

HANDBOOK ON THE NORTHEAST AND SOUTHEAST ASIAN ECONOMIES

Handbook on the Northeast and Southeast Asian Economies

Edited by

Anis Chowdhury

Professor of Economics, School of Economics and Finance, University of Western Sydney, Australia and Managing Editor, Journal of the Asia Pacific Economy

Iyanatul Islam

Professor of International Business, Griffith Business School and Griffith Asia Institute, Griffith University, Australia and Co-Editor, Journal of the Asia Pacific Economy

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Contributors

Ahmad Zubaidi Baharumshah is Professor of Economics at the Faculty of Economics and Management, Universiti Putra Malaysia (UPM). He completed his PhD at the University of Illinois, Urbana-Champaign. Currently, he is Deputy Dean of Research and Graduate Studies at the Faculty of Economics and Management, UPM and Head of Program/Research Fellow at the Institute of Mathematical Research (INSPEM) at UPM. He is now the President of the Malaysian Agricultural Economic Association and the Editorial Member Committee of the *Malaysian Journal of Agricultural Economics* (MJAE). Professor Ahmad Zubaidi Baharumshah is a regular contributor to international journals and has published more than 70 research articles. His work has appeared in *Economic Letters*; *Journal of Post Keynesian Economics*; *Journal of Policy Modeling*; *Japan and the World Economy*; *Global Finance Journal*; *China Economic Review*; *Savings and Development*; *Open Economies Review* and *Journal of Asian Economics*, among others. To date, he has authored and co-authored more than 16 book chapters. His latest edited book is *Open Economy Macroeconomics in East Asian Countries* (Ashgate, 2005).

Melanie Beresford is Associate Professor in Economics at Macquarie University, Sydney. Her publications on Cambodia include *The Macroeconomics of Poverty Reduction in Cambodia* (UNDP, 2004) and an article in *Asian Survey* (2005). She has also published numerous works on the Vietnamese economy.

Andrea K. Chareunsky was born in Pakse, Southern Laos. She is currently completing her PhD on the economics of human capacity building in a least developed country, focusing on Laos, and teaching (Associate Lecturer) in the Economics Department at Macquarie University, Sydney.

Chia Siow Yue is currently Senior Research Fellow at the Singapore Institute of International Affairs, a non-profit policy research institute. She was formerly Economics Professor at the National University of Singapore, Director and Chief Executive of the Institute of Southeast Asian Studies (Singapore) and Director of the Singapore APEC Study Centre. She was also the founder Regional Coordinator of the East Asian Development Network (EADN) until September 2004 and is currently the country coordinator for Singapore. Her current research activities are mainly in the areas of regional economic integration in ASEAN and East Asia, foreign direct investment, labour migration, poverty and gender issues. Her professional activities include consultancies with international and regional organizations such as the World Bank, UNCTAD, WTO, ILO, OECD Development Centre, ADB, UN ESCAP and the ASEAN Secretariat, as well as with national and private sector organizations. She serves on the advisory and editorial boards of several academic journals in and on the Asia Pacific region.

Wan-wen Chu is Research Fellow at the Research Center for Humanities and Social Sciences, Academia Sinica in Taiwan. She has a PhD in economics from Stanford University. She has published studies on East Asian economic development, and is the co-author of *Beyond Late Development: Taiwan's Upgrading Policies*.

Craig Freedman BA St John's (MD), MBA University of California (Berkeley), MA and PhD University of Massachusetts (Amherst). He is Associate Professor, Department of Economics, Macquarie University (Sydney) and Director of the Centre for Japanese Economic Studies (Macquarie University). He is also a widely published author on the economy of Japan.

O. Yul Kwon is currently Korea Foundation Chair in Korean Studies, and Director of the Australian Centre for Korean Studies, Griffith University. Before joining Griffith University, Dr Kwon was Professor at the University of Regina, Canada, and was the Director of the University's Institute for Northeast Asian Studies. Professor Kwon has published a number of books and articles in refereed journals and business magazines, chapters of books and special columns in newspapers. His recent research interest focuses on the Korean economy, its international economic relations and international business.

Kui-Wai Li's research specializes in the areas of economic and financial development, industry and trade and focuses on China and other Asian economies. He is the author of *The Hong Kong Economy, Recovery and Restructuring* (2005), *Capitalist Development and Economism in East Asia: the Rise of Hong Kong, Singapore, Taiwan and South Korea* (2002), *Financial Repression and Economic Reform in China* (1994), and edited *Financing China Trade and Investment* (1997). Dr Li has worked as a consultant to international institutions, foreign governments and business, and has regularly been interviewed by local and foreign press, radio and television on Hong Kong, mainland China and foreign issues.

Joseph Anthony Y. Lim finished his PhD in Economics at the University of Pennsylvania in 1985. He was a post-doctoral visiting researcher in the University of Cambridge in 1988–89. He has several published articles on the East Asian Crisis, the Philippine macro-economy and other Philippine economic issues (such as child labour and gender employment). He is now a Professor in the Economics Department of the Ateneo de Manila University in the Philippines.

Rosnah Opai graduated in 1991 with BA (Ed) Hons, Universiti Brunei Darussalam (UBD). She served as Education Officer, 1991–94 under the Ministry of Education, Brunei. She received a Special Scholarship Award (Asian Youth Fellowship Programme) from the Japanese Government in 1997. She obtained an MSc (Development Planning Studies) from Hiroshima University, Japan in 2001. She is currently Lecturer in the Economics Department, UBD.

Frank Ruediger is a German national with an MA in Korean Studies, Economics and International Relations and a PhD in Economics. He is a Professor at the University of Vienna. He has taught various issues of East Asian and North/South Korean political economy at Humboldt University Berlin, Mercator University Duisburg, Columbia University New York and Korea University Seoul. He visited North Korea in 1991–92 to study at Kim Il-sung University, and in 2004 and 2005 as part of an EU delegation for seminars on economic cooperation and reform. He has written four monographs, over 20 book chapters, and over 40 articles on contemporary East Asian affairs with a focus on Korea. For more information see <http://www.univie.ac.at/koreanologie/frank>.

Somboon Siriprachai is Associate Professor at the Faculty of Economics, Thammasat University. He received his PhD from the Department of Economic History at Lund

University, Sweden. His main research focus has been mainly in the area of economic development and economic history of Thailand. He is currently working as the Deputy Director of the WTO Watch Project funded by the Thailand Research Fund.

Thee Kian Wie is senior economist with the Economic Research Centre, Indonesian Institute of Sciences (P2E-LIPI), Jakarta. He received his PhD in economics from the University of Wisconsin, Madison, USA in 1969. His major research interests are Indonesia's modern economic history and industrialization, foreign direct investment and technological development in the East Asian countries, particularly Indonesia. His most recent books include *The Emergence of a National Economy – an Economic History of Indonesia, 1800–2000* (co-author with Howard Dick, Vincent Houben and J. Thomas Lindblad, Allen & Unwin, 2002) and two edited books, *Recollections – The Indonesian Economy, 1950s–1990s* (Institute of Southeast Asian Studies, 2003) and *The Asia-Pacific Century in Historical Perspective* (LIPI Press, 2005).

John Thoburn is a Reader in Economics in the School of Development Studies, University of East Anglia, Norwich, UK. In recent years he has also held Visiting Professorships at the Universities of Nagoya and Kobe in Japan. He has been working on a research project financed by the UK Department for International Development on globalization and poverty in Viet Nam and South Africa, and he has a long-standing research interest in the economies of China and Southeast Asia. He has authored or co-authored five books on development. His papers have appeared in many journals including the *Journal of International Development*; *Journal of Development Studies*; *IDS Bulletin*; *Oxford Economic Papers*; *Oxford Bulletin of Economics and Statistics*; and the *Journal of African Economies*. He guest-edited a special issue of the *Journal of the Asia Pacific Economy* in 2004 on 'Globalization and Poverty in Vietnam'. He has consulted for a number of organizations, including the United Nations Development Programme, the United Nations Industrial Development Organization, the UK Department for International Development, the ASEAN secretariat and the UN Economic and Social Commission for Asia and the Pacific.

Tin Maung Maung Than, a Myanmar national is a Senior Fellow at the Institute of Southeast Asian Studies (ISEAS). He obtained a PhD in Politics from the School of Oriental and African Studies, University of London, a post-graduate diploma in economic planning from the Institute of Economics in Yangon and an MSc in Nuclear Physics from the University of Yangon. His research interests cover Myanmar politics and economics as well as political culture, democratization, civil–military relations and nuclear proliferation. A member of the International Institute for Strategic Studies (London) and the Association for Asian Studies (USA), he is also the Associate Editor of the ISEAS journal *Contemporary Southeast Asia* and the series editor of *ISEAS Working Papers*. Over two decades, he has contributed more than 70 articles in newsletters, newspapers, journals and edited volumes.

Huijiong Wang is a Senior Researcher and Vice President at the Academic Committee of Development Research Center of the State Council (DRC) in China. He has 25 years of experience of policy research on various issues confronting China. He was responsible for several major domestic and international joint research projects, such as 'China Toward the Year 2000', 'Industrial Policy and Industrial Restructuring' (joint research

with the World Bank), and UNDP project 'Integrated Study of Development and Reform of China'. He has been a part-time professor in six universities in China, short-term consultant of UNIDO, UNDP, World Bank, ADB, ESCAP and OECD. His recent publication is *Integrated Study of China's Development and Reform: Initial Exploration of Social System*, composed of selected papers and speeches given abroad (English version published in 2003). A Chinese version of it was published in 2004.

Preface

Undoubtedly, the rapid transformation of a band of four Northeast Asian economies (South Korea, Taiwan, Singapore and Hong Kong) since the mid-1960s has been unprecedented in economic history. Their experience has surpassed the earlier experience of Japan's transformation into an industrial economy, and that of the former USSR. Although some similarities between the development strategies of these economies and that of Japan exist, there are significant differences between them, as well as among the four economies themselves, especially in the role of the state. Thus grew a voluminous literature trying to understand the so-called 'Northeast Asian development model'. The literature has become much more extensive with the rise of second-generation, newly industrializing economies in Southeast Asia, and lately, of China and other transition economies such as Viet Nam.

Just when a broad consensus about the basic ingredients for rapid growth appeared to have been reached, the sudden coming of the Asian crisis caught most observers by surprise. Vigorous debates about the causes of the crisis, appropriate policy mix and the institutional arrangement for rapid and sustained growth re-emerged. In other words, the validity of the Northeast Asian development model has been called into question. Observers are also examining the cost of such a rapid transformation and likely future challenges in a fast-changing world.

Thus, Northeast and Southeast Asia provide a fertile ground for contesting hypotheses about development strategies. The introductory chapter provides a comprehensive survey of paradigm shifts in development economics, influenced by the experience of Northeast and Southeast Asia. It also focuses on the debates surrounding the rise of China, its future prospects and the challenges it poses to the other economies in the region. Of particular importance is the issue of political reforms and the democratization of China's polity.

The country chapters provide a broad overview of economic and social developments in each of them. The analytical narratives on the economic transformation of these economies are based on the extant literature, and highlight the interactions of socio-political factors. They examine the role of economic policies that were influenced by the historical and political circumstances of individual countries. Each chapter, written by country experts, begins with a brief discussion of the political history of the country and ends with a discussion of future prospects and challenges.

The country chapters are organized in chronological order of their transformation. Thus, the introductory chapter is followed by the chapters on Japan and the first-generation, newly industrialized economies. The chapters on the emerging economies of Southeast Asia are presented next. China heads the list of transition economies, and the volume ends with the chapter on North Korea. The organization of the volume highlights the regional interactions and pull-factors, as well as the evolution of development strategies in light of each country's specific circumstances and the experience of the early starters.

We dedicate this volume to the achievements of the people of Northeast and Southeast Asia.

Introduction: Northeast Asian economic development: which way now?

Iyanatul Islam and Anis Chowdhury

Setting the context

In 1983, the Nobel Laureate Amartya Sen, posed an important question. ‘Development’, he asked, ‘which way now?’¹ At the time, ‘traditional development economics’, as Sen put it, was under attack from economists with conservative proclivities. They admonished policy-makers in the developing world for adhering to the ‘dirigiste doctrine’ – a doctrine that held sway since the end of World War II. Based on the notion that the state should be the engine of growth, policy-makers in many developing economies adopted import-substituting industrialization as the path to self-sustaining growth, and generally intervened in both product and factor markets quite extensively. Often, elaborate five-year plans were drawn up to underpin a state-led strategy of industrialization.

