the relaxation of internal financial constraints, the exercise of a sound fiscal policy, the liberalization of foreign trade, the acceleration of the growth of real assets, and the pursuit of a high interest rate to reflect accurately the investment opportunities. Financial deepening and liberalization will eventually generate a virtuous circle that takes the economy from the availability of financial resources to output expansion, as shown below:

> Financial resources → Positive interest rate → Productive investment → Output expansion

The second group of financial theories relates the importance of the real sector to the nominal or financial sector (Goldsmith 1969; Tobin 1969). The two sectors must be consistent with each other because "the financial inputs to the real side must reproduce the assumed values of the real inputs to the financial side" (Tobin 1969: 16). The efficient functioning of the capital market and banks can facilitate the transfer of funds, and financial deregulation introduces competition into the financial system. Goldsmith (1969: 38) argues that the aggregate market value of all financial instruments to the value of tangible net national wealth tends to increase in the course of economic development. Since manufactured outputs, exports, employment, and infrastructure construction form the basis of the real economy, and financial and monetary transactions mainly constitute the nominal sector, economic development requires a balanced growth in these two sectors.

One simple measure of financial deepening is the money–income ratio. In principle, the closer the ratio is to unity, the greater the degree of financial deepening. In other words, money is output generating. The closer the money–income ratio is to zero, the weaker is the ability of money to generate output. Each of the four East Asian economies has shown a different pace and picture of financial liberalization and deepening. Typically, both Hong Kong and Singapore followed the market approach and provided an efficient regulatory framework. The Hong Kong government instituted a regulatory and legal framework on various occasions with the intention of consolidating the financial sector (Jao 1974; 1985; 1993; 1999; Effros 1982; Cribb 1987). For example, the amalgamation of the four stock exchanges into the Hong Kong Stock Exchange and the establishment of the Hong Kong Monetary Authority in the early 1980s aimed to strengthen market trading and monetary policy. Singapore's development of the financial sector emphasized institutional establishments, sound regulations, and open markets. The government does not become involved in such market activities as direct trading, nor does it have any control over the demand and supply of stocks (Lim 1988). Whereas both Hong Kong and Singapore are regarded as regional financial centers, Singapore serves mainly ASEAN members, namely Malaysia, Thailand, the Philippines, and Indonesia, and Hong Kong serves the mainland China market.

The Taiwan and South Korean governments introduced financial liberalization at a much later stage, and a number of restrictions on foreign banking operations were imposed. In the case of Taiwan, the frequent current account deficit prior to 1976 restricted the movement of foreign exchange. The Banking Law, promulgated in July 1988, provided further financial conditions conducive to internationalization and liberalization. Government-owned banks were gradually privatized. Foreign bank activities were extended to include consumer lending, savings accounts and industrial loans (Chiu 1992).

The financial system in Korea is more complicated and the extent of government intervention among the four NIEs is highest here. The rate of interest has been used as an instrument to direct investment in South Korea. The formal financial and banking sector in Korea coexists with a kerb, or black, market composed of informal financial institutions. There are three reasons for the existence of an informal market. Firstly, formal banking institutions are too remote for the rural population. Village economic life is neither entirely monetized nor commercialized. Owing to tight government controls on formal financial institutions and because the artificial interest rate ceiling was often set below the market rate, Korean households have deposited their savings in informal financial institutions. The most important form of informal financial institutions, known as the *kay*, is a rotating credit club that serves as a social network to promote mutual help, cooperation, and friendship among its members, using members' contributions for collective activities (Van Wijnbergen 1982; 1983; 1985; Song 1990: 164).

Analysis based on the financial liberalization approach (see, for example, Li and Skully 1991; 1992) suggests that Hong Kong and Singapore are more financially liberalized than Taiwan and South Korea. The money–income ratios of Hong Kong and Singapore have exceeded unity in many years, reflecting their strong financial status. The money–income ratios of Taiwan and South Korea, although lower than those of Hong Kong and Singapore, are higher than other ASEAN countries, such as Thailand and the Philippines. Government intervention is generally higher in Taiwan, South Korea, and Singapore than in Hong Kong, and there are government-owned financial institutions.

Economic growth in the four East Asian economies initially concentrated on the real economic sector. Light manufacturing was geared to the export market. Exports provided employment and the rise in income stimulated an increase in output. Imported capital, in the form of either foreign aid or foreign direct investment, filled the domestic investment gap. Exports enabled income to grow and domestic savings soon accumulated. Trade finance and saving activities required a sound banking system. The developments in the real sector required the support of local and foreign banking institutions. Large domestic corporations began to raise capital through the equity market. Together with the growth of international financial activities and the gradual improvement in government regulation and monitoring of the financial

market, the banking activities soon extended to other financial activities. The development of the tertiary sector is the result partly of the maturity of the manufacturing sector and the increased need for services, and partly of the activities arising from investment and finance.

Although there is variation among the four East Asian economies in their industrialization strategies and experiences of financial liberalization, it is fair to argue that, in each case, development began in the real sector, providing manufactured output, exports, jobs, and infrastructure, before the financial sector prospered. The financial sector grew initially to serve the real economy, and its sustainability depends on the expansion of the real economy. The output-led nature of the growth of the four East Asian economies shows a clear sequence of growth between the real economy and the nominal economy, in that the development of the real economy preceded the development of the financial sector. Prudent banking activities formed the initial phase of development in the financial sector. Trade financing, remittances, and saving activities were mainly conducted by banking institutions. The development of domestic corporations led to the development of the stock exchanges. The growth of the external economy gradually called for the development of non-banking financial institutions, such as insurance and pension funds. The development of the financial sector has been completed with such activities as the trading of derivatives, bond and treasury issues, and mutual funds.

The debate over the nominal, or financial, sector and the real sector rests crucially on the variables that link the two sectors. The interest rate is an important monetary variable. Typically, the market interest rate serves two functions. It rewards the capital holders, but it also acts as an indicator of the scarcity of capital. The interest rate is thus the opportunity cost of capital. The more scarce capital is, the higher the interest rate will be. A higher opportunity cost automatically screens out unproductive investment projects, and the limited capital funds are then available for the more productive investment projects. Since the more productive projects can secure a higher return, these projects can afford to pay a higher interest rate. The interest rate is thus the linking variable that transforms financial capital in the nominal sector to output in the real sector (Li 1994: 137).

A positive, or high, market interest rate reflects the scarcity of capital funds and leaves the scarce funds for the highly productive investment projects. However, one misconception needs to be clarified. It is true that a lower interest rate encourages investment. But what is equally true is that a low interest rate also encourages low-return investments. The limited funds that are allocated to low-productivity investment means that less is available for more productive investment. An efficient market must be able to discourage the former and promote the latter. The market mechanism that distinguishes between a low- or high-productivity investment project is the market rate of interest. There is, of course, room for argument over what constitutes a high or a low interest rate. Obviously, when the market interest rate is exorbitantly high, it will kill off all investment. A more secure approach

is to ensure a positive interest rate, though allow the actual rate to be determined by the supply of, and demand for, capital funds.

6.6 Endogenous growth, endogenous development

The "new growth" school extends the simplicity of the neo-classical growth theory, which concentrates on the analysis of capital and labor, to incorporate the quality of human capital, infrastructure, knowledge and R&D development, and so on. It is considered as "endogenous" because it is argued that growth factors are cumulative in nature and do generate a "snowball" effect on the economy. With more knowledge and better training, university graduates earn a higher wage than secondary school graduates do. More university graduates also produce a more educated and knowledge-based society, and so the government will have a larger tax base, which, in turn, allows more resources for R&D activities. The endogenous nature of growth factors can be seen from their various related economic linkages.

The concepts embodied in the endogenous growth theory should be extended to the possibility of endogenous development. A variety of virtuous/vicious circles that generate positive/negative horizontal and vertical linkages in economic development can be regarded as the initial, or first, level of endogenous development. Economic development based on internal economic strength, and supported by a consistent set of economic policies, the elimination of price distortions, and an investment-friendly environment can be considered to be the second level of endogenous development.

The third level takes into account the sustainability of development, and resource replacement, or regeneration, in development. Using one resource for development can have a negative opportunity cost for another aspect of development. A "cross-opportunity cost" exists when, for example, industrial output produces waste that harms the environment. And since much of the industrial output is guided by the market price mechanism, environmental decay becomes a severe case of market failure. Left unnoticed, or without replenishment, the environmental problem becomes a burden on society.

Endogenous development requires a process of resource regeneration. While most resources are being consumed in the priority or advantaged sectors, some resources should also be given to sectors that have been either deprived and underdeveloped or used to produce counterbalancing activities in a production process. A typical example is the process of industrialization, which draws "surplus labor" from the agricultural sector. Whereas industrialization promotes output, export, and growth, the decline in agricultural output often results in an economy dependent on agricultural imports. Industrialization is often anti-ecological and environmental problems are being ignored. A process of endogenous development ensures that some of the profits from output are used to sustain an adequate supply of resources, especially natural resources. This includes expenditure on R&D to promote scientific activities on environmental protection, education about

sustainability and the renewal of natural resources, and encouraging a change in the consumption patterns of non-renewable resources.

The four East Asian economies have, so far, achieved the first two levels of endogenous development. The virtuous circles that resulted from, for example, a high level of government expenditure on education, have produced a knowledge-based economy. Similarly, while all four East Asian economies claim to be export-oriented, a consistent set of domestic economic policies have ensured that economic growth is given top priority. Few resources, however, have yet been devoted to the third level of endogenous development. The concentration of resources in some industries has left other sectors deprived of development opportunities. In Hong Kong, for example, the environmental problem is in great need of attention. Therefore, it would be best to start devoting resources to address "resource regeneration" problems as soon as an economy is capable of so doing.

6.7 Conclusion

The most important message elaborated in this chapter is that expansion in real output is the primary cause of economic growth. Despite the favorable international trade and investment atmosphere that the four East Asian economies have enjoyed, development of their domestic scene has been equally crucial. Given the pursuance of appropriate policies and strategies, domestic conditions can lead to growth and development. Output generation and growth was considered as the first objective in all economic activities. It did not matter whether the final output was to be for domestic consumption or export, emphasis was given to increasing output at all levels. The virtuous circle of output–income–consumption in the real economy created the demand for increased output. A rise in output raises income and employment, which, in turn, gives households a higher purchasing power. This translates into an increase in demand, and supply responds. Capital accumulation in the form of a higher level of saving and investment becomes the prerequisite for output growth, and it determines the quantity side of factor inputs. Improvements in human capital, financial capital, and physical capital are always preferred. The consistently high saving and investment rates in the four NIEs confirms that capital accumulation is successful in promoting growth.

The quality aspect of capital accumulation relates to the productivity of factors. The three conventional factors of production are natural resources, labor, and capital. The four East Asian economies are not endowed with an abundance of natural resources. Labor productivity depends on the level of education. Formal education, vocational training, and professional qualifications have enriched the earning ability, and, simply, the productivity, of workers. Capital, in the form of physical machinery, is often acquired through imports or foreign direct investment. Endogenous growth theories suggest that technology is thus another important productivity factor.

The quantity (factor accumulation) versus quality (productivity of factors)

aspect has been debated. The main argument is typically that Singapore, among the four NIEs, has grown largely due to an increase in factor accumulation, and increases in the productivity of factors has had a negligible effect on growth. The "law of first opportunity" suggests that economic growth depends on the initial availability of factors and means. Economies with a scarcity of labor tend to develop machinery, while labor-intensive industries are developed in economies with an abundant labor supply. Given the economic realities of the four East Asian economies since the 1950s, output growth based on capital accumulation could have been expected. Although output growth is most important, over time, however, one would expect to find an increase in growth due to increased productivity.

Another dimension of the quantity versus quality debate can be seen from financial deepening and the role of government in the control of financial institutions. Government intervention and involvement in the financial markets restricts financial liberalization. Although the four East Asian economies differ in their experiences of financial liberalization, it is generally held that Hong Kong and Singapore are more financially liberalized than Taiwan and South Korea. Nonetheless, the last two have stressed the importance of financial liberalization and have now caught up with the international community. Economic growth and development have taken place in the real sector, in terms of manufacturing, exports, employment, and infrastructure. The financial economy, in terms of trade financing, bank intermediary activities, and later the development of a stock market, bond trading, and issues, derivatives and mutual fund transactions, has developed in response to the growth in the real economy. The development of the tertiary sector has taken place in line with the expansion in the financial sector and the required servicing activities arising from the growth of the real economy.

7 Economism and political regimes

7.1 Introduction

For decades, socio-economists have pondered on the "lead and led" relationship between economic freedom and political democracy. On the one hand, the Lipset hypothesis argues that economic prosperity, measured as increases in the standard of living, is the prerequisite for democracy (Lipset 1959; 1994; Lipset *et al*. 1993). However, after examining panel data from over 100 countries from 1960–90, Barro (1996) argued that economic freedom encourages economic growth, but that democracy can retard growth, and he concluded, "the overall effect of democracy on growth is weakly negative." At most, democracy helps economic growth only at a low level of political freedom. Once a moderate level of freedom is achieved, democracy, in the form of severe income redistribution and political positioning that can lead to the dominance of interested groups, actually retards growth. On the other hand, the advocates of democracy (for example, Friedman 1962; Pourgerami 1994) believe that the two are mutually reinforcing and that democracy serves to foster economic growth.

The fundamental problem in the lead and led relationship is the blurred division between the two disciplinary areas of politics and economics. While politics studies the organization of authorities, institutional power, and the monitor of authority, economics studies the organization of resources. They are, in fact, separate disciplines. Classical economic analysis states that when individuals maximize their welfare, in aggregate the society's welfare is maximized. Complications arise when individuals have different levels of endowment, in terms of either physical resources or financial or human capital, and some individuals with low endowment face the problem of economic survival. The market system does help, to some extent, to channel individual endowment through prices. The resources spent on individuals with low endowment have to come from somewhere, and so the government must act as the "monitor" or "social planner." This requires redistribution of resources, but there is no natural law on redistribution as it is always an artificial process. How much the "haves" should give to the "have-nots" and what is an acceptable level for the "have-nots" to have are obviously normative, often political, decisions. Politics, therefore, infiltrates into the redistribution

process. Furthermore, individuals with a vested interest often politicize the redistribution process. Therefore, value judgments, which are often subjective, enter into the decision process of redistribution.

As the government is often the monitor in the redistribution process, it becomes politically obvious that whoever, or whichever party, controls the governmental body holds the key to the redistribution process. The political adherence of the government is, therefore, decisive in redistribution. The government itself has also become an entity of its own, involved with the creation of revenue, on the one hand, and engaging in public expenditure on the other. Political issues are involved in the distribution and redistribution debate. Such issues include whether the government is elected, chosen, or arbitrarily decided, how long the government should stay in power, how democratic the regime is, the transparency of the government's activities, to what extent the public can have a say in the decisions and functions of the government, and so on.

Theoretically, it is not so much the process of output generation that is mixed up with political decision-making, but rather the redistribution process that allows politics to enter into the economic decision-making process. There is, however, a causal relationship between redistribution and output generation. A redistribution process that tends to favor the "have-nots" could discourage the productivity of the "haves." The balance between the "haves" and the "have-nots" is best to be such that the welfare of both is improving in absolute terms. So, while the redistributive process should improve the productivity or welfare of the "have-nots," the process should also encourage the "haves" to continue to be productive. A "positive-sum" game strategy is recommended.

This chapter expands upon another major component in the economism paradigm, namely the role of politics and the political regime. Despite variation in political regimes (democratic or otherwise), economism is a game of "more or less," in which agents are complementary to each other. The intention is to have a bigger economic pie, which can be distributed to all economic agents. The development experience of the four East Asian economies shows that political differences can be sorted out within the political arena, but that the political regime must be "pro-growth."

Section 7.2 makes a conceptual distinction between political democracy and economic development, drawing a line between growth and distribution, and the possibility of political influence in the process of distribution. The siege mentality is discussed as the political reality in the four East Asian economies in section 7.3, and the discussion clearly highlights the fact that growth is paramount and should be independent from political changes. Section 7.4 carefully considers the political essence of economic growth, namely that the game of "more or less" is highly preferable to other "haves versus have-nots" games. It is argued in section 7.5 that the primary political element in economic growth is economic freedom, which maximizes economic activities and gains in all directions and dimensions. Instead of using such

terms as political revolution and reform, section 7.6 points to the virtue of endogenous democracy, in which ruling political regimes can also gain support through endogenous democratic changes, which minimizes unnecessary political instability and maximizes long-term economic growth. Section 7.7 comprises a brief conclusion.

7.2 Democracy and economic development

Democracy is called for because of the existence of inequalities – the "natural condition of humankind" (Dahl 1998: 63). As every individual has goals, including political goals, which are not necessarily easily attained, cooperating through political means with others who share similar aims and objectives can help individuals to maximize their chances of obtaining their goals. According to Dahl (1998: 38), democracy provides "opportunities for participation, voting, control, inclusion and understanding, but full political equality is impossible to achieve." Conceptually, democracy allows freedom in political involvement.

A market-capitalist economy, as Dahl (1998: 166) argues, helps to foster democracy, as economic entities are privately owned by individuals and groups, and not by the state. Economic growth generates wealth, the social and political consequences of which are the values placed on education, autonomy, personal freedom, property rights, the rule of law, and participation in government. The wealth-holding middle classes are most likely to be liberal-minded and to uphold democratic ideas and institutions. In turn, the sector in the society that holds economic power can monitor and put in place "checks and balances" on the activities of political leaders. In contrast to a hierarchy ("control by leaders"), an oligarchy ("control of leaders") can be developed, in which the economically strong can exert their influence on the political scene (Dahl and Lindblom 1953).

Economic growth can take place in both market and non-market economies. Similarly, not all successful market-capitalist economies are democratic. Market-capitalism and democracy are separate issues that may or may not have some commonality. What is true is that a market-capitalist economy permits individuals to work for their economic goals, and that leads to positive aggregate economic growth. Economic growth allows wealth to be accumulated and absolute income to rise. Both the rich and the poor become better off, and absolute poverty declines. Politically, a class of wealth-holders is created. Since the government needs to deal with the wealth-holders in terms of tax, public expenditure, and, ultimately, political support, the pool of economic wealth becomes a bargaining object and an embryonic "democracy" will then develop, as political exchange takes place between the government (the ruler) and the different wealth-holders (the ruled).

In politics, the strong and influential (measured in terms of wealth, social status, and so on) have a greater voice. A process of political exchange and bargaining will continue as the pool and level of wealth changes. As the

absolute power of the ruler is reduced, the relative power of the ruled is increased. Such a dispersion of economic power will lead to democratic change. To what extent such democratic change takes place, be it free election or otherwise, becomes a point for political discussion. As democracy is a process involving time, the process can vary in time and in form in different economies.

What is equally true, even in market-capitalist economies, however, is that government intervention and regulations are needed to eliminate the harmful effects of market failures. On the one hand, we do not want the government to have absolute power. On the other hand, however, the government is needed to regulate the economy, and in order to be able to do so, the government needs to have power. Political "equality" exists up to the point of allowing equal participation and the possibility of changing the government without getting rid of it. In market-capitalism, a system of polyarchal democracy is suggested, in which the government (however it is formed) rules, but different sectors of the society monitor and control the power of the government. Thus market-capitalism and democracy can reinforce each other, but can also be in conflict with each other (Dahl 1998: 173–8).

Democracy, in the form of general elections at regular intervals, has practical economic implications. In an open economy, for example, foreign investors may choose a "wait and see" policy or select another foreign destination for their investment when there are political elections looming, especially if there are serious divisions between political parties or factions. Large conglomerates may engage in funding political parties, or manipulating political views, as happened in South Korea (Kim 1999). Its economic performance showed clear differences between the pre- and post-election periods, and short-term economic changes may have either positive or negative effects on the long-term growth path. The danger is that long-term economic goals have been sacrificed for short-term political goals.

Politics aside, the spirit of democracy is openness, transparency, and participation. Individuals, organizations, and institutions with different views should be able to engage in a more cooperative dialogue in solving problems, so that extremes and conflicts can be avoided. A typical example is that of the employer–employee relationship, which may change from an one of opposition, with employers' associations and labor unions never seeing eye-to-eye with each other, to one of corporate governance, with the operation of the firm made transparent to workers, and workers' leaders engaging in dialogue with management over labor productivity.

Economic democracy concerns the freedom of participation in the economic aspects of an organization. The allocation of power between employer and employee and the distribution of dividends are different forms of management and control issues that can be discussed within an economic democracy. The activities of a firm in a market-capitalist economy, for example, can influence but at the same time be controlled by, either directly or indirectly, workers, consumers, shareholders, input suppliers, banks and credit institutions, and local residents (Archer 1996). Democracy should be seen more as an

instrument to solve practical problems than as a divisive tool that creates instability.

7.3 The siege mentality and political reality

Despite the differences in the path, pace, and direction of economic growth in the four East Asian economies, and their diversity in the part that government has played, there are similarities in their political history. The high-growth structure of East Asia comprises four political elements (Johnson 1985: 71). One is the pursuit of stability by a political-bureaucratic elite that would not entertain any political demands that might have undermined economic growth. There has been, by and large, cooperation between the public and private sectors under the umbrella of a "pilot-planning agent." Government intervention has been exercised with due respect to the market-price mechanism. There has been a continued emphasis on investment in education as a means of improving human capital and, thereby, equality. The changing structure of society has led to the growth of a middle class, which treasures civic values and political tolerance and views economic development as a precursor of democracy. Economic growth has, therefore, taken higher priority over redistribution, which is usually conducted in a political context (Lipset 1959; 1960).

The "siege mentality" is a common political factor among the four East Asian economies (Tan 1992). A major consequence of such a mentality is that individuals gain more ground while society is in a stable condition. Achieving a greater level of wealth is a means of preparing for "rainy days" in the future when life may become uncertain or when society is less stable. Economic achievement, measured in terms of wealth, naturally becomes the preferred target, rather than political achievement. Since the end of the Korean War, South Korea has been faced with possible invasion from North Korea. Similarly, mainland China's drive toward unification has worried the authority in Taiwan for decades. In the case of Singapore, even though it gained independence in 1985, racial unrest has been equally destabilizing, especially in the 1960s and 1970s. As a British colony from 1842 to 1997, Hong Kong was destined to prosper in the economic arena. Its role as an efficient trading port had led to the establishment of an infrastructure geared for economic growth. Prior to 1997, however, Hong Kong's position as a British colony was only temporary, and an attitude of "borrowed place, borrowed time" consolidated the need for economic growth as its top priority (Hughes 1968).

Hong Kong

As a British colony until July 1997, both Britain and mainland China benefited from the economic prosperity of Hong Kong. While the former considered Hong Kong an investment heaven, the latter supplied materials to Hong

Kong in order to obtain hard foreign currencies (Bueno de Mesquita *et al.* 1985: 67–71). Together with other foreign investments and the growth of its domestic economy, Hong Kong is a wealth-generating machine both for its investors and for its hard-working, entrepreneurial residents. Private individuals and business enterprises have been responsible for the creation of wealth. Local citizens saw seizing personal opportunities for economic progress to be their major challenge. By and large, they did not consider either periodic political elections, or a UK-style welfare-state system, or political independence as attractive options that could improve their economic well-being (Rabushka 1987: 51–58).

In the former British colony, the role of the Hong Kong government was considered to be passive, and a high degree of administrative absolutism was maintained. The government did little more than maintain law and order and raise taxes to pay for government expenditure and the construction of public works. Hong Kong did not incur any debt that would impose a financial burden on the UK treasury (Rabushka 1987). The colonial Governor took advice from the Executive Council before finalizing policies, while the Legislative Council took care of the law-making process. Within the administration, the Attorney General managed the legal department, the Chief Justice managed the judiciary, the Financial Secretary drafted the budget and controlled economic and monetary affairs, and the Chief Secretary headed a number of civil service departments (Lo 1992: 176).

A system of indirect election to the Legislative Council was first introduced in November 1984, while a new method of partially representative government was introduced in September 1985, and the progress of the development of representative government was reviewed in 1987. Political reform was introduced after the arrival of the last governor, Chris Patten, in 1992. The authority in Beijing expressed concern and dismay over the rapid pace of political reform. The resulting tense exchanges of political displeasure between Beijing and London prior to July 1997, however, did not have any negative impact on the pace of growth of the Hong Kong economy.

On the indigenous political scene, weakness and fragmentation in the ruling elite has accounted for the poor public attitude toward indigenous political leaders in Hong Kong. Well-established institutions tend to receive a higher degree of public trust than individual political leaders. Surveys have showed that Hong Kong Chinese have a low opinion of the capability of political leaders, who have been seen as being more interested in political issues and power for themselves than in social and economic issues that actually affect ordinary people's livelihood (Lau 1994). To a certain extent, interest groups have reflected the views and opinions of the citizens regarding Hong Kong's affairs. Political development is seen to be a long-term affair, while economic growth is seen to improve people's livelihood directly (Lo 1988). The Basic Law has stated the pace and form of political development in post-1997 Hong Kong. It is expected that political representation will grow gradually, causing minimum interference to Hong Kong's economic progress,

though political activists argue that the agenda is too slow. However, the existence of interest and professional groups is still useful in providing alternative and impartial views and advice to the post-1997 government in Hong Kong.

Hong Kong's pragmatism is shown in the priority given to economic activities and the rather impatient attitude towards politics. Solving conflicts through political means has not been popular. For example, even though labor unions in Hong Kong are divided, labor strikes are infrequent and their numbers are insignificant. Between 1950 and 1995, the average number of strikes per year was less than fourteen, with only one case in 1952 and peak of fifty-one cases in 1978, followed by forty-nine cases in both 1970 and 1981. Double-digit figures were recorded for all years between 1968 and 1984, but only single-digit figures for most years since 1985.[1]

Another way to interpret Hong Kong's economic pragmatism is its fragility and vulnerability. What does Hong Kong have if it loses its international dimension, its usefulness to mainland China, and its economic ideology that permits wealth to be created by both local and overseas investors? With a population of about seven million people and no natural resources or farmland producing a steady supply of basic staples, Hong Kong's economy is fragile and would quickly encounter problems if political instability were a frequent occurrence. It neither has a rural economy to "fall back" on, nor could its citizens live in the UK and other overseas countries, nor would they be entitled to a household status in mainland China. Given its high population density, civil unrest and political instability could easily lead to social violence. Hong Kong residents have nowhere to turn to. Even if orderly evacuation were possible, it would take years. Therefore, economic pragmatism seems to be the most sensible course.

Hong Kong has reached a high level of economic achievement by international standards. The open nature of the economy suggests that whatever comes to Hong Kong can also leave, and that includes capital. One really has to calculate the "welfare loss" of an unstable economy, which would be brought about by political fragmentation and the "vicious circle" arising from civil conflict. Having considered these factors, the only sensible solution is for Hong Kong to move forward in various dimensions within the economic arena on the one hand, and to eliminate as far as possible any matters, including political ones, that could destabilize the economy on the other hand. Seen in this light, one has to agree that economic growth and development is the most reliable and effective instrument for Hong Kong to survive in the long term.

Singapore

Singapore is said to be a neo-patrimonial state, whereby political leaders and the government bureaucracy act as a father to the citizens. Singapore's leaders believe that they are doing the best for all Singaporeans and the government

should have control of all power instruments (Krause *et al.* 1990: 109). A "soft authoritarianism" is thought to have produced "the good life and a wholesome society, economic and social progress, and a political and social system that is consonant with the values and traditions of the Singapore society" (Roy 1994). The welfare of all Singaporeans is given higher priority than the rights of individuals. "Soft authoritarianism" can be tolerated, while chaos, anarchy, and "hard authoritarianism" cannot. Individualism, including individual human rights, has to give way to concern for the interests of others and the law and order protects everyone in the Singapore society (Chew 1994).

The Singapore authority has long promoted economic growth as the political target, and conflicts have been minimized. The passage of the Employment Act and the Industrial Relations Act in 1968 reduced workers benefits and downgraded collective bargaining power. Management now has full discretionary power over the deployment of workers. In 1972, the National Wage Council established a tripartite body, composed of labor representatives, government officials, and management executives, to set wage levels. The objective of labor unions is not wage bargaining, but seeking to promote better industrial relations between workers and management. The number of union disputes dropped from over 1,100 cases in 1972 to over 300 in 1982 (Bello and Rosenfeld 1990: 304–5). Industrial stoppages experienced a peak in the 1960s, with forty-five and thirty cases in 1960 and 1965 respectively, but dropped to only five and seven cases in 1970 and 1975 respectively. There was only one industrial stoppage in 1990.[2] The term Singapore Inc. (incorporated) is commonly used to describe the Singapore society as one giant corporate firm with profitability as its target. The government is the board of directors, the top civil servants are managers, and the Singapore residents are shareholders (Peebles and Wilson 1996: 33).

