# 1 Perspectives

*Dominic Wilson and Peter Drysdale*

## INTRODUCTION

The role of the state in East Asian development has always been a controversial issue. On the one hand, neoclassical economists argued that three decades of extraordinary East Asian growth were largely the consequence of policies that let the market function and kept distortions to a minimum (Krueger 1995). On the other, critics of the neoclassical approach maintained that the close ties between industry and government and selective government interventions were critical to the extraordinary growth performance of many East Asian economies (Amsden 1989; Wade 1990).

The financial crises in East Asia have rekindled the debate over the appropriate roles of the state and economic enterprise across the region. With the Korean, Malaysian and Thai economies now clearly in recovery – and signs of life in Japan – and with extensive reform programs underway in almost every economy, there is a renewed focus on the role that governments and governance can play both in determining future performance and preventing future catastrophe.

The debate over the appropriate role of governments has surfaced both as part of the diagnosis of the recent crises and as part of the suggested cure. Just as there was no single story of East Asian growth, there is no single set of problems that contributed to the different crises. As in the earlier debate, however, it is possible to identify a set of common features that make comparative analysis useful. Crises in many economies owed their severity in part to inadequate regulation, problems associated with close relationships between government, business and the financial sector, ineffective corporate governance and sometimes outright corruption. Resolution of these issues has proved problematic not only in the region's developing economies, but also in more developed countries like Korea and Japan, as it has in many other economies around the world.

As part of the response to the crisis and, in some countries, as a consequence of structural reform programs agreed with the International Monetary Fund (IMF), governments across the region are redefining the role of state in a whole range of areas of the economy. The focus of reforms is less on whether there should be more or less government involvement in the economy and more on what roles government should play and how it should fulfil them.

These reform processes are altering the boundaries between the government and the rest of the economy in complex ways. In some cases, governments are seeking to reduce the level of direct intervention in the economy, through privatisation, reduction of restrictions on foreign investment, or the dismantling of state-run businesses. In other areas, the crisis has seen increased government involvement. The intervention of the Hong Kong Monetary Authority in the local share market and the imposition of exchange controls in Malaysia are among the most dramatic instances of this renewed activism, but there are also less controversial examples. Widespread banking and corporate failures are prompting moves to strengthen government regulation of the financial and corporate sector and the resolution of non-performing assets and bank recapitalisation has involved the state, at least temporarily, taking effective ownership of large parts of the financial sector in several economies.

The interaction between these processes and reform and recovery poses some big questions about the role of the state and the economy in determining economic performance. This chapter is largely aimed at answering three central questions.

1. How essential were structural reforms to the current East Asian recovery?
2. What contribution can reforms make to reducing future vulnerabilities?
3. How important are reforms to the region's future performance?

To flag the conclusions at the outset, recent experience in East Asia suggests that the answer to the first question is that the process of recovery is largely cyclical, though some minimum commitment to reform appears to have been a precondition for recovery. The answer to the second question is that reforms can play a major part in reducing future vulnerability, though there are considerable problems in making the transition from where economies are now to where they want to be. And the answer to the third question is that successful structural reform *is* a central determinant of long-run growth performance, particularly as countries approach the technological frontier.

## THE STORY SO FAR

Since late 1998, the East Asian region appears to have turned the corner in terms of macroeconomic performance, with the speed of recovery surprising most forecasters. Ross Garnaut (Chapter 2) gives a detailed commentary on the regional recovery. The Korean economy is now growing very strongly and significant positive growth has been recorded in Malaysia and Thailand. Recovery in Hong Kong and Singapore is lagging behind but a strong pick-up is imminent. Growth in the Chinese economy remains above 7 per cent, though there are concerns about a softening over the next year. Even the Japanese economy has pulled off three quarters of successive growth. Only in Indonesia are the prospects for a decisive recovery less clear, though there too the economy has stabilised.