Against the background of a turbulent international environment in the 1970s and early 1980s, characterized by oil price shocks, worldwide inflation and external debt crises, conservative economic thinkers wanted to liberate the developing world from the ‘poverty of development economics’.² They enunciated a brave new world in which the private sector rather than the state, and export orientation rather than import substitution, would be the key drivers of growth. A small group of countries in Northeast Asia, most notably Singapore, Hong Kong, Taiwan and South Korea, were often held up as rare exemplars that managed to go against the prevailing influence of the dirigiste doctrine since the 1960s and earned the enviable distinction of being some of the fastest-growing economies in the world. More importantly, they became showcases of ‘shared growth’; that is, of rapidly growing economies exhibited by sharp reductions in poverty and relatively low levels of inequality. There was a firm conviction among critics of dirigisme that Northeast Asia was the wave of the future and the iconic exemplar of a paradigm shift in development thinking.

When Sen reflected on the troubles of traditional development economics, a paradigmatic shift in developing thinking was indeed underway. In 1980, the Bretton Woods Institutions launched their ‘structural adjustment lending’ (SAL). The purpose of SAL was to use concessional lending to bring about a change in development strategy so that the developing world at large would converge to the Northeast Asian standard of private-sector-driven, export-oriented industrialization. Between 1980 and 1998, close to 1000 SALs were launched.³ The new thinking on development policy was codified in 1990 as the ‘Washington Consensus’,⁴ representing a set of ‘best-practice’ policies. The policy mantra invoked the trinity of macroeconomic stabilization, privatization and liberalization.

As the 1990s progressed, the evolution of development paradigms became more complex. In 1993, the World Bank offered its paean to the ‘Northeast Asian miracle’.⁵ To the original list of four Northeast Asian stalwarts was added a longer list of Southeast

Asian economies – most notably, Indonesia, Malaysia and Thailand. By then, China had truly emerged on the global stage and competed with its Northeast Asian counterparts for the mantle of shared growth. Yet, the interpretation of Northeast Asian success became more eclectic. The World Bank recognized that the Northeast Asian experience did not fully conform to the policy mantra of the Washington Consensus. China was, after all, still one of world's pre-eminent communist states. Admittedly, it made a transition towards a market economy in 1978 and embraced export-oriented industrialization as well as foreign direct investment, but the state still loomed large over the Chinese economy. At the same time, a well-established literature on Northeast Asian political economy demonstrated that the state played a key role in driving the process of industrialization in the first-generation cases as well. This led the World Bank to declare that the synergistic interaction between the state and the market laid the foundations of shared growth in East Asia.

Within four years of the World Bank's celebration of the 'Northeast Asian miracle', a financial crisis swept the region. In mid-1997, massive outflows of capital from the region saw an outbreak of sharp falls in the exchange rate in a number of countries. Soon, financial crises mutated into a 'real sector' crisis, as some of the economies – most notably Indonesia, Malaysia, South Korea and Thailand – experienced the worst recessions in their recent economic history. Although all the economies have seen recovery and the resumption of growth, the euphoria surrounding the Northeast Asian miracle seems to have evaporated.

The 1997 financial crisis that overwhelmed some Northeast Asian economies also paved the way – along with other global events – for both a rethinking of the Northeast Asian model and a rethinking of the Washington Consensus.⁶ The very strengths that were attributed to Northeast Asian success, most notably the close interaction between the state and the private sector, now became liabilities and were scorned as the excesses of 'crony capitalism'. Both the Northeast Asian and the global development agenda seemed to move away from 'market fundamentalism' (as reflected in more strident versions of the Washington Consensus) to a form of 'institutional fundamentalism'.⁷ Defective institutions – or poor governance – were, its advocates argued, the source of the crisis, and institutional – or governance – reform became the new policy mantra for reinvigorating East Asian growth.

It is apt to ask: whither Northeast Asian economic development? Is the institutional fundamentalism an appropriate reconfiguration of both the Washington Consensus and the pre-crisis Northeast Asian model, or is it an overreaction that misunderstands both the sources of Northeast Asian success and the 1997 financial crisis? How does one account for the rise of China? What are its implications for Northeast Asia's future? These are crucial issues and their resolution is likely to play a major role in influencing the evolution of the Northeast Asian economies in the 21st century.

The rise of Northeast Asia: the pre-crisis years

Despite the hyperbole, the pre-crisis years of rapid growth, sharp reductions in poverty and relatively moderate levels of inequality witnessed in a number of economies in the Northeast Asian region were not a mirage. China, Thailand, Singapore and Hong Kong were among the top ten growth performers in the world between 1978 and 1994.⁸ Indonesia and Malaysia were among the top 20 fastest-growing economies between 1965

and 1985.⁹ A comparative historical perspective enables one to appreciate the scale of the achievements. For example, it took some of the rich countries of today – such as the United States and the United Kingdom – between 50 and 58 years to double their income. It took Japan 35 years to double its per capita income. By contrast, China and Korea doubled their per capita income in ten years.¹⁰

As noted, rapid Northeast Asian growth was juxtaposed with sharp reductions in poverty, prompting some observers to proclaim that the regional achievements represented the fastest reduction of poverty in human history. In 1975, 57.7 per cent of the population in Northeast Asia were poor (based on an international poverty line of US\$1 per person per day at 1985 prices). By 1995, the incidence of poverty came down to 21.2 per cent. In terms of all other indicators of social progress – life expectancy, infant mortality, basic education, literacy rates, etc. – the Northeast Asian economies outperformed many developing countries.¹¹

The analysis of Northeast Asian success should proceed on the premise of a distinction between ‘core’ and ‘non-core’ groups. The former pertains to the four ‘Asian tigers’ – Hong Kong, Singapore, Korea and Taiwan – that first came to worldwide attention for their economic achievements. Members of the non-core entail China and some of the populous Southeast Asian economies. In terms of living standards, level of technology, quality of infrastructure and human capital, these countries are some way behind the ‘club of four’ and have a lot of catching up to do. Projections made before the 1997 crisis suggest that the core group will have a per capita income ranging between US\$25 000 to US\$30 000 by 2025. Among the Southeast Asian economies only Malaysia might fall in that range. On the other hand, Indonesia, Thailand and China are expected to have a per capita income of approximately US\$10 000 by the target date.¹²

There has been a tendency among some analysts of Northeast Asian economic development to conflate the core and non-core groups. This has meant that explanations developed to explain the case of the core economies have, at times, been uncritically applied to the rest. Nevertheless, one could argue that some common attributes are shared by the Northeast Asian economies. Such similarities may be enunciated in the form of the following propositions:

- The Northeast Asian economies have generally been characterized by macroeconomic stability, thrift as reflected in a high savings rate, substantial investments in physical and human capital and the provision of basic infrastructure.
- An export-oriented industrialization strategy combined with significant reliance on either foreign capital (as in the case of Singapore and Malaysia) or imported technology (as in the case of Korea) drove economic growth.
- In some cases, such as Korea and Taiwan, favourable historical circumstances facilitated the take-off of some of the Northeast Asian economies. Salient examples include land reform and the massive inflows of US aid to these economies during the 1950s and early 1960s. Land reform in Korea and Taiwan contributed to relatively low levels of inequality. Studies show that there is a systematic correlation between rapid growth and an initially low level of inequality. This is largely due to the relative insignificance of growth-retarding ‘distributional politics’ in countries with moderate levels of inequality. The strategic benefits of US aid also should not be discounted. They engendered some degree of political and economic stability.

Furthermore, countries such as Korea and Taiwan were regarded as bulwarks by the United States against the spread of communism in Northeast Asia during the era of the Cold War. This meant that the first-generation exporters in the region had favoured access to US markets.

- Most of the Northeast Asian economies were also characterized by the prevalence of growth-promoting values. Several observers have attributed such values to the legacy of Confucianism. The latter – in its modern form – has entailed the virtues of thrift, diligence and discipline, respect for order and authority and an almost reverential attitude towards education. It is perhaps not surprising that, by 1960, the Northeast Asian economies had educational attainments that exceeded developing country standards. Thus, the necessary foundations existed for the nurturing of competent bureaucrats, risk-taking entrepreneurs and hard-working, disciplined, if docile, workers.
- Appropriate institutional arrangements – entailing close government-business collaboration – were key to the effective implementation of growth-promoting policies.

There was a time when the first-generation Northeast Asian success stories were simply seen as the product of a virtuous combination of ‘free trade and free markets’.¹³ The role of history, culture, politics and institutions were regarded as either unimportant or, at best, of marginal relevance. Largely because of the work of some regional specialists, this ‘naive neoclassical story’ is no longer regarded as a satisfactory explanation of the Northeast Asian miracle.¹⁴ There is now widespread recognition that growth in the core Northeast Asian economies has been state-led.

Debate persists on the extent to which an activist industrial and trade policy contributed to Northeast Asian economic development. Some authors maintain that the governments were able to ‘pick winners’ through a combination of selective protection and exposure to international competition. Others are less confident about the efficacy of such policies. While conceding that the policies of picking winners could have worked in the particular institutional context of Northeast Asia, the sceptics argue that these policies are vulnerable to a range of risks. For example, the support of loss-making industries might be driven by political expediency rather than a rational calculation of the ex-ante social benefits that could conceivably flow from productive investments in ‘infant’ industries. Trade policy interventions that are typically associated with Northeast Asia of the 1960s are incompatible with current international trading agreements. There is the risk of retaliation by major trading partners. Industries in the fast-moving high-tech sector are not easily amenable to government intervention.¹⁵

Given such concerns, and given the inherent difficulty of empirical verification of competing hypotheses, it is best to focus on the ‘policy fundamentals’ (macroeconomic stability, outward-orientation, rapid physical and human capital accumulation) and the institutional framework that drove Northeast Asian growth in the pre-crisis era.

The salient features of the institutional framework that lie behind the Northeast Asian miracle might be summarized as follows:

- a system of governance that shielded ‘technocrats’ or key policy-makers from the pressures of special interest groups – sometimes known as ‘technocratic insulation’;
- merit-based civil service with considerable in-house expertise in economic policy-making;

- close collaboration between the government and key representatives of the private sector through both formal and informal networks that facilitated information-sharing.

The existence of ‘technocratic insulation’ meant that economic and social policies could be pursued in the ‘public interest’ rather than being beholden to the sectarian interests of lobbies. A merit-based civil service meant that the administrative ability existed for the effective and timely implementation of key policies and the collaboration between the government and key business groups for the creation and sustenance of a common national vision that underpinned rapid growth.

Northeast Asia and the 1997 financial crisis: contested perspectives and controversial policy responses

As noted, events in mid-1997 transformed the Northeast Asian economic boom into a growth collapse in a number of cases. Equity prices and exchange rates plummeted to well below their pre-crisis levels. Korea, Malaysia, Thailand and Indonesia experienced steep recessions, while at times, poverty and unemployment rose sharply. There has, over the space of two to three years, been the recovery and resumption of growth, but in a number of cases, the boom conditions of the pre-crisis era are yet to materialize.

What went wrong in Northeast Asia? What are the lessons to be learnt from the painful experience? What lies ahead? An attempt to resolve these issues has spawned a sizeable literature. A comprehensive coverage is beyond the scope of this introductory chapter, but some broad observations are worth making.

First, there is the paradox of the ‘miracles’ that, almost overnight, became crisis-afflicted economies. Here, the pre-crisis literature seems to be caught in an intellectual straitjacket. Recall that pre-crisis Northeast Asia was held up as a rare exemplar of macroeconomic prudence and a distinctive style of growth-promoting governance. It is now difficult for the cheerleaders to condemn these countries as victims of either unsustainable macroeconomic imbalances or crony capitalism. Yet, this is what some influential protagonists in the debate on the 1997 financial crisis tended to do without reflecting on the internal contradictions of such a position. Perhaps the most conspicuous is the case of the IMF and the role that it played in dealing with the crisis-affected economies.