Singapore started its regionalization program by the promotion of a "growth triangle concept." To that end, its R&D expenditure has expanded substantially, in the hope of closing the technology gap. The Singapore Productivity and Standards Board promotes total factor productivity growth and performance and aims to "sustain total factor productivity at two percent a year in order to achieve four percent productivity growth and seven percent annual economic growth" (Cao and Foo 1997).

To a large extent, Singapore's fragility and vulnerability is similar to that of Hong Kong. With a population only half the size of Hong Kong, Singapore does not have a rural economy large enough to support its demand for daily staple foodstuffs. Geographically, Singapore is too small to make a distinction between urban and rural areas. Equally, Singapore residents have nowhere to turn to in the event of social unrest and violence erupting. Foreign capital plays a dominant role in Singapore, whereas indigenous capital is very small, or even negligible. Like Hong Kong, the openness of the Singapore economy would quickly lead to capital repatriation should the investment environment became unfriendly. Thus, Singapore does not have many choices either.

Politically, Singapore has a leadership succession problem that could also

be uncertain (Bellows 1989; Mauzy 1993). In Hong Kong, the planning of the Sino-British negotiations over Hong Kong's post-1997 political future allowed an early settlement to be reached in 1984, thus allowing transition to take place well in advance. Singapore is a country in its own right and does not have a sovereignty problem, but leadership succession usually does not happen far in advance. The other dimension of political uncertainty in Singapore is racial tension. Armed with the experience of racial violence in Malaysia in the late 1960s between ethnic Chinese and Malays, the Singapore authority has to look for a non-political, positive-sum solution, so that different ethnicities are allowed to participate equally and openly, and one's gain is not another's loss and so will not have any political spillovers. Economic development and income growth have fitted well into the positive-sum solution. On the one hand, economic progress diminishes the residents' desire and enthusiasm for political ambitions. On the other hand, the rise in income encourages individuals to concentrate their efforts on improving their economic well-being, thereby leaving little or no time for politics. The divisive nature of politics is therefore minimized.

Taiwan

Taiwan and South Korea were Japanese colonies until the end of World War II. Taiwan's land reform and the introduction of high productivity farming techniques were politically designed to provide a supply of food to Japan (Tan 1992: 115–21). The Nationalist Party, Kuomintang (KMT), had maintained a one-party state since its retreat to Taiwan in 1949. A one-party state is a common phenomenon in the early to middle stages of development. The Nationalist Party overthrew the dynasty that had ruled China for 250 years and, in turn, it became the ruling party, dominated largely by the military. Japan's withdrawal from Taiwan after World War II left a leadership vacuum which was naturally filled by the Nationalist Party. A process of land reform, involving thousands of hectares, was quickly introduced after the Nationalist Party took over Taiwan; this was designed to redistribute wealth between the farmers and the landlords. Farmers were organized into associations and limited local elections were introduced (Wade 1990: 229).

The economic philosophy of the Nationalist Party is based on Mr Sun Yat-sen's market socialism, which is composed of state ownership in key sectors, private ownership of land but not landlordism, and development of "national capital" with limited private involvement in infrastructure and manufacturing. Small enterprises, however, should not be nationalized. There are basically three eclectic elements in Mr Sun's doctrine; these are: socialism, a planned industrialization, and statism, which is based on traditional legalistic Confucianism. The Principle of People's Livelihood advocates four basic government functions of "ruling, educating, rearing and protection", whereas the state should be responsible for the welfare of "food, clothing, housing and transportation." The Principle of People's Livelihood, the Principle of

Nationalism, and the Principle of Democracy form the Three Principles of the People (Wade 1990: 257–61).

Taiwan has not claimed to be a democracy since the single-party rule by the Nationalist Party was justified by the theories of Mr Sun Yat-sen. It was important to maintain political stability, which was achieved by the establishment of an elite to oversee development, but sufficient equality was maintained in order to avoid conflict. Although the standards set were based on internationally acceptable guidelines, the bureaucratic administration was insulated from political influence (Johnson 1985: 69–71).

Economic and industrial development has been given priority over other sectors, but the industrial structure is composed mainly of small and medium-sized enterprises. Soon after the end of World War II, the Nationalist Party adopted a strategy that combined economic freedom with a national economic plan, based on a series of five-year plans. In the early post-war period, the government favored egalitarianism and tended to intervene in businesses and markets. The intention was to attain a well-balanced sufficiency of national wealth. The nationalist government, however, soon realized that liberal market principles could bring about increases in productivity more effectively than spiritual and moral incentives. Conflicts over economic ideology developed between the government and the local elite. Fiscal policy was eventually considered to be a better instrument for achieving egalitarian goals than restricting the movement of private capital. Nationalist Party leaders had to change their strategy and held instead that "equality and wealth" were the ultimate goals for realizing Sun's Principle of People's Livelihood. In the 1965 fourth five-year plan, for example, the Taiwan government stated its intention that a state-controlled economy and centralized planning would never be adopted. Nonetheless, Taiwan has maintained a huge economic bureaucracy. The Council for Economic Planning and Development (CEPD), which is responsible for economic plans, analysis, and evaluation, and advises the government, employs a large number of economists (Wade 1990: 197, 257–61; Hsu 1994).

Taiwan's drive toward industrialization, the switch from import substitution to export promotion, and the concentration on "pick-winner" strategies and heavy industries have led to changes in labor relationships. Firstly, the supply of surplus labor from the rural areas has come to an end. Workers have become more aware of their legitimate rights and the power of collective actions. They also felt that they were falling behind in wealth creation, and so political instruments were used to push for wage increasess (Bello and Rosenfeld 1990). The number of labor disputes increased tremendously. From a total of seven cases in 1964, it soon reached over 100 cases in the 1970s, and over 1,000 cases since 1982. In 1994, the number of labor disputes peaked at 2,021 cases, an increase from an average of 38.6 cases between 1963 and 1970, 397.4 cases between 1971 and 1980, 1,497.1 cases between 1981 and 1994.[3] Accumulated resentment among unionized workers exerted political pressure on the Nationalist Party. As it had been under the control of the Chiang family for

two generations, reform was badly needed, even within the Nationalist Party itself, in view of the changing nature of Taiwan's economy and political development.

Political reform in Taiwan eventually occurred in 1986 after President Chiang hinted in October that the formation of new political parties would entail agreement to three conditions: to uphold the 1947 constitution, to remain anti-communist, and to oppose moves to establish an independent Taiwan. The 38-year-old martial law was finally lifted on 15 July 1987. Press freedom was established and political parties were allowed to compete in elections. When Lee Teng-hui replaced Chiang Ching-kuo to become Taiwan's new president in 1988, democratization and reunification with mainland China were considered to be major goals (Hsiung 1986; Wu 1986; Myers 1987; Seymour 1988; Ling and Myers 1990; Dreyer 1991; Domes 1992; 1993; Chao and Myers 1994; Tien and Chu 1994).

Taiwan has experienced a number of major political elections since 1987. On 5 December 1998, Taiwan held, for the third time, comprehensive elections of the Legislative Yuan, which is the island's parliament. In addition, the positions of the mayor of Taipei and Kaohsiung were hotly contested (Chu and Diamond 1999). Lee Teng-hui easily won the island's first direct presidential election in 1996, but decided not to run in 2000 in favor of his vice-president, Lien Chan. The March 2000 election was more dramatic. The Nationalist Party's former Secretary-General, James Soong Chu-yu, was also standing, which caused a split vote in the party. As a result, the opposition Democratic Progressive Party's candidate, former Taipei Mayor Chen Shui-bian, won with 39% of votes, and assumed office on 20 May 2000, replacing Lee Teng-hui, and thus ending an era of political dominance by the Nationalist Party.[4]

Taiwan is acceding to a democratic path in political development, but its political leaders have to ensure that economic fundamentals will remain unaffected, other than fluctuations in the stock market. Economic growth and progress has been seen to be a prerequisite, and political elections should not generate unnecessary and negative pressure on individuals' economic well-being. The essence is that, while the process and outcome of political democracy is uncertain, such uncertainty should be confined to political circles and should not spill over to the economic arena. In short, once the economic superstructure is well established and respected, political activities can bring about peaceful changes in the government administration.

South Korea

Both Taiwan and South Korea have established a "capitalist developmental" state in which the state exercises financial control over the economy, economic bureaucracy experiences a high degree of autonomy, and a balance between economic incentives and government guidance is struck (Johnson 1985: 73). Economically, the South Korean authority has intervened positively in a

market-promoting or market-sustaining way. The economic bureaucracy devises long term economic policies and exercises control over both domestic and foreign capital (Koo and Kim 1992).

Although South Korea is ostensibly a democratic country, and in view of the constant threat from North Korea, it has been dominated by a single-party regime composed of a developmental elite which regarded political stability as being necessary for economic development. South Korea gained national independence in 1948, but a functional approach to democratic transition with a strong leaning toward modernization was adopted in the 1950s and 1960s. As a result, socio-economic development and political democracy were given a low priority (Johnson 1985, Chung 1989).

The democratic government was deposed on 16 May 1961 by a military coup led by Major General Park Chung-kee, after which the regeneration of the economy was the top priority and the first five-year plan for economic development was adopted in 1962. The Park regime of the 1960s and 1970s was repressive, but it was able to gain support under the banner of capitalism. The maintenance of high economic growth helped to maintain tolerance for the lack of democratic political change. Park chose a pragmatic and program-oriented approach to political development, which aimed to secure management effectiveness with political stability. The government's power was balanced by strengthening professional expertise (Cole and Lyman 1971; Bello and Rosenfeld 1990; Park 1991).

Despite the emphasis on growth, and probably due to constraints in capacity, in 1979 inflation caused economic hardship and a series of student demonstrations resulted in political instability when Korea's Central Intelligence Agency director Kim Jae Kyu assassinated Park Chung-kee on 26 October 1979. On 12 December 1979, another coup led by Major General Chun Doo Hwan led to the arrest of a number of senior officials. In February 1980, the National Conference of Unification restored the civil right of a political activist, Kim Dae Jung. The political vacuum, however, remained until October 1980 when the Fifth Republic was inaugurated after a new constitution was approved by 92% of voters in a referendum. Under the authoritarian regime of President Chun, the military intervened in politics, and there was serious disunity within the opposition party (Chung 1989).

The Chun Doo Hwan's regime of the 1980s, however, attempted to build up popular support based on economic achievement. Efforts were made to maintain high economic growth rates and inflation was brought under control. The belief was that economic development precedes social reform and political democracy. Both political and economic mean indices were constructed; the economic dimension index comprised inflation, employment, pollution, and wealth, and the political dimension index consisted of freedom of speech, rights, distribution, rural affairs, and defense (Park 1991).

By 1987, the authoritarian nature of the Chun Doo Hwan regime came under severe pressure as a result of a series of political events, for example the torture of a dissident student, and the debate on the selection of the

successor to Chun was ended on 13 April. Finally, a constitution amendment in October of that year replaced the indirect presidential election with a direct one. The general election in 1987 brought Korea into its third change of regime. On 16 December 1987, the opposition candidate from the Democratic Justice Party, Roh Tae Woo, won the election with the largest percentage (36%) of the vote, largely as a result of a split vote between Kim Young Sam (28%) and Kim Dae Jung (27%). It was in the two elections in 1992 (the general election of the National Assembly in March and the presidential election in December) that the authoritarian rule was finally brought to an end. The democratic transition in Korea has gone through the stages of a decline in legitimacy, a loss of confidence and disintegration within the ruling bloc, the emergence of democratic forces, the transfer of power, and, finally, the consolidation of democracy (Chung 1989; Billet 1990; Lee 1993; Mo and Moon 1999).

Economically, the Korean government looks to the Japanese model, with a large government involvement, an emphasis on large business, and a strong manufacturing sector. The development and prosperity of large conglomerates (*chaebols*) in Korea has been largely the result of government help in the form of preferential credit, and lax regulatory and fiscal treatment. The only difference, however, is that the Japanese labor unions have cooperated with employers to raise productivity and improve quality, whereas in South Korea, strong, large business conglomerates have invited vigorous opposition from labor unions (Clifford 1998).

Three major pieces of labor legislation, which were passed at the end of the Korean War, restricted collective bargaining for a long time. The Labor Union Law, the Labor Standards Law, and the Labor Dispute Adjustment Law set unrealistically high labor standards. Workers naturally turned to labor unions for support and comfort, and the unions acted as a cushion for workers to help alleviate their harsh conditions. General Park initially banned labor unions but later allowed the government to supervise the formation of unions in the 1960s. The government's attitude of "develop first, share later" led to the promulgation of the Emergence Decree on National Security, which suspended bargaining in 1972. Under this decree, government approval was required before unions could engage in wage negotiations (Kim 1994).

The Korean government intervention in the management of labor relations and control was direct, and union leaders had little room to exercise their power. Unfortunately, a creditability gap existed between what the government officials said and practiced. Declared policy in principal favored labor, while actual implementation favored businesses. A high degree of distrust and dissatisfaction developed between the workers and the Korean authorities. It was clear that labor unions were deprived of the right to bargain and strike.

Political democratization in 1987 quickly reactivated labor movements. The government intervention in the Hyundai shipyard strike in 1987 led to a city-wide riot. The labor unions were determined to demonstrate their ability

to strike, even if it meant sacrificing the workers' share in the enlarging economic pie. After the democratic election of 1987, labor unrest still continued. The Korean government finally declared a state of "economic crisis" in 1989 and took the position that violence in labor–management relations would not be tolerated. In the meantime, the number of labor unions increased from 1,967 in 1985 to 6,142 in 1988, and further to 7,527 in 1991 (Kim 1994; Moon 1999).

Political democratization, however, coincided with a leveling out of economic performance. Since 1991, reviving economic vitality and enhancing national competitiveness has become a national concern. In 1994 the Kim Young Sam government shifted the direction of economic development and management, changing the old developmentalism to a new ideal of globalization, whereby economic changes can be brought about by external stimuli and incentives. A process of deregulation was conducted in order to correct government failures, but it was agreed that the Korean economy should remain independent from politics. The opposition party now serves as a pressure group, pointing out the various problems with the government's policies (Moon 1999: 8–12).

It is quite likely that South Korea has experienced the highest degree of soft authoritarianism among the four East Asian economies. Nonetheless, because of the constant threat from North Korea, it would be fair to argue that the "siege mentality" is more prevalent in South Korea than in the other three economies (Hong Kong, Singapore, and Taiwan). The determination of the South Korean government's drive to move forward and ahead of North Korea can be seen as a strategy that has prepared South Korea for "the rainy days," or as an instrument that has acted as a buffer to prevent renewed conflict with North Korea. South Korea had to build a strong economy after the Korean War, and politics was definitely not considered to be a relevant instrument. Unlike other economies where small and medium-sized enterprises have dominated the manufacturing sector, the Korean government considered the big conglomerates to be the key agents of economic progress. Other than the periodic labor disputes, political leaders in Korea have generally believed that economic progress must be given the highest preference and that political interference should not be tolerated.

Domestically, the democratization in 1987 led to renewed debates on the role of the *chaebols* and small and medium-sized industries; as a result new resources were channeled to formerly neglected areas and attempts were made to correct the imbalances between sectors. Wage stability was regarded as a more important goal than redistribution (Kim and Mo 1999). The unemployment rate fell gradually from 3.8% in 1987 to 2.7% in 1994. The number of labor strikes and their size declined from 3,749 cases involving 1,628 workers in 1987 to only 121 cases and a total of 302 workers in 1994 (Mo 1999: 111). The removal of authoritarian rule and the introduction of democracy in South Korea since 1987 has led to rising consumption and wages, along with labor activism and related negative economic effects. However, it

has been found that many of the old policies, such as export-orientation and business-friendly and stable macroeconomic policies, have been retained (Mo and Moon 1999).

7.4 The politics of economic growth

Economic inequality concerns the difference between the rich and the poor, whereas political inequality separates the ruler from the ruled. In economics, as the poor get richer, the rich can still remain rich. Coexistence between the rich and poor is permissible and there is no economic conflict in poverty reduction. There is the possibility of convergence in both relative and absolute terms. Such coexistence may not happen in politics. The ruler and the ruled can change roles through a political process, but the distinction is not based on a positive-sum game. The ruler and the ruled cannot both increase their power at the same time. They see each other as opposites: one exercises authority, the other responds to authority. In democratic societies, the exiting ruler becomes a normal citizen under the new ruler. In some undemocratic, antagonistic political regimes, such exchange of roles may be a matter of life and death, as the new ruler will not tolerate the presence of the ex-ruler. When the division of power is so uneven, it is desirable for the ruler to remain in control and to avoid a role change for as long as possible. A ruler therefore is judged on the number of long years in office, and not by what has been done or achieved. In short, the "more or less" nature of economic inequality could be a more accommodating form of inequality than the "ruler and ruled" nature of political inequality.

It is, therefore, less destabilizing and more socially acceptable to engage in the "more or less" game, in which economic agents reinforce and even complement each other. To reduce poverty, the rich can provide as many employment opportunities as possible, which will enable the poor to ease their economic hardship. Improvement in the economic well-being of the low-income earners, in turn, provides more economic opportunities for the rich in terms of investment, labor supply, and demand. The relationships between employers and employees and suppliers and consumers forge links between individuals with different levels of economic well-being, endowments, and needs. A societal equilibrium can be achieved at the economic level, as economic agents complement each other. Thus reduction in poverty is a positive-sum game to both the rich and the poor.

Economic goals are often targets that are inter-temporal and take a long time to materialize. They usually require a politically stable and investment-friendly environment. Periodic changes in policies and polity are highly undesirable, as they can result in severe economic distortion and instability, even before economic results materialize. Economic growth and development should not be interfered with politically, especially in a developing economy when productive resources are scarce. Popular political activities that call for "democratic" governments often interfere with the economic growth

process, resulting in one form of inequality being replaced by another. Political opportunists often look for short-term results. For example, because of the need to appeal to the majority of voters, typical inter-temporal political promises, including large government expenditure on welfare, or increases in wages, will be made without taking into account their effect on productivity or competitiveness. These promises are easy to make, and even easy to carry out when voted into power, but the price can be long-term, often adverse, changes in growth. The more such adverse short-term policy changes are made, the greater the adverse effects on long-term growth. In many less developed countries, economic growth has often been sacrificed for political ends. And since political players often look for short-term results, the path of long-term economic growth becomes more and more remote. And if the rulers are in conflict with the ruled, society ends up moving from one form of instability to another, resulting in a prolonged period of poor economic performance.

Economically, everyone wants to move from "less" to "more." Politically, the "rulers" are always in the minority, while the "ruled" formed the majority. The optimal combination is to have less of the "ruler" in politics, and more of the "more" in economics. This suggests that a responsible regime, however it gains its power and authority, should make economic growth and development *the* political target, and *not* simply an instrument of politics. In other words, when economic growth is considered to be the top priority for society, the government and civic institutions will work for a higher level of economic performance. If political regimes, democracy, and elections all serve to promote a stronger economy, the political outcome will be more acceptable, as everyone prefers the economic "more or less" game.

One has to clarify the argument that economic growth should not be interfered with politically. When the regime makes a conscious decision that economic growth is the ultimate target, such a decision in itself is political. It can be concluded that there has to be a conscious political decision to allow economic growth to be the target, and the growth process should be left alone, free from political interference. If that can happen, the political game and the process of political change will take place within the political arena itself and there will be no adverse political effect on economics. The purpose of government interference, in the form of regulations, is to ensure the efficient functioning of markets and that obstacles to the process of economic growth are removed.

The experience of the four East Asian economies shows that economic growth has been the political target for development. Firstly, the positive-sum economic game is a useful means of reducing absolute poverty and producing wealth, which improves the well-being of the population. Economic growth works on an integrated circuit, and agents in the circuit complement each other. The employer needs the employee and the supplier needs the consumer and so on. Agents do not see each other as the opposition as economic growth requires an increase in all activities within the circuit.

Secondly, distribution is conducted primarily through the free-market mechanism, which rewards each factor endowment economically, supplemented by government intervention through fiscal means to ensure a minimum level of "survival". Growth takes priority over distribution and a virtuous circle is generated. But, there must be something to share before a process of distribution takes place. Thus, the more there is to share, the better the distribution will be, though the two may not necessarily be equal. Whatever is distributed ultimately comes back to the economic circuit, and that stimulates the next round of economic growth.

Political changes and democracy are necessary, but they should not affect economic growth negatively. Despite the various forms of political regime in the four East Asian economies, it has been argued that Asia's communitarian ethos is a temporary phenomenon and political democracy will eventually emerge (Hood 1998; Mascarenhas 1999). This argument is supported by the experiences of Taiwan and South Korea. This is best seen as a consequence of economic growth, whether intentional or not. Political change and the emergence of democracy becomes a separate process. The conceptual logic is that economic well-being is everyone's requirement, and if that cannot be achieved, whoever is in power becomes a purely political matter. The test of a good regime is whether it can ensure continued growth in economic well-being. Political regimes, therefore, must be pro-growth.

7.5 Economic freedom

The essence of a politically-aware, pro-growth regime is probably economic freedom. Freedom in the allocation of resources, economic associations, factor mobility, ownership, and financial transactions are the main components necessary for maximum economic growth. Economic freedom allows agents to maximize their economic transactions in the circuit. Democracy has been regarded as a crucial element in modern politics, but economic freedom is the more fundamental concept. Empirically, there is a consensus that political instability hinders economic growth. Political instability invariably reduces foreign investment, and the capital supply will become inactive if it is not reduced (Haan and Siermann 1996). One way to prevent political instability is to avoid civil unrest or any direct conflict between the ruler and the ruled. The state, in turn, must ensure the availability of readily-mobilized resources and promote the path of economic success toward that end. Some argue that it takes a "hard state" to play the game of economic catch-up (Lee and Lee 1992).

The same argument can be used for the importance of economic freedom. Once agents are allowed to maximize their economic gains through a free market-capitalist system, the attention of society will be devoted to the generation of economic wealth. Given the open nature of society, transactions within the economic arena will dominate. The chance of political instability will diminish as more economic transactions take place. Economic freedom

is, therefore, the key that reduces the threat of political instability. It is easy for a vicious circle to develop once political instability has precipitated the departure of economic factors, especially capital. Conversely, it is easy for a virtuous circle to develop as political stability draws capital into the economy. Conceptually, economic freedom is the key to the success of the positive-sum economic game.

Economic freedom or liberalism is more fundamental than economic or political democracy as it concerns the well-being of every economic agent. The essences of economic freedom are autonomy, mobility, and ownership. Endowments processed by economic agents include economic factors and resources. It is important that they are free to transact goods and resources in the pursuit of their own economic well-being. The degree of economic liberalism differs among the four East Asian economies. Whereas Hong Kong and Singapore have favored a high degree of economic freedom, Taiwan and South Korea are generally less liberal, have a larger public sector, operate a tighter financial system, and have chosen to promote specific industries. Wade (1995: 119) concludes that the main difference in economic freedom is in the "more disciplined use of state power" in promoting development. Nonetheless, differences in economic liberalism are reflected in comparative measurements of economic freedom.

The *Index of Economic Freedom,* which is compiled annually by the Heritage Foundation and the *Wall Street Journal,* has repeatedly shown that countries which permit economic freedom experience a higher rate of long-term growth and are more prosperous. The *2000 Index of Economic Freedom* (O'Driscoll *et al*. 2000) also acknowledges for the first time, based on studies by Barro (1996), that it may not be the promotion of democracy that results in economic prosperity. More important and relevant is the rule of law, or an effective legal system that respects the property rights of the individual and covers not only ownership, but crime, taxation, and government expropriation. Investment is discouraged and productivity falls when the efforts of individual economic agents are subject to social, political, and economic expropriation. In these situations, economic growth will be retarded. Furthermore, economic freedom is an effective deterrent of corruption, which flourishes more in non-capitalist economies. Foreign aid is not always the answer to solve domestic ills in countries with little economic freedom. The *Index* concludes that progress towards economic freedom is a "solid predictor" of an increase in wealth.

Hong Kong and Singapore are ranked first and second in the list of the most open economies out of 161 countries included in the *Index* (Table 7.1). Taiwan and South Korea lag behind in comparison, and their scores have deteriorated after a slight improvement in 1999. The economic freedom index is based on the ratings (from 1 = the best, to 5 = the worst) given to fifty economic variables. These variables are grouped under ten categories of banking, capital flow and foreign investment, monetary policy, government fiscal burdens, trade policy, wages and prices, government intervention,

Table 7.1 Index of economic freedom rankings

		Score in						
Rank	*Country*	*2001*	*2000*	*1999*	*1998*	*1997*	*1996*	*1995*
1	Hong Kong	1.30	1.30	1.30	1.30	1.40	1.30	1.30
2	Singapore	1.55	1.55	1.40	1.40	1.50	1.50	1.50
3	Ireland	1.65	1.85	1.90	1.90	2.10	2.10	2.10
4	New Zealand	1.70	1.70	1.70	1.85	1.80	1.80	
5	Luxembourg	1.75	1.80	1.95	1.85	1.70	2.00	
5	United States	1.75	1.80	1.80	1.85	1.80	1.85	1.90
7	United Kingdom	1.85	1.90	1.80	1.85	1.90	1.90	1.90
8	The Netherlands	1.85	2.05	2.05	2.10	1.95	1.90	
9	Australia	1.90	1.90	1.90	1.90	2.15	2.05	2.05
9	Bahrain	1.90	1.80	1.80	1.90	1.70	1.80	1.70
9	Switzerland	1.90	1.90	1.90	1.95	1.95	1.95	
20	Taiwan	2.10	2.00	1.90	1.95	1.95	1.95	2.00
29	South Korea	2.25	2.40	2.20	2.25	2.25	2.30	2.15

Source: *Index of Economic Freedom*, Heritage Foundation, various years.

property rights, regulation of markets, and activities in the black-markets. In the *2000 Index*, South Korea achieved a score of 3 in four of the macroeconomic variables (trade, monetary policy, banking, and regulations), and a score of 2.5 in government fiscal burdens and government intervention. Taiwan achieved a score of 3 in government intervention, foreign investment, and banking. Banking is the area that needs to be liberalized in both South Korea and Taiwan. Deregulation and reductions in government interference are the next priorities to be tackled in order to improve its performance in the economic freedom index.

The ten categories included in the economic freedom index reflect the importance of maintaining a sound domestic economy rather than relying on foreign support. In the calculation of the economic freedom index, trade policy and foreign investment is the only external item. Economic freedom can conveniently be divided into individual freedom, free market and efficient market practice, freedom from government intervention, and an open economy with no border restrictions. These divisions of freedom can be paired conceptually with the ten macroeconomic categories as follows:

- Individual freedom: the first law of economic incentive – *property rights* – allows individuals to own and transact properties freely. In some economies, for example Hong Kong, land is owned by the government but is leased out for periods as long as 100 years, thus giving the use and right of transaction to the users.
- Market freedom: markets must by and large be free to operate so that transactions are based on private will and perfect information. *Black markets* are eliminated. A free market also implies an efficient market

protected by sound *regulations*, but not over-regulated. *Wages and prices* should also be determined according to market conditions.

- Non-government interference: the government should not be the pioneer in increasing output and production, except in the area of infrastructure. Sound *regulations* (could be interpreted as the exercise of the rule of law) are intended to prevent market failure and eliminate economic outliers. Other than that, *government intervention* should be minimized. A small and efficient government suggests that economic opportunities are left in the private market. A rise in output and job opportunities permits the government to raise more revenue on the one hand, and spend less on welfare on the other. Government expenditure remains within the limits of its ability to earn, and the *fiscal burden* is minimized, if not eliminated.
- Freedom in the financial sector: the rise in production and output necessitates the activities of the monetary and financial sector. Equally, *banking* activities should not be intervened in by government. The presence of market competition and sound *regulation* will direct *capital flows* to their most productive destinations. A prudent *monetary policy* will add to market confidence in *capital flows*.
- Open economy: the free market economy will attract *foreign investment*, which could increase domestic productivity or be export-oriented. The economy will benefit from the supply of external resources via *trade* and *foreign investment*, either direct, or portfolio, or both.

Economic freedom also eliminates underground activities, such as corruption by political opportunists and government officials, as much as possible (for a discussion, see Colander 1984; Rose-Ackerman 1999). A virtuous circle of economic freedom, output, and production, reduction in poverty and deprivation, and ultimately economic prosperity can then be developed.

7.6 Political change or endogenous democracy?

In an extreme situation, while the ruling regime is often judged on its number of years in government, the economy can be deprived of development opportunities. Political opposition builds up and soon leads to demands for reform of, changes in, or even removal of, the ruling regime. The ruling regime will, in turn, devote more of its already scarce resources to containing political opposition, typically by the acquisition of arms from developed countries. The lack of economic development results in further entrenchment of political opposition while the economy becomes more impoverished because resources are now being used for political ends. This creates a vicious circle of political rivalry and lack of development.

