



the **THIRD WAY**

The “Asian Miracle is over,” proclaimed Singapore’s senior minister, Lee Kwan Yew, at the 1999 World Economic Conference in Davos, Switzerland. While he foresaw the resumption of economic growth, he did not expect a return to the extraordinary rates that made the East Asian Tigers the wonder of the world until the 1997-98 financial crisis.

Just so. Though many Asian economies have showed signs of recovery since Davos, evidence is accumulating to support Lee Kwan Yew’s view of the region’s long-term prospects. The Asia-Pacific Economic Cooperation group recently scaled back its 15-year growth forecasts for the Southeast Asian economies to 5.5 percent per year – a sharp drop from the pre-crisis average of 7.5 percent.

The financial crisis and the slowdown in growth are transforming the political, economic and social prospects of the region. Take Indonesia (please... as the Australians might say). If the world’s fourth-most-populous country had managed to maintain the 8.5 percent growth rate it achieved in the early 1990’s through the next decade, per capita

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gross domestic product, less than \$600 in 1989, would have reached about \$4,000 in 2010. Now, even if Indonesia grows at the 5.5 percent average predicted for Southeast Asia, per capita GDP won't make it to \$1,000 by 2010.

Many observers believe that China's growth prospects have also significantly worsened. Beijing claimed that China's growth in 1997-98 was 7.4 percent, within bragging distance of the 8 percent target. However, there is substantial evidence that China's growth has since decelerated. In light of industrial over-capacity, a sharp slowdown in direct foreign investment, a deceleration in the growth of Chinese exports (from 21 percent in 1997 to just 0.5 percent in 1998) and the well-publicized problems of the Chinese banking system, a pronounced slowdown

living standards dim. In particular, the growth of the middle class – generally viewed as the foundation for democracy and a peaceful foreign policy – has received a sharp setback. And with civil or international wars looming from Korea to Kashmir, any increase in stress poses grave challenges to American foreign policy.

Asia's immediate problems point to more deep-seated flaws in the model of development that the continent has followed. Advanced economies like Japan and South Korea have been affected, but so have countries near the bottom of the development ladder, like China and Indonesia. Countries that do not regulate international capital flows have suffered. But neither Malaysia's emergency capital controls nor the more elaborate

**How to reach
beyond export-
led growth**

to ECONOMIC DEVELOPMENT

*By Walter
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appears inevitable.

The implications are ominous. Indonesia, the hinge of United States policy in Southeast Asia and the most important factor in the emergence of the Association of South East Asian Nations as a significant force for regional stabilization, has fallen into conflict and disarray that has already cost thousands of lives. A slowing of economic growth in China could result in mass political disaffection with unpredictable consequences.

Throughout the region, social tensions must be expected to rise as hopes for higher

Chinese currency controls have protected these economies from dimming long-term growth prospects.

Indeed, the economies that, so far, have escaped with the least difficulties have been Australia, which never followed the export-led growth strategies that dominated Asian planning in recent decades, and India and the Philippines, which never fully shifted to the export model. Taiwan, which helped to originate the core model, has always enjoyed a more diversified corporate and financial structure than other export-oriented

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countries.

And if export-led growth is no longer the cure for what ails developing countries, other parts of the world are going to have to rethink their policies. NAFTA and the Caribbean Basin Initiative both are grounded on the belief that export growth is the surest, quickest way for emerging economies like Mexico to trigger modernization. And reform efforts

The recovery of Europe and Japan was seen as the only way to stop Communism.

in Africa and Eastern Europe are also tied to the efficacy of export-oriented growth.

THE DEVELOPMENT OF DEVELOPMENT

The modern era of development begins with the end of the Second World War, when the world faced two basic economic challenges. On the one hand, the leading European states and Japan had been devastated by the war and needed repair. On the other, states emerging from the ruins of the European colonial empires were eager to emerge from poverty.

The United States, then as now the most important economic actor in the world system, placed a high priority on addressing both demands. The recovery of Europe and Japan and economic growth in the rest of the world were seen as necessary both for the long-term health of the American economy – and as the only way to prevent Communist advances during the cold war.

In western Europe, Japan and what would

soon become known as the third world, the economic problem was seen as a dollar shortage. The United States was the world's principle supplier of food, consumer goods and capital goods; access to dollars was thus crucial for countries that needed to prop up their living standards or to invest for the future.

The international financial architecture that emerged was adopted for the double mission of helping advanced war-devastated economies and newly independent economies grow in the teeth of the dollar shortage. Indeed, the formal name of the World Bank – the International Bank for Reconstruction and Development – still commemorates this dual purpose. In broad terms, the strategy was to pursue Keynesian full employment and, when necessary, to ante up hard currency to cover balance of payment deficits.

