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Lessons from the East Asian Economic Tigers

Summary

From his study of the reason for the success of the east Asian Tigers, Prof. Chen of the University of Hong Kong feels it is because (1) the outward orientation of their economies where the emphasis was on eliminating distoritions in the economy, especially an over-valued exchange rate, price, interest rate and wage controls; (2) an emphasis on basic education and the creation of a *trainable* labor force, not necessary a university-educated labor force; (3) a high and effective use of savings, not necessarily domestically generated, but savings that is used for productive investment; (4) a macro-economic policy that avoids high inflation; (5) a government that intervenes in the economy only to correct market failures, eliminating wage, price and interest rate controls, encouraging entrepreneurs (training of entrepreneurs was discouraged), limiting the power of trade unions; and (6) political democracy is neither a necessary nor sufficient condition for economic liberalization (democracy), but if economic liberalization proceeds apace it will eventually necessitate political democracy.

I add to this memo a discussions of the implications of each of these on Nepal.

Background

The UNDP invited Professor Edward Chen, a Professor and Director of the Centre of Asian Studies and Honorary Professor of Economics at the University of Hong Kong, to determine what lessons Asian and Pacific LDCs might learn from the successes of the east Asian tigers.

Professor Chen spoke recently at the UNDP about what he views as the major lessons to be learned. I try to summarize his views on why there were the successes and then try to relate those examples to Nepal. Prof. Chen limited his comments to why the Tigers succeeded, not necessarily what might be appropriate for Nepal.

(1) Outward Orientation

The World Bank has emphasized the necessity of *getting the prices right.* While this is vitally important, he would prefer to emphasize an outward orientation. In no case in east Asia, did rapid economic growth come during an inward-looking phase. This does not mean that inward looking might not have a role at some point, but that rapid economic growth did not occur until the economies became outward-looking: open to world trade and investment. For example, China's current rapid growth is occurring only in those sections of the country that are outward looking. India was unable to have continuous rapid economic growth during its long inward-looking economic policies. It has made no difference whether the economy was large or small, even the largest economies were not able to develop rapidly while looking toward import-substitution, or remaining closed to international trade and investment.

By *getting the prices right* economists mean avoiding subsidies, over-valued exchange rates, price, wage, interest rate controls, etc.. All of these distort the operation of the market and result in non-dynamic "rent-seeking" behavior (that is, corruption, monopoly profits). The most important element to *getting the prices right* is the foreign exchange rate. Without a realistically valued foreign exchange rate, an outward orientation is not possible.

> Nepal's experience supports this thesis. With inward-looking policies there is a lack of innovative investment, monopoly power is dominant, and who you know is more important than what you can produce. Subsidies to protect urban consumers result in reduced production by farmers; subsidized farm inputs result in insufficient resources being made available and thus allocation of the limited resources to the powerful, not the productive. The over-valued exchange rate resulted in mis-allocations in that people with access to foreign exchange could make an immediate profit by redirecting the goods to India, or by use of the parallel market. Neither of these are economically productive for the society.
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> When Nepal went to a fully convertible currency on the trade account, it finally got the exchange rate in line with the free market. However, by tieing the exchange rate to the Indian rupee, Nepal's exchange rate with respect to third countries is too high (over-valued) and it is probably also over-valued with respect to the Indian rupee. Nepal needs to move toward a floating exchange rate: the over-valuation is making it difficult to promote exports and investment. The market expects a devaluation at some time, and thus factors that into decisions. This reduces the return from investment and discourages foreign investment.
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> Similarly, Nepal retains vestiges of protectionism by not permitting foreign investment in the securities market, excluding foreign investment when the capital is less than Rs20million, making it difficult to secure a resident visa.

(2) Human Capital

All of the countries of East Asia showed an emphasis on the development of human capital, especially the development of basic literacy and numeracy. Their emphasis was not on creating a highly skilled labor force but rather, and most importantly, a trainable labor force. In fact, there is the problem of too many college graduates who, because the society feels it must find jobs for all of them, will often resort of government employment. For a good basic education the attitude and support of parents, relatives and friends is necessary.

> Nepal's record on literacy and numeracy is vastly improving, but still weak. Going from 5% literacy 40years ago to around 40% now is excellent, but still very low: female literacy was under 1% 40years ago, and is around 20% now, again, an improvement, but still poor. Worse has been the emphasis given to the development of tertiary education. Tribhuvan University still gets far more than its share of the education budget. Rather than putting the bulk of its resources into strengthening primary education, or adult literacy, government places a disproportionate amount in tertiary (which is very highly subsidized, students paying less than 15% of the cost of their education). Fortunately, parents have recognized the importance of primary education and are willing to invest their limited resources in advancing the education of their children.