Whereas democracy has often been regarded as a political aim, a political regime should instead consider what it has done to improve the well-being of

the economy. Political change is often thought to bring into play exogenous forces from opposition groups, foreign governments, and civil unrest. Political change can also be endogenous with the ruling authority initiating reforms. A deliberate effort to eradicate corruption will eliminate a lot of underhand activities and bring credibility to the ruling regime. Open examinations to recruit civil servants to replace corrupt individuals allows able citizens to work for the government and for the betterment of society. The ruling regime can also set good, creditable examples of how it is working for the good of the economy and society, and show public accountability.

In other words, democratic changes can be introduced endogenously, involving a process of internal changes made by the ruling regime to make the system more accountable, open, and acceptable. Endogenous democracy can generate political virtuous circles that have positive spillover effects on economic development. An improvement in political accountability achieved, for example, through a process of eradicating corruption, will increase the government's domestic and international credibility. In turn, this may attract foreign direct investment, or an improvement in the economy's international rating. The new inputs of investment resources help the economy to grow and employment opportunities will increase. A political–economic virtuous circle can help to foster a positive-sum economic game. Political regimes that introduce endogenous change tend to experience an increase in their credibility, and the resulting economic goodwill promotes growth and development. The increase in income, output, and wealth will in turn lend further support to the increasingly credible regime. Reinforced by such improvement, further political changes can be introduced and the next round of the virtuous circle will develop. Endogenous political changes can also lead to democratic and accountable regimes without an eruption of political instability or civil unrest, and democracy can be achieved through a more gradual process.

The four East Asian economies are regarded as small economies, Singapore is considered to be a city-state. It is convenient to argue, however, that political changes are easier in small economies than in large countries. The credibility of a regime does not depend upon the size of the economy, but whether the political regime is employing a society-centered approach or a state-centered approach in its governance.[5] In the society-centered approach, economic agents employ political instruments for economic ends. Economic democracy and bounded rationality are examples of political dimensions in economic decisions (Williamson 1985). In contrast, a state-centered approach allows political agents to use economic instruments for political ends. Economic redistribution through welfare expenditure is a good example of a state-centered approach. The two approaches have a different emphasis. Whereas maximizing the economic outcome is the target of the former, the satisfaction of interest groups and enlarging the vote are the objectives of the latter.

The process of political change also involves transaction costs and requires an appropriate incentive system of rewards and delegation and/or power

sharing. Endogenous political changes require endogenous democratic practices. Thus, while democracy is the long-term political objective, a ruling regime can improve its credibility through political changes introduced within its own control. A more accountable and responsive political regime will subsequently engender positive economic spillovers. Economic gains will further lend support to the output-oriented regime, and that, in turn, promotes stability and permits more liberal changes to take place. The bottom line is that political change should not occur at the expense of stability nor lead to a decline in economic well-being.

7.7 Conclusion

This chapter attempts to clarify a number of arguments between politics and economics. The "lead and led" relationship between the two is based on the confusion around the extent to which the two disciplines can be separated – but there are areas of commonality. The output and productivity of individuals and organizations are purely economic factors. The issue of distribution is the area of economics that spills over into politics, especially non-market distribution, which involves transfer payments to those with low endowment. The problem rests in the emphasis put on each, and often priority is mistakenly given to distribution rather than output generation. The economy must generate output before it can be distributed. An increase in output, income and, productivity, or simply economic growth, must be given top priority. A high rate of growth implies a larger economic pie, and those with high endowment will have a higher level of well-being. This, in turn, allows more resources to be redistributed, either through the government which acts as a "social planner," or through a free-market system, or through a voluntary system like charity.

Increasing individual endowment, typically through education and training, and social endowment, through R&D activities and the provision of social infrastructure, is often a better strategy than a pure redistribution of welfare from those with high endowment to the lower-endowment individuals. In other words, an improvement in the ability to earn has a more lasting effect and is a preferable strategy to a discrete event of redistribution. There is a circular relationship between economic growth and human development, measured in such indices as education, health, life expectancy, and infrastructure provision (Ranis *et al*. 2000). Economic growth enhances human development, and a higher level of human development, in turn, permits growth. Taiwan's human development index, for example, has increased from 0.728 in 1980 to 0.896 in 1993. In 1992, the human development index of the four East Asian economies were ranked below Japan, in descending order, Hong Kong (0.905), Taiwan (0.894), South Korea (0.882), and Singapore (0.878). Their rankings compared to all economies in the world are 24th, 26th, 31st, and 35th respectively (Ranis 1999: 7–8).

The provision of education, social infrastructure, and so on requires an

increase in income and output, both individually and across society. These activities are objective and positive economic issues, which should not be interrupted by normative political decisions. Democracy is political freedom and should be debated among political scientists. Economic issues are long-term goals that should not be mixed up with political activities. There is, therefore, no "lead and led" relationship between economic freedom and political democracy. Conceptually they represent different issues. Economic freedom gives rise to other forms of freedom. The experiences of the East Asian economies show that economic growth is a conscious political target, regardless of the type of political regime. It is as a result of growth that there is more to distribute, and, in turn, the process of distribution is made easier by growth. As more is available, more resources are devoted to improving factor endowment, including human development.

Economic freedom is the root of positive economic activities as economic powers are decentralized into the hands of individuals and organizations. There are, however, a couple of qualifications. One is the existence of a well-respected set of rules or laws to guard against market failures and/or extreme forms of economic activities, such as child labor. Economic freedom, together with the efficient functioning of the rule of law, governs individual economic agents as they maximize their utility function. Linkage effects can be created once private individuals are economically free. For example, the establishment of entrepreneurial businesses leads to a rise in employment. Wages may start at a low level, but with improvements in skills, experience, and value-added aspects, the rewards will also increase. Competition helps to allocate resources on the basis of supply and demand.

Both Hong Kong and Singapore are economically more free than Taiwan and South Korea. To a large extent, this is reflected in the level of GDP per capita over the years, the extent of foreign investment, and human development indicators. Compared with other developing countries, however, Taiwan and South Korea are more free than a great number.

8 The Asian financial crisis

8.1 Introduction

Has the Asian financial crisis (AFC) torpedoed the paradigm of economism? The AFC occurred at a historic time when stability and prosperity were needed and desired in virtually all economies in Asia. In the late 1980s and early 1990s, there was even talk about the "Pacific century," suggesting that the development of Asian economies would become sustainable and dominate the world economy in the twenty-first century. Optimism remained high despite the structural difficulties that occurred in the Japanese economy in the early 1990s. The Asian economies were thought to be shielded from the economic and financial crisis in Latin America in the early 1990s. However, events in the second half of 1997, immediately after the reversion of sovereignty of Hong Kong, shattered all hopes of any favorable outcome as the growth and assets of number of Asian economies plummeted and their currencies depreciated. The East Asian "miracle" was over, leaving behind a number of "crisis-torn" economies with severe domestic structural problems.

The reasons for the AFC have been explained by a number of theories that can be consolidated into the fundamentalist school and the contagion school. Little discussion, however, has been devoted to the future path of the Asian economies, especially the four East Asian economies of Hong Kong, Singapore, South Korea, and Taiwan. Will the success of the last few decades come to an end? Will the fundamental factors that brought growth to these four economies remain in place? Has the view on poverty versus inequality changed? Or has the role of government been reversed? The discussion should concentrate on whether the AFC has changed the essence of the paradigm of economism.

This chapter attempts to summarize the various issues in the AFC, but argues that the "floor conditions" or fundamentals of the economism paradigm have not been changed. The AFC has not affected the conceptual underpinnings in the economic development of East Asian economies. Indeed, the AFC has brought out the importance of the need to preserve the "floor conditions," as they are an effective shield for the economy. The AFC merely highlighted the importance of business cycles and the need to avoid crisis. An equally important issue is the various implications of the AFC for the

economics of development in such areas as trade and competitiveness and the twin development of the nominal/financial and real economic sectors.

Section 8.2 elaborates on the two phases of the AFC. The first phase relates to the fundamental factors, while the other concerns the spillover from the economic difficulties facing the Japanese economy. Section 8.3 summarizes the two theoretical debates on the AFC, and concludes that the two theories are probably complementary to each other. Section 8.4 examines the AFC within the four East Asian economies. From a comparison of its economic performance with Taiwan, one can see that South Korea is faced with a problem of overcapacity, with excess industrial supply and low foreign demand. Section 8.5 extends the discussion of the AFC to three major implications for the economic development of Asia: trade and competitiveness, the emergence of mainland China, and the importance of the real economic sector. After considering the various dimensions of the AFC, it is argued that the paradigm of economism has not been affected. If anything, the AFC does highlight the need to maintain the essential "floor conditions" of the paradigm. This argument is presented in section 8.6.

8.2 The two phases of the crisis

Although there are alternative explanations for the Asian financial crisis (AFC), which led to the downfall of a number of Asian economies between 1997 and 1998, there was a cluster of economic events in the 1990s, both internationally and in Asia, which could be considered to be the origin of the crisis. The crisis, which began in Mexico in 1994, soon spread to Argentina in 1995. Features that seemed peculiar to one region spread to another and generated a global phenomenon (see, for example, Meigs 1998). The Asian crisis that swept Thailand, Indonesia, Malaysia, and South Korea in 1997–98 was followed by a crisis in Russia in 1998–99. The official start of the AFC is thought of as 2 July 1997, when the Bank of Thailand floated the baht and raised the discount rate to 12.5%, and a team from the International Monetary Fund (IMF) arrived to help resolve the economic crisis. The crisis in Thailand is believed to have been caused by the twin forces of the property bubble bursting and currency speculation.[1] In Malaysia, Bank Negara's support of the ringgit on 2 July 1997 caused the foreign exchange reserve to drop by 12% and the value of the ringgit had fallen to a three-year low by mid-July. The currency crisis swept onward to different South-East Asian economies. Together with Indonesia's rupiah, and the Philippines' peso, Asian currencies all slumped as confidence in the region deteriorated. Both the currency and stock market index saw large percentage declines.[2]

Table 8.1 shows the extent of currency depreciation in the periods before and after the AFC. In 1997 alone, six of the seven Asian economies suffered currency depreciation; the worst affected were Indonesia, Thailand, Korea, Malaysia, the Philippines, and Taiwan. The average percentage currency depreciation among these six heavily affected economies was –61.99%. Hong

Table 8.1 Depreciation of Asian currencies

	Singapore	*Korea*	*Taiwan*	*Philippines*	*Thailand*	*Indonesia*	*Malaysia*
Unit/US$							
1994				24.418	25.09	2,200	2.560
1995	1.5274	774.7		26.214	25.19	2,308	2.542
1996	1.4174	844.2	27.49	26.288	25.61	2,383	2.529
1997	1.4100	1415.2	32.64	39.975	47.25	4,650	3.892
1998	1.4848	1207.8	32.22	39.059	36.69	8,025	3.800
1999	1.6736	1145.4	31.40	40.313	37.52	7,085	3.800
2000	1.6950	1259.7	33.03				
Currency depreciation (%)							
1994							
1995				–7.36	–0.40	–4.91	0.70
1996	7.20	–8.97		–0.28	–1.67	–3.25	0.51
1997	0.52	-67.64	–18.73	–52.07	–84.50	–95.13	–53.89
1998	–5.30	14.66	1.29	2.29	22.35	–72.58	2.36
1999	–12.72	5.17	2.55	–3.21	–2.26	11.71	0.00
2000	–1.28	–9.98	–5.19				

Sources: Asian Development Bank; Monetary Authority of Singapore; Bank of Korea; and www.boma.gov.tw/sta

Kong's currency was linked to the US dollar, though there was speculative pressure for the Hong Kong SAR government to sever this link. Singapore's currency depreciated in the three years after 1997. Indonesia was badly affected as it experienced another substantial depreciation in 1998. The three weaker ASEAN economies of Thailand, Indonesia, and the Philippines saw their currency depreciate throughout most of the 1990s.

In Korea, the financial crisis began with the bankruptcy of the Hanbo conglomerate in January 1997, followed by two others, Sammi in April and Kia in July. By 7 August 1997, Standard and Poor rated Korea's economic status as "negative." The exchange rate soared and Korea faced serious foreign debt. By November, stock prices had plummeted and aid from the IMF was eventually requested on 21 November 1997. The impact of the AFC on Taiwan was marginal; however, one drastic move was the devaluation of the new Taiwan dollar on 18 October, which resulted in a 4% fall in Taiwan's stock index on 20 October.[3] Its industrial sector declined by 3.6% in 1998.[4] The impact of the AFC on Malaysia, Thailand, and Indonesia had a spillover effect on Singapore, which saw a fall in economic growth from 8% in 1997 to 1.5% in 1998. However, sound economic fundamentals shielded Singapore from more severe damage (Chia 1998).

In Hong Kong, the Hang Seng Index dropped dramatically by 23% over three days from 20 and 23 October 1997. The index, which peaked at over 16,000 points in mid-July 1997, was down to around 6,600 points in August 1998. The stock market was volatile during this period, but stability was restored when the Hong Kong Monetary Authority intervened with a total of

HK$15 billion in August 1998. The currency remained under strong pressure, though the Hong Kong authority repeated reassurances that the Hong Kong currency would remain pegged to the US dollar. Interest rates rose sharply in order to defend the Hong Kong dollar from speculative attack. On one occasion, the Hong Kong Monetary Authority pushed the overnight inter-bank loan rate up to 300%. Fortunately, Hong Kong's reserve was sufficiently large to defend its own currency.[5] Its accumulated surplus in the exchange fund amounted to US$24,543 million in December 1997 and increased to U$35,737 million in January 2000 (Hong Kong Monetary Authority 2000).

Table 8.2 shows the monthly stock indices and value changes in the two years, 1997 and 1998, for the four East Asian economies. The four show similar trends, but South Korea was the first to suffer, as its stock index began to fall in June, followed by Hong Kong and Singapore in August, and Taiwan in September 1997. Stock indices remained low for a period of about six months, then recovered in either January or February 1998, though they did not regain their original levels. By the middle of 1998, the four indices had dropped again, but remained steady. Similar movements were seen in the value of stocks. It can be argued that the stock indices of the four East Asian economies recovered in early 1998, but effects of the aftermath of the AFC and the subsequent economic hardship began to emerge in the second quarter of 1998. The economic hardship comprised a fall in growth of GDP and per capita GDP, a fall in exports as well as imports, pressure on the currency to devalue, a rise in unemployment as output fell, and a negative effect on wealth as asset prices depreciated. Economic hardship resulted in increased poverty, which was alleviated slightly by a fall in inflation.

The statistics in Table 8.3 show that many Asian economies experienced a significant fall in the growth rate of merchandise exports in 1996, which remained low in 1997 and was negative in 1998. South Korea and most of the ASEAN economies (Thailand, Malaysia, and Indonesia) also saw a sharp decline in their balance of payment current accounts. Without instant market adjustments in the foreign exchange market, the overvaluation of many Asian currencies eventually invited international speculators.

One other possible cause for the decline in exports of the Asian economies was the devaluation of the renminbi, the currency of the People's Republic of China, by over 30% in 1994 (see, for example, Li 1997; EAAU 1999). Statistically, this led to the recovery of China's balance of payment with a large growth in exports and trade surplus, but it may have resulted in the diversion of exports away from the Asian economies, which were producing similarly competitive, labor-intensive, light industrial manufactured goods to the People's Republic of China. This would appear to be the case, given that world trade is constant in the short run, but evidence seems to suggest that there was no immediate trade diversion (Fernald *et al*. 1999). As can be seen from Table 8.3, several Asian economies experienced a higher rate of export growth in 1995 than in 1994, and China saw a lower export growth rate in 1996. Furthermore, the export shares of both China and the other

Table 8.2 Monthly stocks movements, 1997–98

	Taiwan		*South Korea*		*Hong Kong*		*Singapore*	
	Index (1966 = 100)	*Value (million NT$)*	*Index (1/4/84 = 100)*	*Value (million won)*	*Index (7/31/64 = 100)*	*Value (million HK$)*	*Strait Time Index*	*Value (million S$)*
1997	8,410.56	37,214,148	376.3	162,281.5	13,294.70	3,788,960	1,507.65	114,302.5
Jan	7,135.16	1,865,920	685.8	11,969.8	13,321.79	246,158	2,055.44	10,366.5
Feb	7,642.26	2,305,608	676.5	12,115.4	13,398.72	156,560	2,057.61	13,844.9
March	8,166.46	3,555,460	677.3	12,972.3	12,534.32	194,532	1,894.82	8,830.9
April	8,505.78	3,599,059	703.2	15,198.9	12,903.30	200,238	1,822.28	7,547.7
May	8,146.61	2,408,399	756.8	17,311.7	14,757.81	343,831	1,959.50	8,086.8
June	8,604.60	3,756,763	745.4	17,435.4	15,196.79	398,970	1,921.48	7,408.4
July	9,553.26	5,127,168	726.1	15,233.6	16,365.71	409,601	1,950.18	9,858.2
Aug	9,890.34	3,900,531	695.4	12,696.8	14,135.25	637,007	1,743.96	12,220.8
Sept	9,111.67	2,559,676	647.1	9,258.9	15,049.30	424,605	1,861.05	11,325.1
Oct	7,983.28	2,432,660	470.8	10,711.2	10,623.78	375,729	1,507.51	9,708.8
Nov	7,731.90	2,443,978	407.9	14,317.9	10,526.92	229,284	1,583.79	7,639.1
Dec	8,148.84	3,285,926	376.3	13,059.8	10,722.76	172,445	1,507.65	7,465.7
1998	7,713.97	29,618,969	562.5	192,845.2	9,484.47	1,701,112	1,392.73	98,589.5
Jan	7,849.77	1,453,174	567.4	18,965.6	9,252.36	159,478	1,274.24	8,802.8
Feb	8,807.57	4,526,848	559.0	20,414.0	11,480.69	212,815	1,507.85	14,868.3
March	8,976.49	3,647,688	481.0	15,723.1	11,518.69	174,220	1,484.39	9,460.3
April	8,785.11	2,879,608	421.2	9,513.8	10,383.68	116,325	1,354.06	6,092.0
May	8,226.35	2,172,185	332.0	8,057.9	8,934.56	115,665	1,167.52	5,540.3
June	7,540.08	2,639,282	297.9	8,262.4	8,543.10	128,658	1,009.20	5,927.7
July	7,874.70	2,594,260	343.3	12,349.4	7,936.20	89,016	1,014.96	5,255
Aug	7,218.46	1,792,767	310.2	8,821.6	7,276.04	214,329	856.43	4,939.6
Sept	6,832.38	2,043,773	310.3	9,405.2	7,883.46	114,436	939.65	5,452.6
Oct	6,886.22	1,889,376	403.4	14,588.8	10,154.94	132,910	1,204.62	9,957.2
Nov	7,108.83	2,411,960	451.9	23,047.1	10,402.32	164,457	1,416.55	14,535.6
Dec	6,832.09	1,568,048	562.5	43,696.3	10,048.58	78,804	1,392.73	7,968.2

Sources: *Monthly Statistics Bulletin*, Monetary Authority of Singapore; *Hong Kong Monthly Digest of Statistics*, Hong Kong; *Monthly Bulletin*, Bank of Korea; *Financial Statistics Monthly*, Taiwan.

Asian economies in various industries and world markets were stable between 1993 and 1996.

In the case of foreign direct investment (FDI), the three East Asian economies of South Korea, Singapore, and Taiwan suffered a decline between 1991 and 1993. In South Korea, for example, it fell from US$1,180 million in 1991 to US$727 million in 1992, and to US$588 million in 1993. Malaysia and Thailand experienced a fall in FDI between 1992 and 1995, Thailand's falling from US$2,114 million in 1992 to US$1,730 million in 1993, and US$1,322 million in 1994, before beginning to pick up again in 1995. The fall in FDI in South Korea, Malaysia, and Thailand may have been responsible for the decline in their exports and deterioration in balance of payments, thus creating a foreign exchange gap. Given that total world investment is fairly constant in the short run, more FDI going to one economy necessarily meant less for others. China's accelerated FDI since 1994 could only have taken place at the expense of other Asian economies.

The bursting of Japan's economic bubble in the early 1990s has had a long-lasting effect on the Asian economies. Japan, the second strongest economy in the world, has been investing massively in both Asia and the US for a number of years. Since the early 1990s, Japan's economy has been stagnant, and its GDP growth has remained low, as Table 8.4 shows. Foreign direct investment has slackened, while portfolio investments were unstable in the 1990s. The large swings in portfolio investment probably generated instabilities in Asian and US markets.

Japan's FDI has also shown a mixed performance, as shown in Table 8.5. Japan's FDI to Asia and the US fell in 1998. The increase in Japan's FDI to Europe in 1998 was entirely due to the huge increase in its FDI to the UK, which increased from 5,054 million yen in 1997 to 12,522 million yen in 1998. Japan's FDI to other European countries also fell in 1998. Investment in Europe and Malaysia began to fall in 1994, then in Indonesia and Hong Kong in 1995 and 1997, and mainland China in 1996 onwards. Japan's FDI in manufacturing rose steadily until 1998 and the increase between 1996 and 1997 was slightly less than 4%. However, investment in non-manufacturing was more unstable, declining in absolute volume in 1994, 1996, and 1998, as shown in Table 8.5. The only non-manufacturing item that saw a rise in investment between 1997 and 1998 was finance and insurance, which increased from 14,688 million yen in 1997 to 20,964 million yen in 1998. All other items in the non-manufacturing category suffered a drop in investment.

Most analysts agree that a major problem in Japan's economic downfall was the lack of determination in both the speed and the scope of reform needed. Political decision-making concentrated more on short-term economic stability than on long-term strength. For example, despite mounting financial insolvency, workers were kept on and wages were paid, even though companies were suffering heavy losses. Thus, Japan's economic difficulty was not accompanied by appropriate economic contraction, and the economy was finally confronted with a financial system meltdown in the second half of

Table 8.3 Trade and foreign direct investment of major Asian economies (US$ million)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Hong Kong							
GDP growth (%)	6.1	5.4	3.9	4.5	5.3	–5.1	–0.5
Export growth (%)	13.2	11.9	14.8	4.0	4.0	–7.5	0.5
Balance of trade	–3,808	–10,923	–19,594	–18,352	–21,121	–10,946	–9,151
FDI	1,667	2,000	2,100	2,500	2,600		
South Korea							
GDP growth (%)	5.8	8.6	8.9	7.1	5.5	–5.5	2.0
Export growth (%)	7.7	15.7	31.2	4.3	6.7	–4.9	2.0
BP current account	939	–3,868	–8,507	–23,005	–8,167	40,039	25,000
FDI	588	809	1,776	2,325	2,341		
Singapore							
GDP growth (%)	10.4	10.5	8.8	6.9	7.8	1.5	1.0
Export growth (%)	16.6	30.8	22.1	6.4	–3.1	–5.6	2.0
BP current account	–4,066	5,057	7,231	14,486	14,833	15,362	
FDI	4,686	8,368	8,210	9,440	10,000		
Taiwan							
GDP growth (%)	6.3	6.5	6	5.7	6.8	4.8	4.9
Export growth (%)	4.5	9.4	20	3.8	5.4	–9.4	9.5
BP current account	7,042	6,498	5,474	11,027	7,688	4,649	7,373
FDI	917	1,375	1,559	1,864	2,248		
PRC							
GDP growth (%)	13.6	12.7	10.5	9.6	8.8	7.8	7.0
Export growth (%)	8.8	35.6	24.9	17.9	20.9	0.5	–5.0
BP current account	–11,903	7,657	1,617	7,281	29,720	25,000	10,000
FDI	27,515	33,787	35,849	40,805	45,300		

Indonesia							
GDP growth (%)	7.3	7.5	8.2	7.8	4.9	–13.7	0.0
Export growth (%)	3.4	15.5	13.3	9.0	7.9	0.7	6.5
BP current account	–2,940	–3,488	–6,987	–8,069	–1,698	1,423	
FDI	2,004	2,109	4,348	6,194	5,350		
Malaysia							
GDP growth (%)	8.3	9.2	9.4	8.6	7.7	–6.2	0.7
Export growth (%)	16.1	23.1	26.1	7.3	6.0	–11.4	3.8
BP current account	–2,991	–4,521	–8.47	–4,596	–4,791	5,113	3,671
FDI	5,006	4,342	4,132	4,672	3,754		
Thailand							
GDP growth (%)	8.4	8.9	8.8	5.5	–0.4	–8.0	0.0
Export growth (%)	13.4	22.1	24.8	–1.9	3.8	–6.6	5.1
BP current account	–6,159	–7,862	–13,248	–14,380	–3,130	13,500	11,000
FDI	1,730	1,322	2,002	2,268	3,600		

Source: *Asian Development Outlook 1999*, Asian Development Bank, statistical appendix Tables.

Notes
Exports = merchandise exports; BP, balance of payment current account; FDI, foreign direct investment.

Table 8.4 Japan's economic performance and overseas foreign investment (yen 100 million)

Year	*GDP growth rate, constant price, calendar year*	*Direct investment overseas*	*Overseas portfolio investment*	
			Stocks	*Public and corporate bonds*
1988	6.2			
1989	4.8			
1990	5.1			
1991	3.8	56,862	358	81,040
1992	1.0	44,313	1,315	37,609
1993	0.3	41,514	19,129	27,044
1994	0.6	42,808	9,958	69,801
1995	1.5	49,568	–528	73,480
1996	5.1	54,094	10,225	87,725
1997	1.4	66,229	10,874	–6,282
1998		52,169	29,012	95,677

Source: *Japan Statistical Yearbook*, Statistical Bureau, Management and Coordination Agency, Government of Japan, 1999 and 2000.

Table 8.5 Japan's overseas foreign direct investment (yen 100 million)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*
Asia	7,672	10,084	11,921	13,083	14,948	8,357
Indonesia	952	1,808	1,548	2,720	3,085	1,378
Singapore	735	1,101	1,143	1,256	2,238	815
Thailand	680	749	1,196	1,581	2,291	1,755
Mainland China	1,954	2,683	4,319	2,828	2,438	1,363
Hong Kong	1,447	1,179	1,106	1,675	853	770
Malaysia	892	772	555	644	971	658
USA	16,936	18,016	21,845	24,789	25,486	13,207
Europe	9,204	6,525	8,281	8,305	13,749	17,937
Manufacturing	12,766	14,426	18,236	22,821	23,731	15,686
Non-manufacturing	28,449	27,978	30,395	30,124	41,793	36,025

Source: *Japan Statistical Yearbook 2000*, Statistical Bureau, Management and Coordination Agency, Government of Japan.

Note
Non-manufacturing includes commerce, finance and insurance, services, transport, and real estate.

1997. This began with the closure of Sanyo Securities, a medium-sized securities firm, on 17 November 1997, closely followed by Hokkaido Takushoku, a commercial bank. Financial confidence collapsed as weaker banks experienced massive withdrawals of deposits by worried depositors. The climax was the closure of Yamaichi Securities, Japan's fourth largest

securities firm, on 24 November 1997, which signaled that a number of financial firms could well become insolvent. Yamaichi's debt amounted to 3.2 trillion yen (US$25 billion); the news sent the stock market down by 5.1% the next trading day, and the yen fell to 128 against the dollar, a five-year low. It was disclosed that Yamaichi had concealed losses amounting to 264 million yen (US$2 billion) from the regulators by setting up dummy companies in the Cayman Islands. On 26 November, another bank, the Tokuyo City Bank, also declared trading closed.[6]

The Japanese economy was reported to have contracted on an annual basis by 11.2% in the second quarter of 1997. Fiscal policy was used to address the financial ills in April, when tax rates were increased. A new plan was released on 21 August to "reinvest" the government, and on 21 October a set of economy-stimulating measures was released. The third economic package, released by the Liberal Democratic Party under Prime Minister Ryutaro Hashimoto on 16 December 1997, included a US$16 billion income tax cut and reversed a tax increase announcement made in April 1997. A total of ten million yen (US$76 billion) was spent to ease the financial burden. Japan's budget deficit was already more than 5% of GDP, and the tax cut was not considered to be either a lasting or an appropriate solution.[7]

Japanese banks were riddled with bad debts, amounting to 79 trillion yen, from a collapse in asset prices. Two negative implications emerged from Japan's financial crisis. Firstly, it was feared that Japan might resort to devaluation of the yen in order to boost exports. This would have contributed to a new round of currency devaluation elsewhere. Secondly, there was speculation that, because Japanese banks had been the major lenders in Asia and various other regions, it was possible that they might recall these loans. Furthermore, it was thought that the collapse of Yamaichi would accelerate bankruptcies in the financial sector. Banks were under pressure to shore up their balance sheets and sell off their vast holdings of US treasuries to raise cash.[8]

It was against this background of negative implications that the Asian financial markets suffered drastic falls over a period of time. The Japanese Prime Minister Ryutaro Hashimoto met President Bill Clinton of the USA in late 1997, and it became clear that even President Clinton preferred Japan to solve its economic problems "domestically." Investors and equity holders probably thought differently and held a more cautious view. It would have been easy for Japan to call back loans from US borrowers or liquidate US treasuries. Similarly, investors in the US, and probably in Europe, would naturally want to protect their home markets and equities by recalling funds from other free markets in Asia. Japanese banks and investors would choose to withdraw funds from the politically less restrictive markets of Asia. It has been reported that in South Korea and the four ASEAN economies of Malaysia, Indonesia, Thailand, and the Philippines, a total inflow of private foreign capital amounting to US$76 billion in 1996, became a net outflow of US$36 billion in 1997. Commercial banks lent a total of US$63 billion in

1996, but recalled a total of US$26 billion in 1997. Together, they represented about 12% of GDP in these countries.[9]

Within the short period of time between the last quarter of 1997 and the first quarter of 1998, all financial markets in Asia, typically Hong Kong, Singapore, Taiwan, South Korea, Malaysia, Thailand, Indonesia, and the Philippines suffered a massive withdrawal of funds, which is indicated by the drastic movement of stock indices in Table 8.2. The withdrawal of equity and subsequent depreciation in the stock markets soon generated a vicious circle in the financial sector. Commercial banks, in turn, recalled their domestic loans, and the demand for domestic currency led to a sharp rise in the market interest rates. High interest rates and restrictive loans discouraged investment, leading to a fall in aggregate demand and employment.