Currency flows were tightly restricted in order to deter capital flight. Governments limited imports, channeling dollar reserves to priority purposes and limiting the uses for which individuals or companies could access dollars – even those generated by their own exports. At the same time, the ability of American investors to make portfolio investments around the world was curtailed. And with some reason: In the postwar climate, American investors could have bought up virtually the entire corporate sectors of the war-ravaged economies as well as the resources of the developing world at fire-sale prices.

By the 1950's Europe and Japan had largely recovered from the war, and they gradually eased capital controls. But the developing countries faced more severe problems, and the common response was a range of development strategies assigned the rubric “import substitution.”

Capital controls were maintained and

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scarce foreign currency was reserved for investments deemed likely to reduce dependence on imports. Steel-importing countries, for example, built steel mills with the idea that they could dispense with expensive imports and use the hard currency for other needs. Developing countries followed full-employment policies so that domestic demand would provide a ready market for the new industrial capacity. These policies were politically popular and often led to close alliances between political establishments and trade unions, which shared an interest in building state-supported or state-owned industrial showpieces.

The World Bank blessed import substitution, providing hard currency at attractive terms. And for many years, key developing economies made substantial progress. Brazil, for example, grew at 7.4 percent annually from 1950 through 1974. In the same period, India increased cement and steel production seventeen-fold. And Egypt built the Aswan Dam, bringing 18,000 square miles of land under cultivation.

Living standards improved, too. Between 1950 and 1975, median life expectancy rose 8.6 years in Brazil, 14.2 years in India and 15.3 years in Indonesia.

Despite successes like these, it had become apparent by the 1970's that import substitution had only limited value – and that this value decreased with time.

Building a national steel plant was all very well. But banning imports of foreign steel meant that consumers paid higher than world

market prices for the critical material. And shielded from global competitive pressures, developing-country industries fell far behind in both technology and productivity. At the same time, the political links between privileged industrial groups, policy makers and bankers became closer – and, in many cases, corrupt.



Both the corruption and the inefficiency of the state-sponsored industrial sector gradually became more entrenched and was reinforced by the ties between organized labor, the state and the state-protected industrial sector. Wealthy individuals and companies became more skilled at evading capital controls and exploiting the windfalls created by the rationing of hard currency. By no coincidence, import substitution-based economies began to experience declining growth rates and rising inflation.

The price shocks of the 1970's sounded the death knell for industrialization based on import substitution. Oil prices put great pressure on energy-scarce economies. And because industries lacked access to both the technology and the capital to improve energy

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efficiency, state-organized enterprises had more difficulty bouncing back than their counterparts in more open economies.

The deregulation of international capital markets that accompanied the collapse of the Bretton Woods fixed-exchange rate regime meant that official lenders were increasingly hostile to the exchange rate controls and import substitution strategies. Heavy borrowing from commercial banks to sustain the import-substitution-as-usual pushed many developing countries deeply in the red, yet left them without capacity to service their new debt.

Older Americans can still remember the paper umbrellas, plastic novelties and cheap cameras with the “made in Japan” label.

TAKE TWO: REDEVELOPING DEVELOPMENT

While Taiwan and Japan had both adopted some key features of import-substitution strategies, they addressed their capital shortages in a different way. Rather than building heavy industry to reduce the need for imports, both built labor-intensive industries that exported consumer goods. Textiles played a key role in this early industrialization. And older Americans can still remember the paper umbrellas, plastic novelties and cheap cameras with the “made in Japan” label.

In effect, Taiwan and Japan reprised the industrial revolution in Europe and the United States, in which technology first used in textiles and other light industries was grad-

ually applied to capital-intensive heavy industry. And as policy makers reflected on these successes – as well as on the failure of import substitution – a new development model emerged.

Developing countries that focused on exports enjoyed greater access to capital than import-substitute economies. By selling goods in the United States, exporters earned dollars; reinvesting those savings in additional export-producing enterprises produced ever-larger streams of dollar revenue. At the same time, a shift away from Keynesian, pro-consumption policies increased domestic savings rates – thereby making more domestic capital available for investment.

Developing countries also learned to accept larger amounts of foreign direct investment and to channel this investment into export production. Export Processing Zones played a large role in the early stages; developing countries built infrastructures for importing, manufacturing and exporting goods. And they offered tax holidays, wage and regulatory concessions and the free import of components and materials for export production. The payoff came in both substantial export growth and increasing rates of technology transfer, as foreign investors sought to combine the advantages of cheap labor with those of high-tech production processes.