The pace of reform, like the speed of recovery, has also varied across economies and across sectors. Masahiro Kawai (Chapter 13) provides an assessment of progress in financial and corporate sector restructuring. Much of the progress in reform to date has occurred in the financial sector. The Korean government has taken an aggressive approach to recapitalising the banking sector and the Thai and Malaysian governments have also made considerable progress with banking sector recapitalisation. Secondary markets for non-performing assets have been set up in Korea and Thailand and foreign bank involvement has increased. Regulatory oversight has also been tightened in some instances with new, independent regulatory authorities recently established in Japan and Korea. New regulations on loan classification have been introduced in Korea, Malaysia and Thailand, and new regulations on foreign exchange exposure have been introduced in Korea. In Japan, a more concerted effort towards banking reform was finally launched with a large capital injection in March 1999 in return for the submission of bank restructuring plans.

Outside the financial sector, progress with reform has been more mixed. There has been some progress with the removal of obstacles for mergers in Korea, liberalised foreign ownership laws in Korea and Thailand and new bankruptcy proceedings in Thailand in 1999 and in Indonesia. There has been progress too at the international level with proposals for a new capital accord published earlier this year and the OECD Task Force on Principles of Corporate Governance now complete. But significant obstacles to corporate restructuring remain in many of the crisis economies. In Korea, for instance, reform of the *chaebol* remains slow in comparison to the upheaval in the banking industry.

Overall, the story is one of considerable but patchy structural change. Once again, Indonesia's progress has been the most uncertain, with the political turmoil and the uncertainty surrounding the political transition impeding a coherent and rapid reform process. There are also indications that the Chinese authorities are adopting a more cautious attitude to reform, though renewed attention is being directed at financial sector weaknesses. Even in those economies where reform programs are most advanced, the process is a long way from completion and major challenges remain to be faced.

## THE ROLE OF THE STATE IN THE ECONOMY

Although it is widely acknowledged that financial regulation, appropriate corporate structures, effective government and absence of corruption have important economic consequences, the links between governance and economic performance are not well understood. There is a growing realisation that institutions and policy processes matter, not just at a microeconomic level, but also in terms of their macroeconomic effects.

The recent experience of crisis and the ongoing process of reform and recovery in East Asia provides new material for this debate.

It is easily demonstrated that government intervention in markets can in many instances greatly worsen the allocation of resources. It is also true that governments can play important and constructive roles in addressing market failure and that shortcomings in government performance may consequently stem from sins of omission (failure to intervene) as well as sins of commission. Even in free market economies, governments play a central role in setting out the context in which markets operate. Although the analogy of the 'Robinson Crusoe' economy can be a helpful tool, it is increasingly clear that the institutional requirements for a properly functioning market economy are extensive. These requirements stretch beyond the guarantee of property rights and include the operation of an effective judicial system, the implementation of bankruptcy provisions, provision of a framework for competition policy and the regulation or supervision of a wide range of other economic activities. As David Nellor argues (Chapter 14), the smooth functioning of global markets suggests that rules of conduct are now required at the international as well as the national level.

In any market economy, the way in which governments provide this institutional setting creates the backdrop against which market incentives operate. In providing this backdrop, governments *can* fulfil several crucial functions, though the degree to which they actually *do* so varies enormously. They may provide public goods, regulate private activities to counteract other market failures, act to prevent or limit rent-seeking activities and the abuse of market power, and gather or disseminate information. At early stages of development, there may be a broader role for government to play in terms of coordinating investment activities, overcoming problems of asymmetric information, a role that Rodrik (1995) has argued was important in Korea and Taiwan.

The economic basis for governments to perform these functions lies in the field of welfare economics, which shows that markets may not always yield efficient outcomes where firms or individuals have market power, where externalities are important and where information is imperfect. Recent developments in the fields of asymmetric information, the theory of the firm and in regulatory economics have given us a clearer understanding of how these market failures can be important in reality. These developments also illustrate that appropriate intervention may allow governments to approximate the conditions under which market interactions do actually lead to optimal outcomes.

The importance of government behaviour stretches beyond institutions and policies to the processes of government. Policies and policy making need to be transparent and predictable to allow market participants to plan for the future. The risks associated with government action are an important part of the context in which investment, both foreign and domestic, is made. Public institutions must also be able to implement policy clearly and effectively. There is little point, for instance, in enacting sensible laws if the courts cannot enforce them.