Massive foreign fund transactions required a strong back-up of reserves. Economies that were already experiencing difficulties with their balance of payments or with weak reserves now had to face the dilemma between devaluation and a reduction in reserves, or both. Furthermore, the withdrawal of Japanese funds was coupled with bankruptcy and closure of Japanese banks, financial institutions, and retail outlets. Although fund withdrawal was sharp and generated other financial difficulties, it was short-lived. By the third quarter of 1998, investors were returning to Asian markets, partly because the Japanese financial system had stabilized and the threat of further withdrawal had subsided, and partly because the large falls in share prices in Asia had made it attractive to investors. There was a reversal of capital flow back into Asia and the stability of its financial and banking sectors was restored. Thus, the AFC could be represented by a V-shaped graph of growth in GDP over the period 1998–99, as the performance of the Asian economies both collapsed and recovered very quickly.

Some analysts have argued that the AFC was more of a crisis of success because of the Asian markets' attractiveness. Indeed, one can argue that there were two phases of the AFC. The first phase was caused by the cumulated fall in exports and resulted in a large balance of payments gap, which ultimately invited currency speculation. This began with the devaluation of the Thai baht in July 1997, followed by that of South Korea's won. The first phase ended with great downward pressure on the price of Asian stocks in mid-1997. The second phase began with the financial meltdown in Japan in late 1997, sending world investors back to protect their own markets by recalling loans and liquidating assets in Asian markets. This resulted in further asset depreciation, leading to economic downfall, within a short period of time in 1998. The reversal of capital flow to Asian markets in the third quarter of 1998, however, brought the AFC to an end, though complete economic revival took a longer time. One can argue that the first phase constituted a deficiency in economic fundamentals, whereas the second was a crisis of confidence that resulted in large outflows of funds in a short period of time and a rapid reversal of capital flow once confidence was restored.

8.3 Theoretical explanations of financial crisis

There are two schools of thought in the literature to explain the cause of the financial crisis in Asia. The fundamental-based hypothesis views the unsustainable deterioration in macroeconomic fundamentals and the poor economic performance, based on weak structural factors, as "preparations" for a financial crisis (Kaminsky *et al.* 1998; Krugman 1998a,b). Typical macroeconomic factors include the level of international reserves, the movement of real interest rates, the size of domestic credit and credit to public institutions, the domestic inflation rate, the trade balance, export performance, the growth of real GDP, growth in the supply of money, and the level of fiscal deficit. The movements of these macroeconomic variables provide a number of indicators or "signals" that an economy is drifting beyond certain thresholds.

The so-called "first-generation" models examine the economic fundamentals that caused the crisis (Krugman 1979; Agenor *et al.* 1992; Blackburn and Sola 1993; Garber and Svensson 1994). Typically, there were economic inconsistencies between domestic economic conditions and an exchange rate regime. A persistent money-financed budget deficit coexisted with a limited amount of reserve to back up the economy's exchange rate. The authority was then forced to decide between the two evils of either abandoning the exchange rate and suffering currency depreciation, or raising the interest rate and suffering the adverse consequences of a higher rate of unemployment and a fall in investment and aggregate demand.

Other than the persistent fiscal deficit, there was excessive investment in risky and low-profitability projects. Such investment was facilitated by several factors. Firstly, there was political pressure to increase capital accumulation and enhance economic growth. Borrowing from abroad to sustain a high rate of investment at home is a common feature in rapidly growing economies, but the investment boom in the Asian economies in the 1990s was directed toward projects in the non-traded sector, especially those in real estate, which do not contribute directly to increases in the future trade balance to facilitate the repayment of foreign debts. Secondly, the profitability of new investments was low. The low incremental capital–output ratio coexisted with a rising level of non-performing loans, leading, for example, to bankruptcy in large conglomerates in Korea.

Many of these new investments were borrowed on a short-term basis, whereas the lending was made on a long-term basis. As a result, there was an accumulation of short-term foreign currency denominated debts. In the early 1990s, the international financial markets responded enthusiastically to the investment-oriented policy of most Asian economies. Owing to the low interest rates in industrial countries, investors began to look for higher-yielding investment opportunities in emerging markets. In principle, a large share of capital inflows in the form of long-term foreign direct investment should lead to a decrease in the vulnerability to external crises. In Asia, however, a large portion of foreign debt accumulation took the form of short-term foreign

currency denominated and unhedged liabilities. With the heavy reliance on debt-creating flows rather than foreign direct investment, there were mismatches in maturity and currency denomination between short-term foreign currency liabilities and long-term domestic currency denominated assets. A lack of currency hedging of the foreign debt by banks and firms increased the financial vulnerability of the Asian economies.

The "second-generation" models examine the economic consequences when the crisis broke out. A financial crisis usually begins with a sudden speculative attack on currency through two international transmission channels (Eichengreen *et al.* 1994; 1996; 1998). The first channel works through bilateral trade. Speculative currency attacks can spill over contagiously to other countries through the competition effect of crisis-induced changes in exchange rates, which can lead to a disruptive series of "beggar-thy-neighbor" competitive devaluations (see, for example, Liu *et al.* 1998). Of course, if economies jointly coordinate their response to the global crisis, the devaluation rates will be internalized and the spillover effect will be relatively small. The more likely scenario, however, is that economies are engaged in uncooperative devaluations that end up in a currency crisis. In the absence of cooperation, devaluation can be used as a policy tool to fight the effects of financial shocks on the domestic economy as well as a retaliation device to offset the negative impact of devaluation on other neighboring economies (Obstfeld 1996; Morris and Shin 1998).

The second channel works through macroeconomic similarities. Attacks spread to other countries with similar backgrounds and economic conditions. Investors see the weaknesses revealed in one country that might prevail in other countries. The loss of confidence and the resulting crisis can quickly spread to those other countries. National banks often mistakenly perceive their operations to be secure or insured against adverse contingencies by government promises of rescue. They borrow excessively from abroad and lend excessively domestically to finance uncertain investment projects. The false security of apparent financial insurance causes an obvious ethical dilemma (Corsetti *et al.* 1999). Many Asian economies ended up investing too much with insufficient measures to combat risk. The ethical dilemma was further aggravated by the lack of transparency in both public and private financial institutions, poor bank capital requirements, and inadequate banking supervision and bankruptcy procedures. Financial market liberalization, which proceeded in the 1990s in many Asian economies, paid little attention to proper risk assessment. Ethical dilemmas in financial intermediaries arise when the rewards given to the agent when things go well do not correspond to the penalties exacted when things go wrong. Thus, excessive risk taking and overpricing of assets are encouraged.

When the financial bubble burst, the dramatic fall in asset prices made the insolvency of financial intermediaries highly visible. Some financial intermediaries were forced to cease operation, leading to further asset depreciation. Implicit guarantees turned out to be insufficient and

governments could not fulfill their promise of rescuing domestic financial intermediaries. Asset price depreciation further magnified financial losses, leading to further collapses of banks and financial institutions. Crises become self-fulfilling (Krugman 1996; Obstfeld 1994).

The "second-generation" models of competitive devaluation and ethical dilemmas have been used to explain the scenario of asymmetric country-specific shocks. Firstly, economies with strong fundamentals, such as Hong Kong, Taiwan, and Singapore, were attacked even when they were immune to the real economic disturbances that affected Thailand, Malaysia, Indonesia, and South Korea. Secondly, the analysis of symmetric shocks suggests that the Asian economies did not cooperate to face a common crisis, resulting in dramatic devaluations of different currencies.

The financial panic hypothesis is the other school of thought concerned with the explanation of financial crises (Radelet and Sachs 1998a,b). Financial panic involves a sudden and substantial arbitrary shift, usually downward, in market expectation and confidence. A financial crisis demonstrates the shortcomings of the international capital markets and their vulnerability to sudden reversals in market confidence. The panic among Asian countries was triggered by a combined weakness in the form of growing short-term debts and a series of policy mistakes. Without the panic, the underlying "bad equilibrium" in both macroeconomic and microeconomic problems would not have been sufficiently severe to warrant a financial crisis of the magnitude that took place in 1997–98.

According to Radelet and Sachs (1998a,b), there are several reasons to suppose that the AFC included substantial elements of panic. Firstly, market participants and analysts, involved in compiling indicators from credit rating agencies, IMF reports, data on capital flows and other indicators, did not predict the crisis. The only warnings came from Thailand and Korea. Secondly, the crisis involved considerable bad debt from loans to unprotected borrowers. However, borrowers with either explicit or implicit guarantees also faced bankruptcy. As a result, there has been a clampdown on bank credits available to viable enterprises, especially in working capital for exporters. The crisis triggered a sudden withdrawal of funds from the region, rather than simply a deflation of asset values, and it would be difficult to foresee a reversal of the flow of funds in a short period of time if there were poor underlying economic fundamentals. Indonesia is a clear example of contagion as a result of financial panic. Indonesia's imbalances were among the least serious in the Asian region. It had a rather low current account deficit, an export growth rate approaching 10% in 1996, a government surplus for four consecutive years, and modest credit growth. But Indonesia's extensive meltdown was far more severe than can be accounted for by the flaws in its economic fundamentals. Panic ended only when the short-term debts were either repaid, rescheduled, or declared defaulted.

Despite bad debts, overinvestment, growing current account imbalances, and foreign debt accumulation, the crisis started when the markets at some

point overshot, and the extent of the changes in asset prices went beyond what was necessary to restore the external balance. The "self-fulfilling expectation" analysis, financial panic, and "bad equilibrium" require underlying weak fundamentals (Krugman 1996). Similarly, a crisis triggered by poor fundamentals may lead to an over-reaction in the market, creating situations close to pure financial panic, during which the herd instinct often deepens the crisis, resulting in more panic.

The two "generations" of the fundamental-based hypothesis and the financial panic hypothesis can be interpreted in the context of the AFC to some degree, though no single hypothesis can explain the entire episode. The case of Thailand and Korea belong clearly to the fundamental-based school of thought, while the crises in some of the other Asian economies of Hong Kong, Taiwan, Singapore, and Malaysia were the result of the contagious effect. The events at the beginning of 1998 and the sudden withdrawal of capital flow was more a case of financial panic.

The role of the IMF in the AFC has been criticized for a number of reasons (see, for example, Meltzer 1998). Financial panic deepened as soon as any economy requested help from the IMF. This signaled to the outside world that the economy was in poor shape and needing help. It may also be the case that investors feared the usual IMF recipe, which is a rise in domestic interest rate and resultant monetary contraction that discourages investment opportunities. The IMF's "fire-fighting" role was also interpreted as meaning that the economy was approaching a crisis. The second area of criticism is that the IMF provided the same medicine as that which was given to Latin American countries, apparently unaware that the causes of the AFC were very different from those of the Latin American financial difficulties. While the Latin American countries in the 1980s were faced with huge budget deficits, loose monetary policies, and runaway inflation, Asian economies in the 1990s were running budget surpluses and tight monetary policies. The bureaucratic nature of the IMF has also been criticized (US Institute of Peace 1998; Stiglitz 2000).

In response, the IMF is aware of the trade-off between allowing a crisis to deepen and helping economies to mitigate the effects of the crisis. The best approach, as Fischer (1998) argues, is to effect a sharp, but temporary, increase in interest rates to discourage the outflow of capital, while the long-term target is to restructure the financial sector. The short-term course is to recapitalize or close insolvent banks, protect depositors, and require shareholders to face up to their losses. The long-term aim is to encourage improvements in banking regulations and supervision. The primary purposes of the IMF, as stated in the IMF Articles of Agreement, are (Fischer 1998: 6):

- to promote exchange rate stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation;
- to provide members with opportunities to correct maladjustment in their

balance of payments without resorting to measures destructive of national or international property.

8.4 South Korea: the excess capacity hypothesis

The imprudence of banks and financial institutions and the economic misbehavior of large conglomerates (*chaebols*) are thought to have been the cause of Korea's financial crisis (Kwack 1998; Mascarenhas 1999; Mo and Moon 1999). The indiscriminate nature of bank lending to conglomerates overlooked the risk factor and was based on implicit guarantees. The large conglomerates were regarded as "too large to fail." Prior to the 1997 crisis, there was a rapid accumulation of non-performing loans and mounting external debt, and short-term borrowings were used to finance current account deficits. For example, total external debt was US$78.4 billion in 1995, increasing to US$104.7 billion in 1996 and to U$120.8 billion in December 1997. Total external liabilities amounted to US$154.4 billion in December 1997. Foreign exchange reserves fell rapidly from US$33.2 billion to US$20.4 billion in December 1997, while usable foreign exchange reserves fell from US$29.4 billion to only US$8.9 billion in the same period (Bank of Korea 1999a: 18).

The Korean government turned to the IMF for stand-by funds on 21 November 1997. The agreement with the IMF was that Korea should pursue macroeconomic stabilization, structural reform, capital account liberalization, and opening of financial markets. A total of forty-eight banks, merchant banks, securities, and other financial and non-bank financial companies were shut down. Public funds were injected into viable financial institutions and prudential supervision over financial institutions was strengthened. This included recapitalization of non-performing loans, improvements in financial supervision and credit systems, and development of the capital market infrastructure. There have been various measures applied to support capital account liberalization. One is a two-stage liberalization of foreign exchange transactions. The provision of an information network on worldwide financial transactions, the monitoring of activities in the international financial market, and the implementation of an early warning system on financial instability are other important measures (Bank of Korea 1999a,b; EAAU 1999; Mann 2000; Park 2000).

Large conglomerates were favored for large investment funds and high growth rates were maintained. There was large external borrowing that was channeled into untenable investments in real estates. A total of eight out of thirty conglomerates were declared bankrupt. The size of the conglomerates far exceeded their economies of scale and they became uncompetitive. Other problems of the large conglomerates included skewed governance structures, competition for prestige, and venturing outside their core competencies. Also, large debts were hidden in mutual-payment guarantees among the conglomerates, thus financial transparency and accountability was low.

The "big deals" approach, which involved the more financially sound conglomerates taking over from those that were not sound, was taken up by the new Kim Dae-jung administration in 1998. Corporate sector reform was based on five principles of: transparency in corporate management; capital restructuring; the abolition of cross-payment guarantees; link-ups between conglomerates and small and medium-sized enterprise; and holding majority shareholders accountable (Bank of Korea 1999a: 19). However, the "big deals" approach has also been criticized. The mergers and acquisitions were based on financial convenience and arbitrary arrangements. For example, Hyundai took over the Kia group, but Hyundai had to take on additional debts in order to finance the take-over (Graham 2000). Secondly, the reforms ended up making the big five conglomerates even bigger, although the major problem to emerge from the crisis was that the conglomerates were too big already. The reforms should have aimed at reducing and consolidating the number of conglomerates, while at the same time encouraging the establishment of entrepreneurial forms of small and medium-sized enterprises.

The globalization (*segyehwa*) issue was given top priority in the Kim Young-sam government between 1993 and 1998. Globalization was seen as a necessity to transform Korea into a world-class advanced country through a process of political, economic, social, and cultural enhancements. A committee was formed in 1995 to work out policies and programs in six areas of education, legal and economic systems, politics and the mass media, national and administrative systems, and the environment and culture (Kim 2000: 22). The globalization strategy was seen as an important instrument in gaining Korea's acceptance as a member of the OECD in February 1996. Economically, the Korean economy was faced with its lowest corporate profit in 1996 and three highs of labor costs, the cost of capital, and the costs of distribution.

Mo and Moon (1999: 190) are critical of the fact that the pursuit of democracy since 1987 has not accomplished any fundamental reforms, as there has been no change in the authoritarian behavior in government circles. Instead, conflicts between opposing factions have become more open. Kim (2000: 51) summarized the new Korean national identity as the "People's Republic of Endless Strikes". The government strikes against the opposition, big labor unions strike against big businesses, the south-east region strikes against the south-west region, one religious group strikes against another, and so on. The new political freedom had been misused and the private sector has become irresponsible. Banks and financial institutions have disregarded discipline and prudence. It can be concluded that the reform issues were debated without concrete resolution and so resulted in increased uncertainty and confusion. The drive toward democracy in Korea has remained immature and only produced negative effects (Mo and Moon 1999: 173).

The banks and conglomerates are the agents of Korea's economic development. For decades the Korean economy has aimed to be a major industrial powerhouse in Asia. The switch from import substitution to export-led industrialization, the concentration of light industries in the 1960s, the

deliberate efforts to expand heavy industries in the 1970s, the high saving and investment rates, financial concentration on large conglomerates, and foreign borrowing were all geared to promote Korea's industrial capacity. For example, exports of light industrial products had declined from 69.7% in 1970 to 51.4% in 1979, while exports of heavy and chemical products in the same period had increased from 12.8% to 38.5% (Bank of Korea 1999a: 8).

In export-led economies, the increase in industrial output is probably the result of either a rise in domestic demand or an increase in exports. There is, of course, the possibility of excess supply, a rise in inventory, or a fall in demand due to fluctuations in business cycles or changes in demand. Excess capacity may result from an economy making a deliberate effort to boost its industrial capacity, probably in anticipation of an increase in future demand. This requires deliberate investment in new industries that will enlarge the comparative advantage of the economy.

A simple comparison between South Korea and Taiwan (Table 8.6) indicates a situation of excess capacity. An increase in output should lead to an increase in either domestic demand or export. In the case of South Korea, the annual growth rates of manufactured output are, at regular intervals, higher than the annual growth rates of GDP, the annual growth rates of final consumption expenditure, and even the annual growth rates of principal commodity exports. For example, between 1983 and 1998, the growth rates of manufactured output exceeded each of the above growth rates in ten years, nine years and seven years respectively. This reflects a situation of a greater increase in industrial output than in income, consumption, or exports. In other words, the rise in industrial output has not been matched by a rise in either domestic or foreign demand in many years. Excess capacity has gradually been built up. Furthermore, the annual growth rates of light and heavy industrial exports show an unsteady trend. Exports from light industries grew rapidly in the mid-1980s, but there were negative growth rates in 1992 and 1993. Exports of heavy industrial products have experienced dramatic changes in periodic growth rates. However, all indicators saw negative growth in 1998.

Although Table 8.6 shows a shorter time period for Taiwan, it can still be seen that the situation is different in that the annual growth rate of manufactured output is in general lower than the annual growth rates of income, consumption, and exports. The growth rates of exports were weaker than the growth rate of manufactured output only in 1996 and 1997. With one or two exceptions, the growth rates of both light and heavy industrial exports of Taiwan have been steadier than that of South Korea.

Such a simple comparison shows clearly that the South Korean economy has experienced excess capacity. In time of economic boom or increases in demand, excess capacity enables the economy to increase output quickly. In a recession period, however, excess capacity, especially in heavy industry where large investment is involved, leads to industrial and structural rigidity, high costs, and wastage. For example, the automobile industry in South Korea

Table 8.6 An indication of excess capacity: South Korea and Taiwan compared (percentages)

South Korea

	Growth in real GDP	*Growth in manufacture output*	*Growth in final consumtion expenditure*	*Growth in principal commodity export*	*Growth in light industry export*	*Growth in heavy industry export*
1983	11.5	15.3	8.0	11.8		
1984	8.7	16.9	6.7	19.6	16.1	24.0
1985	6.5	6.2	6.2	3.5	0.5	5.8
1986	11.6	19.5	8.2	14.6	27.3	5.4
1987	11.5	19.5	7.8	36.2	35.8	37.7
1988	11.3	13.8	8.8	28.4	21.3	36.7
1989	6.4	4.2	10.4	2.8	3.5	2.2
1990	9.5	9.7	10.1	4.2	1.5	7.1
1991	9.2	9.5	7.9	10.5	0.6	16.0
1992	5.4	5.3	5.6	6.6	–1.8	1.2
1993	5.5	5.4	5.4	7.3	–3.0	13.3
1994	8.3	10.8	7.1	16.8	6.9	22.0
1995	8.9	11.3	8.2	30.3	14.0	37.4
1996	6.8	6.8	7.2	3.7	7.5	0.9
1997	5.0	6.6	3.2	5.0	3.5	4.2
1998	–5.8	–7.2	–8.2	–2.8	–3.6	–2.2

Taiwan

	Growth in GDP current price	*Growth in manufacture production*	*Growth in private expenditure current price*	*Growth in industry export*	*Growth in light industry export*	*Growth in heavy industry export*
1991	11.69	11.7	11.73	13.0	15.7	13.4
1992	10.41	5.5	13.41	7.3	2.9	12.2
1993	9.73	5.0	11.95	4.7	–3.4	12.6
1994	8.11	3.1	12.75	9.3	4.4	13.6
1995	7.93	4.8	9.30	20.3	7.7	30.0
1996	8.23	7.6	9.60	4.1	–0.5	7.1
1997	8.51	7.7	9.28	6.8	2.5	9.4

Sources: *Economic Statistical Yearbook*, Bank of Korea, Seoul, various issues; *Monthly Statistics Bulletin*, Taiwan, various issues.

Table 8.7 Capacity utilization rate in automobile manufacturing in Asia (%)

	1998	*1999*
Mainland China	89.0	66.0
India	30.0	35.0
Indonesia	7.5	15.0
Malaysia	25.0	46.0
South Korea	42.0	49.0
Thailand	21.0	41.0

Source: *The Wall Street Journal*, 8 May 2000, pp. A25 and A28.

faced tremendous overcapacity, loss, and debt after the AFC. Some automobile plants were eventually sold to foreign firms from France, Japan, and the US. The capacity utilization rates in Asia's automobile manufacturing are generally low, as reported in Table 8.7.

If held for a prolonged period of time, excess capacity leads to structural weakness, even though the original intention is to widen the economy's industrial base. In the case of South Korea, the situation was made worse by the financial favors the government gave to the large conglomerates. South Korea's "rush to development" has been criticized for such economic consequences as price distortion, the socio-political antagonistic nature between big conglomerates and labor unions, and other undesirable consequences (Hart-Landsberg 1993).

The ambition to become the second Japan could in fact be the unspoken aim of South Korea's economic development. The technology and design of both light and heavy industrial products manufactured in South Korea bear resemblance to Japanese products. A scenario in which world demand for South Korean manufactures rose would result if Japanese products became expensive, or as a result of trade retaliation arising from Japan's huge trade surplus. Since the 1980s, when Japan was running a huge trade surplus and the US was suffering from the "twin deficits" in trade and budgets, the pressure to restrict Japanese exports has mounted. Being a closer and cheaper substitute, manufactures from South Korea would have had a good chance of replacing Japan's export market.

Taking such an optimistic view of the "future" demand for Korean products, it would be quite likely that South Korea would enlarge its industrial capacity. The experience of the 1990s, unfortunately, does not bear out such a switch in demand. Beginning in the 1980s, Japanese manufacturers began to invest in North America and Europe, so that a considerable number of Japanese manufactured models, for example automobiles, are now produced in these economies. This reduced Japanese exports, but consumers in the US and Europe switched to "home-made Japanese" products, which did not benefit Korean exporters. Secondly, the taste for Japanese goods has not changed in favor of Korean goods, and so Korean exports did not increase as anticipated. South Korea has become the second Japan in terms of industrial capacity but not in terms of world demand.

8.5 Implications for economic development

The AFC not only stimulated theoretical debates, it also had various implications for development economics and economic development, particularly those issues relating to the more popular areas in trade, regional balance, and the connection between the real and nominal sectors. Firstly, in trade, the AFC reflected a scenario of rapid changes in trade competitiveness and the globalization of product life cycles. Why did the AFC occur in the late 1990s when there was no trade protectionism, and not in the 1970s and

1980s when the larger Asian exporters were battling against protectionism? Secondly, the gigantic size of the Chinese economy and its capacity to absorb both trade and investment does have implications for other Asian economies, in the short-term, when world trade and foreign direct investment remain unchanged. In the longer run, when the Chinese economy has grown to an even greater size, more intra-regional economic activities might be expected. Thirdly, the AFC has provided "food for thought" on the relationship between the development of the nominal (monetary and financial) and real sectors. This basically concerns the sustainability of growth and development, as activities in the real sector "back up" the activities of the nominal sector.

Protectionism and competition

Trade protectionist policies, imposed by advanced countries, have been regarded as restrictive, but a contrary argument is that, in times of increasing competition from latecomers in the export of industrialized manufactures, trade protection actually protects the market share of the existing exporters. The case of the Asian textile trade and the various phases of the Multi-Fiber Agreement (MFA) showed that existing Asian exporters expanded their textile exports according to the agreed annual percentage growth rates. These translated into the fixed and protected quotas that the importing country would take from the exporting country. Thus, trade protection actually protected the exporting economy's export share in textiles and clothing.

The case of electronic and electronic-related manufactured products is very different. Here, there is no protectionist policy that governs any economy's export shares. Foreign investment in electronics can be very mobile and investment switches from one economy to another are possible. Electronics and electronic-related products are also becoming standardized, and their product-life cycle is becoming shorter as, for example, one generation of computer software replaces another in a short period of time. Competition for investment and export markets in electronic manufactures has definitely become more severe. In the 1980s the relatively large and favorable investment in electronics, computers, and related industries resulted in an expanded export share, replacing the more traditional exports of textiles and clothing in the major Asian economies. By the 1990s, electronics and related manufactures had become the dominant export, occupying a large share of total exports, especially in Singapore.

When the demand for exports was rising, the increased concentration of electronics and electronics-related manufactures would lead to an overall increase in exports. In contrast, when the demand for electronics and electronics-related manufactures fell, as happened in 1996, the economy could end up with excess supply and a very rigid export structure. Furthermore, the standardized nature of these manufactures meant that existing exporters could easily lose their export shares to newcomers which were more competitive on price. The economy is then left with the worse of two worlds

in exports: a high concentration in electronics leading to an inflexible export structure, and a loss of export shares to the more competitive newcomers.

Table 8.8 shows the domestic export concentration ratios of five principal export commodities, as well as exports of electronics and electronics-related products, for the four East Asian economies. There may be differences in classification due to statistical reporting in different economies, but the trend in exports of electronics and electronics-related products can still be seen. As far as the overall export concentration ratios are concerned, both Singapore and Hong Kong show higher ratios than South Korea or Taiwan. This suggests that the industrial bases of Hong Kong and Singapore are narrower than those of South Korea and Taiwan. The two major industries in Singapore are mineral fuels and electronics and electronics-related products. Together, they occupy more than 70% of exports from Singapore. On the contrary, the industrial bases of South Korea and Taiwan are more diversified and include heavy industries. In the case of electronics and electronics-related manufactures, Singapore has the greatest concentration (as a proportion of total domestic exports) with a ratio that has increased rapidly since 1985 and exceeded 60% in the mid-1990s. The electronics export concentration

Table 8.8 Principal commodity export concentration ratios (percentage of domestic exports)

	Taiwan		*Singapore*		*Hong Kong*		*South Korea*	
	L5	*E5*	*L5*	*E4*	*L5*	*E3*	*L5*	*E2*
1985	44.73	20.45	74.46	25.83				
1990	45.88	25.88	72.29	44.17				
1991	45.75	25.17	71.14	44.74				
1992	46.42	25.68	69.77	49.36	62.03	19.80	53.91	26.47
1993	47.18	26.72	71.90	52.59	61.73	21.78	51.62	26.90
1994	49.30	27.36	74.70	58.90	62.86	22.19	53.17	29.68
1995	51.77	29.88	75.42	61.49	63.30	23.85	55.49	32.06
1996	53.72	31.56	77.43	61.46	63.96	23.07	53.24	30.68
1997	55.58	33.22	76.55	61.77	65.17	23.59	54.44	31.62
1998	55.65	34.26			67.86	20.98	53.18	30.59

Sources: *Taiwan's Statistical Data Book 1999*, Council for Economic Planning and Development, Taiwan; *Statistical Yearbook of Singapore,* 1995 and 1997, Department of Statistics, Singapore; *Hong Kong Monthly Digest of Statistics*, Census and Statistics Department, Hong Kong; *Monthly Bulletin*, Bank of Korea, Seoul.