The IMF diagnosed the 1997 financial crisis as the twin products of unsustainable macroeconomic imbalances and institutional imperfections. The design of its initial rescue package bore the imprint of such a mindset. The IMF recommended sharp fiscal contractions and substantial increases in interest rates to stabilize the exchange rate. At the same time, it proposed wide-ranging structural and institutional reform to rectify alleged deficiencies in the financial system, the corporate sector and public administration. The expectation is that this dual approach of attacking perceived macroeconomic imbalances and institutional vulnerabilities would win back the confidence of international investors, and engender a resumption of capital inflows that would, in turn, nurse the crisis-affected economies back to recovery. It is now recognized that the IMF package probably worsened the severity of the crisis.¹⁶ As the IMF notes, it did not anticipate that the region ‘was heading for a major economic slowdown’.¹⁷

It is possible to take a radically alternative view that the Northeast Asian crisis had little to do with internal causes. In this analytical framework, the 1997 financial turmoil was

externally driven by the particular way in which the global capital market functions. In an era of high capital mobility, 'hot monies' can typically move in and out of regional economies with breathtaking speed because of adverse shifts in investor sentiments. Such shifts can be entirely rational responses, reflecting a correct assessment of poor economic fundamentals, but can also be 'overreactions'. This can also be due to a number of factors, such as herd behaviour, or even an inaccurate appraisal of the underlying economic situation. In such a situation, regional economies can become the innocent victim of 'contagion' – or the notion that a financial crisis in one economy can spill over into another related economy, as nervous international investors pull out funds from a region and seek safe havens elsewhere. Some prominent economists have argued that the primary cause of the Northeast Asian crisis was indeed financial panic (or 'contagion' as noted above), driven largely by foreign investors. Hence, an approach that penalized national economies for the sins committed by others was fundamentally flawed.¹⁸

This alternative interpretation of the Northeast Asian crisis seems to have had some influence in shaping post-crisis developments. Global opinion has shifted from merely trying to engender reforms within Northeast Asia to reforming the international financial system as well. An important element of this initiative entails tighter checks on short-term capital flows across the world. At the same time, attempts have been made, and continue to be made, to foster greater regional cooperation across Northeast Asia on the premise that greater policy coordination and the pooling of financial resources can stave off the next financial crisis.¹⁹

One can, of course, craft a middle path between views that attribute the causes of the 1997 crisis to largely internal factors and views that interpret it as essentially an externally driven phenomenon. The notion that the crisis was simply driven by longstanding macroeconomic imbalances seems overstated. After all, the Northeast Asian economies were for decades before 1997 well known for their credible commitment to macroeconomic stability. These economies saved and invested at a very high rate – in the order of 30–40 per cent of GDP – but against a background of low inflation (usually well below 10 per cent) and relatively sound government fiscal positions.

However, in some cases, a favourable internal balance (reflected in a sound fiscal position) has not been matched by a comparable external balance. One could argue that an inflexible exchange rate regime compounded this mismatch and intensified the problems of a slowdown in export demand for key exports of the regional economies (such as semi-conductors) that emerged in 1996. It is pertinent to recall here that most of these economies had tied their currencies to the US dollar. When the dollar appreciated 50 per cent against the yen, it led to a predictable loss of international competitiveness. This widened the trade deficit in many of the Northeast Asian economies and raised concerns about its sustainability. In the case of Thailand, for example, the current account in the 1990s approached 8 per cent of GDP. Furthermore, an increasing proportion of the external deficit was financed by short-term capital inflows. These developments prompted the Asian Development Bank (ADB) to speculate on the risks that lay ahead. Commenting on Thailand, it made the following remarks that in retrospect appear prophetic:

The current account deficit reached an historically high level . . . in 1995. Large capital inflows continued to cover the deficit . . . However, there was a change in the composition of capital inflows: portfolio and direct investment weakened while short-term inflows to the banking sector increased . . . This heavy reliance on foreign saving is of . . . some concern as a sudden change

in the international perception about the soundness of the Thai economy could cause serious difficulties.²⁰

When a heavy reliance on foreign saving is combined with weak financial regulation, the net effect can be deleterious. As Joseph Stiglitz has emphasized, the juxtaposition of large-scale capital inflows combined with weak financial regulation:

allowed lenders in many Southeast Asian countries to rapidly expand credit, often to risky borrowers, making the financial system more vulnerable. In Thailand, for instance, banks and other financial institutions took large, short term dollar denominated loans from foreign lenders, then re-lent the money to fuel a domestic real estate boom and stock market speculation.²¹

Weak financial regulation in much of Northeast Asia is a reflection of a weak financial system that has been saddled with a significance of non-performing loans. In the past, rapid growth masked systemic weaknesses in the financial system, but they have become exposed because of increasing financial integration.

In sum, the contested perspectives on the causes of the Northeast Asian crisis and the controversy caused by the IMF-led policy response to it suggest a greater need to develop a much more nuanced understanding of the Northeast Asian model of economic development and its future evolution. Some of the proponents of the Northeast Asian miracle made an important contribution by highlighting plausible sources of shared growth and by debunking the naive view that these economies were iconic exemplars of free markets and free trade. They also did a disservice to the region by generating a sense of euphoria and by paying insufficient attention to putative macroeconomic and financial vulnerabilities that collided with the fickle sentiments of international investors in an era of rapid capital mobility. While it is an exaggeration to argue that the 1997 financial crisis was exclusively externally driven, attempts by some of the protagonists in the debate on the Northeast Asian crisis to interpret the event as the product of inherently internal weaknesses appear to be particularly troublesome. This view, as noted, is clearly inconsistent with the collective praise that was heaped on Northeast Asia's macroeconomic performance and its institutions during the golden age of growth. One must note that the very institutional frailties that some Northeast Asian economies are accused of are evident in China – and yet it did not become a victim of the 1997 financial crisis.

Despite these concerns, it is important to appreciate that the financial crisis and its aftermath enable one to focus on some long-term issues that remain highly pertinent in projecting the likely evolution of the Northeast Asian region in the 21st century. This forward-looking discourse represents the purview of the next section.

Transcending the crisis: long-term issues and the future of Northeast Asia

In moving forward in this discussion on Northeast Asia and its future, the following propositions may be highlighted:

1. Growth in the region appears to be primarily input-driven, not productivity-driven, raising concerns about future growth.
2. Inequality has re-emerged as a significant social issue in the region.
3. The protection and management of the environment has received insufficient attention in Northeast Asia. This could become a barrier to sustainable growth.

4. The rise of China has caused considerable ambivalence in the region and has brought to the fore longstanding issues about the development of broad-based political and social institutions and their relevance to respond to the challenges of the future.

Input-driven vs. productivity-driven growth

Paul Krugman is perhaps the best-known and provocative advocate of the view that growth in Northeast Asia may dissipate permanently – in the same way that rapid industrialization in the ex-Soviet Union came to a halt. As he puts it: ‘Asian growth, like that of the Soviet Union, in its high-growth era, seems to be driven by extraordinary growth in inputs like labour and capital rather than by gains in efficiency’.²²

Krugman offers the logic of elementary economics to substantiate his apocalyptic predictions. Thus: ‘Economic growth that is based on expansion of inputs rather than on growth in output per unit of inputs, is inevitably subject to diminishing returns.’ Hence, ‘input-driven growth is an inherently limited process’.²³

The much-cited and controversial contribution by Krugman relies heavily on a very few ‘growth accounting exercises’ that aim to isolate the sources of growth into ‘factor-driven’ and ‘productivity-driven’ components. Yet, the growth-accounting exercises are notoriously sensitive to changes in datasets and parametric manipulation. Others have produced rather different results and, in many cases, quite optimistic results.

Kenneth Kasa proposes an alternative approach. He focuses on a measurable notion of dynamic efficiency at the national level: if gross investment exceeds gross capital income (profit, rental and interest income) ‘then the financial sector is draining resources from the economy. This is inefficient, since the whole point of investment is . . . [augmenting] future consumption possibilities’. A dynamically inefficient economy, Kasa argues, is unlikely to be characterized by high productivity growth. Applying this method to Singapore using the 1975–95 data allows him to suggest – or at least does not allow him to rule out the possibility – that Singapore is over-investing and is not dynamically efficient. The IMF has also applied this criterion to Korea and come up with similar conclusions.²⁴

In sum, the Krugman hypothesis can by no means be dismissed, although it is difficult to support it conclusively. Yet, by engaging in a provocative discourse on the need to shift to productivity-driven growth as the only effective insurance against long-term economic slowdown, Krugman has certainly asked the right questions.

The re-emergence of inequality in Northeast Asia

As noted, pre-crisis Northeast Asia was hailed by many commentators as a rare example of ‘growth with equity’. New evidence compiled by several scholars suggests a less optimistic picture. As one author observes:

The available data indicate that the distribution of income in . . . [East Asia] . . . has shown a tendency to become more unequal in recent years. This is in contrast to their earlier periods of development where income inequality declined as the economies grew.²⁵

The phenomenon of growing inequality in a number of Northeast Asian economies became discernible in the 1980s. A scrutiny of the available evidence for that period suggests the following trends:

- Inequality rose sharply in Hong Kong (1980–91), Singapore (1980–89) and Thailand (1980–90).
- Moderate increases in inequality occurred in Indonesia (1987–93).
- Inequality remained either constant or declined slightly in Korea (1980–88), Malaysia (1979–88) and the Philippines (1986–99).²⁶

Other observers have also highlighted cases of growing inequality in Northeast Asia. Focusing on the case of China and Thailand, one writer notes that they bear the unenviable distinction of registering one of the highest increases in inequality in recent decades.

What has happened since the 1980s? The evidence is mixed. Data for the 1990s indicate that inequality in Hong Kong and Taiwan appears to have improved. In South Korea, inequality declined until 1993 and rose thereafter. The evidence for Singapore is mixed, with one set of estimates showing a decline in inequality and another showing widening disparities. The evidence also shows that, while the 1997 financial crisis paradoxically led to a reduction in the shares of the top income groups in Southeast Asia (the ASEAN-4), emerging trends indicate a rise in inequality since then.²⁷

Most of the studies cited so far report findings based on the well-known Gini ratio. One study uses an alternative index – the Theil index – to decompose trends in inequality between 1990 and 1997 into a ‘between-country’ and ‘within-country’ effect for eight Northeast Asian economies (China, Viet Nam, Thailand, South Korea, Philippines, Malaysia, Laos, Indonesia). With the exception of South Korea, inequality – based on the Theil index – rose in all the countries that were reviewed, signifying the importance of intra-country inequality as a key component of Northeast Asia-wide inequality. Not surprisingly, inequality in the region as a whole rose between 1990 and 1997. Given China’s large weight in the regional economy, the sharp increase in inequality in China – which doubled between 1990 and 1997 in urban areas – played the most significant role in the increase in inequality in Northeast Asia in the 1990s.²⁸

It appears that inequality may well be emerging as a significant social concern in the future of the Northeast Asian region. As Francois Bourguignon has noted, growth, poverty and inequality represent the ‘eternal triangle’.²⁹ Higher growth leads to lower poverty, but this can be offset by growing inequality. At the same time, rising inequality runs the risk of triggering growth-retarding effects. This can happen in a number of ways: by adversely affecting social cohesion and parity of opportunities; by lowering productivity and efficiency as scarce resources can be diverted into inefficient redistributive policies; by reinforcing credit constraints in a context of imperfect credit markets that impair the capacity of individuals in unequal societies to finance much-needed investments in human capital. In sum, policy-makers in post-crisis Northeast Asia can no longer seek comfort from the somewhat outmoded notion that the inequality does not matter as long as growth takes care of the problem of poverty. The eternal triangle of growth, poverty and inequality cannot be neglected.

The state of the environment in Northeast Asia

It is generally agreed that the Northeast Asian region has a poor record in terms of a range of environmental indicators. As the ADB notes: ‘For far too long, Asian policy-makers ignored the environmental impact of rapid growth. Concern about pollution or degradation was simply not a priority’.³⁰

A UN agency has recently released a major audit of the 'state of the environment in Asia'.³¹ The report assesses the health of the environment by monitoring overall conditions and trends in air quality, freshwater supply, forests and land resources, biodiversity and marine and coastal resources. The audit concludes that the air pollution is unacceptably high, leading to continuing deleterious effects on health and mortality rates. In the cities that were reviewed, over 50 per cent had incidence of air pollution that exceeded WHO standard limits. There is evidence of growing water scarcity and contamination by nitrates and heavy metals. Significant land degradation is evident due to agriculture and deforestation. The region also contributes significantly to the rapid global decline of biodiversity. There has been a dramatic decline in fishery resources and a continued degradation of coastal ecosystems. It is also important to note that, in the post-crisis era, some Northeast Asian economies decided to cut back on resources allocated to environmental protection measures as part of their fiscal adjustments.