The political arguments for effective governance are as important as the economic ones. Lack of transparency, arbitrary decision making, corruption and prolonged deadlock erode the legitimacy of governments. Where legitimacy is lost, the risks of widespread political and social instability, particularly at times of economic stress, are greatly increased, a point emphasised in Hadi Soesastro's analysis of governance problems in Indonesia (Chapter 6).

## THE BUSINESS–GOVERNMENT NEXUS IN EAST ASIA

A large part of the task of providing effective governance lies in defining appropriate relationships between government, business and the financial sector. In most of the East Asian economies, close relationships between government and business have been common. Governments have often played significant roles, directly or indirectly, in the banking system and banks, in turn, have generally played a dominant role in corporate finance. In many economies, large, vertically integrated firms have also been common – sometimes explicitly encouraged by government. Aspects of these arrangements have been widely blamed for contributing to the financial crises. Yet it is important to remember that these arrangements also proved capable of supporting the extraordinary investment effort and the massive, unprecedented mobilisation of resources that characterised the period of outwardly oriented East Asian growth.

There are strengths as well as weaknesses to a system of close networks between business and government. At early stages of development, where there is great potential for large productivity gains, where investment returns are high and where market failures may be substantial, close relationships between firms, banks and governments may encourage investment by promoting long-term financing relationships and by lowering the cost of credit. Government involvement arguably helps to overcome problems of asymmetric information that can limit the ability of firms to finance projects and may have helped through coordination of the massive investment effort and provision of infrastructure. With ample scope for productive investment, the sheer quantity of investment may be the most important source of growth, particularly if the system is broadly market-conforming.

As development progresses, the risks of these kinds of arrangements appear to rise. As marginal returns fall and the scope for 'easy' productivity gains is exhausted, the costs of inefficient resource allocation may become relatively more important. With opportunities in the real sector decreasing in profitability, the temptation for more speculative ventures is likely to increase. As the costs of existing institutional arrangements grow, countries are then faced with the difficult task of making the transition to institutions that are needed for a more developed market economy, where innovation rather than factor accumulation takes over as the engine of growth.

In hindsight, it appears that three weaknesses arising from the system of business–government relationships in many East Asian countries have been particularly important. These problems are encountered everywhere, but have been particularly acute in some economies in the region.

*1. Existing structures have not provided effective discipline for firms and banks.* For market mechanisms to provide efficient outcomes, effective discipline is needed to prevent firms from abusing market power, to stop managers from exploiting privileged information and to ensure that resources are allocated to the most efficient firms and projects. In practice, this discipline can be provided in a number of ways. Vigorous competition from other firms, the threat of takeover through capital markets or monitoring by creditors can perform the function of ensuring that private decisions lead to efficient resource allocation. To the extent that monitoring has features of a public good, public authorities may also be required to play a regulatory role.

As Angelo Unite points out (Chapter 9), the tradition of family ownership in many East Asian economies and of large corporate groups in Korea and Japan has meant that capital markets have not been active in many of the region's economies. Much of the monitoring of firms has in practice been left to banks. Ideally, bank monitoring of firms through long-term relationships should prevent the kinds of agency problem that lead to inefficient investments. But in many cases, banks themselves have not faced sufficient incentives to discipline firms and related party lending has been common. Inadequate regulation and close links between government agencies and the corporate sector have made regulatory forbearance common. Akiyoshi Horiuchi (Chapter 3) provides a comprehensive diagnosis of the Japanese banking crisis, where these problems have been particularly prevalent.

With limited competition in the financial sector and government intervention to support weak institutions, the incentives to alter inefficient practices have often been low. The disastrous performance of the Japanese financial sector indicates the dangers this may pose. There is growing acceptance that competition can play an important role in providing the incentives for effective management in the corporate and financial sector. Particularly for economies where domestic markets are small, foreign involvement may be an important part of ensuring a competitive environment.