Notes
L5 = concentration ratio of the five largest export products. E = electronics and electronics-related manufacture. Taiwan's E5 commodities are electronics products, electrical machinery products, information and communication products, household electrical appliances, and precision instruments. Singapore's E4 commodities are office machinery, electric generators, telecommunication apparatus, and other electric machinery. Hong Kong's E3 goods are electrical machinery apparatus and appliances and electrical parts, parts of office machinery, and automatic data processing machines and telecommunication equipment. South Korea's E2 products are electronic products and machinery and equipment. In the case of Hong Kong and South Korea, the statistics on SITC were revised in 1992.

ratio in Taiwan has also increased substantially since 1985. The ratios for South Korea and Hong Kong, however, are lower.

Other Asian economies are increasingly competitive in the export of standardized electronics and electrical goods. Investment will flow to areas where the cost is lowest, and the increased output of the newcomers will compete with the exports of existing suppliers. A major lesson from the AFC concerns the increase in competition for trade and the export replacement or substitution that can occur once exported products become standardized. A decline in exports exerts pressure on the foreign exchange and a lack of adjustment in the foreign exchange market can create opportunities for speculators. For any economy to sustain its export share, an increasingly short product life-span and increasing product standardization requires that the economy has to be flexible to cope with the changing comparative advantages in the export market and open to foreign investors that can widen the economy's export base. In short, the era of open and free trade will be equally, if not more, difficult than the era of protectionism, because the nature of competition has changed. At the same time as the more traditional exports of textiles and clothing have become very competitive and are being taken up by economies with low labor costs, the exports of electronics and electronics-related products have also become more competitive because of the increased supply by newcomers, shorter product lifespans and investment cycles.

A leapfrogging goose?

The "flying geese" model has been used successfully to explain the emergence of different tiers of economies at different stages of economic development in Asia. Japan industrialized in the 1960s and has grown considerably since the 1970s. The four East Asian dragon economies of Hong Kong, South Korea, Singapore, and Taiwan are said to have caught up in terms of their industrialization in the 1960s and 1970s, and achieved economic development in the 1980s. By the 1980s, the four remaining ASEAN countries, namely Malaysia, Thailand, the Philippines, and Indonesia, were considered to be the next tier of "flying geese" in Asia.

The Japanese economy became the industrial powerhouse of the world in the early 1970s, and Japan had about two decades of economic prosperity in the 1970s and 1980s before various economic difficulties emerged in the early 1990s. Similarly, the four East Asian economies captured the world export market for about two decades between the mid-1970s and the end of 1997. It seems as if a two-decade period of economic prosperity is perhaps as much as will be enjoyed by the next tier of "flying geese". The four ASEAN economies consolidated their domestic economies in the 1970s, and began their take-off only when the advanced countries, including Japan and the four East Asian economies, increased their investment in the mid-1980s.

The AFC came as a shock to the four ASEAN economies as they had only

begun to enjoy stable economic development in the late 1980s. The emergence of the People's Republic of China as a major competitor in absorbing foreign direct investment and light industrial exports has imposed new challenges to the development of the ASEAN economies. This is particularly true in terms of foreign direct investment in standardized light manufactured products. Whereas the cost of labor in the four ASEAN economies was low, the cost of labor in mainland China is even lower and has been attracting foreign direct investment since the early 1990s, in addition to the large domestic market which is an attraction in itself.

In term of per capita GDP, the ASEAN-4 economies of Thailand, Malaysia, Indonesia, and the Philippines are stronger than mainland China (Table 8.9). However, all five economies doubled their GDP per capita between 1989 and 1996. In terms of GDP growth rates, however, mainland China is catching up fast; it has exceeded the ASEAN-4 since 1993 and performed better than those economies in 1997. The ASEAN-4 experienced a higher rate of export growth than the NIE-4 (Hong Kong, Singapore, Taiwan, and South Korea) in the years before the AFC. Between the ASEAN-4 and mainland China, the latter's export growth rates are higher than the formers' in most years during the 1990s. The pattern of foreign direct investment also works more in favor of mainland China. Both Malaysia and Thailand have seen annual reductions in FDI in the 1990s, and FDI in the Philippines and Indonesia is unstable. Mainland China is the economy that has not experienced any negative growth rates in the 1990s, and saw substantial increases in 1993 and 1994. Thus, the economic downfall of Malaysia and Thailand was not so much due to their rising costs, as costs were also rising in the four East Asian economies, but more because they were faced with a stronger competitor.

Since 1978 the Chinese economy has grown tremendously. Mainland China's nominal GDP increased from 896.4 billion renminbi (rmb) (US$305.2 billion) in 1985 to rmb7,801.8 (US$2,656.7 billion) in 1998. The annual real GDP growth rate averaged 9.4% over the period 1989–98, the highest among all of the Asia–Pacific Economic Cooperation (APEC) economies (Li 1999). By 1998, the exports and imports of mainland China were ranked ninth and eleventh, respectively, in the world. Exports grew at an annual average rate of 17% between 1991 and 1998. China's trade surplus amounted to US$44 billion in 1998. Utilized foreign direct investment increased from US$46.5 billion in 1985 to US$585.6 billion in 1998, giving an annual average growth of 24.3% between 1991 and 1998. Total trade and fixed asset investment amounted to 34% and 36% of GDP in 1998 respectively. The AFC did not have any immediate impact on the economy of mainland China. The decision to join the World Trade Organization required that the Chinese economy had to be more competitive, open, and liberalized, particularly in the financial sector. Accordingly, banking reform in 1995 and the reform of state-owned enterprises since 1997 will make the Chinese economy more open and market oriented.

The leapfrogging of mainland China up the "flying geese" ladder has

Table 8.9 Economic performance of ASEAN-4 and mainland China

(a) Growth in GDP

	Indonesia		*Malaysia*		*Thailand*		*Philippines*		*China*	
Year	*(1)*	*(2)*	*(1)*	*(2)*	*(1)*	*(2)*	*(1)*	*(2)*	*(1)*	*(2)*
1989	541	7.5	2,161	9.2	1,252	12.2	709	6.2	380.0	4.3
1990	592	7.2	2,398	9.7	1,430	11.6	717	3.0	342.0	4.0
1991	637	7.0	2,545	8.7	1,626	8.4	717	–0.6	352.0	8.2
1992	688	6.5	2,996	7.8	1,806	7.9	838	0.3	415.0	13.0
1993	835	6.5	3,121	8.3	1,937	8.2	853	2.1	503.0	13.5
1994	930	7.3	3,688	8.7	2,460	8.5	934	4.3	460.0	12.5
1995	1,040	8.2	4,344	9.4	2,830	8.7	1,055	4.7	590.0	10.5
1996	1,116	8.0	4,684	8.6	3,080	6.4	1,552	5.8	690.0	10.5
1997	1,080	4.6	4,517	7.7	2,540	–1.3	1,118	5.2	750.0	8.8

Note
1, Per capita GDP (US$); 2, real GDP growth.

(b) Growth of export and FDI

	Annual export growth (%)			*Annual growth in FDI (%)*				
Year	*NIE-4*	*ASEAN-4*	*China*	*Indonesia*	*Malaysia*	*Thailand*	*Philippines*	*China*
1990	8	15	18					
1991	15	17	16	60	40	38	–6	3
1992	12	16	18	36	71	–18	3	25
1993	10	13	8	20	30	5	–58	156
1994	16	19	32	13	–3	–15	443	145
1995	21	23	23	5	–13	–27	29	23
1996	4	6	2	106	–5	51	–8	6
1997	4	3	21	42	13	13	4	14
1998	–8	–19	1	–42	–20	59	–18	11

Sources: *International Financial Statistics*, International Monetary Fund; *Key Indicators of Developing Asia and Pacific Countries*, Asian Development Bank; Monthly Statistics of Foreign Trade, OECD; and *International Trade Statistics*, United Nations, various issues.

Notes
NIE-4 = Hong Kong, Singapore, Taiwan, and South Korea. ASEAN-4 = Indonesia, Malaysia, Thailand, and Philippines.

increased competition and posed challenges to other developing Asian economies, notably the four ASEAN economies. Other lower-tier Asian economies have now to compete with mainland China for both trade and investment, especially in the short run, when world trade and investment remain fixed. In time however, as mainland China's economy expands, the lower-tier Asian economies will gain. A larger Chinese economy will absorb trade from or provide investment to neighboring Asian economies at the same time as enlarging the world trade and investment pie, which will provide more trade and investment opportunities for the other Asian economies.

The AFC might not have been the result of mainland China's leapfrogging over other Asian economies, but China's rapid expansion could be responsible for the decline in the export trade of the lower-tier ASEAN economies in the mid-1990s and had introduced a greater degree of competition in the long run. Thus, while the four ASEAN economies have attracted a considerable amount of trade and investment from the advanced Asian economies in the past, newcomers to the region can quickly change their ranking in terms of economic competitiveness.

Sustainability from the real sector

The fragility of the financial sector and its deviation from the real sector is another major problem exposed by the AFC. In the real sector, as discussed in Chapter 6, both domestic and foreign direct investments will generate income and output. The economic impact of investment in the real sector usually lasts longer and cannot easily be reversed. There is thus a clear investment multiplier that works positively toward increasing domestic income, consumption, and output. Investment in the real sector ultimately promotes growth and widens the economic base.

In the financial sector, one has to distinguish between the activities of the banking sector and portfolio investments in equities, bonds, and derivatives. Other than retail banking activities, commercial banks are the conventional financial intermediaries that typically channel funds from savers to investors. Although commercial banks can create money through the process of deposit multipliers, an effective monetary policy together with prudent practices can effectively control the activities of banks. The monetary activities of the real sector are often conducted through commercial banks. Such activities as wage transactions, export credits, and short-term business loans are conducted by the commercial banks. Although commercial banks are primarily business entities and have to appeal to individual depositors for surplus funds, commercial banks have become "semi-public" goods that affect the economic health of individuals, households, and business enterprises. Thus, because commercial banks cannot be allowed to fail, prudent monetary policies and effective banking disciplines must be maintained.

In contrast, portfolio investments are more volatile, respond more to daily or periodic shocks, and are often speculative in nature. Although in principle

the price of stocks reflects the economic and business performance of the corporate sector, there are a number of market factors that continuously influence stock prices. Compared with investment in the real sector, the effect of the portfolio investment multiplier is uncertain. As portfolio investment capital is highly mobile, and movements are also rapid and volatile, financial shocks can easily develop when a large number of stock traders make the same decisions simultaneously. This is especially likely with open trading when the movement of portfolio investments is not easy to monitor or control (see, for example, Shiller 2000).

In small open economies such as those of Hong Kong and Singapore, it can be argued that a dual economy exists between their financial and real sectors. As an international financial center, the large daily volume and instantaneous movements of portfolio capital reflect more the world financial scene than their own domestic economic realities. Inflow and outflow of capital become part of the daily trading activities. In the larger two economies of Taiwan and South Korea, their banking sectors have become more open to foreign competition and restrictions on capital flows have been eased thus enlarging trading potential in portfolio investment activities. Whereas financial liberalization has been welcomed by the international community and has been hailed as a success, financial prudence has not been given the same degree of emphasis.

One of the lessons to be drawn from the AFC is the importance of the ability of the real sector to sustain the activities of the financial sector. Whereas direct investment expands output and stabilizes growth, portfolio investments can generate financial volatility. Within the financial sector, banking activities are more fundamental and adhere more to the real sector. There are basically two post-AFC financial strategies: restructuring of banks and loans, and consolidation of financial institutions, regulations, and trading practices. While the former strategy addresses the issues of non-performing loans and the pursuit of efficient banking, the latter aims to ensure prudence, transparency, efficient monitoring, and fair play in the capital markets. The IMF introduced financial restructuring measures to South Korea, along with two other economies, Thailand and Indonesia. In the case of South Korea, there were six major measures that were introduced between December 1997 and June 1998 (EAAU 1999: 42–3). These ranged from the new legislation governing supervision and allocation of losses to recapitalization, closure of banks, and provision of public funds for bank restructuring.

Prudential reforms should include the strengthening of regulations, such as capital adequacy ratios, classification of non-performing loans, and provision for loan losses. Legal reforms on bankruptcy laws should also be strengthened. Independent bank supervision could be conducted through the various functions of the central bank and commercial banks. Government deposit guarantees should only be used selectively and adequate deposit insurance should be ensured. Market-based regulations and disclosure standards should also be introduced efficiently., including the construction

of macroprudential and microprudential indicators to ensure the soundness of the financial system (International Monetary Fund 2000).

Financial consolidation is the major focus in both Singapore and Hong Kong. In the case of Singapore, a new class of foreign bank license with fewer restrictions on branching has been introduced. Foreign equity limits were abolished on new banks. The Hong Kong Monetary Authority introduced significant banking reforms, and financial market reforms included the merger of the stock and future exchange markets. In the case of Taiwan, the process of financial liberalization has been proceeding for a number of years as Taiwan is preparing for its accession to the World Trade Organization. For example, foreign banks may be allowed to acquire a 50% share in local banks, and the stock market aims to attract international participation.

In international banking centers, supervision and governance should follow the international standard as specified by the Bank of International Settlements (BIS). For example, the 1999 Basle Committee on Banking Supervision provided a consultative paper on a new capital adequacy framework. Also, in international financial centers, although a level-playing field has to be provided for all investors and speculators, consolidation of trading and market disciplines seems to be the strongest possible policy an economy can use to guard against future crises. For example, both the Singapore and Hong Kong Stock Exchanges consider demutualization, which separates exchange ownership from access to brokering rights, to be an important trend in reinforcing stock market reform.[10]

To sustain economic growth, investment in the real sector (such as manufacturing industries and infrastructure) is important. Attractive conditions, such as a low tax regime and an open economy, have been used to promote investment in the real sector, because a larger real sector can ultimately help to overcome difficulties in the financial sector, including financial shocks and crises.

8.6 The end of economism?

Has the AFC brought economism to an end? Economic development in Asia has been labeled a "miracle." Indeed, major Asian economies, typically Japan and the four East Asian economies, have experienced continued growth since the 1960s and the four ASEAN economies since the 1980s. Major economic downturns, such as the oil crisis in 1973, did not have any prolonged impact on Asia's economic growth. While most advanced economies have suffered from economic recessions and deficits in trade and fiscal budgets, and the rest of the developing world has remained either stagnant or has experienced financial difficulties, there had been no serious dents in the growth of the major Asian economies for a number of decades. Historically, the AFC, which was the result of both structural rigidities and financial imprudence, was an unprecedented event.

Equally unprecedented, however, was its sudden arrival and its even more

precipitate departure, forming a V-shaped graph of capital outflow and inflow over a short period of time. Although the short-term phenomenon of capital flow reversal was favorable, the restructuring process will take longer and will require more adjustments in such real economic variables as employment and asset price adjustments. Typically, many Asian economies will have to experience asset depreciation and a period of economic deflation in order to iron out inefficiencies and reallocate resources to the most efficient ends.

The post-AFC strategy of economic restructuring and financial consolidation adopted by the four East Asian economies did not alter the basic elements of their economic fundamentals. If anything, the features of economism have actually been redefined, strengthened, and consolidated, helping the four East Asian economies to project an even stronger economic image. Economism provides a set of "floor conditions" for economies to grow. Whether one economy grows at 5% and another grows at 7% is not an important argument within economism. The crucial point is that, once these "floor conditions" have been established and maintained, any economy can grow. But the pace of growth varies according to business cycles. Similarly, economic downturns and financial crises are signals that some elements in the economy are off course and corrections are needed. A financial crisis that lasts for one or two years in a continued growth period of thirty to forty years is a small price worth paying for a significant lesson. The more important message behind the AFC, however, is that the conditions that have permitted growth in East Asia in the last thirty to forty years will not be the same in the next thirty to forty years.

The AFC has acted as a "wake-up" call and has indeed heightened the need to pursue, maintain, and strengthen the paradigm of economism. The presence of the free market and ownership has facilitated trade and investment. The attitude toward inequality and poverty and the "fertilizer" role of the government have determined the importance of equal opportunities and the supply and earning sides of the economy. The determination to achieve economic growth and the appropriate political attitudes have avoided unnecessary political disturbance. The driving elements in the East Asian economies have been the need to acquire foreign capital and float with the world economy. The crucial concern in economism is that the economy grows. Therefore economism has definitely not come to an end following the AFC. The AFC indeed served to highlight very vividly the cohesiveness and permanence of the economism paradigm.

9 A challenge to economism

Hong Kong's sovereignty reversion

9.1 Introduction

The negotiations on the reversion of Hong Kong's sovereignty from the UK to the People's Republic of China in 1982–84 changed Hong Kong's political path. Hong Kong, a British colony since the end of the Opium War and the subsequent declaration of an unequal treaty in 1842, became the Special Administrative Region (SAR) of the People's Republic of China, under the "one country, two systems" framework, in July 1997.

It is a rare occurrence in history for two sovereign nations to agree on the political reversion of a region some thirteen to fourteen years in advance. The Sino-British negotiations ended with the Joint Declaration in December 1984, and the subsequent establishment of the Basic Law in Hong Kong in 1990 was unprecedented. Like a business contract, which includes the delivery arrangements for a sale, it specified the kind of Hong Kong that the Chinese government would take over in 1997. This included not only the territory and its people, but also the existing social, political, economic, and cultural fabrics. The Basic Law literally mapped out the constitution for the post-1997 Hong Kong.

While economic stability and prosperity were highly preserved in the transitional years from December 1984 until July 1997, they were faced with severe challenges soon after the handover. The fall in property prices in late 1997 triggered the bursting of the economic bubble, while the outbreak of the Asian financial crisis in July 1997 resulted in a massive withdrawal of funds in the first half of 1998, the decision to stop the sale of land, and the unprecedented intervention in the stock market by the monetary authority. The Hong Kong economy suffered a big blow; deflation accompanied rising unemployment, a budget deficit in 1998, and asset depreciation. Various political, social, and legal phenomena, such as the "bird flu" epidemic in 1998, created a number of social grievances for the new SAR regime. The sudden economic downturn deepened the difficulties, and it was not until 1999 that there were signs of the economy stabilizing with inflows of foreign capital.

The post-1997 economy suddenly looked very different from the pre-1997 situation. Would the post-1997 difficulties erode Hong Kong's traditional

advantages and strengths? Hong Kong's reversion of sovereignty has been a testing case for the economism paradigm. This chapter takes a closer look at the economic events in the transition period, as well as the post-1997 years, then examines whether the situation in the post-reversion period will pose a challenge for, or erode the essence of, the paradigm. Section 9.2 summarizes events in the Sino-British negotiations, while section 9.3 elaborates on the growth scenario. The next four sections discuss four aspects of the economy prior to 1997, while section 9.8 considers the immediate post-1997 economy. Section 9.9 outlines the various economic difficulties facing Hong Kong and possible strategies for overcoming them. Before concluding, section 9.10 relates Hong Kong's post-1997 economy to economism.

9.2 The Sino-British negotiations

The two years of negotiation generated a great deal of political uncertainty (Cha 1984; Lau 1987; 1993; Domes and Shaw 1988; Ng 1991; Segal 1993; Chan 1994; Roberti 1994, Flowerdew 1998).[1] Even before 1982, and during the negotiation years from 1982 to 1984, the UK made various attempts to keep Hong Kong, for example proposing continued British administration rather than a return to sovereignty, and including the British Hong Kong government as a third party in the negotiations. China rejected all such proposals and insisted that Hong Kong's sovereignty was not open to negotiation. China also made various promises, for example that the "one country, two systems" concept would maintain and guarantee Hong Kong's capitalistic system, its connections with the international community, and its style of living for fifty years; and the self-rule principle (Hong Kong people ruling Hong Kong), which would ensure autonomy and that Beijing would maintain a hands-off policy with regard to Hong Kong affairs.

Soon after the conclusion of the Joint Declaration, the British Hong Kong government was branded as a "lame duck," reflecting the temporary nature of the British administration in Hong Kong. Emigration of Hong Kong citizens to such popular destinations as Canada and Australia raised the problem of a "brain drain," as most of the emigrants were qualified professionals or skilled workers. As Table 9.1 shows, the estimated number of emigrants was fairly small in the early 1980s, but increased rapidly in 1987, and reached a peak in the early 1990s.

The UK government's decision in 1990 to grant a full British passport with the right of abode in the UK to 50,000 businessmen, professionals, and administrators and their families was rejected outright by the Beijing authority. The proposal to build a new airport at Chep Lap Kok on Lantau Island led to the establishment of a Memorandum of Understanding in 1992, which allowed China to have a say in the construction of the new airport. The Beijing authority preferred a slower pace in the introduction of representative government and the establishment of political parties and elections. Governor Chris Patten's announcement of his proposal for the 1994–

Table 9.1 Estimated number of emigrants leaving Hong Kong

Year	*Number of individuals*	*As percent of labor force*	*As percent of population*
1980	22,400		0.44
1981	18,300	0.73	0.35
1982	20,300	0.81	0.38
1983	19,800	0.78	0.37
1984	22,400	0.86	0.41
1985	22,300	0.85	0.41
1986	19,000	0.70	0.34
1987	30,000	1.10	0.53
1988	45,800	1.66	0.81
1989	42,000	1.53	0.73
1990	61,700	2.25	1.07
1991	59,700	2.13	1.02
1992	66,200	2.37	1.12
1993	53,400	1.86	0.89
1994	61,600	2.10	1.01
1995	43,100	1.44	0.69
1996	40,300	1.30	0.63
1997	30,900	0.96	0.47
1998	19,300	0.57	0.28

Source: Statistics Unit, Security Bureau, Government Secretariat, and Census and Statistics Department, Hong Kong Special Administrative Region.

95 political elections, which broadened the electoral franchise, provoked stern opposition from Beijing, and the Sino-British relationship went into a state of "deep freeze," which affected a number of transitional issues and agreements on infrastructure projects. Beijing reacted with the setting up of another "stove," and derailed the "through train" that would have allowed the last legislature elected before 1997 to become the first legislature after 1997. It was clear in the Sino-British negotiations that the UK government's concern was that China might not stick to its promises of "one country, two systems" and the "self-rule" principle. Political reform and democratization was seen as the creation of a "buffer zone" for the future of Hong Kong. In contrast, China worried that the UK would not keep to the "contractual nature" of the Joint Declaration and instead introduce policies that would prolong the British influence in the territory.

Articles 105–135 of the Basic Law of the Hong Kong Special Administrative Region (SAR) formed the basis of the post-1997 economy.[2] These articles are grouped into four sections. Section 1 deals with public finance, monetary affairs, trade, industry, and commerce. Section 2 concerns land leases, whereas shipping and civil aviation are the focus of Sections 3 and 4 respectively. Most attention has been given to Section 1. The essence of Section 1 guarantees a capitalistic economy with a free market and property rights. It states that the Central People's government shall not levy tax from Hong Kong, shall follow a fiscal balance, and shall keep the existing low-tax policy. The SAR

government shall formulate its financial and monetary policies, and the Hong Kong currency shall continue to circulate. Free flows of capital into and out of the SAR shall be maintained, and the SAR government shall participate in relevant international organizations. In short, the Basic Law guaranteed the maintenance of the economic fabric of Hong Kong as it existed in 1984.

9.3 Economic opportunities and the growth scenario

There are two schools of thought on the economic future of Hong Kong. Hicks (1988) argued that economic stability is an illusion and could not be guaranteed. Mushkat (1989; 1990) constructed hypothetical "optimistic" and "pessimistic" scenarios for the post-1997 Hong Kong economy. The former argued that Hong Kong would be free of internal and external barriers to the mobility of production factors, manufactured goods, and capital, whereas the latter predicted that Hong Kong would become fully integrated into the mainland economy and would lose many of its pre-1997 characteristics. The "hostage effect" theory (Huang 1997: 107), however, argues that Hong Kong's economic advantage will persist because the massive investment in south China by Hong Kong investors created a large number of jobs in that region.

Mainland China's economic reform policy, which was initiated by the late Deng Xiaoping in 1978, provided Hong Kong with a new role in trade and investment and its role as a re-export center was revitalized. Overseas Chinese and foreign direct investment passed through Hong Kong, making use of its international banking and finance position (Sung 1991; Bowring 1997; Wu 1997). By the late 1980s and early 1990s, Hong Kong had turned itself into a fully formed service economy, with over 80% of GDP derived from the service industries. The linked exchange rate system, which was introduced in 1983 and pegged the Hong Kong dollar to the US dollar, proved to be effective. Seizing Hong Kong's bullish investment opportunities, corporations and institutions from mainland China gradually became involved in Hong Kong's financial and property markets.

At the time of the Joint Declaration in December 1984, the UK government could not decide on the post-1997 economy, as that would have been seen as an extension of the British rule. Equally, the Central People's government could not initiate economic issues for the post-1997 Hong Kong, as that would have been seen as a violation of the principle of "self-rule." Thus, the two sovereign nations, together with the British Hong Kong government, concentrated on the importance of keeping Hong Kong stable and prosperous. The business community commissioned a study in September 1989.[3] That report advocated a five-part strategy that basically reiterated the existing strength of the Hong Kong economy.

Hong Kong's economic performance in the 1978–97 period remained strong, as shown in Table 9.2. Between 1978 and 1982, Hong Kong experienced high growth rates, but domestic investment dropped between 1982 and 1985, and unemployment reached a peak in 1983. Political uncertainty affected

Table 9.2 Hong Kong macroeconomic performance, 1978–99 (US$ million)

Year	*GDP at current price*		*GDP per capita (US$)*		*Domestic investment*		*Unemployment rate*	*Real GDP growth rate*
1978	17,740	(17.2)	3,803	(15.1)	4,701	(27.3)	2.8	8.6
1979	22,586	(31.2)	4,626	(24.2)	6,775	(48.5)	2.9	11.5
1980	27,641	(26.9)	5,491	(23.5)	8,969	(37.3)	3.8	10.1
1981	30,088	(20.4)	5,810	(17.6)	9,921	(22.4)	3.9	9.1
1982	29,482	(12.2)	5,629	(11.0)	9,056	(4.5)	3.6	2.7
1983	27,336	(11.1)	5,114	(8.8)	6,808	(–10.0)	4.5	5.7
1984	32,787	(20.6)	6,076	(19.4)	7,329	(8.2)	3.9	10.0
1985	34,779	(5.9)	6,375	(4.8)	7,333	(– 0.1)	3.2	0.4
1986	40,098	(15.1)	7,258	(13.6)	8,692	(18.3)	2.8	10.7
1987	49,547	(23.0)	8,879	(21.8)	11,819	(35.4)	1.7	13.0
1988	58,276	(18.3)	10,366	(17.4)	14,873	(26.6)	1.4	8.0
1989	67,101	(15.3)	11,811	(13.9)	17,446	(17.3)	1.1	2.6
1990	74,676	(11.2)	13,111	(10.8)	19,712	(12.9)	1.3	3.4
1991	85,916	(14.8)	14,949	(13.8)	22,841	(15.6)	1.8	5.1
1992	100,650	(16.6)	17,311	(15.6)	27,613	(20.3)	2.0	6.3
1993	116,161	(15.2)	19,659	(13.2)	31,735	(14.7)	2.0	6.1
1994	130,639	(12.6)	21,670	(10.1)	38,913	(22.8)	1.9	5.4
1995	139,310	(6.6)	22,620	(4.5)	42,625	(9.5)	3.2	3.9
1996	154,071	(10.7)	24,420	(7.9)	48,129	(13.0)	2.8	4.5
1997	173,522	(12.8)	26,740	(9.5)	61,038	(27.0)	2.5	5.3
1998	166,006	(– 4.3)	24,874	(–7.0)	52,537	(–13.9)	5.7	–5.1
1999	157,867	(– 4.9)	23,490	(–5.6)			6.0	3.1
Average								
1980–85		18.22						7.52
1985–90		15.49						6.93
1990–95		14.07						5.25

Source: Census and Statistics Department, Hong Kong Special Administrative Region.

Note
Figures in brackets are the nominal growth rates calculated in Hong Kong currency; the fall in nominal GDP but rise in percentage growth rate in 1983 was due to the fall in the Hong Kong currency in that year.

the economy most severely in 1985. Between 1986 and 1994, however, Hong Kong enjoyed a stable period of robust growth. Both the nominal GDP and domestic investment remained at double-digit growth rates, while unemployment achieved a record low of 1.1% in 1989. Economic expansion could have been checked in 1995, when the growth rates slowed, but the drive to prosperity and stability in the transition period of 1997 quickly reinstated the upward growth trend.

The Hong Kong economy has experienced a rapid structural change (Hong Kong Government 1993; 1996; 1997; Luk 1995). The industrial share of GDP at factor cost was halved from 31.7% in 1980 to 14.7% in 1997, but the share of the service sector has increased almost by twenty percentage points from

67.5% to 85.2% in the same period. The rapid structural change is reflected in the distribution of domestic loans among major sectors, as Table 9.3 shows. Together with loans to wholesale and retail, loans given to the service sector increased from a total of 58.15% in 1981 to 69.39% in 1986, but fell to 66.84% in 1997. Loans to manufacturing were almost halved, falling from 9.29% in 1986 to 4.84% in 1998. Loans to the building and construction sector leveled off in the early 1980s, but increased from their lowest share of 11.2% in 1987 to 21.61% in 1997.