In most cases, the export-oriented model supplemented import substitution, but did not entirely replace it. Following Japan’s lead, export-oriented economies continued to restrict the free importation of foreign goods – but through tariffs and quotas rather than the capital controls and outright prohibitions that marked the old system.

By the same token, the structure of corporate ownership and the financial system did

not change much. With the exception of Taiwan, financial markets in export-oriented countries were similar to those of import-substitution economies. They did not serve as competitive financial intermediaries, allocating credit on the basis of prospective returns. Rather, they were instruments of state planning, channeling savings into target industries and companies. Complex ownership structures, marked by cross holdings and often linked to politically powerful families, insulated these economies from competitive market forces. Restrictions on foreign ownership insured that foreign capital would move primarily through the politically reliable banking system.

As with import substitution, export-oriented growth models yielded striking results in their early years. But their limitations became evident over the long haul. Like the import-substitute economies, the “developmental state” proved less successful at long-term guidance. Corrupt connections between business and political leaders warped the focus of policy. Meanwhile, growth itself made developing societies more difficult to run, with increasingly diverse interest groups demanding a place at the table.

DOUBLE BUBBLE TROUBLE

A combination of external factors posed challenges that ultimately proved too much for these societies to manage. The first was a growing mismatch between international financial architecture and the financial institutions of the export-oriented economies. Just as the end of fixed exchange rates and capital controls exposed the import substitution economies to international financial pressures they were ill equipped to withstand, financial liberalization in the 1990’s outstripped the capabilities of export-oriented financial systems.

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Initially, the post-Bretton Woods system served export-oriented economies relatively well. financial deregulation facilitated the transfers needed to accommodate trade and investment. Trade liberalization improved developing countries’ access to markets for manufactured goods. And through the 1980’s, little was asked in return.

Developing countries were allowed to maintain high import tariffs in what they deemed strategic industries, insuring that their champion exporters controlled profitable domestic markets. Moreover, they weren’t pressed to open their domestic service



sectors to foreign investment.

But the easy times ended with the collapse of Cold War solidarity. The World Trade Organization agreement mandated increased foreign access to both goods and service markets in developing countries. And as international flows of funds increased, developing countries were pressed to ease capital controls and to allow foreign investors access to local stock markets.

Banking systems were also deregulated under international pressure, with the result that two financial regimes came to exist side by side in many economies. On the one hand, the old system of state-allocated credit continued, preserving the culture of cronyism. On the other, hot money poured into the

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market and was available for speculative investments.

An international economic regime that once supported the export-oriented approach to development while allowing developing countries to shelter their fragile financial systems was replaced by a more open system with greater opportunities. But the new regime came with greater risks and dangers. Simultaneously, export-oriented economies began to encounter problems of diminishing returns.

and lenders quickly note a pattern of stagnant or falling profits and transfer capital from one company (or industry) to others. But the state-guided credit systems of many export-oriented economies react in just the opposite way, pumping ever more cash into troubled companies. This pattern was visible in countries as advanced as Japan and South Korea, but also in countries at much earlier stages of development like Indonesia, Malaysia and Thailand.

In financial systems designed for maximum obfuscation, news doesn't travel fast.

As more economies joined the export pack, competition tightened. A textile factory in the Philippines must now duel with counterparts in Bangladesh, China and Sri Lanka.

The first countries to embrace the export-oriented path had enjoyed markets for their products that were essentially infinite. Japan and Taiwan competed with producers in high wage, high tax, high regulation environments in Europe and North America. Thus, they were able to undercut their competitors on price while still achieving strong rates of return.

But as more economies joined the export pack, competition tightened. Today's textile manufacturer in the Philippines does not compete against companies in West Germany or Pennsylvania; those factories closed long ago. A factory in Manila must duel with counterparts in Bangladesh, China and Sri Lanka. And, surprise: returns from exports in this ferociously competitive environment are lower.

Advanced industrial economies deal with similar problems all the time. Shareholders

Thus, even as returns eroded, investors (domestic and foreign) were mesmerized by GDP growth rates close to 10 percent and remained eager to buy into the game. Breakneck growth, they reasoned, would surely lead to greater demand for office space, shopping malls and upscale housing.

The newly deregulated international and local financial markets allowed investors to act on impulse and permitted inexperienced bankers who knew little about managing risk to lend billions of dollars in short-term money to optimistic and inexperienced borrowers. So Asia suffered not from one bubble but two: an industrial investment bubble caused by crony capitalism, and a real property/stock market bubble caused by investor herd behavior.

