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What East Asian countries can learn from China's economic policies?

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In his recent book "How Asia Works", Joe Studwell analyses the development patterns of nine economies in East Asia. He notes that until nations have achieved a certain technological self-sufficiency, they cannot possibly succeed with a neo-classical economic model. Moving away from the 10-step Washington consensus, Studwell proposes a three-step recipe for success, which he calls "the economics of learning": land reform to maximise high-yield household farming, a focus on export-oriented manufacturing to produce globally competitive goods, and strict capital controls and financial repression to support these objectives. As the steps echo policies implemented by China over the last few decades, we can ask ourselves if a new development paradigm is emerging. How have development ideas and models spread back and forth from certain Asian countries to others? Is there a "Chinese lesson" for East Asian countries? Which kind of political leadership does this development model require? How are good governance and democratic governance articulated in this framework?

A lunch-debate with:

Joe Studwell
Journalist, Public Speaker and Author of "How Asia Works"

Jean-Christophe Defraigne
Professor in Economics at the University of Saint-Louis Brussels and at the Louvain School of Management

Moderated by:
Pierre Defraigne
Executive Director, Madariaga – College of Europe Foundation

Joe Studwell begins by pointing out the importance of recognising that **the true intellectual breakout in East Asian development policy actually took place in Japan** during the Meiji era. The Meiji oligarchs spent a great deal of time travelling the world to discover what policies and structures could help them develop, but they also took development into their own hands. The Chinese have followed that example. The Chinese Communist Party was very diligent in consistently evaluating the advice it received, partly due to paranoia, and this served the Party well by allowing it to tailor advice to suit China's needs.

So the intellectual starting point for East Asian development policy came from Japan. It was then filtered through Korea and Taiwan, both of which were Japanese colonies. The advantage they got from being the colonies of an industrialising power, instead of the industrialised European colonial powers, was that they could see development happening in real time. China's policy track was a bit more confused, starting with the Japanese model but then being diverted by Russian communism.

This transmission of ideas is important for understanding the development of all the East Asian countries. **In Southeast Asian countries that have not seen the same rapid, positive development stories, the problem is most often that this transmission process breaks down**. Moreover, countries like Japan and Korea that are further along in their development tend to give the wrong advice, focusing on what works for them at the time rather than when they were at a previous stage of development. This can be seen with Malaysia's effort to learn by engaging with Japan and Korea, as well as with the Chinese presence in Africa. **Joe Studwell** is hopeful that Vietnam can break out of that pattern and become the first Southeast Asian success story.

Having established that China did not create the model, **Joe Studwell** explains that there are certainly things to be learned from China's version of it.

In East Asia, Japan, South Korea, Taiwan, China, and hopefully Vietnam have emerged as the successes, as compared to the Philippines, Indonesia, Malaysia, and Thailand. Looking at these case studies, three policy dimensions stand out.

The first is **getting the most out of human capital when skills are lacking**. All the East Asian countries saw their populations double or triple within 50 years after World War II, leading to massive amounts of human capital. But what the success stories have in common is having made use of this resource, **especially through land reform**. Land reform policies in these countries pushed aggregate agricultural output up by 50-75% in seven to ten years. This was possible because agriculture is one sector where, unlike manufacturing, returns are in inverse proportion to scale if cheap labour is super-abundant. Studwell likens such high-yield farming to gardening – average farm size in land reform countries was only 1 hectare.. The increase in output allows for more investment and consumption, and it provides a broad-based increase in capital which primes rural industrialisation, creating a "perfect capitalist laboratory" where everyone has some capital they can use to compete.

The second commonality of these successful countries is **an acute, policy-driven focus on manufacturing**. Manufacturing is good for developing economies because of the high potential for productivity gains. It also has a nice learning curve, because unskilled labourers can learn on the job and increase their human capital while still producing positive economic gains. Beyond that, manufacturing is the best way for a country to get involved in global trade. The development of infrastructure, though of course it is positive in and of itself, is also connected to this focus on manufacturing. Working to improve infrastructure creates demand for domestic manufacturing industries.