*2. Institutional arrangements have encouraged inefficient management and allocation of risk.* Much attention has been directed at the problems of implicit and explicit government guarantees to firms and banks, frequently grouped together under the general heading of 'moral hazard'. Exposure to risk is an important discipline in ensuring that firms face the consequences of their actions. By subsidising or suppressing the risks faced by firms, government involvement can encourage excessive risk-taking and over-investment. Problems of moral hazard have been most obvious in the banking sector but extend to other implicit guarantees of support and rescue. Heather Smith (Chapter 4) contrasts the problems that arose from these forms of government intervention in the Korean and Taiwanese economies.

Extensive government involvement in the financial sector, particularly where it underwrites risk, may also impede the development of alternative structures for risk management. Many of the region's economies have underdeveloped financial markets. In some instances, governments actively discouraged development of futures markets. Thin equity markets, narrow fixed-income markets and the absence of simple derivatives make it difficult for the private sector to engage in effective risk management and to hedge effectively.

*3. The interrelationship between government and business has sometimes increased opportunities for rent seeking.* Where governments are closely involved in business activities, there is a risk that rent seeking or outright corruption becomes entrenched. Ross McLeod (Chapter 7) presents a strong critique of the Soeharto regime as government by 'franchise', by way of example. While McLeod may overstate the case, there is no doubt that increased rent seeking or corruption not only increases the inefficiency of resource allocation, but may also undermine the legitimacy of government and weaken the prospects for transparent and predictable policy making. In practice, the degree of competence and honesty in the civil service varies greatly across the region. The development of an entrenched and privileged group of rent seekers can increase the fragility of the political system and may inhibit the smooth transfer of political power in crises or a vigorous reform process. The Korean and Thai cases where that transfer occurred naturally through the electoral process provide a stark contrast to the painful transition process still underway in Indonesia. Less dramatically, the difficulty of insulating the Japanese political process from powerful sectional interests or of ensuring genuine political turnover has contributed to policy deadlock there.

## THE ROLE OF REFORM AND RECOVERY IN EAST ASIA

This brief consideration of the conceptual issues now permits more detailed answers to the three original questions.

### The role of reform in recent macroeconomic performance

It is hard to argue that the recent recovery across the region reflects the impact of reforms already undertaken in the crisis economies. Reform programs are far from complete and the recovery in many economies is now well underway. In Korea, for instance, where recovery has been most rapid, the quantity of outstanding non-performing loans is still large and debt–equity ratios remain high.

Although a large component of improved regional economic performance represents a cyclical recovery from the deep recessions of 1998, recent reforms have played an important role in *enabling* macroeconomic recovery. Some immediate action in the banking sector was a precondition for mitigating the problems of disintermediation and credit rationing that impeded the recovery in its early stages. But the influence of reform process has been broader. Although completion of the reforms themselves has not been necessary for recovery, some commitment to structural reforms and to credible economic management does appear to have been a prerequisite for a return of confidence and for the sharp rebound in domestic spending in the recovering economies. Those countries that have rebounded most sharply, Korea and Thailand, established that confidence swiftly, electing new governments that were firmly committed to structural change. In Japan too, recovery was preceded by a more vigorous government commitment to cleaning up the financial sector. By contrast, where the reform process has been less certain, as in Indonesia, foreign capital has been slower to return and the recovery has not yet appeared.

The notion that a credible reform commitment may play a role in current performance is consistent with forward-looking economic behaviour. The credible foreshadowing of reforms is sufficient to affect macroeconomic activity even before the impacts of the reforms themselves are felt. But the ability to reap benefits from announcing reforms suggests that there may be problems of time consistency in government commitments to reform. In Korea, in particular, the speed of recovery has raised concerns that the pressure for difficult reforms may ease. The 'false dawn' in Japan in 1996, when the economy recovered, only to stumble again, indicates that postponing the resolution of underlying problems is rarely costless and that governments that cannot deliver on reform are eventually punished.