Despite such grim statistics, there are some areas in which progress has occurred. There has been:

significant progress in establishing legislative and institutional frameworks for environmental protection. There has been a measurable improvement in urban air quality in some cities, slowed rates of forest loss, increased forest planting rates and considerable success in reducing ozone-depleting substances.³²

Yet, an emphasis on environmental protection, while a useful development, is by no means enough to cope with the unrelenting pressure on Northeast Asia's environmental carrying capacity unleashed by decades of industrialization and urbanization. A much more fundamental transformation is necessary in which the prevailing orthodoxy of 'grow now and clean up later' needs to give way to a 'green growth' development framework. The latter would entail policies and institutions that seek to alter fundamentally the way Northeast Asian societies produce and consume in order to attain sustainable growth. Whether the political will and the resources exist to bring about a transformation in the shift of the development paradigm remains to be seen.

The rise of China and its ambivalent implications

The rise of China in the last decades of the 20th century as an economic powerhouse has acquired mythical status. China strides like a colossus in export markets and acts as a magnet in attracting foreign investment. Rapid growth has been accompanied by historically unprecedented reductions in poverty. Given its large weight in the world's population, the 'China effect' makes the reductions in global poverty in recent years rather impressive, and lies at the source of so-called income convergence between rich and poor countries. China seems to have shed its isolation and insularity that characterized the Mao regime. Gone are the days of the chaotic Cultural Revolution. One is struck by a political leadership that is still wedded to the ideology of communism and yet prepared to selectively embrace the ethos of capitalism. China's coming of age in an age of globalization was marked by its accession to the WTO in 2001.

Despite such dazzling achievements, current discourse among China-watchers is characterized by a certain degree of angst. Will the Chinese economic boom last? How is the rest of Asia reacting to the rise of China?

In a recent issue of *Foreign Policy*, the prestigious Washington-based international affairs magazine, Mixin Pei has vigorously argued that the inability of the Chinese political leadership to make a democratic transition will fatally impair the Chinese 'economic miracle'.³³ The author maintains that China has graduated, at best, to 'neo-Leninism' from the traditional one-party communist state of the '50s and '60s. Under the traditional system, Chinese communism was essentially a one-party rule, constrained by Mao's personal authority. The country was isolated from the global economy and pursued an anti-Western foreign policy. Internally, there was a firm commitment to egalitarianism. Private wealth was divorced from political power. There was strong state support for health and education as well as support from workers and peasants. Yet, the state relied on mass terror and repression to sustain its authority, while cultivating a vengeful anti-elitism that persecuted intellectuals and entrepreneurs.

Contemporary China, Pei argues, is best described as 'neo-Leninist'. It is still a one-party rule, but constrained by rules and procedures. The self-imposed isolationism has been replaced by an open trade and investment regime, most notably since 1978, but with firm state control of key industries. The state still controls 56 per cent of the country's industrial assets and is responsible for 70 per cent of GDP. The anti-Western foreign policy of the past has been replaced by pragmatic diplomacy. Unlike the Mao era, there is dwindling state funding for social services. The anti-elitism has given way to a culture that actively flatters and co-opts elites and seeks support from technocrats, the military and the police. There is selective targeting of political opponents. What is most conspicuous is the monetized corruption on a grand scale spurred by a wealth creation process that relies heavily on political connections. The predictable outcome is a sharp increase in income and wealth disparities. Pei claims that 1 per cent of Chinese households control 60 per cent of the national wealth.

There are also concerns about China's heavy reliance on foreign investment. One study notes that, in the absence of FDI inflows, Chinese economic growth would be 3–4 per cent lower.³⁴ This means that if FDI inflows reach a plateau, Chinese growth will be adversely affected. This will in turn affect the legitimacy of the Chinese political leadership. Indeed, the Chinese ruling elite currently have to contend with growing dissenting voices with a distinct anti-FDI tone.³⁵ These nationalist stirrings, combined with concerns about sharp economic disparities, represent threats to the durability of the Chinese political class. How will these tensions be resolved over time?

A well-established view in the democratic transitions literature is that growth spawns a middle-class that in turn sows the seeds of political pluralism. Paradoxically, argues Pei, 'China's economic growth is having the perverse effect on democratization: It makes the ruling elite even more reluctant to part with power'.³⁶ Rapid growth lends legitimacy to Beijing and puts less pressure on the ruling elite to engage in any significant political liberalization.

Of course, other scholars contest Pei's pessimistic prognosis. They note that dire predictions about an impending Chinese implosion have often been made in the past, but they have yet to materialize. Admittedly, there is a dark side to Chinese-style capitalism, but this grim view overlooks the ability of the Chinese political leadership to make tactical adjustments and respond to emerging social concerns. Such pro-China scholars argue that there is now a more 'balanced regional strategy' to offset the obsession with a highly iniquitous coastal development. One can also detect a more 'populist approach that seeks

to protect the interests of farmers, migrant workers, the urban unemployed and other vulnerable social groups'.³⁷ More importantly, the 'peasant apartheid' system (instituted through the urban household permits) that seriously curtailed the free movement of people between rural and urban areas is scheduled to be abolished. These changes both in strategy and philosophy might appear modest, but they are in effect monumental, given the political leadership's prolonged obsession with economic growth.

Others have argued that the comparative and historical evidence on democratic transitions point in the direction of largely peaceful change in the Chinese political economy.³⁸ Ex-communist states in Eastern Europe have made a successful transition to democracy over the past decade. Within Northeast Asia, there is also the inspiring case of Indonesia that graduated from a highly centralized and authoritarian political system to a reasonably well-functioning democracy within a relatively short span of time. In the late 1980s, highly authoritarian states, such as Korea and Taiwan, have also engaged in a successful democratic transition. There is no reason why China should be an exception to such political transformations.

The current debate over China's future is a particular manifestation of the broader debate on the role of institutions in economic transformation. To the 'institutional fundamentalists', self-sustaining growth is not possible without a deeply embedded set of liberal democratic institutions. As Dani Rodrik points out, this thesis suffers from a serious flaw. It describes an idealized state of development without explaining how one approaches such a state. Furthermore, growth take-offs are typically triggered, as in the case of China, with minimal institutional reforms tailored to country-specific circumstances that remove some binding constraints on growth. It is neither necessary nor desirable to engage in comprehensive institutional reforms that seek to replicate OECD standards and norms of institutional development. Indeed, it is important to appreciate the need for alternative institutional configurations that can engender standards of good governance, such as transparency, accountability and responsiveness to social concerns.³⁹ China, as in the case of the rest of Northeast Asia, will need to engage in local experimentation and adaptation to find the appropriate mix of institutions (that may or may not approximate OECD-style, liberal democratic norms) that will enable the country to attain sustainable and equitable growth.

The rise of China has also caused ambivalent reactions among its Asian neighbours, most notably low-wage economies in Southeast Asia. Ben Anderson makes the intriguing observation that China's isolation under Mao provided the critical space for a Southeast Asian economic miracle to ensue, but ironically, China's embrace of globalization now constrains the capacity of Southeast Asia to sustain its rapid growth through exports and foreign investment. As Anderson put it:

The Maoist project of building a mighty, autarchic, socialist economy outside the global capitalist order, reinforced for a long-time by an American-orchestrated trade embargo, kept China from playing a significant role in, or competition with, Southeast Asia until the mid-eighties. Only then, under the regime of Deng Xiaoping, did the Middle Kingdom . . . start attracting huge investment from America, Japan, the EC, Taiwan and even South Korea. In the nineties, therefore, China was finally in a position to outcompete Southeast Asia in manufactured exports, *a situation which seems certain to continue indefinitely* [emphasis added].⁴⁰

Is the rise of China, then, a 'zero-sum' game, in which Southeast Asia is expected to end up on the losing side? The Anderson hypothesis seemed to find resonance even in

economic modelling studies undertaken by the World Bank and others. Not surprisingly, politicians and academic commentators in Southeast Asia are concerned about such a development. A more recent analysis using trade and investment data by John Ravenhill suggest that such fears are probably unfounded.⁴¹ FDI to Southeast Asia fell in the post-crisis period, but this reflected the aftermath of the 1997 financial crisis and country-specific factors rather than an 'investment diversion effect' created by the presence of China in world markets. FDI inflows are not necessarily extracted from a fixed pool of capital: if more goes to X, it does mean less goes to Y. FDI inflows to China are not also exceptional when one takes account of its market size. It appears that FDI inflows are exaggerated and reflect 'round-tripping'; that is 'Chinese flight capital returning home or foreign investors bringing back to China some of the profits they have made elsewhere'.⁴²

An examination of trade flows suggests that Chinese exports are supplanting ASEAN exports to the United States, EU and Japan. On the other hand, ASEAN exports to China are increasing. This suggests the emergence of a regional division of labour in which China procures components from its Southeast Asian neighbours to feed its 'value chain', which serves key export markets in the OECD. This development, if sustained over time, augurs well for the consolidation of an East Asian economic community. Nevertheless, challenges remain in which Asia's two giants, Japan and China, are embroiled in low-intensity political bickering, despite durable bilateral economic relations. The prickly political relationship between China and Japan reflect historical animosities tied to Japanese militarism before World War II. While anti-Japanese sentiments run high in China, Japan, for its part, is keen to play a more assertive role in international affairs and is unlikely to allow its role as a regional leader to be eclipsed by a rising China.⁴³ Only time will tell how the Sino-Japanese relations will evolve over time and how it will affect the project of a Northeast Asian economic community.

Concluding comment

This wide-ranging discourse on leading issues in Northeast Asian economic development has sought to make sense of the stunning economic performance of Northeast Asia in the pre-crisis period. It has reflected on the causes of the 1997 financial crisis and has offered a prognosis of Northeast Asia's evolution since then. The so-called Northeast Asian 'economic miracle' was celebrated by the Bretton Woods Institutions in 1993, but within four years of such a celebration, the 1997 financial crisis erupted and led to a remarkable transformation in the economic fortunes of some of the most rapidly growing countries in the world. What struck many observers in the pre-crisis period was the existence of 'shared growth', namely, rapid growth combined with sharp and sustained reductions in poverty and relatively low levels of inequality.

Initially, the literature that focused on this phenomenon regarded Northeast Asian success as largely the product of free trade and free market policies. Over time, this interpretation gave way to a more 'institutionalist' approach in which the shared growth of Northeast Asian economies could be attributed to an amalgam of favourable initial conditions, macroeconomic prudence, rapid capital accumulation, a unique Northeast Asian-style governance (that combined technocratic insulation with close government-business relations) and activist industry policy geared towards supporting domestic firms that served export markets.

The 1997 crisis dented the credibility of the institutionalist framework. It led to an unfortunate tendency among the international pundits to re-invent the causes of the pre-crisis miracle as the causes of the crisis. Thus, Northeast Asian-style governance was now seen, at least from the perspective of powerful external agencies entrusted with the task of dealing with the crisis, as a case of 'crony capitalism' and macroeconomic imprudence. The IMF-led rescue package in late 1997 bore the hallmarks of such a mindset. The IMF interventions left the region with ambitious policy and political agendas that emphasized macroeconomic conservatism and large-scale structural and institutional reform in order to improve the quality of governance. The presumption that the crisis was largely the product of internal deficiencies remains influential even a decade after the crisis. The economies of the region have recovered from the trauma of the 1997 crisis, but one can detect a sense of uncertainty about the future. Were the victims of the crisis primarily responsible for their victimhood and must they now atone for their sins with large-scale institutional reform?

In retrospect, the 1997 crisis was probably a combination of external and internal causes. Externally, the experience of the Northeast Asian economies testify to the risk that global capital markets can be subject to herd-like behaviour unleashing capital flights, regardless of the behaviour of policy fundamentals. At the same time, years of rapid growth probably made policy-makers complacent and led them to overlook frailties in financial markets and putative external imbalances that were exacerbated by fixed exchange rate regimes.

The rapid growth of the past and the collective praise that was heaped on the region by the cheerleaders of the Northeast Asian miracle also provided insufficient incentives to subject these economies to a closer scrutiny of some of the long-term challenges that they faced. One possibility is that long-term growth in the region could be constrained by lack of productivity growth. Admittedly, a medium-term priority is the resumption of investment on a scale significant enough to boost the recovery, but over time, productivity-driven growth is the key to durable improvements in living standards.