The buoyant economy was supported by strong growth in total exports (Table 9.4), especially in the re-export trade, which experienced an average annual growth rate of 28.3% between 1978 and 1997. Hong Kong's sizeable exports were matched by substantial imports, and were rescued by the rapid expansion of export of services. Trade is still a major comparative advantage in Hong Kong, as its total exports as a proportion of GDP rose from 63.27% in 1978 to 108.32% in 1997. In short, re-exports and service exports have dominated Hong Kong's trading position.

Table 9.3 Percentage share of loans and advances in Hong Kong

Year	*Total (HK$ million)*		*Manufacturing*	*Building and construction*	*Miscellaneous*		*Wholesale and retail*
					Total	*Residents*	
1978	*56,398		12.94	12.28	32.50		30.52
1979	*75,793	(34.9)	12.50	13.04	34.48		29.06
1980	*124,287	(64.0)	10.72	15.45	37.98		25.92
1981	143,409	(15.4)	9.90	23.53	45.75	10.71	12.40
1982	187,321	(30.6)	9.03	26.44	43.76	10.20	10.87
1983	208,931	(11.5)	8.93	22.55	44.26	12.05	12.57
1984	220,906	(5.7)	8.51	21.78	45.21	13.29	12.79
1985	234,943	(6.4)	8.40	17.06	51.31	15.85	12.57
1986	270,730	(15.2)	9.29	12.78	56.96	18.16	12.43
1987	352,685	(30.3)	8.46	11.20	61.13	18.55	12.31
1988	465,487	(32.0)	8.38	12.65	58.10	18.48	12.83
1989	584,593	(25.6)	7.91	16.47	57.48	18.83	10.72
1990	689,368	(17.9)	7.15	15.68	58.93	21.15	10.83
1991	817,077	(18.5)	6.67	15.38	60.43	24.38	9.87
1992	909,912	(11.4)	7.00	15.88	59.83	24.61	9.69
1993	1,075,777	(18.2)	6.85	16.77	59.99	24.92	9.24
1994	1,258,589	(17.0)	6.82	19.79	55.08	23.72	10.92
1995	1,398,193	(11.1)	7.16	18.75	55.59	24.98	11.89
1996	1,637,191	(17.1)	6.57	20.34	55.64	25.77	10.78
1997	2,037,278	(24.4)	5.43	21.61	56.74	26.55	10.10
1998	1,957,752	(–3.9)	4.84	21.25	57.74	30.12	9.18

Source: Census and Statistics Department, Hong Kong Special Administrative Region.

Notes
*Figures based on old series. Figures in brackets are annual growth rates. Building and construction includes property development and investment. Residents = loans to professional and private individuals to purchase flats under the 'Home Ownership Scheme' and the 'Private Sector Participation Scheme' and to purchase other residential properties.

Table 9.4 Hong Kong's financial performance

Year	*M2 (HK$ million) (% change)*		*M2/ GDP*	*Inflation (%)*	*Hang Seng Index*	*Stock turnover (HK$ million) (/GDP)*		*Savings deposit rate*
1978				8.01	526.91	27,419	(0.32)	3.29
1979				17.51	619.71	25,633	(0.23)	5.29
1980	96,240		0.68	15.4	1,121.17	95,684	(0.67)	7.95
1981	116,756	(21.3)	0.68	10.28	1,506.84	105,987	(0.62)	11.71
1982	206,688	(77.0)	1.08	9.72	1,105.79	46,230	(0.24)	6.54
1983	257,685	(24.7)	1.21	4.52	933.03	37,165	(0.17)	7.38
1984	314,081	(22.0)	1.22	9.69	1,008.54	48,787	(0.19)	6.59
1985	390,239	(24.3)	1.44	5.36	1,567.56	75,808	(0.28)	3.28
1986	518,131	(32.8)	1.66	3.89	1,960.06	123,128	(0.39)	2.5
1987	677,042	(30.7)	1.76	8.93	2,884.88	371,406	(0.96)	2.13
1988	824,648	(21.8)	1.81	9.52	2,556.72	199,481	(0.43)	3.19
1989	988,836	(19.9)	1.89	12.32	2,781.04	299,147	(0.57)	5.79
1990	1,210,050	(22.4)	2.08	7.53	3,027.47	288,715	(0.50)	5.92
1991	1,371,029	(13.3)	2.05	9.2	3,471.54	334,104	(0.50)	4.71
1992	1,518,777	(10.8)	1.95	9.71	5,545.97	700,578	(0.90)	2.32
1993	1,764,416	(16.2)	1.97	8.51	7,695.99	1,217,213	(1.36)	1.5
1994	1,992,351	(12.9)	1.97	6.92	9,453.52	1,137,414	(1.13)	2.45
1995	2,282,849	(14.6)	2.12	2.52	9,098.47	826,800	(0.77)	4.2
1996	2,532,236	(10.9)	2.12	5.89	11,646.55	1,412,242	(1.18)	3.77
1997	2,742,993	(8.3)	2.04	7.16	13,294.70	3,788,960	(2.82)	4.08
1998	3,066,089	(11.8)	2.38	0.8	9,484.47	1,701,112	(1.32)	5.19

Sources: Census and Statistics Department, and Hong Kong Monetary Authority, Hong Kong Special Administrative Region.

Notes
M2 = Notes and coins with the public + customers' demand deposits with licensed banks + customers' savings and time deposits with licensed banks + negotiable certificate of deposit issued by licensed banks held outside the monetary sector. For Hang Seng Index, 31.7.64 = 100, figures are monthly averages. Savings deposit rate is period average figure, percent per annum.

Hong Kong has remained attractive to foreign direct investment, as Tables 5.7 and 5.8 showed (see pp. 128–9). Statistics available since 1994 show that foreign direct investment in the non-manufacturing sector is much higher than the corresponding figures in the manufacturing sector. The growth of foreign direct investment in the manufacturing sector has dropped since the early 1990s, with electronics and electrical products accounting for about 50%, followed by food and beverage, printing and publishing, chemical products, and textiles and clothing. In the non-manufacturing sector, the banking sector is the major recipient of inward foreign direct investment, followed by holding companies, and wholesale and retail. Japan is the leading supplier of inward foreign direct investment in the manufacturing sector, followed by the US and mainland China. In the case of the non-manufacturing sector, the UK is the major supplier, followed by mainland China and the US. The prominence of Japan has declined since 1994.

Hong Kong's role as a financial center can also be seen from Table 9.4 (for discussions, see Jao 1985; 1987; 1988a; 1991; Hong Kong Monetary Authority 1993; 1994; 1995). Money supply (M2) experienced a rapid annual growth of more than 20% throughout the 1980s, and remained at more than 10% in much of the 1990s. The rapid expansion of M2 also reflected a rapid rise in domestic savings, which, in turn, supported the large domestic investment. The money-deepening ratio (M2–GDP) remained high and has exceeded unity since 1982, suggesting high returns on investment.

The Hang Seng Index and stock turnover has shown a steady increase over the years. Stock turnover as a percentage of GDP has increased steadily since 1984, reaching an unprecedented height in 1997. Domestic investment and investment in the stock market has been encouraged by the negative real interest rate (inflation less savings deposit account rate) in most years. After the Hong Kong currency was linked to the US dollar at US$1:HK$7.8 in 1983, the Hong Kong interest rate could no longer be used as a monetary instrument for regulating the domestic economy, because it has to follow the movement of US interest rates. When the US currency was weak in the mid-1980s, there was pressure for the Hong Kong currency to revalue, but severe speculative activities on the revaluation of the Hong Kong dollar were subsequently deterred when the Hong Kong monetary authority declared the possible use of a "negative interest rate" in 1987. The nominal interest rate remained low from the mid-1980s to the mid-1990s.

9.4 The wealth effect and the short-term investment hypothesis

Much of the growth in Hong Kong's GDP during the transitory years was due to the emergence of two waves of asset appreciation and the consequent increases in wealth (Li 2001). An initial increase in income enabled residents to engage in the bullish stock market, which was made all the more attractive by the low real interest and rising inflation rates. A continued rise in stock prices generated a considerable amount of asset appreciation and wealth for equity holders. This constituted the first wave of the wealth effect.

With rising income and wealth, the demand for property naturally increased. The rising demand for private property drove up the prices of new and older property. This price appreciation created the second wave of the wealth effect. Thus, apartments that cost about HK$0.5 million in the late 1970s or early 1980s could cost HK$3–4 million by the late 1980s and early 1990s. The increase in property price far exceeded the inflation rate or the rate of wage increase and was further encouraged by speculation. The two waves of the wealth effect soon developed their own pace, though their causality may not be identifiable. It seems likely that wealth appreciation in the stock market spilt over to the property market, and vice versa. Increases in wealth raised aggregate demand, and provided a bullish investment climate and a rise in employment, leading eventually to an economic boom in Hong Kong.

Hong Kong's stability and prosperity in the transition period before 1997, however, had a different meaning for different individuals and investors. While some considered June 1997 to be a terminal date, others saw a thirteen-year period of opportunities and a stable investment environment, starting in 1984. Either way, investors were most likely to show short-term investment behavior, engaging in low-cost investments with a quick return. For example, labor-intensive manufacturing industries would have been more favorable than capital- or technology-intensive manufacturing industries. Cost minimization was seen as another means to realize a quick return. Investment in the special economic zones in south China fitted such criteria. Secondly, when the entire "production–sales–revenue–profit" process is short, investors can realize the returns quickly. Various small-scale service industries provide opportunities for investors to have a shorter production–sales–revenue–profit cycle. Investors in restaurants, for example, engage in only a three-to-four-year cycle. Local investors therefore switched from long-term investment in manufacturing to new investments in various services.

Speculation is another type of short-term, quick-return investment behavior. Speculative activities in taxi licenses and export quotas are industry-specific examples. The two waves of wealth increase, reflected in equity and property appreciation, coupled with the banks' eager support for loans, permitted speculative activities to flourish, of which small real estate agencies are a good example. Other extreme examples of speculative activities include school students speculating on game cards and stamps as 1997 drew nearer. At the peak of property speculation in the 1990s, for example, a car park in the mid-level of Hong Kong Island sold for HK$1 million (about US$129,000). People queued up overnight to buy number tags that enabled the holder to then buy one of a block of new apartments in Kowloon. The first number tag sold for as much as HK$250,000 (about US$32,200). Short-term investment behavior usually produces a period of rapid growth in income and wealth, but this cannot be sustained for a long period of time without the formation of bubbles when large financial transactions are not backed up by corresponding increases in the real economy.

9.5 Industries and services: a shrinking real economy?

A process of "industrial hollowing" was responsible for the reduction in industrial output. The "push" and "pull" factors of cost differences between Hong Kong and south China resulted in a massive migration of industries, especially labor-intensive industries, and one-way investment flow from Hong Kong.[4] Statistics show that Hong Kong's outward investment increased from US$2,377 million in 1990 to US$26,000 million in 1997 (Hong Kong Government Census and Statistics Department 1993). Mainland China is the major recipient of Hong Kong's outward foreign direct investment, mainly in the form of outward processing (Tuan and Ng 1995). For example, the repatriated profits from Hong Kong's direct investment in mainland China

amounted to US$10.5 billion and US$15.7 billion in 1993 and 1994 respectively (Wu 1997: 118).

Employment in the entire manufacturing sector has declined from 35% of total in 1986 to 12.2% in 1998. Finance, insurance, real estate, and business services have doubled their combined share from 6.2% in 1986 to 13.1% of total employment in 1998. The production indices of all manufacturing kept rising steadily until 1995, before declining considerably in 1997 and 1998. The two manufacturing industries that recorded a rise in production indices are electrical goods and electronics and paper products and printing. The increase in labor productivity suggests a process of technology transformation in the manufacturing industries. The decline in industrial growth has been responsible for the slow growth of domestic exports since 1984. Huang (1997: 112) investigated Hong Kong's declining industrial exports by comparing the US trade deficit with those of mainland China, Chinese Taipei, and Hong Kong, and concluded that export replacement or substitution has taken place between exports from mainland China and from Chinese Taipei and Hong Kong.

Spending on research and development, which has been extremely low in Hong Kong, is regarded as an endogenous factor. Berger and Lester (1997: 77) estimated that Hong Kong's total expenditure on R&D amounted to only 0.1% of GDP in 1994. The other three East Asian economies have a much higher investment in R&D (Korea 2.29%, Taiwan 1.8%, Singapore 1.18%). One endogenous factor that has worked to the disadvantage of the textile and clothing industry is the considerable degree of speculation on the export quota in the 1980s and 1990s. Its allocation depended largely on the export size of the exporting firms. The larger exporting firms naturally secured a larger quota. Quota holders gained from quota price appreciation simply by selling their quota to smaller manufacturers at a handsome profit. Such a vicious circle of speculation raised the price of quota and weakened the competitiveness of the textile and clothing manufacturing sector, thus hastening the "sunset" process.

There are broadly two types of services: exportable (banking, insurance, tourism, and air transport) and non-exportable (car parking, hairdressing, public utilities, and personal services). Unlike manufactured goods, which face competition from other local and overseas suppliers, non-exportable service industries often do not have foreign-sourced equivalents to compete with. Their "monopolistic" nature allows the suppliers to raise the price easily, especially at a time of an economic boom. Table 9.5 shows the movement of the composite consumer price index (CPI) and the composite consumer service price index (CSPI). The CSPI has remained higher than the CPI, especially when inflation was rising, and the two converged only when the economy went into recession in 1998. This suggests that prices are stickier, both upward and downward, in services than in manufactured products. This means that in times of inflation prices in the service sector increase faster than the average price increases, whereas in a deflationary situation prices in service industries fall more slowly than the average price changes.

Table 9.5 Inflation movements: general versus service sector (percentages)

Month/ year	*Index A*		*Index B*		*Hang Seng index*		*Composite index*	
	CPI	*CSPI*	*CPI*	*CSPI*	*CPI*	*CSPI*	*CPI*	*CSPI*
Dec-92	8.6	9.6	8.5	9.8	10.2	11.3		
Dec-93	8.1	11.2	9.5	12.2	10.3	12.0		
Dec-94	6.6	9.7	7.3	9.8	7.9	11.4		
Dec-95	6.7	8.4	6.5	7.6	6.7	7.9		
Dec-96	4.8	6.0	5.2	6.8	5.8	7.7	5.2	6.7
Dec-97	–1.4	–2.5	–1.7	–1.8	–1.8	–0.1	–1.6	–1.4
Oct-98	–3.1	–1.1	–5.1	–4.1	–4.1	–3.2	–4.2	–2.9

Source: Hong Kong Coalition of Service Industries, Hong Kong General Chamber of Commerce.

Notes
Index A = Household monthly income range is HK$2,500–HK$9,999 before December 1995, and HK$4,000–HK$15,999 since December 1995. Index B = Household monthly income range is HK$10,000–HK$17,4999 before December 1995, and HK$16,000–HK$29,999 after December 1995. Hang Seng Index = Household monthly income range is HK$17,500–HK$37,499 before December 1995, and HK$30,000–HK$59,000 after December 1995. Composite index = Household monthly income range is HK$4,000–59,999. CPI = consumer price index. CSPI = consumer service price index. The CSPI made up of the service items in the CPI. Before December 1995, the CSPI occupied 39.26% of the weighting of the CPI(A), 43.05% of CPI(B), and 50.65% of the Hang Seng index. Since December 1995, these percentages are, respectively, 44.38%, 49.2%, 57.01%, and 49.75% of the composite index.

The real economy comprises various industrial production activities. The growth of financial transactions in the nominal economy depends on actual growth in the real economy. A rapid increase in the nominal sector suggests that monetary transactions are large, but they should keep pace with the real economy. Typically, gains deriving from speculative activities do not have any impact on the real economy; they are just monetary transactions without parallel increases in physical output. This produces a monetary bubble, as asset appreciation produces a nominal wealth effect. Speculative activities can lead to an increase in nominal wealth in the short-run. When people realize the large monetary gains to be made in the nominal economy, a process of resource reallocation in which capital flows from the activities in the *real* economy to activities in the *nominal* economy. Ultimately, activities in the real sector are not keeping pace with those in the nominal sector and the economy experiences shrinkage in the real sector. A monetary bubble is formed when nominal activities are growing, but it will burst once expectations have been revised, leading to a steep drop in asset prices, at which point the shrinking real economy can no longer sustain the rapidly diminishing nominal economy. A period of prolonged asset depreciation occurs, resulting in a severe economic downturn with rising unemployment, falling income levels, and increases in bad debts. Asset depreciation may also lead to the withdrawal of funds and pressure on the exchange rate to depreciate, which can create negative spillover effects in the external sector.

In the transition years before 1997, the Hong Kong economy experienced a typical case of strong growth in the nominal economy at the expense of a

shrinking real economy. High inflation and low nominal savings deposit interest rates produced a prolonged period of negative real interest rates. Since 1993, the stock turnover–GDP ratio has exceeded unity, except in 1995, suggesting possibly a large inflow of "hot money" and the rapid formation of a financial bubble. The prolonged rapid expansion in the nominal economy, coupled with the continued shrinkage in the real economy, meant that the economic bubble would have to burst upon the emergence of an unpredictable trigger.

9.6 The real estate sector and economic narrowness

Housing in Hong Kong is either supplied by the government in the form of public housing estates and the various government-built home ownership schemes or by private real estate developers. Two common questions are whether the Hong Kong government sustains a high land price, and whether the few handfuls of large real estate developers collude over land prices. The sale of land in Hong Kong is conducted mostly through public auction, or is granted under private treaties. In a public auction in which the land goes ultimately to the highest bidder, it is difficult to argue that the Hong Kong government maintains a high land price. What actually influences land prices is the nature of the auction. In a closed-door bid, bidders can bid only once, thus the price offered by the final bidder is an average price. In an open auction, bidders can bid more than once and the government gains the advantage of the "consumer surplus" from the bidder. Land prices will definitely be higher in an open-bid auction, as compared to a closed-door bid. In a buoyant market situation when prices are rising, developers may react together and choose a similar sale strategy. When the market price is falling (for example, in 1982 and in 1999), however, developers may undercut each other in order to speed up the sale and reduce the inventory. There is hardly any evidence for collusion among large property developers.

Developers use various market strategies to their advantage and will begin by releasing a small quantity of property to create a situation of excess demand and thereby justify an increase in price. An upward-sloping demand scenario is produced. As price rises, so does demand, based on the fear that the price will increase further. The limited supply of new apartments released by the developers and the subsequent increase in price in the next round generates a series of points that actually follow the upward-sloping demand curve of real estate consumers. Figure 9.1 shows that the first round of supply (Q_1) is sold at P_1. Because of the limited supply in the first round and the subsequent rise in price, the second round of the limited supply (Q_2) will be sold at a higher price (P_2), and so on. Joining up these intersection points follows the upward sloping demand curve (DD), not a supply curve. The rising price is further fueled by the presence of speculation. The activities of property speculators effectively push the price up, resulting in an upward shift of the upward-sloping demand curve to the line D_1D_1 in Figure 9.1. The consequence

is that the speculator buys the property at P_1 and sells it at P_2. The difference P_2–P_1 is the speculator's profit. Similarly, at Q_2, the speculator gains P_3–P_2. It is even possible to have an unparalleled shift in the demand curve, resulting in an even higher speculator's gain at higher price, and vice versa.

An extreme situation of a "speculation–price escalation" spiral can easily develop. Assume that at quantity Q_1, the speculators manage to purchase the property at price P_1, and sell at P_2. Realizing the speculative gain, developers expect the price in the next round of supply (Q_2) to equal P_2. When the new supply falls into the hands of the speculators, the price becomes P_3, which, in turn, becomes the price indicator to the developers for the next round of supply (Q_3). The combined activity of the developers and the speculators produces an upward spiral of accelerated property prices, as shown by the arrows in Figure 9.1.[5]

Property has become an instrument of speculation. Speculation redistributes income among various parties. The government gains because of the high land price. Developers gain because they profit from a rising price. Speculators get a quick cash return and the owners of existing property gain because their property has appreciated. Commercial banks gain because the realized interest is higher than the mortgage interest if the property is sold before the maturity of the mortgage agreement. Two groups of individuals lose, however: those on a fixed income, especially when the rate of increase in wages is less than that of property prices, and those who cannot afford the initial down-payment on a mortgage. The "deadweight loss" is the erosion of Hong Kong's competitiveness.

Table 9.6 provides an indicative measure of supply and demand. Total land disposed of (urban areas and the New Territories) through public auction

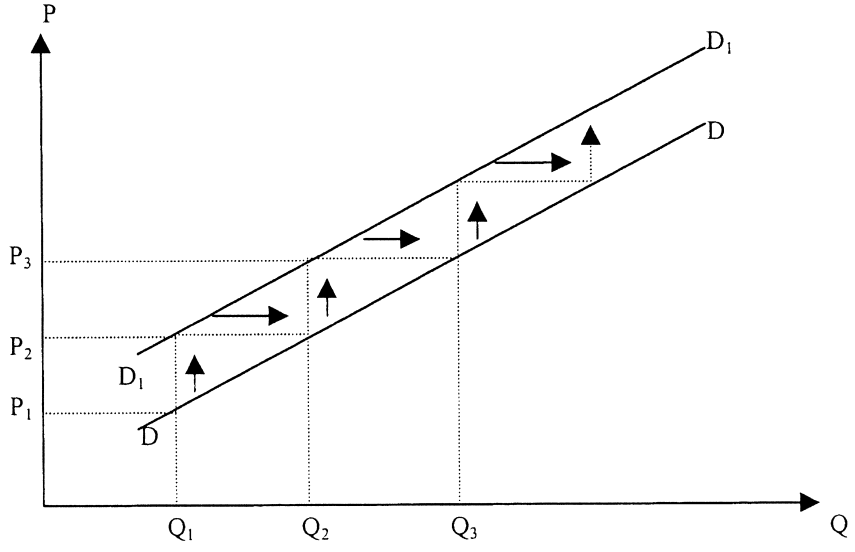

Figure 9.1 The upward property price spiral

has varied over the years, and reached peaks in 1983, 1988, and 1996. The realized premium is the contribution to government's purse from the sale of land. The total completed number of private domestic units shows the supply of new property, varying from the smallest size, not exceeding 39.9 m^2, to 40.0–69.9 m^2, 70.0–99.9 m^2, 100.0–159.9 m^2, up to a size of 160.0 m^2 and above. The actual demand can be deduced from the agreements for sale and purchase of building units and land. An indication of the average price of building units can be realized from the last two columns in Table 9.6. For example, the average price of a building unit and land was HK$0.6794 million in 1985, increased to HK$1.777 million in 1988, to HK$3.099 million in 1993, and HK$3.2105 million in 1998.

An indicative measure of price movements in the property sector is shown in Table 9.7. In the private sales market, prices remained extremely high, generally higher than the inflation rate, between 1985 and 1994. The property sector then suffered a set back in 1995, but rebounded in 1997. The British Hong Kong government did attempt to put pressure on the rising property price by introducing various measures, such as the reduction of the upper mortgage limit to 70% of the market value and the restrictions on developers in their pre-sale strategies in the mid-1990s. These measures, however, were considered to be ineffective and property prices kept rising.

In terms of employment, the rapid growth in the property sector has led

Table 9.6 Supply of land and completion of private domestic units

Year	*Total land disposed (sq. m.)*	*Realized premium (HK$m)*	*Total number of private domestic units completed*	*Agreements for sale and purchase of building units and land*	
				Number	*HK$ million*
1982	372,190	4,817	23,140	17,436	
1983	539,116	585	21,620	24,447	
1984	114,560	789	22,270	29,959	
1985	230,271	3,521	29,875	54,405	36,965
1986	191,484	3,325	34,105	56,549	48,954
1987	179,050	4,109	34,375	55,504	73,222
1988	478,535	7,619	34,470	67,270	106,414
1989	262,763	12,292	36,485	61,896	110,009
1990	159,189	3,264	29,400	69,619	108,370
1991	270,700	10,116	33,380	103,432	225,078
1992	229,166	9,954	26,222	139,927	385,384
1993	207,943	17,234	27,673	136,915	424,329
1994	168,481	15,783	34,173	118,481	505,496
1995	247,389	18,642	22,621	100,171	283,226
1996	892,913	17,775	19,875	150,715	517,767
1997	302,200	42,893	18,202	210,594	937,806
1998	318,199	15,073	22,278	113,569	364,612

Source: Census and Statistics Department, Hong Kong Special Administration Region.

Table 9.7 Percentage change of indices by type of premises

	Price indices				*Rental indices*			
Year	*PD*	*PR*	*PO*	*FF*	*PD*	*PR*	*PO*	*FF*
1983	–15.1	–22	–34	–20.4	–8.2	–6.3	–25	–17.6
1984	–4.4	–9.5	–30.3	7.7	–3.4	–8.3	–11.1	0.0
1985	11.6	5.3	8.7	13.9	5.6	5.5	0.0	4.8
1986	10.4	17.5	2.0	2.4	8.8	5.2	18.8	6.8
1987	22.6	14.9	36.7	35.7	9.7	13.1	26.3	17.0
1988	21.5	33.3	51.2	38.6	16.2	17.4	27.1	40.0
1989	26.6	31.6	61.3	26.6	26.6	23.5	63.9	29.9
1990	11.0	12.0	–4.0	6.0	10.0	12.0	1.0	5.0
1991	37.8	27.7	1.0	7.5	8.2	12.5	–5.9	3.8
1992	40.5	39.9	37.1	28.9	9.2	18.3	6.3	7.3
1993	10.2	22.0	19.5	20.4	7.7	12.1	8.9	10.3
1994	36.3	16.8	39.6	6.8	21.4	15.0	21.8	3.1
1995	–7.2	–2.8	–15.3	–12.2	2.4	0.0	–1.5	–1.5
1996	9.6	3.6	–2.1	–13.9	–1.7	0.0	–15.2	–9.9
1997	40.9	33.1	12.0	–0.7	13.5	5.7	2.7	0.0
1998	–29.0	–28.3	–36.4	–21.8	–15.7	–8.4	–12.2	–10.2

Source: Census and Statistics Department, Hong Kong Special Administrative Region.

Notes
PD, private domestic premises; PR, private retail premises; PO, private offices; FF, private flatted factories.

to a rapid rise in the number of persons engaged in the real estate sector from 19,304 in 1980 to 82,696 in 1997, about a fourfold increase. This increase was entirely due to the expansion in the real estate service business. Employment in the construction sector first decreased in the 1980s then increased again in the 1990s. The number of persons engaged in the construction sector was 90,498 in 1980: this figure fell gradually to 59,292 in 1991, but then increased again to 83,251 in 1997 (Hong Kong Government Census and Statistics Department 1993).

The buoyancy of the property sector created a scenario of investment over-concentration. The first column in Table 9.8 shows the percentage share of total loans and advances provided by all authorized institutions to the property sector, which comprises building and construction and private residents purchasing either government supplied or privately supplied property. In the early 1980s, other than 1982, property's share declined gradually to 29.75% in 1987. Thereafter, however, the trend was reversed as it increased to 40.49% in 1992 and expanded rapidly to 54.55% in 1999. The process of economic narrowing began in 1987. Since then, property price appreciation has encouraged investment to concentrate in economic activities related to the property and construction sector.

The abnormal upward spiral of the demand for property was brought to a halt by two forces. The first was the first policy address delivered by the Chief Executive, Mr Tung Chee Hwa on 8 October 1997. He pledged to curb

Table 9.8 Investment concentration and real interest rate

Year	*Percentage share of loans and advances to building construction and purchase of property*	*Real interest rate*
1978		–4.7
1979		–12.2
1980		–7.5
1981	34.2	1.4
1982	53.2	–3.2
1983	34.6	2.9
1984	35.1	–3.1
1985	32.9	–2.1
1986	30.9	–1.4
1987	29.8	–6.8
1988	31.1	–6.3
1989	35.3	–6.5
1990	36.8	–1.6
1991	39.8	–4.5
1992	40.5	–7.4
1993	41.7	–7.0
1994	43.5	–4.5
1995	43.7	1.7
1996	46.1	–2.1
1997	48.2	–3.1
1998	51.4	4.3
1999	54.6	9.3

Source: Table 9.3 (sum of columns 3 and 5) and Table 9.4 (saving deposit rate – inflation).

the soaring property prices by increasing the supply of land and introducing a plan to build 85,000 apartments annually. The second event was the Asian financial crisis, which hit Hong Kong hardest in the first half of 1998 and led to steep depreciation of assets. The supply of new flats was expected to peak in 1999–2000. The overall monthly price indices (1995 = 100) of private domestic estates (based on selected popular developments) dropped from 167.5 in October 1997 to 145.2 in December 1997. By October 1998, the index had dropped to 81.3 (*Hong Kong Property Review 1999*: Table 16).