## The role of reforms in reducing vulnerability

The fact that macroeconomic recovery has been possible, largely independently of the completion of structural reforms, says much about the nature of the links between governance and economic performance. An important thrust of structural reform is concerned with reducing future vulnerability. It is possible, and well demonstrated by East Asian performance, to record strong economic performance even in the presence of severe structural weaknesses. Even where these weaknesses do not clearly affect performance in good times, they are likely to increase the economy's fragility to disturbances and to raise the cost of those disturbances when they occur. These problems were evident in East Asia, where economies that had histories of very strong macroeconomic performance did not prove robust to shocks. Those economies, like Singapore and Hong Kong, where financial sector weaknesses were less severe, generally found themselves less seriously affected by the crises, as Christopher Findlay, Cheng Yuk-shing and Chia Siow Yue (Chapter 11) point out.

Creating institutions that are robust under pressure is also important to how effectively economic management can tackle crises and recovery. In Indonesia, where governance was weakest, the system collapsed under stress. Initial government responses to the crisis were erratic and the lack of confidence in the political system's ability to deliver results was central to the scale of capital flight. The fragility of the political system in the face of a large downturn also explains why reform and recovery efforts have been slow and frustrating. It is no coincidence that it was here that economic problems turned into systemic crisis. Less dramatically, the Japanese decade of stagnation also indicates the problems of weak governance in responding to shocks. The asset price collapse of the early 1990s has had a much larger and more persistent impact on the Japanese economy than similar shocks in other economies, largely because of the difficulties of delivering the necessary adjustments through the existing system.

Regardless of its broader impact, there is little doubt that proposed reforms, particularly those related to the financial sector, should significantly reduce the vulnerability of affected economies to the kinds of deep crises that they have recently experienced. Dominic Wilson (Chapter 12) discusses a range of policy options to reduce future vulnerability to international capital flows. The pressure to address these vulnerabilities is one of the more important beneficial side effects of the crises. Identifying and tackling vulnerabilities in advance is problematic, since weaknesses are generally hidden in the booms that precede crises and pressure to address them when times are good is inevitably weaker. Given the different starting points, it is natural that details of the reform paths will differ across countries. In Thailand, for instance, the private sector and international banks have played a larger role in bank recapitalisation than elsewhere, as Bhanupong Nidhiprabha and Peter Warr (Chapter 5) note.

## The impact of reforms on long-term performance

While short-term recovery has proceeded ahead of reforms, it is increasingly clear that long-term growth prospects are affected by structural weaknesses. There is now considerable empirical evidence linking the quality of institutions to economic performance. Cross-country regressions that examine the links between growth and measures of institutional quality (the quality of the bureaucracy, risk of expropriation and level of corruption) strongly support the notion that countries with stronger governance record higher long-term growth, all else being equal (Knack and Keefer 1995; Easterly and Levine 1997). This appears to be true not only because vulnerabilities can lead to deep crises, but also because trend growth appears to be adversely affected, particularly as economies exhaust potential for 'catch-up' growth.

There is no doubt that strong growth can also be achieved against a background of structural weakness. Even the extraordinary corruption of the Soeharto era did not prevent a long period of impressive growth. The constraints on growth posed by structural problems are weaker, the further an economy is from its technological frontier, when there is ample scope for productivity improvements despite structural inadequacies. But as returns on investment fall and the burden of growth shifts from accumulation to innovation, the constraints of institutional and policy weaknesses are likely to become more binding. Japan provides a clear example of how structural weaknesses can contribute to stagnant productivity performance. The Japanese case also indicates that the costs of delaying the reform process appear to rise with time. It is now widely accepted that increased competition and reform of the incentive structures facing firms and banks in Japan is a prerequisite to raising trend growth. By the same token, reforms elsewhere in the region should not only reduce vulnerability but improve future growth performance and prevent a sharp decline in growth rates as development continues.

**PROBLEMS OF TRANSITION**

Although the crisis presents new opportunities, the task of structural reform and the redefinition of the role of the state and economic enterprise in East Asia present considerable challenges for government policy.

At a general level, desirable directions for reform are relatively easy to identify. Financial sectors should be recapitalised, non-performing loans resolved and corporate sectors restructured. Competition policy should be strengthened and more effective systems of prudential regulation and risk management put in place. A move away from quantitative controls to market instruments in credit allocation and capital account restrictions, and the removal of obstacles to mergers and foreign participation in the financial and non-financial corporate sector are probably also desirable. In some countries, civil service reform and reform of the judicial system may be necessary if new regulations are to be effectively implemented and enforced. Even the Malaysian experiment, described by Prema-chandra Athukorala (Chapter 8), conforms to this broad pattern despite the flirtation with capital controls.