The Northeast Asian economies were lauded in the past for their egalitarian distribution of income, but rising inequality is an emerging social concern that cannot be overlooked. In particular, the notion that rapid growth alone will take care of poverty is no longer an intellectually tenable position. The point is, growth, poverty and inequality represent the 'eternal triangle'. Rising inequality can paradoxically undermine both growth and poverty.

The most recent audit of the state of the environment in Northeast Asia by a UN agency reveals a grim picture of a region where rapid growth, industrialization and urbanization have placed relentless pressure on air quality, fresh water supplies, biodiversity, land, marine and coastal resources. Admittedly, there is a greater degree of consciousness about environmental problems among governments of the region and there is evidence of some improvements. Nevertheless, a mindset of 'grow now, clean up later' has to eventually give way to a fundamental transformation in development paradigm, in which environmental concerns are placed at the core of a growth strategy.

Finally, it would be fair to say that the literature on Northeast Asia has been preoccupied with understanding the economic miracle in the pre-crisis period and to make sense of the ramifications of the 1997 financial crisis. Yet, the challenges facing Northeast Asia's future are likely to be shaped by China, Asia's new giant and one that has so far remained

unaffected by the 1997 financial crisis. Despite this, and despite its stunning economic success, China-watchers are divided about the country's future. At the same time, the rise of China has caused latent tensions among its neighbours. Can China, with its inimitable brand of communism and selective embrace of capitalism continue to stride like a colossus on the global stage, or will it implode under the weight of its highly imperfect political institutions? Optimists believe that China can navigate a prosperous future within its current framework as long the political leadership is flexible enough to make tactical adjustments to its economic and political strategy to respond to emerging social concerns, such as rising inequality and the need for political pluralism. Others are worried that China's future holds decay rather than democracy.

The current debate over China's future reflects in microcosm the debate over Northeast Asia's future. Does sustainable and equitable growth in the future depend on embedding a comprehensive range of liberal democratic institutions, or is this a case of 'institutional fundamentalism'? Some believe that development does not have to wait for the inauguration and consolidation of OECD-style institutions. Minimal reforms that alleviate binding constraints on growth, followed by local institutional experimentation that may or may not fully resemble liberal democratic institutions can go a long way towards meeting the developmental aspirations of many societies.

China's rise has raised concerns about the future of a Northeast Asian economic community. China's Southeast Asian neighbours are worried that the propensity of the former to attract foreign investment and to win export markets is occurring at their expense. Fortunately, recent data on trade and investment flows suggest that the rise of China is not occurring at the expense of others in the region. Despite this, there is another issue that can complicate regional cohesion. This stems from low-intensity political bickering between China and Japan that reflects innate historical animosities and barely concealed aspirations for regional and global leadership. Whether Northeast Asia's two giants will eventually collide or collude to foster a peaceful Northeast Asian economic community remains to be seen.

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1 Japan

Craig Freedman

Political history

Japan has a total land area of 377 864 square kilometres; only 13.6 per cent is cultivated. Approximately 70 per cent of the land is covered by largely uninhabited mountains, grasslands, forests or waterways. Most of the population of 127 450 000 (2002 official estimate) is huddled together on 4 per cent of the entire land. Half the population is centred around Tokyo, Osaka and Nagoya, living in a low-rise sprawl consisting of single or double storey dwellings. Until quite recently, the history of Japan has always been a case of too many people living on too little land, or in purely economic terms a country chronically rich in labour resources but traditionally capital poor. Without any substantial natural resources of note to fall back on, the Japanese have, over the centuries, come to see themselves as a country lacking the luxury of being able to afford mistakes. Japan, in fact, does not differ greatly from a number of European countries in lacking a generous natural endowment. However, Japan has come to view itself as a unique case whether justified or not.

It can be persuasively argued that Japanese reluctance to take chances resulted in the transformation, but not rejection, of many aspects of the feudal system. Certainly from Toyotomi Hideyoshi's (1536–98) misconceived adventure in Korea until Japan's even more foolhardy ambitions in World War II, the Japanese were hesitant to pursue goals beyond their capacity. A continuation and preservation of Japanese life against outside elements of change remained the hallmark of political life. The use of the clan, or group, to provide stability did not die with the end of the great feudal lords (*daimyo*) and the loyalty of their trusted *samurai*. Echoes in more modern times could be seen in the dedication of the post-war 'salaryman' to his corporate overlord.

The closed country (Sakoku)

The consolidation and unification of Japan under Tokugawa Ieyasu extended for the more than 200 years of the Tokugawa *Bakufu*.¹ Its hallmark was a deliberate strategy of isolation. The overriding policy objective was to slow down and control change in order to provide a stable platform for economic viability and to maintain continuing dynastic power. Once so warmly welcomed, trade, especially with Europeans, virtually ended. The Tokugawa *Bakufu* granted the Dutch sole access to the island of Deshima off the port city of Nagasaki. This limited the damage that might flow from any and all outside shocks. Previous European missions (both religious and secular) had intrigued in the civil wars and politics of Japan. The highly regulated Dutch trade would provide a continuing window on the outside world. Knowledge would flow in, but unwanted interference or agents of change would be filtered out.

Meiji Restoration

Outside shocks have long proven to be an effective impetus for major change in Japan. Change however, even that which on the surface creates dramatic transformations, has

had a more enduring link to existing structures and hierarchies than is immediately apparent. Change has been perennially co-opted by elements of the old order and remained essentially conservative.

The forced opening of Japan is best symbolized by the entry of the 'black ships' into Edo (Tokyo) Bay in 1853 and 1854. The US fleet under Commodore Matthew Perry left the Tokugawa Shogunate without a viable alternative. The inevitability of accepting this foreign ultimatum however, also revealed an underlying weakness in the status quo. Provincial clans from southwest Japan, strongly supported by younger *samurai* retainers, seized upon the disruption created by foreign entry to overthrow Tokugawa rule in the name of the teenage Meiji emperor. This same group of new leaders would form, from then on, the core of a ruling oligarchy for the next 50 years. In essence, they shared the same ultimate goals with the forces they defeated, namely expelling the barbarians. They however, were realistic enough to accept the long-range nature of this goal. The shameful treaties (specifying foreign access and trade) dictated by the Western powers would be overturned, but only eventually. Japan would accomplish these goals by rapid modernization of its society and economy. Modernization would bring the sort of military power ('strong army, strong country') that the Japanese rulers saw as essential if China's creeping colonial fate was to be avoided. In the future, the Japanese would tend to view all treaties with the Western powers in a similar fashion, imposed by the West for the benefit of the West and demeaning to the honour and interests of Japan.

But an economic transformation under these circumstances was not an internal class revolt against the existing power structure. The dominant cultural myths did not need to be displaced. Instead, under the guidance of a newly restored and powerful emperor, they could become the engine for rapid industrialization and capital accumulation. The peasantry was too dispersed and powerless to present a sustained challenge. Nor did the ruling caste have to contend with a burgeoning and somewhat independent commercial class. With the extended closure of foreign trade, merchants had become dependent on the government for the smooth functioning of internal commerce. The marketplace, where price mechanisms usually reigned, was also subservient to government directives. The invisible hand would continue to defer to perceived national imperatives.

Japan rapidly adopted the leading systems of the industrialized nations and modernized itself over the next 50 years. The Japanese became a unified nation loyal to the emperor rather than to their clan. However, the old-line *samurai* characteristics of loyalty, obedience and self-sacrifice were to some degree universalized in the education and institutions of Meiji Japan. To use a well-worn cliché, the over-riding motivating goal was a desire to achieve 'a place in the sun' as a major military power'. Economic modernization was to a large degree only a means to that end.

The Meiji government attempted to incorporate new industrial technology within the existing social structure by taking full advantage of long-standing hierarchical relations. This programme gained currency under the slogan of combining Japanese spirit with Western ability (*wakon yosai*). Under state guidance, the unified people of Japan could be carefully shepherded and quite blatantly squeezed toward completion of this monumental task.

The first signs that those goals were within Japan's grasp came with a series of successful wars, first against China in 1895 and then against Russia in 1904–05. While the first victory might have surprised Western powers, the second came as a shock to these same

countries. By 1910, Japan's colonial domination extended over Taiwan and Korea.

However, Japan's perceptions of unequal treatment by the West grew, at first caused by German, French and Russian pressure to give back territory ceded by the Chinese government. Subsequently, the US-brokered treaty ending the Russo-Japanese War was again perceived by the Japanese as too favourable to the defeated Russians. This growing distrust of the United States was further aggravated in the post-World War I era by the Treaty of Versailles, followed by US pressure on Britain to end its alliance with the Japanese and finally with the Washington Naval Peace Conference. In each case the Japanese government, backed by popular sentiment, perceived US actions as depriving Japan of its just rewards.

The period following World War I encompassed a relatively brief, but significant deviation from more general patterns that seem to dominate Japanese history. The Taisho era (1912–26), displayed many less rigid, more open-minded characteristics. As opposed to the stereotype of a Japanese people heavily constrained by their group-oriented culture, this period, boosted by an economically profitable World War I, moved the Japanese toward a more individualistic, market-oriented economy and society. These years were in one sense atypical. They did, however, display the possibility of a different type of Japanese society, perhaps one more in tune with Western values. Even at its height, this 1920s model never succeeded in dominating the whole of the country given its very short life span. The country was fiercely divided between rural conservative and the increasingly urban and liberal rest of the population (a 50–50 split by 1920). Perhaps with reliable economic growth, liberal parliamentary democracy might have survived. But slow growth marked the decade of the 1920s, slower than for any comparable span between 1880 and 1940. As in the Weimar Republic, the Japanese people sought stability and an end to economic deprivation after a rather tumultuous decade.² A financial crisis in 1927 and an unwise decision to return to the gold system (1930) sealed the fate of this era.

Starting in the 1930s, economic and political freedom was simply the price paid for security. At the heart of this exchange lay a feudal mindset, which substituted a clan-like governance system for one dominated by market relations. This system, which was only gradually imposed, borrowed elements already dominating the Japanese economy and the Japanese character to redefine policy objectives. These elements were then cultivated while letting incipient moves toward more Western contractual relationships, and a reliance on parliamentary democracy, wither.

Japan at war

In a wartime economy, or one gearing up for war, the major problem is trying to rapidly increase production. This is equivalent to producing to order (essentially defence-oriented goods) rather than producing for the market. The Japanese government needed to reconstruct its economy so that heavy industry could provide an expanded array of war materials. The government of the day eased a potentially binding capital constraint by shifting corporate finance from a system largely dependent on equity and retained earnings to one almost entirely based on bank finance. By doing so, the government could funnel investment directly to achieve specific ends. Banks became mere conduits for funds, while shareholders lost any real ability to hold corporate managers to account.

Japan's Manchurian moves against China in 1931 initiated a wartime era that ceased only with Japan's unconditional surrender in 1945. The puppet state of Manchukuo

(Manchuria) became Japan's operational base. However, US opposition continued to thwart Japan's dreams of Asian dominance. A US trade embargo, shutting off the flow of vital oil to Japan, brought past animosities to the surface. The military leadership, portraying Japan as having no other option, initiated war against the United States with a surprise attack on the US fleet at Pearl Harbor (7 December 1941). Japan's military took a calculated gamble that US and Allied troops would not withstand an all out attack and instead sue for peace, leaving Japan to control the East. Under the guise of liberating Asia from colonial rule (establishing the Co-prosperity Sphere) Japan rapidly swept through Hong Kong, Malaya, Singapore, Java, the Indies, Burma, Indo-China and most of the Pacific Islands. The brutality that defined military discipline in the Japanese army displayed itself in the treatment of enemy prisoners and the local Asian population. Despite early success, the tide of the war slowly turned. Given its limited resources, Japan's gamble was bound to fail over a longer time span. Badly underestimating the resolve of the Americans, British and other Allied troops, Japan's refusal to surrender unconditionally led to the first atomic bomb falling on Hiroshima (6 August 1945), followed by another on Nagasaki three days later.

Post-war occupation

Japan's refusal to surrender reflected a desire by Japan's rulers to preserve the existing militaristic order in Japan. Ostensibly they failed miserably. An essentially US occupation (1945–52) sought to install democratic institutions in place of the old order. Beneath the perceived surface, the stated aims of democratization were subtly subverted. The former militaristic regime may have vanished with the Allied victory, but many of the institutions and even individuals associated with the wartime effort re-emerged, however superficially transformed. The old guard eventually triumphed over attempted bottom up changes.