Japan was the first to experience the double bubble – and, as a capital-rich country, has been able to sustain economic activity, if

not asset prices, through a combination of government stimulus and continued credit allocation. Lacking Japan's capital resources, the export-oriented economies on lower rungs of the development ladder suffered sharp economic contractions that, ironically, prepared the way for a more rapid recovery.

However, even as that tentative recovery takes hold, the problems of export-oriented growth will prevent a return to the good old days of the 1980's. We may well see Asian economies cycle to the brink of health and then relapse into recession until a new development model more suited to contemporary conditions can be adopted.

TAKE THREE: TOWARD THE NEW DEVELOPMENT MODEL

The world needs its third postwar development model. Developing countries can't revert – as some nostalgically propose – to import substitution. For while Malaysia's experience since 1997 has shown that targeted, short-term controls on capital are feasible, the wholesale capital controls that import substitution requires are simply impossible in the contemporary world.

Note, too, that the option of industrial autarky is no longer realistic. Industrial production is directed by an international division of labor, with components built in many countries and assembled in others. Even if it were practical, neither the rules of the World Trade Organization nor public opinion in the advanced industrial democracies would allow large developing economies to re-establish the restrictions on imports of an earlier era. What's more, the pace of technological change would mean that any country attempting to return to the import substitution path would quickly fall far behind countries integrated into the global system.

Developing countries thus must seek new

ways to accomplish old objectives – to overcome the capital constraints that limit their growth potential and to find sustainable strategies for meeting their priorities in the prevailing international context. In brief, the new strategies will require (1) a shift from dependence on demand for manufactured exports; (2) reform that enables developing countries to use capital more efficiently while buffering national economies against international panics; (3) substantial increases in capital flows to developing economies.

Escape from dependence on manufacturing exports will be difficult, but it is the key to success. For everything points to a continuing deterioration in the terms of trade for manufactured goods.

The parallel to an earlier transition from agriculture is instructive. When the manufacturing economy first developed in the 19th century, mechanization, transportation and preservation technologies were opening new areas of the globe to the production of food and fibers. But the increases in agricultural productivity combined with vast expansion of land under cultivation led to a permanent fall in the price of agricultural commodities compared with other goods. Farm employment plummeted along with commodity prices; only well-capitalized and mechanized farms – along with those protected by tariffs and subsidies – were able to survive.

Something similar seems destined to happen to manufacturing. With the industrial revolution expanding into thickly populated districts of the developing world, manufacturing faces the sort of chronic over-capacity problems that agriculture has endured for most of the last century.

The demand for manufactured goods will surely grow more slowly than demand as a whole in the developed economies. As populations age, they spend more on medical care

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and less on stereos and sports cars. Slow population growth, or absolute population decline in countries like Italy and Japan, will also trim the demand for housing materials and home furnishings. And even where manufacturing demand remains strong – for computer components, for example – ferocious competition will squeeze returns.

To suggest that developing countries must move away from dependence on manufactured exports is not to suggest that they should abandon the export business – or that

States households currently enjoy access to clean water. In India, the comparable figure is 25 percent. In Germany there are 10 hospital beds for every 100 people; in Indonesia there is less than one.

The \$64 trillion question is this: how can developing countries move quickly toward the standards of living now accepted as normal in the advanced industrial countries? Transforming pent-up demand into an engine of balanced growth is now a high priority for development policy.

Many developing countries face a situation

All the anecdotal evidence suggests that the markets of export-oriented economies remain shockingly inefficient at allocating capital to its most productive uses.

Western protectionism should be met with indifference. The export of manufactures will remain a major factor for many countries. By the same token, while it is no longer realistic to count on agriculture for much development oomph, many countries would benefit substantially from an end to the unconscionable restrictions on agricultural trade.

Growing domestic and regional demand (or, more broadly, South-South trade) will have to replace demand growth in the North as the major engine of future expansion in manufacturing. And, for better and worse, emerging market consumers do have a lot of catching up to do. China, for example, has barely one-half the television sets per capita as Germany. In the United States there are 40 personal computers per 100 people; in Brazil there are fewer than three.

The same pattern emerges when it comes to necessities. Some 74 percent of United

similar to that of the advanced industrial economies in the middle of the 20th century. Having built the means of mass production, they must now find ways to stimulate and finance domestic mass consumption to substitute for export demand.

BALANCED GROWTH

To put it another way, the shift from export-oriented growth will almost certainly require a reduction in savings rates. Private and, in some cases, government consumption must rise as a percentage of GDP. And that will require big changes in spending patterns. In France private consumption represented 79 percent of GDP in 1995; in Britain the number was 85 percent. By comparison, private consumption in Thailand was just 54 percent of GDP; in China, 48 percent; in Malaysia, 53 percent.

