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New Development Strategies: Beyond the Washington Consensus

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The state and development strategy

Development economics became an independent field of study in the 1950s. Since then we have witnessed differing views on the relationship between (nation) states and their economic development (Meier and Rauch, 2000, p. 421). In the early days, states were optimistically presumed to be represented by social-welfare-maximizing governments, but then the pessimistic view emerged that states were one of the largest hindrances to development and served only to maximize the profits of selected interest groups, politicians and/or bureaucrats.

Subsequently, a more neutral view came to prevail: that, since the performance of states has been quite diverse, not all states hinder development and could in fact aid development given the right policies. The next question was how to build up states' capacity to formulate and implement the right policies. Also, even if we can hardly have social-welfare-maximizing government, intervention by the government with good will, information and competence could be justified for market-failure cases in resource allocation and for equity purposes in income distribution.[1]

On one hand, the view that markets, and not states, should play the central role in economic development, recently appears to have become mainstream. The so-called Washington Consensus is most representative of this.[2] According to this view, such concepts as developmentalist states and industrial policies run counter to economic development. As a matter of fact, even the East Asian countries, once praised for their successful industrial policies, experienced severe economic crises in the 1990s and their reputation of successful developmentalist states appeared to have plummeted.

This view that government failure, rather than markets, hinders development may be unquestionable to those who have witnessed development experiences in Sub-Saharan Africa. Generally, if there is government intervention, it creates opportunities for rent seeking. No matter how benevolent the intervention, the behaviour of the private sector is distorted by rent seeking.

Moreover, private interest groups are motivated to lobby the government to create rent-seeking opportunities. In other words, government intervention necessarily calls for corruption.

Nonetheless, on the other hand, the growth performance of the East Asian Miracle countries (World Bank, 1993) was spectacular enough for many economists to admit activist role for the state and/or government. East Asia is far from homogeneous, especially in terms of political stability, law and order, infrastructure development, independence of the bureaucracy and so on. The East Asian countries exhibit a wide spectrum of arrangements, which in turn is reflected in their diverse economic performances. However, they have clearly demonstrated that states do not always maximize the profits of only a few selected interest groups.

Why have some states tried to maximize public interests more than others? Is it true that political independence and/or bureaucratic expertise tend to support the success of developmentalism? Why do information exchanges and communication between developmentalist bureaucracies and the private sector appear to be immune from corruption? Even if there is some consensus on the kinds of policies to be implemented by governments, how can we motivate them to adopt those policies?

As discussed in the Preface, we are concerned about the recent *market fundamentalist* view on development strategy and uncomfortable with the Washington Consensus. In our view, markets and governments are complementary, particularly in the case of economic development. To illustrate this, in this book we assess development strategies and policy issues in the context of individual and/or regional economies' history and political-economic reality. The complementarity just mentioned may be conditional on these.

The book consists of four parts. Part I (Markets, Governments and Institutions) considers some fundamental aspects of economic development, including the interaction between markets, governments and institutions. Part II (Development Strategies under Globalization) deals with the impact of globalization on development strategy. Part III (Policy Reforms and the Asian Financial Crisis) examines the Asian financial crisis from political, country-specific and sectoral points of view. Finally, two case studies of transition economies are presented in Part IV (Transition to a Market Economy).

Markets, governments and institutions

The collapse of the socialist centrally planned economies and the stalemate of capitalist welfare states revealed that nation states, if they neglect the market mechanism, can fail to improve national welfare and sustain national economies. We should not, however, jump to the conclusion that we need the market, but not the state any more, or that national economies are no longer relevant to people's welfare. Why? First, the welfare state was born because the market could not bring about distributional equity and adequate public good provision. Second, as demonstrated by some *marginalized* economies, the loss of state functions has led to the collapse of national economies, severely damaging people's welfare.

Lessons from the twentieth century

Along with a large swing in development strategy thinking, we have learned valuable lessons from events in the twentieth century, one of the most important of which is the complementarity between state and market. With this complementarity in mind, in Chapter 2, Dani Rodrik tries to build a groundwork for designing new development strategies for the twenty-first century. Particularly, the author focuses on the role of public institutions, which is inadequately addressed by the Washington Consensus. Evaluation of the successes and failures of development experiences suggests the need for more diverse combinations of state and market in different sociopolitical contexts and different historical phases.

In order for markets to work properly, public institutions must play specific roles with the support of capable governments. Knowing that the present mixed economies have successfully developed in quite different ways over extended periods, Rodrik argues that market incentives need to be underpinned by strong public institutions, that the public institutions could function in diverse arrangements, and that the arrangements would and should be formed as fitted to local practices and needs over a due time horizon.

Strategies for reforms and regime changes

Institutional changes are evolutionary and take time, and economic development is not always a smooth and continuous process. Rather, it is often accompanied by discontinuities such as regime changes and reforms in response to changes in views on development strategies and changes in the national or international political and economic environments.