There are perhaps two distinct stages of the occupation presided over by US General Douglas MacArthur. The initial stage bore the imprint of Roosevelt's New Dealers. Here the aims centred on insuring that Japanese militarism would not arise again and on democratizing Japanese institutions even to the point of destroying existing ones. The US-drafted Japanese constitution included an article (Article IX) limiting Japan to a strictly self-defence posture and seemingly eliminating the possibility of any future military adventures. In a parallel fashion, US occupation forces demanded land reform, released political prisoners (including communists), encouraged labour unions, provided women with voting rights, pushed for educational reforms and broke up the large business trusts (*zaibatsu*). This activist US stance was short-lived.

In the ongoing battle between those corporatist elements wanting to restore the previous status quo of power and those elements desiring either liberal reform, or the application of left-leaning ideologies, 1945–47 represented the high-water mark for the forces of change. Shigeru Yoshida, the dominant conservative politician of this critical period 1946–54, fought a successful rearguard battle against New Deal reformers surrounding MacArthur. His legacy was the Liberal Democratic Party,³ a political coalition that would form one of the bulwarks of the re-emerging 'Iron Triangle'. This subset of business, administrative and political leaders would manage Japan successfully throughout the post-war period. The key battles all involved transforming US reform initiatives into policies that achieved conservative business objectives. Japan would adopt the appearance (*tatemae* – outside face) of Western liberal democracy as a vehicle to promote a reality

(*honne* – inside face) involving traditional feudal structures in which risk was minimized and collectivized. In exchange, conservative business leaders implicitly offered the vision of an all-inclusive middle class society. The defining issues of this transformational struggle would revolve around four inter-related aspects of the post-war economy:

- establishing a working agreement with labour;
- land redistribution;
- corporate business structure;
- financial institutions.

The first, and most pitched, battle arose over labour. Without stability, conservatives and occupation forces saw no possibility for economic growth. Economic growth (the middle class society) would placate the Japanese people and maintain conservative control. Together, stability and economic growth would insure that Japan would become a reliable surrogate and ally in strategic East Asia.

The turning point came on 1 February 1947 when MacArthur refused to allow a potentially crippling general strike to go forward. This clearly marked a change in the US approach to the reconstruction of Japan. The Cold War was intensifying. Out went the New Dealers, in came the political and fiscal conservatives. Then, following the fall of China to communist forces, Japanese unions in 1949 were purged of communist members. An estimated 10 000 workers lost their jobs, dissuading many times that number from joining.

The Cold War marked a significant shift in labour relations away from Western-style confrontation, which had made the immediate post-war era in Japan one of rolling strikes and radical unions, to an era of consensus agreement in which enterprise unions accepted security (low risk) in return for delivering a dependable rising level of productivity (at least in a selected group of manufacturing industries).

Two events at this time clearly marked the changeover in Japan's political and economic life. One was the arrival of Joseph Dodge in Japan on 1 February 1949. Dodge came with the aim of reshaping the direction of the Japanese economy. In a brief three-month tour of duty, Dodge laid a foundation that allowed traditional Japanese business interests to re-emerge. His insistence on conservative economic policies (balanced budget, low inflation and low exchange rate) would provide the opportunity to construct an economy that kept the appearance of an imposed Western-style system while undermining the reality through a programme of clever risk sharing and income redistribution.

The Korean War⁴ was the other great event of the time. Like some *dues ex machina* in a Greek tragedy, the sudden surge of demand that the war created, rescued the Japanese economy. Firms, like Nissan, would survive by producing parts and vehicles for the US army.

The post-war Japanese miracle

The formation in 1955 of the Liberal Democratic Party sealed the shape of post-war Japan, with the Japan Federation of Economic Organizations (*Keidanren*) acting as a proud midwife. The LDP evolved into one of the most flexible of Japanese institutions. In fact, it was hardly a unified party at all, existing more as a collection of party factions representing different special interests. Since the party firmly held no strongly grounded

beliefs, it faced very small costs in changing direction. Over the years, the LDP has made few specific ideological investments. Instead, the party's *raison d'être* has been the distribution of spoils to its constituents.

In keeping with a pronounced penchant for political compromise, the Yoshida Doctrine came to define the foreign policy of post-war Japan. This approach substituted economic growth and eventual economic dominance for military objectives. To accomplish this growth, Japan relied on the United States to provide an essential security umbrella. With the coming of the Cold War, The US-Japan Mutual Security Treaty (1951) tied Japan firmly to the United States. In return for the end of the prolonged occupation, the Japanese agreed to allow US military bases to remain on the mainland as well as in Okinawa (returned to Japan in May 1972). This approach fell foul of both right-wing members of the LDP who wished Japan to re-arm, as well as left-wing parties that desired a total withdrawal of US troops. An attempt by Prime Minister Kishi to force through a revised treaty ended in his resignation in 1960 and a reversion to the Yoshida Doctrine.

The decade of the 1960s focused obsessively on building an industrialized economy. Beginning with Prime Minister Hayato Ikeda's income-doubling plan, this decade created the belief that the Japanese had built a miracle economy. Growth throughout this period expanded at a rate exceeding 10 per cent per annum. By the start of the 1970s, the Japanese economy had become fully industrialized. Under Prime Minister Tanaka, a factional heavyweight who would continue to exert political power after his forced resignation, plans were laid for increased infrastructure projects and a widening of the social welfare net. Unfortunately, Japan was hit heavily by the first oil shock of 1973. As a reaction, Japan financed the increased cost of oil imports by an export-led growth strategy. Consumer electronic goods and cars made their way in increasing numbers to US markets. This marked the start of an extended period of trade tensions that would spill over into security matters.

These problems were eased somewhat in the 1980s by the efforts of Japanese Prime Minister Yasuhiro Nakasone and US President Ronald Reagan. Nonetheless, the Japanese faced charges of unfair trade practices in both the United States and Europe. The increasing direct foreign investment in the United States by Japan caused tensions to continue to rise. The Plaza accord between the G-7 large industrial countries in 1985 sought a resolution to these problems by drastically revaluating the Japanese yen. In reaction to the rising yen, an expansionary monetary policy in Japan laid the seeds for the Japanese bubble economy that characterized Japan until its collapse in 1992.

Unfortunately, political leadership at this time became bogged down in the share-trading scandal centred on the Recruit Cosmos Company. This set up a period characterized by a lack of leadership, with a series of very short-term prime ministers, and a marked inability to deal with pressing economic issues. Even before the economic bubble burst, Japan's foreign policy had come under fire. The Gulf War (1991) clearly illustrated the constraints Article IX of the constitution could exert. Attempts by Prime Minister Kaifu to send 2000 non-combatant personnel to the conflict met with defeat in the Diet. Instead, Kaifu offered \$US4 billion to defray the cost of the war, only to be met by US pressure for an even more substantial contribution. Japan would become the largest contributor to the allied effort, increasing financial support by an additional \$US9 billion. Done at the height of the US/Japan trade conflicts, this move was derided by US critics as cheque book diplomacy. The US-Japan alliance was clearly beginning to feel the strain of conflicting objectives.⁵

In July of 1993, the LDP itself, racked with dissension and scandal, lost control of political power for the first time since its 1955 formation. A multi-party coalition, centred on two new political parties created by breakaway LDP members, formed government with Morihiro Hosokawa as Prime Minister. The coalition did manage a successful reform of the electoral system, which helped break the stranglehold of rural constituencies (though a rural vote continued to be weighted more than an urban one). This move seemed to indicate that a major change in the very structure of the country was possible. Broad-range reforms put forward by the Hosokawa coalition took clear aim at the 'iron triangle' that had essentially run Japan since World War II. The reforms took particular aim at bureaucratic control that characterized so much of the economy.

The unstable coalition did not survive. Forced to resign in April 1994, Hosokawa was followed by Tsutomu Hata, who was gone almost as soon as he arrived. By June 1994 the LDP was back in a ruling coalition with Japan's Socialists. Though Tomiichi Murayama would become the first socialist prime minister in 47 years, he would best be remembered for his failure to deal adequately with the January 1995 Kobe earthquake and the March 1995 sarin gas attack by the Aum Shinrikyo religious sect. The LDP was clearly back in charge by January 1996 with Ryutaro Hashimoto as prime minister. Initially he pushed what for Japan was a bold reform package centred on a Japanese version of the 'Big Bang'. This essentially accelerated financial decontrol while reforming accounting practices and encouraging more transparency in corporate matters.

However, the overwhelming problem in 1996 was whether Japan's post-bubble economy would finally revive. Traditionally, Japanese governments faced with economic downturns regarded them as short-term phenomena. Nothing drastic needed be done. Fiscal expansion would limit the duration and damage of any recession. Adjustment schemes would ensure that no particular sector or company suffered inordinately. Japan's post-bubble policy followed predictable steps. Expansion of fiscal policy did seem to mute the depth of the recession. Money, as could be expected, was not well spent. Most went toward highway and similar projects favouring rural districts and the construction industry (a major LDP contributor). Despite the limited effectiveness of this approach and the efforts of the Ministry of Finance to cover up rather than resolve banking problems, the economy by 1996 seemed on its way back to sustainable growth.

The Hashimoto government then ran head on into a combination of bad policy moves, bad luck and increasing financial scandals. Urged on by the Ministry of Finance, the Hashimoto government sought fiscal rectitude by raising taxes, particularly the VAT. Unfortunately, the largely unforeseen Asian Crisis (1997) dealt a staggering blow to Japan's already troubled banking sector. Japanese banks had sought to earn their way out of a rising post-bubble bad debt problem through loans to fast-growing East Asian countries like Thailand and Indonesia. A collapse in these economies saw Japanese banks pull in their loans and worsen the Asian Crisis. The collapse also uncovered the fragility of the banking system and ineffectual government attempts to disguise the problem.

In response to a faltering economy, the LDP performed poorly in the May 1998 elections. Hashimoto was out, replaced by LDP stalwart Keizo Obuchi, a triumph of factional politics over any potential reform programme. His death in April 2000 brought in as Prime Minister Yoshiro Mori, possibly the very epitome of the party machine politician. With the economy floundering, Mori proved to be particularly maladroit in his public dealings. His approval ratings bottomed at 10 per cent. Fearing an overwhelming loss in upcoming

elections, Mori bowed out. In a surprising outcome, perennial leadership contender, Junichiro Koizumi managed to triumph over party stalwarts who backed ex-Prime Minister Ryutaro Hashimoto. Koizumi raised hopes for fundamental change by championing economic reform and a new way of doing business. Koizumi took the LDP to an unexpected victory, although it did need support from both the New Komeito and Liberal Parties to gain a ruling majority. The reality of Koizumi's policy turned out to differ from the promise. Capable at forming media sound bites, Koizumi proved to have no real interest in economic reform. He could best be seen as a political reformer determined to break the factional nature of LDP politics and the power of both the *zoku* politicians representing vested interests and the bureaucrats of the powerful ministries. The more cynical might suspect that his real aim in all his reform policies was simply to consolidate the power of his own supporters by cutting off financial flows to opposing LDP factions.

By 2004 Japan had poked its way out of the worst of its economic woes. Little responsibility for Japan's very limited economic success could be laid at the door of Prime Minister Koizumi. He seemed more interested in pushing forward a revived nationalistic foreign policy than in Japan's uncertain economy. The result of his approach could be traced in the steadily worsening relationships with China and South Korea. Koizumi has gone on to become one of Japan's longest-serving, though perhaps least successful, prime ministers. He seems determined to transform the LDP to fit his predetermined objectives. As his attempt to push through a postal reform bill demonstrated in August 2005, he is willing to gamble on the collapse of the LDP rather than seek a compromise. The subsequent September 2005 election demonstrated the new-found importance of spin in Japanese elections. By ignoring all other issues and asserting that his plan for postal reform was equivalent to the pressing need for economic revitalization, Koizumi was able to achieve the LDP's biggest electoral victory since 1986. Winning 296 of the Diet's 480 seats, the LDP in coalition with its New Komeito partner now holds a two-thirds majority. This will allow Koizumi to overturn any attempt by the Upper House to veto one of his bills. Moreover, 83 of the new LDP members are new, most of them handpicked by Koizumi. In the near future, neither the LDP, nor the weakened opposition Minshuto (Democratic Party), seem to promise much in the way of initiating change.