These two events restructured the pattern of property demand from an abnormal upward-sloping spiral back to a normal downward-sloping curve indicating an inverse relationship between supply and price. The bursting of the price bubble in the property sector stabilized property prices. Hong Kong's economic base could have been widened only after investments had been diversified into non-property related areas. Given a stable property price, non-speculative demand for property could have risen only when investments in other areas had generated sufficient income and employment.

9.7 Competitiveness and the wage–price spiral

The argument over the competitiveness of Hong Kong's economy has attracted supporters as well as critics. In *The Hong Kong Advantage,* Enright *et*

al. (1997) argued that one should not simply look at Hong Kong's high cost, but also at its "value for money" in business terms. The "clustering effect" permits businesses to achieve economies of scale and scope, particularly in China-related businesses. The "multifaceted" service sector makes Hong Kong a hub for financial services, business services, and regional activities, and it has the advantage of being the "gateway to China". Such a unique combination of features is unrivaled elsewhere.

The American Chamber of Commerce in Hong Kong has compiled a list of forty-seven fundamental points that are of vital importance in projecting Hong Kong's advantage to the international business community (see Table 9.9). The Cato Institute voted Hong Kong to be the most open economy in the world for a number of years in the 1990s, while Singapore was in second place. The Heritage Foundation, a Washington-based institute, also named Hong Kong as the most open economy in its *Index of Economic Freedom* (Heritage Foundation 1999).

In the case of wage movements in Hong Kong during the period 1982–98, the increases in nominal wages were much higher than those in real wages, reflecting the fact that nominal wage increases are closely related to inflation. The only year in which there was deflation was 1998, when the real wage increase was higher than the nominal wage increase. Table 9.10 shows that the two "best" performing sectors were transport, storage, and communication, and electricity and gas, with five and four years of double-digit growth in wages in nominal and real terms respectively. The performance of the financial sector, however, was weaker than expected. Given the rising financial status of Hong Kong, this suggests that earnings are derived largely from such non-wage payments as commissions and bonuses. The sector with the overall weakest performance is the external trade sector (wholesale, retail, export–import trade, restaurants and hotels); most of its real wage increases remained low, suggesting a high degree of competition. The trend in wage increases also reflected the changing industrial structure. While the manufacturing and mining sectors saw double-digit increases in the 1980s, most of the service industries experienced theirs in the 1990s. The trend also shows that the manufacturing and mining sector, the external trade sector (wholesale, retail, export–import, restaurants, and hotels) and the exportable service (financial) sector maintained their competitiveness with reasonable wage increases. The sectors that enjoyed high wage increases were the non-exportable sectors (transport, storage, and communication, and electricity and gas), suggesting a greater monopolistic element.

Wage increases in the civil services have been high, as shown in Table 9.11. The nominal adjustments are supposed to make up the loss in income due to inflation, on top of the one salary-point annual increments that civil servants enjoy. There are three pay adjustment rates to reflect the lower, middle, and upper ranges of civil servants' pay. The discrepancy between the three grades, however, is minor, reflecting that there is divergence in absolute income among highly paid and poorly paid civil servants. With the exception of 1998–2000, when there was a freeze on pay adjustment, there were eleven,

Table 9.9 Fundamentals of Hong Kong's success

Rights and privileges of residents Mostly unrestricted entry and departure for business travel and tourism. Simple procedure for obtaining resident visas and local employment. Local residence status granted to individual expatriates operating small businesses. No restriction on expatriate staffs assigned to work in Hong Kong. No quota on continued residence for expatriates. No guarantees are required for resident permission. Non-discrimination on residence and employment.
Business/legal environment Market forces as the principal economic determinant. Minimal use of centrally directed incentives. Lack of governmental bureaucratic or administrative approval requirements. Simple tax system. Government's traditional view of tax and rates as incentives for trade and investment. Extensive body of commercial law. Consistent and assured access to an impartial arbiter in law dispute. Existence of comprehensive company law. No restrictions on setting up offices or register branches. No restrictions on company restructure. Efficient and well-managed civil service.
Communications/transportation Autonomous entity in all world communication links. Telecommunications are not monitored or censored. Unrestricted data flows. No government monopoly on communication technology and equipment. Privately managed telecommunication. Efficient freight handling, forwarding, transportation, and passenger services.
Banking and financial services Large number of local and overseas financial institutions. Funds are freely convertible. Full range of banking services. No restriction on borrowing and lending, other than normal commercial constraints.
Human resources A large pool of high productivity human resources. Advanced education overseas, training with multinational corporations. Freedom to employ, direct access to the labor market. Relaxed labor relations.
Education Readily available public and private education with international standards. Freedom to establish institutions serving special needs. No censorship of materials. Universities offer internationally recognized degrees.
Social environment Equity before the law. Freedom of movement within the territory. Unrestricted activities of the mass media. Wealth of cultural activities. Variety and accessibility of shopping and distribution centers. Existence of a deeply rooted spirit of tolerance and cooperation. Available supply of various types of accommodations. Religious freedom. Freedom to participate in community life. Maintenance of the English language for business and government. High-quality medical facilities.

Source: *Journal of the American Chamber of Commerce in Hong Kong Transition Edition*, May 1997.

eight, and seven years of double-digit pay adjustments in the lower, middle, and upper scales, respectively, between the 1979/80 and 1998/99 fiscal years. Apart from 1998/99, 1982/83 was the other year with the lowest pay adjustment, with a range of 4.48–5.53%. This was the year when the Sino-British talks over the future of Hong Kong suffered a setback. The four

Table 9.10 Wage performance in different Hong Kong industries, 1982–98

Economic sectors	*No. of years of two-digit growth (nominal and real)*
Mining and quarrying	2 (1986, 1989)
Manufacturing	2 (1986, 1992)
Electricity and gas	4 (1985, 1989, 1996, 1997)
Wholesale, retail, trade, restaurant, and hotel	1 (1986)
Transport, storage, and communications	5 (1982, 1984, 1989, 1991, 1994)
Financing, insurance, real estate, and business services	1 (1993)
Community, social, and personal services	1 (1991)

Source: Census and Statistics Department, Hong Kong Special Administrative Region.

Table 9.11 Civil service pay adjustment (percentages)

	Salary band		
Year	*Lower*	*Middle*	*Upper*
1979–80	16.55	16.16	17.14
1980–81	18.20	17.38	18.03
1981–82	15.01	14.95	14.96
1982–83	5.53	4.74	4.48
1983–84	11.21	9.93	9.12
1984–85	10.98	9.12	8.76
Special from 1.1.86*	2.70	2.70	2.70
1985–86	7.00	7.00	7.00
1986–87	7.13	6.40	6.30
1987–88	9.62	9.93	9.56
1988–89	14.81	14.81	13.43
1989–90	15.00	15.00	15.00
1990–91	10.43	10.43	10.43
1991–92	11.60	11.60	11.17
1992–93	10.66	10.66	9.76
1993–94	9.89	9.89	9.47
1994–95	10.14	10.14	9.98
1995–96	7.67	7.67	7.68
1996–97	6.81	6.81	6.90
1997–98	5.79	5.79	6.03
1998–99	0.00	0.00	0.00
1999–00	0.00	0.00	0.00
2000–01	0.00	0.00	0.00
2001–02*	2.38	2.38	4.99

Source: Civil Service Bureau, Hong Kong Special Administrative Region.

Notes
Special pay adjustment for non-directorate staff, with effect from 1.1.86.
*Announced (*Mingpao*, June 6, 2001).

consecutive years that double-digit pay adjustments were made were from 1988/89 to 1992/93. These years of high pay adjustment correspond to the years with the highest emigration figures (see Table 9.1, p. 231). In 1995/96 there were equal wage increases across the three categories, but since then the upper salary band has received higher salary adjustments than the lower and middle bands.

Although the wage–price causality is not easily identified, there was definitely a wage–price spiral between wage increases in the civil service, the price of goods set by suppliers, and other workers demanding higher wages. In Hong Kong, the private sector raises the price of goods to reflect the inflation rate, and the government adjusts its pay awards according to wage increases in the private sector. The private sector uses the government's pay adjustment as a benchmark in making wage increases. Public utilities also raise their prices to reflect rising costs. Inflation results from high wages and strong demand. The wage–price–inflation spiral becomes self-fulfilling and everyone appears to gain in nominal terms.

9.8 The post-Olympic syndrome

Prior to hosting the Olympic Games, a government invests in the sporting infrastructure, and hotels and accommodation are built to cater for tourists and players. Various industries expand, employment rises, and increased expenditure promotes income growth. Domestic investment increases along with the booming economy. A positive investment attitude raises expectations in the stock market and foreign investment is attracted. The local economy booms and experiences various positive multiplier effects. When the Olympic Games are over, players and tourists depart and government expenditure on infrastructure ceases. A decline in expenditure results in a rise in unemployment. Expectations are reversed and the fall in stock prices can lead to the withdrawal of funds. The fall in expenditure further discourages investment. The economy then experiences deflation as excess supply emerges. The growth in income finally switches from an upward to a downward trend and short-term investment behavior ceases. Old funds are withdrawn, and new funds are not forthcoming, thereby creating an investment vacuum.

The immediate post-1997 economy in Hong Kong could best be described as suffering from "post-Olympic syndrome," which is characterized by a decline in tourism, a drop in consumer expenditure, a rise in unemployment, and a withdrawal of funds. The July 1997 handover captured global attention, as tourists from all over the world were attracted to Hong Kong. Visitor arrivals reached a peak of 11,702,735 persons in 1996, and then fell by 11.08% in 1997 and by 8% in 1998, reaching a total of 9,574,711 persons in 1998. Private consumption fell by 3.92% (equivalent to US$4,041.68 million) between 1997 and 1998. This was partly compensated by an increase of 3.8% (equivalent to US$558 million) in government expenditure. As shown in previous tables, real GDP in 1998 fell by 5.1%, GDP per capita fell by 7.8%,

and domestic investment at current market prices fell by 13.9%. Similarly, domestic exports and export of services fell by 10.9% and 10.3% respectively. Inflation was replaced by deflation. The various economic difficulties of rising unemployment (from 2.2% in 1997 to 4.7% in 1998), falling consumption and fewer tourists were historically inevitable economic consequences of the July 1997 event. These activities not only cooled off speculation, but also created a situation of excess supply.

In his first policy address on 8 October 1997, the Chief Executive, Mr Tung Chee Hwa, devoted much attention to the theme of caring for society and the promotion of such industries as film, music, and broadcasting. The need for an increased supply of land and housing formed another key feature of his policy address.[6] While Mr Tung rightly considered housing as a necessity, others saw housing as an investment vehicle and an instrument for speculative gains. This immediately created pressure for the property price to fall, after it had reached a historical peak in the first half of 1997. Asset depreciation discouraged speculators, and suppliers were unwilling to let prices fall indefinitely, whereas buyers were expecting prices to fall further. It was a situation of "speculation in reverse."

One of the pressures Hong Kong had to face in the Asian financial crisis was whether the linked exchange rate should be abandoned because of currency devaluation in neighboring economies. Hong Kong had suddenly become the "automatic telling machine" of foreign investors and, therefore, it became the victim of massive fund withdrawals amounting to billions of Hong Kong dollars in early 1998. One report stated that funds used by the highly leveraged institutions to engage in hedging and other types of financial speculations amounted to HK$625 billion (US$80.75 billion) during this period.[7] The collapse of Peregrine Investment Holdings in January 1998 generated global fallout.[8]

Economic uncertainties finally led to the suspension of land sales on 23 June 1998. At the same time, Mr Tung unveiled a HK$30 billion economic plan involving the return of real estate rates, a freeze on high civil servants' pay, and further encouragement for home ownership.[9] The stock market panic continued and was made worse by the different messages given out within a short time by key officials, despite repeated assurances by the Hong Kong and the Beijing authorities that Hong Kong would not do away with the linked exchange rate. The inter-bank rate rose in response, and speculators used New York and Melbourne to facilitate their hedging activities in Hong Kong. On 14 August 1998, the Hong Kong authority intervened in the stock market by deploying over HK$80 billion (US$10.34 billion) to acquire a substantial equity portfolio in order to reduce supply and prevent the Hang Seng Index from diving below 7,000 points.[10] This drove the speculators away, but invited much criticism of the government for abandoning the principle of non-intervention.

Land sales based on a closed-door bidding system were reinstated in April 1999. By that time, foreign portfolio investment had returned, partly as a

result of the "V-shaped" rebound following the Asian financial crisis. The Hang Seng Index reached an average of 13,333.20 index points in April 1999 from 10,942.2 index points in March, an increase of 21.85%. The re-emergence of foreign capital effectively brought an end to the "post-Olympic syndrome." Nonetheless, the Asian financial crisis exposed the various structural weaknesses of the Hong Kong economy, particularly the fact that there was a lack of new elements to add to Hong Kong's comparative advantages.

9.9 Economic dilemmas and restructuring strategies

Economic dilemmas

Hong Kong faces a number of economic dilemmas in the immediate post-1997 years:

Balance between short-term and long-term investment

Short-term investment activities fell while long-term investments were absent. Despite asset depreciation in property and stock, many investors have maintained short-term investment behavior. A balance between short-term and long-term investments requires a stable price regime. The economy must be exposed to a broad-based and diversified investment portfolio. A stable property price discourages speculation and encourages investments ultimately to move away from the property sector into other non-property-related investments.

The China factor

Under the "one country, two systems" framework, Hong Kong has its own system and the entire country (People's Republic of China) has become its market. Economic integration with mainland China should benefit Hong Kong. Yet, the enormous price differences have led to a "one-way" flow of capital and private expenses to the mainland. Such a divergence in price competitiveness will persist for a period of time until deflation in Hong Kong has reduced its prices to levels comparable with southern China, or prices in south China have caught up with those in Hong Kong.

Economic policies

The linked exchange rate system has successfully preserved currency stability for Hong Kong, but at the expense of a sound monetary policy. As the interest rate in Hong Kong has to follow that of the US, Hong Kong effectively cannot use monetary policy to manage the domestic economy. Interest rate movements in the US may not be appropriate for the needs of the economic scene in Hong Kong.

In the case of the fiscal policy, and due to the continued fiscal surplus, the government has eased tax exemption by 134.78% from HK$46,000 (US$5,900) to HK$108,000 (US$13,846) within the five financial years between 1993/94 and 1998/99.[11] Such enlargement has narrowed the government's tax source and limited the "automatic stabilizer" effect of the tax system, resulting in a "T-shaped" instead of the normal "V-shaped" salary tax structure. Thus, in times of economic ills, when income fell rapidly, the government has been faced with a revenue collection problem. For example, direct tax fell by 17.2% from HK$91,524 million to HK$75,746 million between the 1997/98 and 1998/99 financial years. The estimated income tax yield of the total working population in 1998/99 (based on provisional assessment) shows that the top 100,000 earners in the working population accounted for 62.4% of income tax, and the top 400,000 provided 90.4% of income tax. The mid-1999 population in Hong Kong was 6.84 million. In the case of corporate tax, 5% of taxable business entities paid about 80% of the total in the 1999/2000 fiscal year.[12] In addition, the large revenue from land sales was cut when the SAR government postponed the sale of land. Donald Tsang, the then Financial Secretary, eventually highlighted Hong Kong's narrow tax base and recognized the need to widen its tax base in December 1999, in preparation for the 2000/01 fiscal budget.[13]

Various new tax items, such as the cross-border tax and sales tax, have been proposed. It certainly is a difficult task to collect more tax in a recession. A dual strategy has to be constructed in order to balance the interests of the various social strata in the economy. The short-term fiscal strategy should aim to reduce the deficit, while the long-term strategy should enable the tax base to be widened. Despite the various suggestions put forward, the tax structure has been left unchanged in both the 2000/01 and 2001/02 budgets.

The unemployment–inflation trade-off

The choice between price stability and unemployment, the typical Philips curve trade-off, is another dilemma. Whereas unemployment reached an unprecedented high of 6.1% in 1999, the economy was enjoying price deflation of about 3.5%. Deflation permitted Hong Kong to regain its competitiveness, and benefited the fixed-income earners as the purchasing power of money increased. A falling price, however, creates low business expectations, and a rise in employment becomes unlikely. Owing to the structural nature of unemployment, analysts, however, tend to believe that, even if price deflation stops, it is unlikely that unemployment will fall. Deflation has provided a temporary easing of the pressure on purchasing power, while a fall in unemployment will require new long-term investment opportunities. Others believe that inflation will help to restore business confidence and economic recovery.

Bank lending

During the boom time, the business of commercial banks concentrated on property mortgages, but speculative activities in the stock market and properties since the 1980s have marginalized many small and medium-sized firms, especially if they are engaged in manufacturing, which has lost its competitive edge, and so they are not favored by commercial banks for loan provision. The fall in property price and demand, coupled with the rising interest rate, led to an increase in the banks' liquidity. The dilemma is that, although banks are keen to provide loans for home mortgages, because the profit margins are generally higher, the demand for property has slumped. In contrast, banks are reluctant to lend to small and medium-sized firms because of their low credit-worthiness and high risk.

Economic strategies

The economic strategy adopted by Mr Tung's government in 1999 comprised four crucial elements:

Economic fine-tuning

Various strategies were applied in order to ameliorate the harsh conditions. These included a tax rebate amounting to HK$8.5 billion (US$1.1 billion), announced in the budget speech on 3 March 1999.[14] The renewal of land sales in April and subsequent months has also generated positive results. The closed-door bidding system, which permits the use of an average price, was adopted for the initial sales.

Consolidation of financial sector

A series of measures to consolidate the financial sector were introduced and summarized in the 1999/2000 budget speech. Technical changes have been introduced in the banking sector. These include the attempt to reduce the volatility of the interest rate by allowing local banks unlimited access to the discount window of the exchange fund, and the introduction of a currency board (for a discussion on the currency board, see Judy 1998; Tsang 1998; Yam 1998a,b; Jackson 1999). Supervision of banks will be strengthened by a further reduction in interest rate rules, a revised two-tier structure of banking institutions, and further easing of the requirements for foreign banks.

Consolidation in the non-banking financial sector included the development of the debt market and the reform of the securities and futures markets in the areas of clearing and technological application, legislating new regulations, and the demutualization and merger of the two markets before the end of 1999. Increased transparency is the major objective in financial consolidation.[15] Nasdaq has announced its intention to list its shares in Hong Kong in 2000, beginning with seven high-technology related

companies, including Microsoft and Intel. This decision has further boosted Hong Kong's status as a financial center, making it an integral part of a 24-hour trading center in the future.[16]

Widening economic base

The Hong Kong authority has highlighted the vital role of small and medium-sized enterprises (SMEs). In his 1998 policy address, Mr Tung pointed out that SMEs employ some two-thirds of the workforce. In order to ease the impact of the credit squeeze and provide working loans for these firms, a special finance scheme with a total of HK$2.5 billion (US$0.3230 billion) was to be established, with the government providing guarantees, with the aim of revitalizing the SMEs.[17] The development of various other industries was also encouraged in the Chief Executive's policy address in 1998, including broadcasting and communication, the film industry, Chinese herbal medicines and information technology. The decision to develop the "cyber-park" in the southern part of Hong Kong Island was aimed at attracting foreign technological firms to station their businesses in Hong Kong, though the project has been criticized for its large property component.

Commitment to long-term investment

The Hong Kong SAR government has attempted to foster long-term investment behavior by engaging in the following strategies:

1 The Commission on Innovation and Technology, which was chaired by a prominent scholar Professor Chang-Lin Tien and reported in 1998 and 1999, suggested three areas for improvement: the need for stronger institutional arrangements, such as the university–industry link; the need to foster an innovation culture and build up human capital by importing technological talent from mainland China; and the need to set up innovation and technology funds and research institutes.[18] These recommendations basically reinforced the indirect nature of government involvement in technological development. A new initiative on the long-term development of Hong Kong was established in February 2000 under an economy-wide commission entitled "Bringing the Vision to Life – Hong Kong's Long-Term Development Needs and Goals."[19]
2 The successful negotiation, announced in early November 1999, with the Walt Disney Company to set up a theme park in Penny Bay, situated in Lantau Island, which will enrich Hong Kong's tourist attractions. Initial calculations included an estimated economic benefit of HK$148 billion (US$19.1 billion) over forty years, the creation of 16,000 jobs during the construction phrase, and between 18,400 to 35,800 jobs upon the completion of the theme park in 2005. The estimated development costs amount to HK$14.1 billion, while the supporting infrastructure

development requires another HK$13.6 billion. The total equity of the theme park amounts to HK$5.7 billion, and the Walt Disney Company will inject HK$2.45 billion.[20]

3 The Hong Kong SAR government has turned part of its equity, acquired in August 1998, into a unit trust, popularly known as the Tracker Fund, as an instrument to encourage households and firms to invest on a more long-term basis.[21]

4 While the 1998 policy address by Mr Tung focused on new commitments in infrastructure development, mainly in aviation and local transport, the 1999 policy address discussed joint development possibilities with southern China. This further demonstrates the desire to cultivate long-term investment behavior.

Since the third quarter of 1999, the Hong Kong economy has stabilized considerably. The strong US currency in 1998 led to large export growth in most Asian countries, particularly exports from mainland China, and the re-export business in Hong Kong has naturally benefited. The policy address delivered by Mr Tung on 6 October 1999 opened up new long-term avenues and goals for Hong Kong in various areas of the knowledge-based economy, high technology and innovation, pursuit of infrastructure and economic integration with the mainland, and so on.[22]

Economic optimism increased upon the sudden conclusion of the Sino–US talks over China's accession to the World Trade Organization on 15 November 1999. The negotiations have meant that China will open up its markets in banking, agriculture, information technology, and telecommunication within a few years . Many argue that China will trade directly with the international community and Hong Kong's re-export role will decline. Others believe that the expanded trade between China and the rest of the world will revive Hong Kong's trading role (see, for example, Fung 1997). The Hang Seng Index climbed from about 13,000 points around the time of the announcement in mid-November to about 16,000 points in early December 1999. It has also been reported that the number of companies using Hong Kong as a base for their operations in Asia rose by 1.7% in 1999, compared with a drop of 2.6% in 1998. The US (205 companies), Japan (114 companies), and the UK (eight-two companies) top the list.[23] Government officials believe that economic revival began in the third quarter of 1999. In March 2000, the International Monetary Fund revised its economic forecast for Hong Kong's GDP growth from 3.5% to 4.3% for the year 2000, whereas the 2000/01 budget forecast was 5%, following 8.7% growth in the fourth quarter of 1999.[24]

Economic restructuring

Structural imbalances, coupled with short-term investment behavior and weak competitiveness, are the fundamental ills of the Hong Kong economy. It needs new comparative advantages. Investment or resource allocation since the

1980s has concentrated mainly on non-exportable sectors, speculative activities, and financial funds that have absorbed a large amount of capital with little impact on employment or output. Paradoxically, investment has focused more on the cart than on the horse, but the horse is too weak to pull the cart. Conceptually, economic restructuring requires an effective process that gradually shifts investment from the cart to the horse. A number of restructuring activities can be identified, though administrative red tape may cause delay.

Infrastructure

Speeding up infrastructure development is an appropriate strategy because it utilizes lower costs in the short run and accelerates future growth in the long run. Road construction and land reclamation are the most popular forms of infrastructure development, and urbanizing Lantau Island should produce a number of business and development opportunities. The infrastructure of the communications and transport network should extend beyond the local territory to the Pearl River delta region. Indeed, economic integration with South China will be a major element of economic growth for Hong Kong in future. Despite the large cost differences, it will still be appropriate for Hong Kong to expand its economic integration.

Resource redeployment

Resource redeployment involves the movement, reorganization, and/or restructuring of some economic activities into new areas. The purpose is either to free high-value resources for more efficient usage, or to increase the efficiency of particular activities. In the process, employment will be generated, and the improved resource allocation will lead to higher economic efficiency. The building of the new Chek Lap Kok airport is a successful example, but the land released from the old airport should be redeployed efficiently for other usage. Another example is the redeployment of old buildings and land in urban areas. Demolishing old buildings, particularly in the urban slump areas, encourages new uses for existing land. Similar ideas should be further explored. The building of "elder villages" for retired individuals in remote areas with medical and social support would also allow the redeployment of many of the homes for the elderly, which are currently situated in urban areas.

Housing

Real estate is a non-exportable resource, and demand for housing is a derived demand. A low housing cost, for example through a public housing policy, reduces an individual's survival cost, and, in turn, means more purchasing power for the individual. The housing and real estate sector in Hong Kong

needs to be restructured. On the one hand, privatization of public housing or government-built housing will keep the housing price stable, provide new revenue to the government, and allow property developers to gain from the development process. On the other hand, prime sites in Hong Kong can still be sold to private developers for the building of luxury apartments. By stabilizing the housing market (the cart), investment will gradually move to other areas that will diversify the economic base of Hong Kong (the horse).

New industries

A common consensus is the commitment to high technology, especially the development of electronic commence and other electronic and computer-related applications. The indirect nature of government support for technological development should definitely be maintained. There are two additional dimensions that the SAR government can consider. One would be to incorporate technology development in infrastructure expenditure, and then the scientific results could be used by relevant industries. In addition to the low-tax regime, the Hong Kong SAR government can offer a limited period of tax exemption to foreign investment that helps Hong Kong to enlarge its strategic industries. The intention is to absorb investment that will bring new comparative advantages to Hong Kong.

In addition, investors should work harder to develop new industries and diversify existing industries. More attention should be given to the traditional role of small and medium-sized firms, which tend to be more flexible in output and industrial development. While keeping high standards of business criteria, commercial banks can also play a critical role in the provision of loans and advances to firms with good investment potential.

9.10 Testing economism

There are basically two challenging issues: the balance between income equality and poverty, and the "fertilizer" role of government. The population in Hong Kong changes because there is constant migration and immigration. In early 1999, the Court of Appeal in the Hong Kong SAR ruled that, under the Basic Law, children born to parents with Hong Kong citizenship status have residents' rights in Hong Kong. This was originally intended for the children of Hong Kong residents who had emigrated, but it sparked off a political debate on the legality and economic implications of these "immigrants." The Hong Kong authority stressed an orderly entry within the daily immigration quota and that applications must be made from immigrants' home towns or villages in mainland China. The initial government estimate was a total of 1,675,000 persons eligible for residents' rights in Hong Kong. This included the first and second generations of 692,000 and 983,000 respectively. The Hong Kong authority claimed that government expenditure on such social institutes as housing, education, and medical care

would amount to HK$30 billion over a ten-year period.[25] However, a more recent government report estimated that there would be a total of 824,800 persons connected with mainland "children born within registered marriages" to Hong Kong residents. This total is divided into three categories: firstly, Hong Kong residents who have mainland children born within registered marriages (209,400); secondly, mainland children (286,300); and, thirdly, mainland children of mainland children (329,100). A survey of the second category shows that the median age is twenty-seven years, only 9.3% have received tertiary education, only 41.2% are working, and less than 20% of this working group are managers, administrators, or professionals.[26]

Hong Kong experienced a large influx of immigrants in the 1950s, which provided a source of cheap labor for industrial development and output. Over the years, the prosperity of the Hong Kong economy has provided employment opportunities and economic growth has alleviated poverty considerably. Can such an experience of economic growth and employment repeat itself? With a total of 1,076 km^2 of developed and non-built-up land and a mid-year population of 6.6872 million in 1998, can an extra million persons come to reside in Hong Kong within a decade? It has been argued that immigrants will add to the pool of labor resources in Hong Kong and the long-term impact will be an increase in productivity and output (Lam and Liu 1993a; 1993b; 1997; 1998). This assumes that employment opportunities will continue to grow. There is also an externality debate. While family reunion is a private affair, it has a social cost attached. The Chinese mainland economy has experienced steady growth, and workers will stand a better chance of securing employment and improving their living standards as employment rises.

The challenges to the Hong Kong economy relate more to the economics of the supply side. One is the geographical feasibility of housing another million or so individuals in the tiny territory of Hong Kong, and the related social and environmental implications. Firstly, the increased supply of low-income workers would keep the average wage low, as competition among these workers is keen. Secondly, unemployment would rise if the increase in job opportunities is not keeping pace with the influx of new immigrants. Hong Kong is pursuing a technology- and knowledge-based economy. The divergence in wages and income scales will widen, and income inequality will become more explicit as wage differences are polarized as Hong Kong's Gini coefficient deteriorates (see, for example, Lui 1997). Such an artificial increase in the population of low-income earners in Hong Kong will require new policies to alleviate poverty and increase employment.