The final point, **the prerequisite for accomplishing either of these tasks, is financial repression, and above all capital controls**. No country in the world, save the offshore centres, has successfully developed without capital controls. By using industrial policy to pursue accelerated development, countries are prioritising technological learning ahead of short-term profits as they seek to improve their comparative advantage. In order to be able to push capital in certain directions while still allowing for competition, governments turn to controlling the allocation of capital. This can come through a focus on banks instead of stocks and bonds, regulation of interest rates, low deposit rates, central bank rediscounting of policy loans, and more.

Joe Studwell then briefly explains **what went wrong in Southeast Asia** regarding these three conditions of success. There has been, more or less, a total lack of land reform. Rather than domestic manufacturing, the focus has been on multinational processing, which undermines the learning-by-doing effects. Industrial policy is often poorly implemented, with no domestic competition and no pressure to export. Of course the legacy of colonialism in Southeast Asia has an effect. But to completely avow the 'dependency' view is to avow that nothing can be done to change the course of these states' development. Studwell rejects this.

With all that said, is China different? Though its development has mostly followed the established model, China is different for two reasons. First of all, **China is developing in a much more global context**. Japan, Korea, and Taiwan's development took place during the Cold War, with a great deal of indulgence from the United States. Today, China is not a US ally and likely will not become one. The US has demanded market opening from China much earlier than the other countries. But even though the global nature of today's development can make things difficult, it also provides advantages. Recruiting people, buying firms, and licensing technology has never been easier. This global reach has led to the rise of very cosmopolitan Chinese companies in the private sector, incorporating foreigners and a great deal of knowledge about the outside world. This is certainly something that other East Asian countries could learn from.

The second difference in China's development is **its talent for learning from the three East Asian exemplars that came before**. The government and the planning apparatus have looked very closely at Japan, Taiwan and Korea and incorporated lessons that could help China avoid problems.

Problems, of course, always arise, and **Joe Studwell** warns of a major pitfall in looking for permanent solutions. **There are no permanent solutions to economic problems**, only solutions to particular problems at particular stages of development. While the successful East Asian countries have been able to increase their GDP per capita very significantly, a bigger problem comes in managing the new vested interests and rigidities that inevitably flow from dirigiste development policies.

For China, a few steps can be taken into the future to help maintain growth. The market must begin to have more control in the allocation of capital. China is already moving in that direction with the Third Plenum. There should also be more of a focus on institutions. Though China will not move as quickly on that front as it should for optimum development, **Joe Studwell** is encouraged that institutional change is on the agenda as well.

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Jean-Christophe Defraigne raises a few points about **Joe Studwell's** book and presentation. First, he briefly mentions the intended audience of the book. It is relevant beyond Asia, really for any developing country, anyone studying economic development, and perhaps even EU officials.

The methodology of the book is also interesting—very much connected to economist Friedrich List. It rejects many of the mainstream international economic theories, and the focus on industrial policy and state-controlled financial policy is Listian as well. The abundance of case studies and economic history set the book apart from many of its predecessors and helps to explain **why certain policies were necessary for the development of the East Asian successes**.

Jean-Christophe Defraigne then **examines the priorities and sequence of conditions for success**. Land reform is completely valid. In terms of manufacturing, it is of course important that the manufacturing capacity be truly autonomous. But export discipline, along with some element of competition to avoid rent-seeking, is equally significant for allowing manufacturing to have the strongest possible effects on development. As far as capital control is concerned, the main point is to make sure that capital is used for development and not for consumption. Having enough capital at cheap rates available for business and for agricultural producers would also be a positive, and that is something that is not seen in many developing countries today.