The Japanese economy

Reforms and post-war trends

The Japanese post-war miracle had two basic cornerstones. By implicitly promising the Japanese people a secure, low-risk economy where living standards would predictably rise, the allure of achieving a universally middle class economy allowed the 'iron triangle' (business, bureaucrats, politicians) that essentially created wartime Japan to maintain its hold on the reins of power and insured the political stability needed for a vibrant economy. Socializing risk and redistributing income required dependable and significant large increases in economic growth.

Three particular reforms defined the future path of post-war Japan. In each case, traditional and conservative Japanese interests subverted the intentions of the reformers within the occupation forces. While initially successful in driving the economic growth during the catch-up stage of development, the structures growing out of and transforming these reforms eventually became an impediment to growth as the Japanese economy grew ever larger and more successful.

The first of these reforms saw the enactment of a new set of labour laws. The occupation forces hoped to establish industrial labour unions similar to those in the United States. Given the 55 per cent unionization rate of the early post-war workforce, this Western adversarial approach to union organization initially led to industrial unrest, with the Japanese worker characterized as unreliable and confrontational. The fall of China in 1949 to communist forces, followed soon after by the Korean War, changed the initial US objective of keeping Japan economically weak and unthreatening. Japan rapidly graduated to a more privileged position as the United States' main industrial client state in Asia. In return, Japan implicitly received approval to reassert something resembling the wartime status quo. Companies in the early 1950s embraced a union-breaking strategy. More compliant, hierarchical structures conveniently became reframed as representing true, traditional Japanese order. Employers utilized and encouraged the strong group identification so common in Japanese society. They managed to redefine the relevant economic and social group in a way that supported and drove corporate growth. The company unions, which supplanted the industrial-based ones, resembled, not coincidentally, the *Sanyo Hokokukai* (in-house unions) of wartime Japan, where maximizing production was the guiding objective of union and corporation alike. However, the security promised in return for labour compliance and productivity would create an unending pressure for corporate growth and expansion.

The dissolution of the large financial conglomerates (*zaibatsu*) was the second reform. Vertical and horizontal groupings of firms (*keiretsu*), often around a main bank and a trading company, took on many of the properties of the wartime conglomerates. The ostensible break up simply acted as a means to redistribute wealth and remove any residual control from the old *zaibatsu* families. Effective control shifted to an entrenched, new management elite. US-style anti-trust legislation lacked enforcement, as both government officials and corporate management failed to accept the competitive rationales driving such laws.

The associated emphasis on bank financing had its origins in the 1930s when strict limitations on dividend policy made it difficult to raise funds on equity markets. While initially seen as a way in which management could focus on long-term investments, the subsequent loosening of links to main banks and the concomitant failure of these banks to perform their implicit monitoring requirements, ultimately led in the late 1980s and 1990s to poor investment choices. Structures that had assisted economic growth during the 1950s and 1960s began to create problems once Japan completed its catch-up phase.

Widespread land reform was the third influential change. Land reform would seem to be the most US-inspired and successful occupation achievement.⁶ The enacted programme adhered closely to its explicit objective. Its stated aim was to end the era of large, absentee landlords, labelled as being the mainstay of Japanese militarism. The hoped for and underlying objective was to create a hard core of support for conservative parties (the forerunners of the LDP) via rising rates of subsidization. This insured that a sufficient core of voters would remain in these rural districts, but doomed Japanese agriculture to increasing inefficiency.

There is a clear lesson to be learned from the way in which the Japanese cleverly subverted the aims of the occupation's reforms. Japan faced the challenge of a devastated industrial structure not by transforming itself into the sort of liberal capitalist economy envisioned by its occupiers, but by using structural elements developed in the 1930s and

1940s to compete in the post-war era against Western industrialized societies. This effort was guided by sheer necessity, utilizing the cooperative, group mentality that has often characterized Japanese society. Growing rigidities and other associated problems started to emerge in the 1970s, as Japanese economic structures drifted inexorably out of step with changing world markets, eventually leading to the stagnation of the 1990s and beyond.

Four distinct growth periods reflect both post-war Japan's internal institutional and structural development and also its reaction to external factors. The first period (the 'miracle economy' of 1945–73) recorded double-digit growth. These rates were markedly above those of Western industrial countries, which were, for the most part, also enjoying an unprecedented post-war boom. This initial growth period lasted until the first 'oil shock' in 1973. Japan as a major petroleum importer, was quick to register the effect on its economy, but unlike many Western industrial countries rapidly adjusted to these changed circumstances.

During the second period of economic growth, which lasted until 1992, although slower than the initial years of rapid expansion, Japan still outperformed most other economies by having higher growth, lower inflation and lower unemployment. Per capita growth declined from its previous unsustainable levels to only three-fifths of its former rate, with other comparable economies experiencing a similar or even worse decline. However, while Europe in particular would struggle with high unemployment levels in the 1970s and 1980s, the Japanese seemed immune to these difficulties as well as to the 'stagflation' that became the defining characteristic of the US economy in the 1970s. Japan's reputation for resilience was enhanced in the 1980s, by avoiding the fluctuations experienced by the economies of the United States and the United Kingdom and definitely escaping the growing and ineradicably high levels of unemployment that plagued Western European economies. By the end of the 1980s, the myth of Japan's invincibility was taken seriously not only by outsiders but by the Japanese themselves.

The Japanese were increasingly accused of unfair trade practices by Western industrial nations that felt unable to compete with what by then had become known as Japan Inc. The height of confusion occurred when it was assumed that Japanese financial muscle would inevitably come to dominate all Western competitors. This forecast served only to demonstrate how little outsiders knew about Japanese banks and, as it transpired, how little Japanese banks knew about banking. During the late 1980s, instead of laying the foundation for the Japanese economy to become dominant, the financial sector created and fanned an asset inflation, which led inevitably to the collapse of those unsustainable price levels and to Japan's economic growth. The end of the 'bubble economy' in 1991 marked the start of a reassessment of Japan's accomplishments.

In the decade following 1992, the third and most recent period completed, Japan can be characterized as having an almost narcoleptic economy. During those years, Japan averaged no more than 1 per cent per annum growth of real GDP. This was amongst the lowest of any developed economy in the post-war era. From seeming unable to make one wrong move, the Japanese appeared incapable of taking any decisive step to initiate the required policy changes or recommended structural reforms.

It is still early days, but 2003 may mark the long anticipated break with Japan's past economic doldrums. However, growth levels continue to be quite low. Japan will need a higher rate of per capita growth to handle the demographic changes characterizing an ageing economy. A more detailed assessment of each one of these periods follows.

1945–73: the ‘miracle economy’

Japan’s development has been characterized by a pattern that might be denominated as capitalism from above. Since the Meiji Restoration, this has meant a degree of indicative planning on the part of the government. During both the Meiji Restoration and the immediate post-war years, Japan focused on the development of human capital. Given the scarcity of physical capital, this strategy was the only possible way to escape the limitations of an economy that would otherwise be characterized by cheap, labour-intensive goods. The ability of the Japanese to work cooperatively proved to be their greatest strength and source of flexibility

Labour relations and corporate structure Job security, promotion heavily based on seniority, and a high cost of job loss all promoted an exceptional degree of loyalty and trust between management and workers. An early retirement age mandated by large corporations (55 or 60) and an influx of workers from the primary sector made a seniority system feasible (or at least a seniority system modified by merit criteria). Reluctance to recruit established employees from other corporations limited the options available to a typical ‘salaryman’ working his way up a corporate ladder. By leaving, a corporate employee would be forced to seek work among smaller firms, which offered significantly lower remuneration. The belief that corporate hierarchies would ensure individual well-being created a workforce more willing to adopt and adapt to new technology, without the fear that such acceptance would translate into fewer jobs.

In the immediate post-war years, the Japanese toured US factories looking for those most advanced industrial techniques and technologies that would lend themselves most easily to the Japanese workplace. This allowed Japan to develop and emphasize such ideas as total quality production and the *kanban* system. Both reflected the shortage of physical capital in the 1940s and 1950s. Avoiding mistakes (instead of correcting them) saved on capital and eventually provided Japanese output with a dependably high standard of quality. Given the shortcomings of the transport system and the need to minimize working capital requirements by reducing inventory, just-in-time production provided an obvious solution to this problem. Highly skilled workers, scientists and engineers were available to abet the development of consumer manufacturing (cars and electronics), owing to the mandatory restrictions on the growth of the defence sector. Japanese firms soon became world leaders in a number of heavy industries and later in the field of consumer electronics. Although not in these years a noted innovator (developing countries steal, borrow or license), Japan’s strong commitment to research and development did lead to an improvement of existing industrial products.

The corporate sector remained dominated by firms established and certainly shaped by the wartime years. Toyota, Nissan, Toshiba and Hitachi were at best an evolutionary extension of those formative years, rather than an attempt to depart from a familiar mould. Firms formed loose associations (*keiretsu*), reflecting the structure of dominant wartime conglomerates (*zaibatsu*). These associations reduced the risk otherwise inherent in competitive markets. Vertical *keiretsu* provided needed flexibility and certainty to production. Commitment to a limited number of suppliers, providing that their quality and price met required standards, allowed greater sharing of knowledge and especially development of new products. The structure also allowed parent corporations to shift more easily the cost of economic adjustment on to these suppliers, providing them with a strong

incentive to pursue continual and incremental improvements. Horizontal *keiretsu*, with their interlocking ownership, made hostile takeovers an improbable event, allowing corporate management largely to ignore shareholder objectives. Removing this particular constraint supposedly permitted long-term planning rather than the sort of unquestioning obedience to short-term indicators that exemplified their Western counterparts. In lieu of this familiar type of corporate accountability, main banks provided loans as well as a check on imprudent corporate decisions.

The *keiretsu* approach was part of a widespread attempt to reduce overall market risk. This form of sporadic cross-subsidization allowed firms affected by temporary cash-flow problems to recover. Unfortunately, a cash-rich *keiretsu* might decide to subsidize an unprofitable operation to insure continued organizational expansion. This aspect of corporate welfare is sustainable in a growing economy, but is increasingly difficult to maintain in any prolonged economic contraction.

Government policy The role of government policy in initiating and sustaining Japan's era of high growth remains immersed in continuing and unresolvable controversy. Recent revisionist work indicates that industrial policy merely served to sustain non-competitive, declining sectors. Even if true, this contention overlooks the fact that government protection of low productivity sectors defused potentially dangerous social pressures. These instabilities were the unintended consequences of the dislocations caused by rapid economic growth. Low productivity sectors served to absorb otherwise excess workers.

In this first period of growth, a reserve of low-cost funds financed governmental infrastructure and export industries via the Fiscal Investment and Loan Programme (the FILP). What was essentially a second government budget did not require Diet approval until 1972. The source of these funds was the postal savings system, as well as additional funds arising from various nationally administered insurance and pension schemes. Postal savings were virtually tax-free and attracted a considerable share (up to a half) of all private bank deposits. Given the high personal saving rate during this period in Japan, infrastructure and other growth-inducing projects could be funded while maintaining a balanced and relatively small governmental section.

From 1949 until 1971 the yen was pegged to the dollar at the fixed rate of 360 yen to the US dollar. This clearly became an artificially low rate (partially a reward for Japan's role as loyal ally) as the Japanese economy grew. Nonetheless, given Japan's initially small economy (GDP per capita was \$US1873 in 1950 compared with \$US11 017 in 1970), and the fact that until 1973 domestic and export growth was balanced, Japan's trade surplus remained relatively small. Owing to the pegged yen and capital controls, monetary policy remained almost entirely immune to changes in international capital markets. In other words, a generation of Japanese bankers felt no need to evaluate the underlying risk of their operations, protected as they were from outside shocks.