(3) Savings

While many have emphasized the need for high savings rate, his research on the new Tigers does not show there to be any critical value. Savings need to be at least 12-15% of GDP, but higher savings are not necessary. Part of the reason for this is that it is not necessary that the society itself saves, but rather that investment is being made. For example, a society with low savings, but which attracts considerable foreign savings, will be able to grow rapidly. Further, the amount of savings is less important than how the savings are used. In this case, too much emphasis has been placed on the efficiency of the savings institutions. Even if there are no formal savings institutions, if the economy's savings are efficiently used for investment, then the economy will grow. What becomes important is the use of the savings, not the amount, or how the money gets to productive investment, but rather that it gets to productive investors.[1]

> While there was high savings during the Rana regime, it was used unproductively for palaces, jewels and foreign travel. During Nepal's long period of inward-looking policies, savings were used for illegal activities, or to amass

[1] In this area Prof. Chen made a error. He emphasized the need to subsidize housing so as to encourage savings. His point was that Hong Kong had subsidized housing and without it the level of savings would have been much less, as all potential savings would have gone into housing. By subsidizing housing one encourage additional resources into housing. The subsidy distorts the market, and correct valuation would have resulted in pressure to save to afford housing. Usually subsidies of this sort reduce saving by those who already have resources, and has minimal impact on those who lack resources: a help the rich scheme.

resources outside the country. Savings were not used productively, but were used to maintain, or gain, monopoly power through bribes, savings was kept outside and benefited the countries where the savings were held. Recent policies to encourage the return of these savings are in the right direction. The growth of new savings institutions, new ways of investment, are both good, but more effort must be made to encourage effective use of the savings, that is, to encourage productive investment.

(4) Macro-economic Policy

The most important element to macro-economic policy is the avoidance of inflation. As the inflation rate is primarily determined by money supply, it becomes important that the government does not run, or finance the deficit by running the printing presses. Thus, the emphasis on reducing the deficit as much as possible, and financing it in non-inflationary ways. There is no reason to emphasize reducing the balance of payments deficit, having a low debt-service ration, or avoiding foreign loan financing. When foreign capital is used for development, then there must be a deficit on the balance of payments, the debt service ratio might be high for awhile, but if these are used effectively, then the capacity to repay will also grow.

Nepal's experience supports the experience elsewhere. Structural adjustment is designed to reduce Nepal's excessive domestic borrowing, which reduces the amount of capital available for private investment, it strives to improve tax collections, and thus reduce any borrowing. The balance of payments is of less concern, if it is financed through foreign investment, then this is another source of savings (so long as the savings are used effectively -- the key element. I would add to Prof. Chen's list of needed macro-economic policies, a predictable, understandable policy.

(5) Role of Government

As one can imagine from the nature of the countries in east Asia, there is no definitive conclusion as to whether intervention works better than reliance on a free market. Both have worked. The conclusion appears to be that government intervention is needed to the extent there is market failure, or a non-operating market. Since the market was working well in Hong Kong, it needed less government intervention. One area where Prof. Chen advocated strong government intervention is to stop trade unions from growing too powerful, to where they interfere in market operation. At the beginning of industrialization the economy will export labor-intensive products. If strong unions push up the minimum wages, this possibility will be lost.

Should the government intervene in developing entrepreneurs? He does not believe entrepreneurship can be taught, "entrepreneurs are born," and therefor not much effort ought to be given to training. Instead government ought to increase the flow of information and make the enabling environment positive. Foreign investors can be effective teachers of local entrepreneurs. One of the arguments for foreign investment is to change attitudes and approaches, develop new ways of doing business.

> There has been considerable misreading of the Tiger experience with respect to the need for intervention by government. Prof. Chen is on sound ground by emphasizing that it is not interventionism that is important but why government's intervene. If there is a market failure then intervention is necessary (by market failure we mean some factor which precludes the market from operating, for example, a monopoly, lack of information or a necessary input), and it is better for government to emphasize providing information and encouraging investment and risk taking.

> Whether entrepreneurs are born or not, whether there are cultural factors that are necessary, is a philosophical argument, but some skills entrepreneurs need can be taught. Thus, they can learn where information can be gotten, they can be taught bookkeeping, marketing and management. None of these will make an entrepreneur, but they can help make an entrepreneur successful.

(6) Democracy?

Prof. Chen's conclusion is that political democracy is neither necessary nor sufficient for economic development. However, as economic development continues there will be increasing pressure for political democracy. It is possible that India, Pakistan and Malaysia were all harmed by too much democracy too early in the process of development. What is important for economic development is not whether the political regime is democratic or not, but whether it is able to take advantage of the elements in the previous five sections of this memo. That is, is the government supportive of liberal, open, outward-looking, non-rent seeking development? A non-democratic, corrupt government that dispenses economic favours to its political cronies, will not develop, nor will a democratic government that is unable to make a decision, and tries to buy the electorate through subsidies and price controls.