Why do some countries take a long time to adjust to new development strategies and environments while others do not? What is needed is a set of strategies tailored to the circumstance of individual countries. In Chapter 3, Jeffrey B. Nugent examines how, and under what conditions, we can reorient policy and institutional regimes. Particularly, the author highlights not only the initiation but also the sustenance of policy reforms by looking at countries' experiences of two types of reform: the introduction of property rights and outward-oriented reforms.

Nugent tentatively suggests that the initiation of serious economic reform is enhanced by a regime change and a significant crisis. But at the same time, he argues that sustenance of the reform requires the new regime to be legitimate and the crisis not to be too large, and that, in general, economies with greater income inequality, lower literacy and higher natural resource endowments tend to have greater difficulty sustaining their reforms.

The increasing roles of government under globalization

There is an optimistic view that the increasing integration of the world economy will equalize opportunities of people and help poor countries to catch up with the rich, in terms of capital and technology. If that is the case, then globalization will substitute for some functions of national governments and the role of the nation state will dwindle. Reviewing the outcome of past development strategies, in Chapter 4, Akira Kohsaka examines possible interactions between state and market under globalization.

Since the accumulation of knowledge and technology takes time, uncertainties and asymmetric information are unavoidable and their allocation and accumulation tend to be inadequate. Moreover, technological innovation, a driving force of globalization, has external effects in terms of economies of scale and agglomeration. If such cumulative effects serve to marginalize some developing countries, national welfare will decline and income differences across countries will widen. Hence Kohsaka argues that there is every reason for governments to provide these knowledge-related factors and/or minimize uncertainties and incomplete information through risk sharing and information provision, but little reason for globalization to substitute for government roles.

Furthermore, globalization can exacerbate market failures by magnifying the effect of uncertainties and incomplete information, as happened in the Asian economic crisis in 1997. Enhanced capital mobility has brought increasing risks for emerging market economies, and more volatile financial flows is apparently one of the costs of globalization. Minimizing these negative externalities can be partly handled by national governments, for example by introducing more flexible exchange rate regimes and strengthening bank supervision, but it can be better addressed collectively through international efforts to establish a new international financial architecture and new debt work-out schemes.

Development strategies under globalization

Inequality and globalization

Enhanced capital, labour, knowledge and other factor mobility under globalization may not necessarily benefit developing economies. Agglomeration could be one of the reasons for this. Enhanced factor mobility may well deprive developing countries of the opportunity to catch up with developed economies. Globalized standards or codes of conduct could be another reason, when they are formulated under circumstances of imperfect and asymmetric information. They may narrow the scope for national policy discretion of developing economies.

When analyzing the possible negative effects of globalization on labour markets and poverty reduction in developing economies, Kaushik Basu

(Chapter 5) argues for international efforts to counter the erosion of global democracy. Labour standards used to be a purely national matter but have become less so recently. In particular, the globalization of labour standards is likely to be used to protect workers in developed economies at the cost of those in developing economies. Hence, globalization could result in the marginalization of certain nation states and of certain social groups within nation states. Moreover, the author argues that global income inequality is reaching an intolerable level due to globalization, so special international initiatives are needed to redress this and ensure stability in the future.

Alternative industrialization strategies in Southeast Asia

Since the 1990s the international economic environment has changed significantly. One feature is acceleration of global economic interdependence, where both trade and investment flows have grown far faster than output across developed and developing economies. Another feature is a tightening of international policy coordination. Particularly remarkable changes can be found in trade and investment policy, with international rules constraining the room for domestic discretion in these policy fields.

In Chapter 6, Fukunari Kimura discusses the effects of these changes on the industrialization strategies of developing countries. Because of the international division of labour by multinational corporations and the disciplinary power of the WTO and other international institutions, the author argues that the conventional approaches to industrialization, such as whether to pursue import substitution or export promotion, have become irrelevant.

According to Kimura, the strategy of protecting infant industries which was a major factor in the development of Korea and Taiwan in East Asia, is now not only economically ineffective but also infeasible in a political-economic sense. Rather, the Southeast Asian model, in which foreign investment is actively introduced and trade and investment liberalization is promoted within the WTO framework, should make a reference for the future industrialization of developing economies.

However, Kimura points out that the Southeast Asian industrialization does not offer unconditional success. In fact, the Southeast Asian countries have suffered from such problems as technology gaps between foreign and local firms, and distortions brought by policies to attract footloose foreign firms. Nonetheless, because of these common experiences shared by other developing economies, the Southeast Asian example can still provide better reference than the East Asian model.