The challenge to economism is to maintain the continued growth of Hong Kong's economic pie so that employment and absolute income will increase. The post-1997 economic downfall and the Asian financial crisis have put more pressure on the role of the Hong Kong SAR government in reviving the economy. The test for the SAR government is, while trying to remain apolitical, whether the "provider of fertilizer" nature of the pre-1997 government can be preserved. There have been cases that lead one to question the role of the

government since 1997. For example, in June 1998, the SAR government stopped the sale of land to prevent further deterioration in property prices. On 14 August 1998, the SAR government intervened in the stock market in order to ward off speculative attacks. The decision in early 1999 to build a "cyber-park" was criticized for bowing to big developers, and many argued that the project related more to property development than to technology development. In other words, paradoxically, the question is, should the government change its role from a "provider of fertilizer" to a "farmer," engaged in economic activities on its own account?

The immediate post-1997 period was a difficult time for the SAR government in various senses. Firstly, the sudden economic downfall was unpredicted and, for an open economy, there was indeed little the government could do. Secondly, the emergence of social, legal, and health issues in 1998 and 1999 led to a considerable degree of disgruntlement on the part of the public. In addition, the speculative attack on the Hong Kong currency and the financial market was well-coordinated, ruthless, and left little room for the Hong Kong authority to act. It was against such a background of twin extremes, "foreign attacks (in financial market) and domestic disruption (fall in income and property price)," that the SAR government engaged in such drastic economic reactions as market intervention and collaborating with large business corporations. Equally, there are incidences in which the SAR government has provided guidelines to investors without getting involved. Examples include the discussions on the development of Chinese herbal medicine, and the decision to promote high-technology firms and environment-related industries.

At most, one can argue that the SAR government has become more active in taking Hong Kong to a new stage of economic development. The targets may have changed, but the fundamental instruments have, at least, remained largely unchanged and, at most, broadened. The fiscal and taxation system for businesses has remained unchanged. The provision of loan support to small and medium-sized firms is regarded as temporary and not a "free lunch." In 1998, the SAR government, against the wishes of environmentalists, refused to support environmentally friendly industries, such as paper recycling. While the economic dimension will be left unchanged as long as economic freedom is preserved, the post-1997 regime will face more political pressure on the role of the government in the economy. Economic growth has to be seen to be a deliberate political target, regardless of either changes in the regime or the pace of political reform.

9.11 Conclusion

Peaceful sovereignty reversion is a rarity. The reversion of Hong Kong's sovereignty to the People's Republic of China has been a civilized affair. A transitory period (1984–97) gave rise to new economic opportunities. As investors in general considered July 1997 to be a terminal date for their

activities, the decision to invest before and after July 1997 became a discrete, rather than a continuous, decision. Coupled with a general increase in wages and income, Hong Kong enjoyed a period of prosperity. Few would have complained about the wealth generated. Short-term investment behavior, however, diverted investment into speculative activities, mainly in property and stocks.

Such short-term investment behavior can only be sustained for a short period of time. Speculative activities have a redistributive effect. Although expectations of speculation remained high, it would become detrimental when the real economy shrunk. Then a sudden economic or financial shock would serve as the trigger that led to the bursting of the bubble. In a sense, it was a blessing that Hong Kong's economic bubble burst sooner rather than later, as it enabled the Hong Kong authority to readdress difficult economic issues and restructure economic priorities, and investors to rework their investment plans in the light of the post-1997 economy. Sovereignty reversion brought about the engagement of long-term investment, which would encourage the Hong Kong economy to look to the long-term perspective.

The post-1997 Hong Kong can adopt a dual economic strategy. On the one hand, the post-1997 regime can introduce drastic changes and even a reorganization of resources that were either not introduced or incorrectly deployed in the colonial era. The various strategies pursued in 1998 and 1999 contained both externally and internally oriented elements. Consolidation of the financial sector, aimed at strengthening the business role of Hong Kong, is externally oriented, whereas the widening of the economic base and promotion of long-term investment attitudes is internally oriented. While externally oriented strategies favor the business community and preserve Hong Kong's international status, there is also room for internally oriented strategies. With a population approaching seven million, the domestic market is large enough to sustain considerable economic changes.

On the other hand, Hong Kong must maintain the features that made it such a success in the pre-1997 era. Such conventional features as a free and open economic system, low and consistent taxation system, and no free welfare assistance should be maintained. There are two challenging aspects in the continuation of the economism paradigm. One is the ability to reduce poverty while preventing inequality from becoming worse. The other is the role of the government as the supplier of "fertilizer," which can help individual sectors or industries to progress. If sovereignty reversion simply means a regime change without alternations in economic philosophy, then the continued success of the economism paradigm is ensured, because it depends more on the will of political leaders than on the kind of political regime. Economic growth will still be the political target, regardless of political changes.

10 Asia is no miracle

10.1 Economism: the emerging paradigm

There are no miracles in the four East Asian economies, but they have adopted a paradigm that sets economic growth as the goal of their society. Emphasis has been given not to income equality, but rather to reduction in poverty and efforts to make available as many equal opportunities as possible. Whereas private investment has concentrated on output and capacity expansion, social investment has concentrated on infrastructure and capital that either helped to increase output capacity further or was favorable to the expansion of future productivity. Handsome social welfare provisions are not available, but a "survival" net has been assured. Entrepreneurial and hard-working efforts are treasured, while reliance on social welfare by individuals is discouraged. The government plays an active, but often indirect, role. It provides "fertilizers" as encouragement or incentives for individuals and business organizations to progress. The higher the degree of economic progress, the more active the business sector will be and the resultant rise in employment will, on the one hand, alleviate the need for welfare and, on the other hand, enlarge the government revenue pie. An effective and sound system for the rule of law has permitted the private sector to generate as many business and economic opportunities as possible.

The pro-business domestic environment has been rewarded by the continuous inflow of foreign capital that has expanded domestic output, export, and income. The export-oriented nature of the economy has enabled it to float according to world demand and change with the global economy. The expansion in the industrial sector soon spread to the banking sector. Monetary transactions aided the development of the financial centers, which, in turn, led to the development of modern services. The economy moved from one to a multiple number of virtuous circles. Economic development and growth has thus accumulated over a number of decades, thereby moving the four East Asian economies from the status of developing economies to industrialized, matured, and advanced economies. Their income has even caught up and surpassed some developed countries.

The political regimes in these economies are pro-business and pro-growth. Economic freedom is regarded as the fundamental issue. Economic well-being,

individual progress, and wealth accumulation are the social and political targets, and they have led to Pareto-optimal and positive-sum outcomes, so that everyone has gained in absolute terms.

The economism paradigm consists of a number of conceptual underpinnings that have been translated into realistic "floor conditions," or a minimum survival level that has prepared the economies to pursue a period of steady and sustainable growth. The extent of growth has varied from one economy to another, depending on the availability of resources and endowment, the degree of aggressiveness in which the conditions were applied, the human factor, the system of governance, and so on. Typically, the extent of the government's involvement has also varied among the four East Asian economies. A government that "overgoverns" would have posed as much danger to the economy as a heavily interventionist state (Kenworthy 1995; Seldon 1998).

With their doors open to the international market, their investment, output, and exports become tied to the changing needs of the world market. Comparative advantage in trade has changed from one area of export to another, resulting in the emergence of dynamic comparative advantage: from light manufacturing with labor-intensive production to banking and finance, to heavy or capital-intensive or knowledge-intensive industries, and to modern services. By the late 1990s, electronic commerce has become the new frontier in commerce and trade, further deepening economic development in the service sector. While electronic commerce is still the star of the day in the first decade of 2000, the East Asian economies have to be prepared to leap from one comparative advantage to another. Hi-tech, health and genetically altered biological products may still be considered as luxury goods, but a market for the new biologically innovated products may soon develop along with the necessary biotechnology. In addition to the existing factors conducive to growth, the next phase of sustained growth will depend on endogenous factors of either home-grown or imported technology, and high-quality human capital, information, and knowledge.

10.2 Capitalism, socialism and economism

Most of the economic mechanics in capitalism are deployed extensively in economism. The free market principle has been widely adopted, though governments have helped by supplying many social goods and infrastructure. Private property rights have been taken for granted in economic transactions. Private ownership has facilitated exchanges and transactions, and acted as an incentive in promoting general well-being. The extensive application of the market mechanism has permitted the exercise of economic liberalism in as many legalistic areas of economic activities as possible (see, for example, Peacock 1997).

Equality has been given attention but certainly has not been the top social priority (for a discussion, see Young 1994). In economism, the employer–

employee relationship is complementary, and as income and employment opportunities increase employees have more job opportunities. Economism focuses also on economic reproduction, a major aspect of socialism or Marxism. In contrast to socialism, reproduction under economism ends up enlarging output time after time, thus contributing to the multiplication of virtuous circles. Political stability and increases in economic well-being and opportunities are the desired macroeconomic values. The value at the individual, micro level relates to personal economic achievement and the opportunity to go forward toward a better future and a bigger absolute share in the growing economic pie.

Economic well-being, wealth, and overall growth and development of the economy, facilitated by the existence of economic freedom, equal opportunity, and individual progress, are considered to be the positive social values. Political democracy, in the form of popular political elections at regular intervals, becomes more of a choice than a conflict between different strata in the society (see, for example, Diamond and Platter 1993; Waligorski 1997). Compared with the pace of economic development, political democracy among the four East Asian economies is developing at a slow pace. Economic-led changes are considered to be socially desirable and preferable. Though differences arise, the Pareto-optimal, positive-sum economic outcome has turned out to be socially less controversial and more beneficial in absolute terms. Economism is a "more or less" game that allows the "less" to gain "more" under a situation of equal opportunity, openness, and economic freedom.

The business sector is vital under capitalism, but has been criticized by the Marxists as being the agent of economic exploitation. The capitalists hire workers at a wage lower than their realized output value, and the difference appropriated by the capitalists is considered to be exploitation. There is a clear conceptual misunderstanding in such a nominal analysis. In a resource-based economy, the capitalists (employers) and workers (employees) are inter-related economic agents. There is no natural law that identifies the capitalists from the workers. A worker can become a capitalist if the worker starts his/her own business. In a free and open society, economic mobility is feasible and wealth accumulation can permit individuals to change roles.

The sequence in economic growth, however, requires that investors, capitalists, and employers pioneer the growth process and make the initial move. The act of investment generates employment opportunities for those who cannot invest and have to "sell" their labor in return for a wage. In this process, it is possible that the investor's reward is higher than the wage paid to the worker. Similarly, the risk taken by the investor is greater than that by the worker. In absolute terms, both the investor and the worker gain as their economic welfare increases. In relative terms, the investor may have a higher return and become "richer" than the worker. But the wage obtained by the worker is the result of someone's investment. One act of investment gives

rise to another, and the cumulative nature of investment produces ample opportunities for workers.

Though unequal, both the investors and the workers get their own market share in the process. Increases in economic opportunities allow more investment activities, which, in turn, permit new investors to emerge. Such a process links up individuals in the capacity of either an employer or an employee, but their common goal is welfare improvement. In an open economy with equal opportunities, the role of investors is a fluid concept. Workers can become investors in industries and in equities. Individuals with a large endowment may start as an investor, but every investment carries risk. Differences in resource endowment constrain an individual's role, but economic mobility allows individuals to switch roles once sufficient endowment has been acquired.

A major conceptual tool in the economism paradigm is the distinction between absolute and relative. What should be considered in absolute terms? What should be considered in relative terms? In economics, everything is relative to everything else, but the distinction often leads to subjective and normative judgments. Issues that should be considered in absolute terms include income differences between individuals, society-wide economic growth, and economic freedom. The issues that are examined in relative terms include the differences in the rates of growth (among economies and in time), the strategies adopted, the role of government, and changes in comparative advantage.

10.3 The next phase of East Asian development

The economism paradigm has given the East Asian economies a foundation on which to grow. The pace of growth between the 1960s and the 1990s may not be repeated in the next thirty to forty years. New challenges will appear both indigenously and regionally. There are several regional trends that cannot be reversed. The growing expansion and importance of the Chinese economy will have great and long-term impact in the world and especially in the Asian economies. The economy of China will grow at a rate approaching double digits for a number of years and its economic capacity will catch up, or even surpass, the East Asian and other Asian economies. The other trend is the bearish development of the Japanese economy. As long as Japan is faced with huge financial losses and the need for decade-long restructuring in its domestic economy, its role in the Asian region will remain stationary and passive, especially in trade and foreign direct investment. Thus, the four East Asian economies will face a greater degree of competition for trade and investment in the future. On the one hand, unlike the 1950s to 1970s, East Asia is no longer the only destination for foreign direct investment in the Asian region. There are the ASEAN countries, mainland China and the lower-tier, newly emerging and capital-hungry Asian economies, as well as the traditional large economies of India, to compete with East Asia. On the other

hand, capital and investment have become much more mobile, and coupled with standardized manufacturing production, and good information flow, it will become more difficult to attract both domestic and foreign capital. Similarly, the four East Asian economies' position as the "natural recipients" of Japanese capital in the 1960–80 period will no longer be guaranteed. Thus, these economies will have to compete on quality and productivity on the one hand, and foster development in their neighboring economies on the other.

Each of the four East Asian economies has to face domestic challenges that differ from the post-war years. In the post-1997 Hong Kong, the politically young government will have to demonstrate its gravity. Although the post-1997 regime has repeatedly pointed out that economic issues should not be politicized, a number of either indigenously generated or mainland China-related issues could create noise. While the Hong Kong economy remains pro-business, it may be strategically wiser to include professionals in both the design and decision-making process of development policies.

The narrowness of the domestic economy in Hong Kong, which has concentrated on services and real estate development, needs to be diversified. The dichotomy between the large financial sector and the dwindling real sector should be of grave concern if no long-term action is taken to address the imbalance. The intention of making Hong Kong a knowledge-based economy should be translated into efficient practical actions, supported by consistent and complementary policies. The artificial increase in labor resources through immigration requires a massive expansion in job opportunities. Even if unskilled jobs are available, there will be severe competition for low-paid jobs. Economic integration with southern China will require time and political will. Its economic outcome will also be a positive-sum game, but may lead to a different pattern of resource and wealth allocation.

While Hong Kong faces an artificial expansion in its labor force and worries about the availability of sufficient jobs, Singapore is constrained by its tight immigration policy. With a population of three to four million (about half that of Hong Kong), the Singapore economy may have reached its saturation point. Unless drastic changes occur in other ASEAN economies, Singapore's economic capacity will grow only when additional investment occurs. Thus, economic growth in Singapore will remain constant, though Singapore will remain pivotal to activities in the ASEAN region. The concentration on petroleum and the electronics industry remains a concern for diversification. Although the petroleum industry in Singapore basically faces little competition in the Asian region, competition in the electronics industry is keen. Similar to Hong Kong, the dichotomy of the large financial sector and the somewhat narrow real sector should not be ignored. Inflation and pressure on exchange rates and reserves is the root cause of the imbalance between the nominal and real sectors.

The Taiwan economy is more balanced in that the growing real sector supports the financial sector. The real sector is more balanced between large

and small companies and between electronics and other manufacturing industries. The desire to pursue economic liberalization since the 1980s has made Taiwan increasingly consistent with international practice. It has become more flexible to adjust to changing conditions. The challenge for Taiwan is its political links with mainland China. Unlike Hong Kong, for which the reversion of sovereignty was fixed to take place on a certain historic date, Taiwan's negotiations with mainland China do not have a terminal date.

Although the South Korean economy is the largest of the four, it is facing economic problems and imbalances. The imbalance between favored and non-favored industries and large corporations and small and medium-sized enterprises, compromise between firms and unions, and non-performing loans and new allocations are all good examples. The role of the government in the economy in the last twenty years has definitely needed to be re-examined. With political elections held at regular intervals, South Korea would be politically more stable, but how much each elected regime could achieve is another concern. The threat from North Korea and the unification issue could also be a costly problem for South Korea. It should, however, be able to translate its state of "overcapacity" into favorable conditions. Improvements in quality through technological innovations would help to raise demand. South Korea's international marketing strategy may also need to improve to boost industrial exports.

The next phase of development should incorporate more endogenous features of growth, including home-grown technology, protection of the environment, and emphasis on human development. It seems that one form of siege mentality has replaced another. New challenges, however, also bring new opportunities. Overall, the four East Asian economies should avoid just talks and discussions and concentrate on more action on reform. Both South Korea and Taiwan have new governments as a result of political elections in the late 1990s, and Hong Kong has a new post-1997 regime. The very basic requirement, nonetheless, is the maintenance of the economism paradigm.

10.4 What do the critics say?

The economism paradigm has proved to be a recipe that can help economies to set in motion a process of growth. There are two major repercussions as the paradigm nears its maturity stage, though these repercussions can equally be found in other capitalist economies. One is money-mindedness, because everything is measured in wealth and money terms. Efforts spent on enriching an individual's well-being become a calculating and self-centered exercise, leading to an imbalance between rapid economic growth on the one hand, and apathy toward social and human consciousness on the other. Education seems to be the long-term and passive instrument in correcting the money-minded culture by pointing out the parallel importance of economic growth and social responsibility.

Another repercussion is the possibility of a growing monopolistic element

as industries and economic sectors develop. Government-favored industries that were part of the "pick winner" strategy have definitely led to the emergence of large (monopolistic) firms and corporations which have a high degree of market control and ability to manipulate and distort the market. The withdrawal of government-aided development could introduce competitive elements in industrial strategies and development. The emergence of large corporations may be the result not of the lack of competition, but of competition itself. The open nature of the economy invites initial competition. Over time, the larger firms gain market powers and eliminate or marginalize smaller firms, either through mergers and acquisitions or through market share, expansion, and price strategies. Hong Kong, for example, does not have institutions and laws, such as the anti-trust laws, or a monopoly commission that governs market shares. The growing concentration of market powers and emerging monopolies could allow giant corporations to exercise economic market authority that may not be beneficial to the community at large.

There is thus a dilemma in economic competition. Market competition encourages the establishment of firms. Through the free market system, however, small firms grow to become big corporations, and begin to acquire smaller firms, leading them to a dominant position in terms of market share. Eventually, its large market share enables the firm to hold monopolistic power that goes against the spirit of open competition. Although the emergence of monopolistic firms can be safeguarded against by the possibility of foreign competition, there is still great potential in the non-tradable sectors of the economy.

The discussion on the economism paradigm invited both supporters and critics. Two critical statements require intellectual responses:

1 Criticism: the work on the economism paradigm is just a mixture of monograph, journalism, and political proclamation. Response: this book has employed a number of intellectual tools, and including references to the experience of the four East Asian economies is essential. Economism is a conceptual paradigm, which incorporates some debatable political elements. These are meant to be instruments and means for the complete elaboration of the paradigm. The paradigm is described and discussed in simple, "reader-friendly" language.
2 Criticism: universalization of the paradigm: can the experience of the four East Asian economies be treated as a universal model applicable to other developing economies? Response: the objective of this book is to use the growth experience of the four East Asian economies to build a development paradigm that could have a universal character.

It would be a premature judgment if one jumped to the conclusion that the economism paradigm is an Oriental model that may not be applicable or transferable to other developing or even matured economies. The economism

paradigm has no cultural attachment and should work for any developing economy provided the same "floor conditions" are met and instituted, and time is allowed for the paradigm to work its way through.

Economic freedom should not be culturally constrained. It produces positive-sum outcomes that are of benefit to the transacting parties. Economic virtuous circles are developed as economic freedom grows, leading the economy from one level or dimension of growth to another. Economic freedom allows individuals to pursue, maximize, and translate their ability and intelligence into economic goals and outcomes. The increase in one's economic well-being has further "snowball" effects on other individuals. With equal and increased opportunities, competition and measurement of success can thus be considered in economic terms. And, as everyone is gaining from an expanding pie, literally, there will be no zero-sum conflicts.

The paradigm of economism is not meant to be an end in itself. It serves to reinterpret and consolidate the successful growth of the four East Asian economies, and it also opens up the debate for new studies and discussions in Asia, as well as other regions and developing as well as developed countries. Discussion of the economism paradigm stimulates the development of conceptual economics, which looks for new theories and explores new frontiers but at the same time reinterprets, readdresses, and re-examines established issues and theories so that new economic insights can be uncovered. Ultimately, economism argues that economic instruments should be used in solving human problems.

Notes

2 The expansion of the East Asian economic pie

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4 *Estimates of Gross Domestic Product 1961–1996*, Hong Kong: Hong Kong Government; *The 1997–98 Budget, March 1997*, Hong Kong: Hong Kong SAR Government, pp. 22–3.
5 *Taiwan Statistical Data Book 1996*, Taipei: Council for Economic Planning and Development, Taiwan Government, p. 41.
6 *Taiwan Statistical Data Book 1996*, Taipei: Council for Economic Planning and Development, Taiwan Government, p. 59.
7 *Economic Survey of Singapore 1996*, Singapore: Ministry of Trade and Industry, February 1997, p. 104.
8 Calculations are based on data in *Key Indicators of Developing Asian and Pacific Countries*, Manila: Asian Development Bank, various issues. The average percentage figures for China and Thailand are based on the period 1980–92.
9 *Estimates of Gross Domestic Product 1961–1996*, Hong Kong: Hong Kong Government; *The 1997–98 Budget*, *March 1997*, Hong Kong: Hong Kong Government, pp. 34–5.
10 *Taiwan Statistical Data Book 1996,* Taipei: Council for Economic Planning and Development, Taiwan Government, p. 47.
11 *Taiwan Statistical Data Book 1996*, Taipei: Council for Economic Planning and Development, Taiwan Government, pp. 51–3.
12 *Economic Survey of Singapore 1996,* Singapore: Ministry of Trade and Industry, February 1997, p. 106.
13 See *Hong Kong's Clothing Industry, Economic Analysis*, Hong Kong: Bank of East Asia Limited, October 1996.
14 *Building Prosperity: A Five-Part Economic Strategy for Hong Kong's Future*, prepared by SRI International, published in Hong Kong by Hong Kong Economic Survey Ltd, September 1989, p. 71.
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16 *Taiwan Statistical Data Book 1996,* Taipei: Council for Economic Planning and Development, Taiwan Government.
17 *A Handbook of Korea 1993*, Seoul: Korea Overseas Information Service, January 1994.

18 Value added indices can be found in various issues of the *Hong Kong Review of Overseas Trade*, Hong Kong: Hong Kong SAR Government Census and Statistics Department.
19 For a discussion, see for example, *Hong Kong*, London: Euromoney Publications, 1993, p. 34.
20 *Estimates of Gross Domestic Product 1961–1966,* Hong Kong: Hong Kong Government Census and Statistics Department, March 1997, pp. 12–13.
21 The statistical data on Taiwan's trade are produced from *Taiwan Statistical Data Book 1996*, Taipei: Council for Economic Planning and Development, Taiwan Government, pp. 181–224.
22 For example, refer to the discussion on international orientation in *Economic Survey of Singapore 1992*, Singapore: Ministry of Trade and Industry, February 1993, pp. 104–6.
23 *Country Profile: Singapore 1996–97*, London: Economic Intelligence Unit., p. 37.
24 *Yearbook of Statistics 1994,* and *Economic Survey of Singapore 1996*, Singapore: Ministry of Trade and Industry.
25 *Economic Survey of Singapore 1996*, Singapore: Ministry of Trade and Industry, p. 144.
26 *National Accounts*, Seoul: The Bank of Korea, various years.
27 See *Report of the Source of Investment in Hong Kong's Manufacturing Industries*, Industry Department, Hong Kong SAR Government, various years.
28 For example, the American Chamber of Commerce in Hong Kong sends out a survey to American firms in Hong Kong. The survey is conducted on an annual basis, and the results are disclosed to the public.
29 *Country Profile: Singapore 1996–97*, London: Economic Intelligence Unit, pp. 14–15.
30 *A Handbook of Korea 1993*, Seoul: Korea Overseas Information Service, January 1994, p. 368.
31 *National Accounts 1990*, Seoul: The Bank of Korea, p. 470–1.
32 *National Accounts 1997*, p. 50, and *Monthly Statistics Bulletin, March 1997*, p. 135, Seoul: The Bank of Korea.

3 Growth, inequality, and the survival cost

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8 *A Handbook of Korea 1993*, Seoul: Korea Overseas Information Service, p. 475.
9 *Economic Survey of Singapore*, Singapore: Singapore Government, various years; *Social Indicators in Taiwan*, Taipei: Taiwan Government, various years.
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6 The law of first opportunity in economic growth

1 *Key Indicators of Developing Asian and Pacific Countries*, Manila: Asian Development Bank, various years. The calculations for China and Thailand cover the period 1980–92.

2 *Taiwan Statistical Data Book 1998*, Taipei: Council for Economic Planning and Development, Taiwan Government, p. 275.
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7 Economism and political regimes

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8 The Asian financial crisis

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7 *Far Eastern Economic Review*, 21 August 1997; *Business Week*, 11 September 1997; and *Economist*, 22 November and 20 December 1997.
8 *Far Eastern Economic Review*, 4 December 1997; and *Economist*, 20 December 1997.
9 *Asian Development Outlook 1999*, Manila: Asian Development Bank, p. 28.
10 For a detailed discussion of post-AFC financial reforms in the major Asian economies, see East Asia Analytical Unit (1999).

9 A challenge to economism: Hong Kong's sovereignty reversion

1 This is a selected list of references. There are numerous works on the politics and future of Hong Kong, many of which are written in Chinese.
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3 The report, entitled *Building Prosperity: A Five-Part Economic Strategy for Hong Kong's Future*, was prepared by SRI International and published in Hong Kong by Hong Kong Economic Survey Ltd.
4 Details on investment in Hong Kong can be found in various survey reports. For example, the Federation of Hong Kong Industries and the American Chamber of Commerce have conducted such surveys regularly since 1990.
5 An alternative and more conventional explanation is that the upward sloping demand curve is flatter than the upward sloping supply curve. As the price is above equilibrium, the excess demand results in a higher price. The rise in price leads to a greater excess demand, which, in turn, raises price further. This also results in a price escalation spiral.
6 *Policy Address 1997*, Hong Kong: Hong Kong SAR Government, 8 October 1997.

7 *Mingpao*, 12 November 1999.
8 *The Wall Street Journal*, 13 January 1998.
9 *South China Morning Post* and *Mingpao*, 23 June 1998.
10 *Hong Kong Economic Journal*, 1 September 1998.
11 "Building on Success – The 1993–1994 Budget", speech by the Financial Secretary, Hong Kong, 3 March 1993, article 103, p. 28; "Riding Out the Storm – Renewing Hong Kong's Strengths", speech by the Financial Secretary, 18 February 1998, article 82, p. 23; both published in Hong Kong by the Hong Kong Government and the Hong Kong SAR Government respectively.
12 *1999–2000 Budget: Revenue Measures,* Background Note, Financial Secretary's Office, Hong Kong Special Administrative Region, Chart L, Hong Kong: Hong Kong SAR Government; and *South China Morning Post*, 2 December 1999.
13 *South China Morning Post*, 2 December 1999.
14 "Onward with New Strengths – The 1999–2000 Budget", Speech by the Financial Secretary, Hong Kong Special Administrative Region, 3 March 1999, published in Hong Kong by the Hong Kong SAR Government.
15 Details of these consolidating reforms can be found in "Onward with New Strengths – the 1999–2000 Budget", speech by the Financial Secretary, Hong Kong: Hong Kong SAR Government, 3 March 1999; Report in *Financial Market Review*, Hong Kong: Financial Services Bureau, April 1998; *Proposed Regulation on Share Margin Financing*, Hong Kong: Financial Services Bureau, May 1998; *Working Group Report on Automated Trading Systems*, Hong Kong: Securities and Futures Commission, February 1997; *Hong Kong Economic Journal*, 8 September 1998; *South China Morning Post*, 7 September 1998. A policy paper on the reform of the securities and futures market is available for public consultation (see the web-site of the Financial Services Bureau of the Hong Kong SAR Government at www.info.gov.hk).
16 *South China Morning Post*, December 16, 1999.
17 "From Adversity to Opportunity", address by the Chief Executive, Hong Kong: Hong Kong SAR Government, 7 October 1998, pp. 17–18.
18 *Chief Executive's Commission on Innovation and Technology*, Hong Kong: Hong Kong SAR Government, First Report, September 1998, Second and Final Report, June 1999.
19 See the materials available under the Central Policy Unit of Hong Kong SAR Government information web-site at www.info.gov.hk.
20 *Hong Kong Disneyland: Economic Benefits*, Hong Kong: Information Service Department, Hong Kong SAR Government, 3 November 1999.
21 *South China Morning Post*, June 22, 1999.
22 *The 1999 Policy Address by the Chief Executive*, Hong Kong: Hong Kong SAR Government, 6 October 1999, section VI B.
23 News release, Agency France Presse, 13 December 1999.
24 The International Monetary Fund Public Information Notice (Note 1) No. 00/15, 6 March 2000; Hong Kong 2000–2001 Budget, 8 March 2000.
25 *Estimate Based on the Court of Appeal's Decision on the Right to Reside in Hong Kong*, Hong Kong: Security Bureau, Hong Kong SAR Government, 6 May 1999.
26 *Hong Kong Residents with Spouses/Children in the Mainland of China*, Special Topic Report No. 22, Census and Statistics Department, Hong Kong SAR Government, July 1999.

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