Raising private consumption will require

more than a shift away from taxes on consumption. In export-oriented economies, corporations have been encouraged to retain as much income as possible for future investment – often in unprofitable ways. Both shareholders and workers lose in the process. Reforms aimed at stimulating consumption (and at improving the efficiency of capital markets) would encourage higher dividend yields and perhaps higher salaries as well.



capital markets in export-oriented economies is in part the result of deliberate state credit allocation policies, in part the result of cronyism and corruption. Improving the ability of these markets to make effective use of available capital would simultaneously reduce the need for foreign capital and make it easier to attract. And while capital market structure often reflects entrenched power relationships, the potential rewards for

countries that can boost capital market performance are so great that even the most entrenched interests may give way.

For planners steeped in 1980's thinking, all this is heresy. Certainly it would expose developing countries to a serious challenge – the substitution of foreign savings for domestic. Otherwise, increased demand in the domestic economy would likely lead to currency depreciation – an all-too-familiar spectacle from the last years of import substitution.

As they introduce domestic reforms, developing countries must find ways to benefit from greater access to the global capital market while defending themselves from its perils. This means using the unprecedented power and flexibility of the international market system to tap long-term capital, while reducing exposure to short-term fluctuations and crises.

To make this strategy effective, the flow of foreign capital into emerging markets must increase dramatically. Developing countries must be able to consume more products produced in the South while exporting a smaller percentage of their output to the North – without experiencing the inflation that historically has dogged high spending developing countries.

While “dollarization” – effectively making the dollar the national currency – has shortcomings for developing economies, it does offer certain countries (especially in Latin America) a real opportunity in this vein. In particular, dollarization would make it easier for them to tap securities markets. Thirty-year mortgages in Argentina could be packaged and securitized much as they are in the United States with the help of Fannie Mae. Such securities would offer Argentina a relatively stable source of long-term credit, while providing investors with a liquid asset that could be bought or sold at will – without pro-

An important part of the fix lies in the evolution of more effective domestic capital markets. And while figures are hard to come by, all the anecdotal evidence suggests that markets of most export-oriented economies remain shockingly inefficient at allocating capital to its most productive uses.

The catastrophically poor performance of

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voking an economic crisis in Argentina.

In economies where, for either political or economic reasons, dollarization won't fly, there are other ways in which contemporary capital markets could provide attractive new options.

The current model in which the dollar, the euro and the yen all serve as media of global exchange whose relative values fluctuate without undermining the status of each could provide interesting opportunities for the creation of artificial currency units.

East Asian countries might use a currency unit that tracked, say, the yen or the dollar at any given moment – depending on which was the weaker. East Asia would gain the advantages of a stable unit of value, whose fluctuations would be easy and cheap to hedge in the global markets, while their economies would be partially shielded from the consequences of rapid changes in the value of the parent currencies.

Managed by a regional central bank, the “yendo” could buttress a securities market that would attract significant long-term capital to the region at lower rates than would otherwise be available. Modest capital controls, modeled on the Chilean approach, could be used to discourage short-term capital flows.

Besides reducing the cost of capital across the “yendo” region, a currency regime of this kind offers other advantages. Giving a regional central bank responsibilities as a lender of last resort would necessarily entail giving it regulatory responsibilities as well. And since capital-market development is one of the most urgent and difficult tasks facing export-oriented economies, a regional authority that commanded the respect both of foreign governments and investors could play a critical role.

Both dollarization and regional currency regimes would require much closer supervision of financial institutions and capital markets by the International Monetary Fund and other multilateral lenders.

That would no doubt be resisted in the name of sovereignty. However, proposals offering both a fast track to cheap capital and higher domestic consumption would likely meet less resistance than previous attempts to introduce transparency into developing financial markets.

Central bankers are never universally beloved, and one of their jobs must always be to provide local politicians with convenient scapegoats when economic troubles strike. But policies like the Argentine convertibility plan, which allows ordinary people to tap credit markets, have proved surprisingly popular – even when their introduction was accompanied by painful retrenchment and recession.

Other initiatives could be part of a Take Three development strategy. For example, the United States could certify Mexican health care providers as sufficiently well trained to qualify for reimbursement for services under U.S. social insurance programs – at perhaps at 60 percent of the prevailing rates north of the border. This would give an enormous boost to the development of retirement communities in Mexico for the ballooning population of older U.S. citizens – not to mention cutting Medicare costs.

The changes contemplated may seem radical. At the very least, they would require openness to fresh ideas. But it is hard to think of a higher priority for global economic policy. Export-led growth is heading the way of import substitution. And sooner rather than later, we must find an alternative that both developed and emerging economies can live with. **M**