Getting policy intervention right

While the roles of market and state (government) can be complementary in economic development and development strategies, the argument for positive roles of government, even in a limited way, has been frowned on recently. In Chapter 7, Koichi Ohno sheds new light on the role of government intervention in economic development. He focuses on such fields that the structural adjustment approach appears to neglect a priori or for a political economic reason. The structural adjustment approach has not met with visible success in Sub-Saharan Africa or Latin America, and that it has confronted unexpected difficulties in transition economies in Central and Eastern Europe.

Ohno first examines the characteristics of market structures that tend to make structural adjustment difficult. He argues that the market structure intended to be achieved by the approach is so distant from the existing one, that the structural adjustment turns out to be basically inconsistent or irrelevant. Next, focusing on East Asia, he reevaluates the role of trade policy during the East Asian Miracle period by empirically scrutinizing the comparative advantage of industries. It is shown that the Miracle was due not to the use of static comparative advantages but to the creation of dynamic advantages through policy intervention. Learning effects, agglomeration effects and technology policies provide rationales for policy intervention in a framework of the recent theory of endogenous growth.

Policy reforms and the Asian financial crisis

The onset and management of the crisis: a political view

At the onset of the Asian financial crisis, some observers pointed to crony capitalism as a fundamental cause of the crisis. However, if this was the case, how could the preceding economic miracle be explained? Meanwhile, country studies of the crisis have found that political factors were crucial in the onset and management of the crisis, particularly, among them is business–government relations.

In Chapter 8, Stephen Haggard discusses three political and institutional aspects of the crisis and its management in the four crisis-hit Asian economies, Indonesia, Korea, Malaysia and Thailand. These three aspects are said to constitute political institutions that had supported the East Asian Miracle. First, government decision making under different political regimes and its economic outcomes are examined. The different regimes are proved to affect the outcomes because political uncertainties play some key roles. Second, close business–government relationships are scrutinized. While market liberalization has been regarded as an alternative development strategy, it turned out to lead to the abuse of private power. Third, as part of crisis as well as globalization management, the possible replacement of the region's traditionally thin social safety net (the social welfare bargain) is discussed.

Admitting that these political institutions had been in transition even before the crisis accelerated its pace, however, the author is not certain how these institutions metamorphose themselves from good, old Asian types.

Regime transition in Korea: an economic view

Contrary to the view that regards the Asian economic crisis as one of external origins, e.g. as a capital-account crisis, country studies have pointed to structural defects and the vulnerability of the economy as fundamental causes of the crisis. In Chapter 9, Yoon Je Cho discusses how deep-rooted structural problems were the main reasons for the crisis in Korea.

Examining the asymmetric financial restructuring of the bank and non-bank sectors and the lack of coordination between monetary and supervisory policies, the author argues that the speed of Korea's transition to a more open and more liberalized economy was far greater than market players expected, and also outpaced institutional development, which would have made a crisis unavoidable sooner or later. He adds that the transition to a more liberalized economy will continue to be bumpy and unstable because of the lack of necessary institutions, a social safety net and an economic incentive structure in Korea.

How to tame hedge funds

It was not only in Korea that the speeding up of capital mobility was far greater than market players expected and also outpaced institutional development. The same also applies to the world economy and the international capital market. Indeed, one could say that the *Asian flu and the Russian virus* (Forbes, 2000) was also unavoidable.

One example is the call for regulating hedge funds, whose speculative activities are often held responsible for the Asian financial crisis. In Chapter 10, Barry Eichengreen examines the role of hedge funds in international financial markets, with a particular focus on market manipulation and systemic stability. While being sceptical about their possible market manipulation, the author shares the concern about systemic stability and scrutinizes the pros and cons of alternative regulations on these funds. Policy options for emerging markets include higher margin requirements, entry and exit taxes on short round-trip transactions, and more flexible exchange rates, although all are far from perfect. The author also argues that regulations on hedge funds' counterparties, i.e. those on international banks' exposures to hedge funds, are more effective.

Globalization goes hand in hand with financial integration. Both phenomena result in, as well as result from, the growing number of high-income investors seeking to diversify their portfolios to include high-risk, high-return investments. As far as we live with this trend, the author suggests that emerging markets should protect themselves by adopting more flexible exchange rates and some less costly capital control measures such as those in Chile and Malaysia. He also advocates international collaboration in collecting information on bank exposures in investor countries.

Transition to a market economy

So far our focus on development strategies has been restricted to national economies with functioning market systems, albeit imperfect ones. Economic reforms in former centrally planned, transition economies have brought new challenges to our thinking on appropriate development strategies.

The policy advice given to transition economies by the IMF and other international financial institutions, was based on the experiences of developing economies such as those in Latin America. It is not difficult, however, to see that a straightforward application of the structural adjustment approach would raise serious problems. There are two reasons why transition economies face difficulties that have not been experienced by ordinary developing economies. First, in Eastern Europe many of the transition economies were once part of the Council for Mutual Economic Assistance (CMEA, or Comecon). The collapse of the CMEA in 1991 meant that they were abruptly thrown into the world of completely different comparative advantage. This shock, particularly to external sectors, would be unfathomably large and far beyond the difficulties encountered by the developing countries.