It is one thing to be able to list an 'ideal' set of regulations – it is quite another to design a path that can take a country to them. There is a tendency in recommending reforms to overlook the difficulties of transition that any reform process implies, particularly one that envisions a comprehensive overhaul of large sections of the economy. Particularly in the least developed economies, where problems are deeply entrenched and interconnected and where existing institutions are a long way from best practice, issues of sequencing and timing take on critical importance.

In China, for instance, Yiping Huang and Ligang Song (Chapter 10) identify the problems in existing relationships between unproductive state-owned enterprises and state-owned banks under pressure by government to continue lending to non-performing borrowers. It is relatively straightforward to sketch the features of a desired end-point: a system of tougher regulation, a banking system at arms length from the corporate sector, the resolution of non-performing loans successfully completed and state-owned enterprises either returned to solvency or closed down. It is much harder to be confident about how the government should move to improve the current situation. What should the government do first? How can the achievement of long-term goals be reconciled with short-term stability? How much control does the government actually have? What is politically feasible? These kind of questions need clear answers if a sensible reform process is to be implemented.

The reality is that governments in general have limited capacity and limited control over the reform process. The technical and institutional capacity needed to deliver effective government supervision must also be built – a process that will take considerable time. International institutions and foreign firms can play a useful supporting role, but building effective local capacity will be important over the longer term.

It is also true that separate reforms are interdependent, with the success of reform in one area often relying on accompanying reforms elsewhere. For that reason, the inappropriate sequencing of collectively desirable measures can create new problems. In many of the crisis economies, greater competition in the financial sector in the absence of adequate regulation reduced the franchise value of banks for instance and increased the willingness of financial institutions to take risks. The loss of bank business from the internationalisation of corporate bond markets in Japan may have encouraged more speculative bank financing. And while a more open capital account may be desirable in the long run, capital account liberalisation in China against the background of current financial sector weakness would be ill-advised.

Throughout the reform process, a wide range of groups and individuals must be persuaded to make adjustments and, in many cases, to take losses of one kind or another. Reform always generates resistance but is particularly difficult when the capacity of the government to deliver outcomes is itself at issue. Where the political process is dominated by interested parties, the very same institutional weaknesses that reforms must address may hamper the ability to carry out the reform process. The Japanese political system, for instance, has proved itself slow and resistant to reforming itself.

Resolving these transitional issues is not a peripheral problem, but the key to successful reform. The financial crises have inflicted a great deal of pain on the East Asian region. As other countries have learnt, the opportunities to take tough decisions in the wake of crises are often greater than at any other time. With many of the characteristics that supported East Asia's last high-growth period still in place (high savings, outward orientation and disciplined macroeconomic management), successful reforms undertaken now can play a large part in ensuring that the current recovery marks a return to sustained and stable growth throughout the region.

## REFERENCES

Amsden, Alice (1989) *Asia's Next Giant: South Korea and late industrialization*, New York: Oxford University Press.

Easterly, William and Levine, Ross (1997) 'Africa's growth tragedy: Policies and ethnic divisions', *Quarterly Journal of Economics* 112 (November): 1203–50.

Knack, Stephen and Keefer, Philip (1995) 'Institutions and economic performance: Cross-country tests using alternative institutional measures', *Economics and Politics 7(3): 207–27.*

Krueger, Anne (1995) 'The East Asian experience and endogenous growth theory', in Takatoshi Ito and Anne Krueger (eds) *Growth Theories in the Light of the East Asian Experience,* Chicago: Chicago University Press.

Rodrik, Dani (1995) 'Getting interventions right: How South Korea and Taiwan grew rich', *Economic Policy* 20: 53–97.

Wade, Robert (1990) *Governing the Market: Economic theory and the role of government in East Asian industrialization,* Princeton: Princeton University Press.