An important consideration with regard to the East Asian development successes is the exogenous factors. Though **Jean-Christophe Defraigne** agrees with the sequence of conditions for development, he maintains that **there is an element of luck needed as well**. Japan, for example, certainly followed all the policy elements that **Joe Studwell** named, but it had a few lucky breaks too. In 1910, Japan had a major trade deficit and a great deal of external debt. But World War I gave Japan the ability to reverse its trade deficit into a large surplus, making enough money to pay back its external debt and capture economies of scale through more robust industrial policy. In 1944-45, Japan was lucky again, as the US decided to support it during the Cold War to create industrial opposition to the Soviet Union, communist China, and North Korea. This led the US not only to pursue Japanese land reform but to organise a great deal of technology transfer as well.

The US undertook a great many technological and development programmes in East Asia, but the Northeast Asian countries were able to make more of that assistance than the Southeast Asians because they followed the sequence mentioned in the book. Even so, though, the context of the Cold War surrounding US support cannot be reproduced, so it has a certain exogenous quality of influence.

Jean-Christophe Defraigne's last comment is about public goods. Some of **the mentioned East Asian countries were very successful in two key public goods**. The first is education. The second is infrastructure. One reason China has been able to develop so well is because its transport and energy infrastructure easily facilitates exports. Treating infrastructure as a public good with positive effects is essential for the development of these nations.

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DISCUSSION

An audience member asked if there were any Western European comparisons to be made with this development model, and why economists in the past had been so wrong in predicting that Africa would develop before Asia.

Joe Studwell brings up the comparison of **Sweden**, which is particularly interesting because it shows that these types of economic and developmental reforms do not always need to be accompanied by a very authoritarian approach to governance. There is also the example of **Italy**, which is very similar in its pursuit of post-WWII land reform and its high degree of rural industrialisation resulting from industrial policy.

As regards past negativity about Asian development, part of the issue is that many observers were basing their analyses on cultural factors. While these may have been valid approaches in the 19th century, in China, the Communist Party took over and changed the culture. **While it is better to change the economic position of a society and wait for the culture to catch up, it is possible to change the cultural position as well (typically by violent revolution)**.

A participant wondered about the ability of the Chinese education system to keep up with the rapid pace of development. This participant also asked how to deal with the major problem of bad loans being given in China.

Joe Studwell explains that **the Chinese education system is not in the best shape at the moment**. There is a great deal of corruption. The *hukou* system excludes migrant populations from education. The pedagogy is extremely old-fashioned. What is the way around all these problems? China has allowed more foreign education providers into its market, and it is very popular to send students abroad for university and, increasingly, secondary education. But this will not substitute for a substantive reform of the domestic system, whose negative repercussions will only increase as time goes on.

An audience member mentioned that one thing that sets China apart from, for instance, Japan or Korea is its cultural heterogeneity. This participant questioned how much of a role the cultural differences might play in analysing the development of East Asian countries.

According to **Joe Studwell**, it is true that China has a very high number of Non-Performing Loans in the system. But **contrary to those who predict these NPLs will lead to the collapse of the Chinese economy**, there has been a significant shift in capital allocation within the banking system towards the private sector in recent years (he recommends Nicholas Lardy's latest book on this). Also, if it becomes truly necessary, China's public debt is only around a quarter of GDP and this menas the government can afford another recapitalisation of the banking system. This should of course be a last-ditch policy, but it is a possibility.

Jean-Christophe Defraigne concludes asserting that **there is still a great deal of national feeling among the Chinese**, despite there being a large ethnic and regional diversity. This has been one of the long-term effects of the central government taking so much of the policymaking authority into its own hands. Of course culture is not irrelevant for any of these developmental questions, but **it is not as important as class structure, economic development, colonialism, and technology**.

Joe Studwell agrees, stating that **China has developed very strong capacities for dealing with its cultural heterogeneity**. One of these tricks is the rotation of provincial leaders. The party schools, both in Beijing and at the provincial level, also go a long way towards establishing a national political agenda. There is also a great deal of internal migration that helps to break down cultural barriers. So although culture is important, there are systems in place which make it less so in the development context.

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