Second, the transition economies have had to build their economic and institutional systems from scratch. The reforms needed for transition to a market economy are not partial, but involve revolutionary changes to the entire institutional framework, including a new system of ownership based on private property rights, a new corporate system based on privatization, a new financial system to replace the *monobank*, and a new fiscal and social security system to replace the government–state enterprise relationship based on the 'soft budget' principle.

Building a market system from scratch

While a soft budget relationship between the government and state enterprises and/or repression of the financial system can be found in some capitalist developing countries, the latter nonetheless function on the basis of private property rights and decentralized decision making. The difference between developing economies under a capitalist regime and former planned economies is therefore not simply a matter of degree. For transition economies there is an enormous gap between the start and the goal of economic reforms, and therefore far more extensive reforms are needed than in developing economies.

In Chapter 11, Koji Nishikimi examines the difficulties involved in building a market system for agriculture in the case study of wheat production in Kazakhstan. The collapse of the centrally planned economy, through the collapse of the state credit system for financing and input materials, destroyed production linkages, and brought about an extreme output decline. The government failed to form an alternative production linkage, but the private sector has started institutional arrangements through trial-and-error processes of contractual and organizational reforms among farmers and distributors. The author's case study of Kazakhstan shows that the mere existence of exchanges does not necessarily enable the market system to function, and that market systems are barely supported by a complex combination of institutions and a network of trust between market participants.

Strategic choices for China and Vietnam

In contrast to the ex-CMEA economies, China and Vietnam have retained significant state-owned sectors since they began their transition to a market economy. As it turned out, it has not been a mistake to retain some control over the markets so far. Is it sustainable, though? Can they continue to progress by maintaining the strategies adopted in the 1990s even at the turn of the century?

In Chapter 12, Dwight H. Perkins argues that sooner or later the governments of the two countries will have to face serious decisions about the future of their economic systems and their role in the economy, but so far Vietnam, and to a lesser extent China, have appeared unwilling to minimize the role of government in ownership and control. They may refer to the successes of government intervention in Japan, Korea and Taiwan in the 1960s and 1970s, but the world has changed substantially since then, and the author argues that China and Vietnam are in sharp contrast to Japan, Korea and Taiwan in some respects on the national or domestic front.

First, nowadays there is a wide range of international codes of conduct that impose restrictions on government intervention. If China and Vietnam are to reap the fruits of globalization they must follow the new rules of the game in the world economy. Second, in order for government intervention to be successful, decision makers must be free from political and rent-seeking pressures, which may not the case in either country. Hence Perkins concludes that the two countries have little choice but to orient themselves towards more openness and less government intervention. However, he warns that constructing a new system will take at least a generation even if there is a strong will for reform, and that the transition to a market economy will not be smooth, but full of possible setbacks due to political, economic and other elements.

Concluding remarks

The argument that it is not the state but the market mechanism that should lead economic development has appeared to become mainstream. The collapse of centrally planned economies seemed to prove this. However, if we went one step further and said that the state was unnecessary for economic development we would have gone too far. Rather, we should consider how to establish a good division of labour between the state and the market. In order for the market to function effectively, it must be integrated properly and systematically. This requires not only good policies but also good institutional designs.

Designing institutions is a complicated job. While the basic unit for institutions would be a state, states are too diverse to have one-size-fits-all institutions. Moreover, we need to grasp the mechanisms of institutional change. Institutional change takes time. One reason for this is that it involves changes in income distribution among participants, and those who stand to lose will naturally resist the change. If this resistance becomes extreme, the resulting political instability will hinder any change. Meanwhile, the existing institutions may not be supported by the majority of people, and while the latter may demand reform they may be too ill-organized to bring it about. If the stalemate can be broken by effective leadership, institutional innovation can accelerate.

Institutions are constituted in a complex way as a system of mutually complementary subinstitutions. Thus, in the case of institutional reforms, we do not know a correct and consistent sequencing of introducing subinstitutions.

Apart from official institutions, unofficial institutions could play a significant role. Particularly in developing economies, where official institutions tend to be underdeveloped, custom-based unofficial institutions can be utilized at least as temporary substitutes for official ones. Not only national and local governments, but even international organizations are subject to institutional development. Finally, in the interest of development the market needs a strong and competent state, and not an arbitrary and corrupt one.

Notes

1. Here we include activities that are of public-good nature in the broad sense of non-rivalry and non-excludability, such as education, public health, national security, environmental protection and so on.
2. This is discussed in more detail in Chapters 2 and 3.

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