Government protection combined with cheap funds encouraged industrial development. By the end of the 1950s, only about 20 per cent of Japan's imports were free of either bans or quotas. During the post-war occupation (1945–52), US vehicles filled the Japanese market, owing to limited domestic production and the suspension of pre-war restriction on imports. The MITI (Ministry of International Trade and Industry) subsequently restricted foreign exchange allocations and imposed a value-added tax of 40 per cent on imported automobiles. As a result, domestic production blossomed. Between 1951 and

1961 the ratio of imported cars to domestic sales declined from 44.6 per cent to 0.7 per cent. Imports remained at this negligible level for the next 20 years. It is doubtful that an entirely indigenous Japanese car industry would have existed without direct post-war government protection designed to foster that sector. Government and industry enthusiastically embraced this policy since it maintained limited foreign reserves while providing a large outlet for a revived steel industry.⁷

Household sector Post-war Japan placed a distinctive emphasis on economic growth, focusing on the need to draw level with Western industrialized countries, much as it did during the Meiji Restoration. Although living standards did rise rapidly during this period, Japan was a society with a distinct focus on production rather than consumption. Government welfare expenditures were initially very low. Even by 1965, these outlays consisted of less than 1 per cent of national income, leaving Japan at the very bottom of the spending tables formulated by the Organisation for Economic Co-operation and Development (OECD). This was feasible due to several factors. In the 1950s, Japan was still a very young country, with just 5 per cent of the population over 65. The extended family, in particular the heavily burdened daughter-in-law, took care of the elderly. Even in the early 1990s, 60 per cent of the elderly were still living with their son and daughter-in-law (compared with 20 per cent in the United States). Employers came to be major providers of social services. This included housing and recreational activities, as well as pension and health care. The fact that such a large percentage of welfare services remained in the private sector would emphasize the need for a predictably growing economy. Private rather than public provision would increase the role played by job security and insure a relatively stable workforce. Japanese employees would change jobs much less frequently than their US counterparts.

Lacking publicly provided security, Japanese workers responded to demands for corporate loyalty. (The Japanese of this era took fewer than nine days' leave per year.) The evolving hierarchical structure cultivated a perceived Japanese desire to belong, to be part of a group. Widespread consultations (*nemiwashii*) became the norm before decisions were taken. This allowed responsibility to be shared broadly, as well as rewards. Rapid responses might be difficult but implementation was highly effective once a decision was taken.

From the Western viewpoint, the Japanese were still no more than 'workaholics living in rabbit hutches'. Population density ensured that housing remained small and expensive. The problem was exacerbated by legal restrictions and societal norms. Agricultural subsidies meant that land, even in urban regions, remained farmland rather than shifting into the ever-growing housing sector. Land itself as an asset was lightly taxed, with agricultural land taxed below residential or commercial use rates. The belief in an ever-rising value of land led owners to hold on to their property.

The Japanese however, do share a desire to own their own homes, and considering housing costs, the percentage privately owned is quite high (approximately 60 per cent). The enormous postal savings system underwrote home ownership assisted by tax incentives. Tax-exempt postal savings could be lent at below market rates to the government Trust Fund Bureau, which in turn could lend at subsidized rates to the Housing Loan Corporation (HLC). In this way the HLC became Japan's biggest housing loan originator.

The social safety net showed signs of expansion with expenditure on health care growing rapidly, although from a low base. The rate of physicians per 1000 inhabitants however, still lagged behind Western standards, and the quality of care remained variable. Government protection of the pharmaceutical sector resulted in a non-competitive and non-innovative industry, riddled by scandals involving the dubious approval of dangerous drugs. The production psychology that dominated these early post-war years led the government to provide little protection for ordinary citizens against possible corporate misdeeds. Nor were funds expended on public and recreational facilities. In a work-saturated environment, the driving force was to rebuild Japan into a dominant economic power. At this stage of its development Japan remained a country clearly looking to the future.

1973–92: a period of dominance

Japan depends heavily on imports for its petroleum supply (by the 1990s, 99.7 per cent of its requirements were imported, with 79.4 per cent coming from the Middle East). Before 1973, with petroleum prices remaining at low levels, Japan followed the West in fostering energy-specific industries. The sudden increase in petroleum prices, combined with the ending of the Viet Nam War, was a severe setback for the Japanese economy. Industrial production declined by 9 per cent in 1974, profits disappeared and some 11 000 firms shut down. How to pay for the dramatically increased outflows of capital without institutionalizing either inflation or a cyclically stagnating economy became the paramount problem. In resolving this major challenge, Japan would make a decided break with common Western practices. The ‘oil shock’ turned into an opportunity rather than a catastrophe. By 1983 Japan would have withstood both the first and second (1978) oil shock to emerge as the world’s second largest economy. Japan’s success in resolving this unforeseen challenge would set in motion not only measures to maintain its current account position and to permit the economy to grow in an uninterrupted fashion, but also would foster structural distortions. These eventually led to the ‘bubble economy’ of the late 1980s and its subsequent collapse in the 1990s.

From the early 1970s, growth in aggregate demand began to fall short of growth in output, a pattern that has become increasingly pronounced since the late 1970s. From 1979, Japan’s growth in domestic demand has, on average, lagged a full percentage point behind the pace of output growth. Reflecting this gap, the current account surplus widened dramatically to more than 4 per cent of GDP in 1986. Japan attempted to offset the additional expense of higher petroleum costs by increasing its exports. With productivity rising faster than wages, domestic demand therefore gave way in importance to rising exports.

Docile in-house unions cooperated in a cost-sharing effort aimed at keeping those wages internationally competitive. Workers accepted a smaller share of productivity increases in return for secure jobs. This was crucial, as during this period Japanese productivity increases were clearly the highest among OECD countries. Consensus-driven Japanese employees did not engage in inflationary wage demands. As a consequence, wage increases varied little among industrial sectors. The close collaboration that had developed between union leaders, employer associations and government bureaucrats resulted in the unions agreeing to make the maximum possible concessions.

The government supported employment in structurally depressed heavy industries (like steel and shipbuilding), while such value-added industries as cars, consumer electronics

and machine tools gained an increasing percentage of exports, as well as absorbing a greater share of the workforce. By 1987, road vehicles accounted for 25 per cent of total exports compared with 15 per cent in 1975. The contribution of the iron and steel industry however, declined from 18 per cent in 1975 to 5 per cent in 1987. Japanese manufacturing breakthroughs delivered higher quality output at lower cost. This allowed Japan to maintain a substantial high value-added manufacturing sector in contrast to other industrialized countries that were rapidly switching to more service-dominated economies. In Japan the number of employees working in the primary sector decreased from 53.4 per cent of the workforce in 1947 down to 17.4 per cent in 1970 and then only 7.2 per cent in 1990. However, the numbers employed in the secondary sector (manufacturing, mining and construction) rose from 23.3 per cent in 1947 to 35.2 per cent in 1970 and only tailed off to 33.6 per cent in 1990.

The success of the manufacturing sector, particularly in exporting to the United States and Europe, enabled the Japanese not only to subsidize their agricultural sector by increasing amounts, but also to continue to protect jobs in unproductive service and financial sectors. Protection (and income redistribution) extended as well to declining industries like textiles, steel and shipbuilding.

When compared with the export performance of the United States during this critical period, Japan began to be regarded in the 1980s as invincible. Both US and European counterparts saw Japan's growing exports as a threat to their domestic manufacturing industries. The disappearance of US-manufactured television sets, for example, became for many US politicians a warning of the dire future in store for the entire domestic manufacturing industry. Less competitive countries ascribed Japan's success to unfair practices such as 'dumping' overseas while protecting domestic markets. The Japanese responded by making straightforward efficiency claims. Accurate analysis was beside the point. Japan's reluctance to import, inevitably increased trade tensions. Political solutions led to 'voluntary' quota restrictions on Japanese exports such as steel, televisions, cars and semi-conductors.

Attempts to open up the Japanese market encountered little success during this period. Debate over whether or not non-tariff barriers were the root cause of the problem remained an unsolved issue. Both sides simply chose to interpret data to support their objectives. Whatever its true cause, the Japanese export success was even more remarkable given the steady strengthening of the yen once it was allowed to float from 1973. Starting in that year at 301.5 yen to the US dollar, by 1992 the yen's value against the dollar had risen to 158.8.

Labour relations and corporate structure The special characteristics of what might be termed the 'Japanese system' became more pronounced during this period. Internally generated cash flow enabled many of the largest firms to become self-financing. The indirect system of financing through the main bank, and the associated restraints exerted by these generally more conservative organizations, weakened substantially. The need for the government to draw on national savings through bond issues in the years immediately following the first 'oil shock' (expanding the social safety net, for example) initiated a loosening of financial control, leading to the beginning of financial deregulation. This further shifted the balance between main banks and their borrowers as more funds began to be raised directly. Corporate investment, although not at the insupportable rates of the

previous period, was still considerably higher in absolute terms than in corresponding industrialized countries. Critics contended that this essential lack of accountability to any stringent monitoring agent allowed Japanese managers to push for market expansion whatever its profitability. Even so, corporate investment could not sufficiently absorb the huge lump of national savings produced every year. Japan inexorably accumulated a current account surplus. It rose steadily from \$US4700 million in 1981 to \$US87000 million in 1986, before a strengthening yen reduced it to \$US35000 million in 1990. However, this ineradicably persistent surplus reached \$US117500 million just as the Japanese bubble burst in 1992. A result of this expanding surplus was a corresponding increase in direct foreign investment abroad. Although initially a way to overcome trade barriers or to secure essential raw materials, rising wages and a steadily appreciating yen began to make Japanese exporters less competitive, especially when faced with improving performances by foreign firms.

Moving production offshore, especially to East Asia, became one way of constraining cost. Starting from \$US227 million in 1966, investment reached a record \$US67000 million in 1989 (17 per cent of the world's total). This was nearly equal to the United States (\$US40000 million) and the United Kingdom (\$US37000 million) combined. Projecting continued expansion into the foreseeable future, Japanese firms increased their hiring, in effect attempting to hoard labour in anticipation of a future shortage. Job stability became even more entrenched, especially in large firms. Mid-career recruits became rarer, with most workers entering corporate life directly from school and seldom switching employment after the age of 30. Japanese workers came to expect secure employment and an absence of risk.

Government policy The 'oil shock' plus rising demand for social services caused the Japanese to deviate from the conservative budgeting approach laid down by their occupation mentor, Joseph Dodge. Japan was obliged to address the dual threats of stagnation and inflation, while learning to accept a floating exchange rate. Consumer prices increased 24.5 per cent in the 12 months preceding December 1974. For the first time, Japan recorded budget deficits, seeking to stimulate the economy while using constrictive monetary policy to restrain inflation.

An ensuing thrust into world capital markets led to a gradual deregulation of the financial system. In 1980, foreign exchange controls were abolished and large security companies were allowed to borrow in the call market. In the following year, city banks were permitted to buy in the *gensaki* (repo market). Having been given the go ahead to sell government bonds over the counter in the previous year, in 1984 a government bond futures market was established. By 1993, interest rates on time deposits had been completely liberalized and in 1994, interest rates on non-time deposits (including postal savings) were also liberalized. This signalled a breakdown of the traditional role of corporate lending as the almost exclusive focus of city banks (the main bank role). The search for alternative financial functions in part fuelled the lethal bubble economy ending this last period of growth.

Household sector While the United States was agonizing over the problem of its growing underclass and Europe worried about increasing structural unemployment, the Japanese were busily maintaining their position as the archetypical middle class country. Income

distribution remained relatively equal when compared with other industrialized countries. Despite the rapid expansion of the corporate sector, executive management staff did not achieve gains similar to those won by their US counterparts. While executive compensation in the United States reached 30 times that of the wages earned on the factory floor, Japan's levels barely reached a multiple of 10. The Japanese idea of creating a low-risk society where no one was excluded seemed within reach.

However, despite, or perhaps more accurately because of, the rising sums being spent on government-subsidized mortgages, the increase in house prices in the 1980s started to raise the cost of housing beyond the reach of younger people attempting to enter the market for the first time, thus denying to many the very symbol of middle class life.⁸ Houses were bought by an increasingly older demographic group. Children tended to remain with their parents longer, while trying to save for the necessary down payment for their first home. Correspondingly, marriages were delayed and the birth rate edged down steadily. Given the increase of single children in these late marriages, this tended to amplify the problem since traditionally the eldest son bore responsibility for the care of aged parents. With a greater percentage of eligible men being single children, women faced the prospect of becoming the primary carer for their in-laws and further delayed any marriage commitment.

Urban land prices increased fivefold between 1970 and 1991. In the six biggest cities (Tokyo, Yokohama, Osaka, Nagoya, Sapporo and Kobe) these prices increased sixfold. The major cities continued to expand, creating ever-lengthening commuter journeys to work. With husbands often at home only at weekends, the households increasingly became the sole domain of women. Education became the domain of 'the education-crazed mamas' left by their 'salarymen' husbands to look after the household and raise the children. The path to a successful career increasingly lay in securing entry into a good university. Places were awarded according to examination results, which stressed prodigious memorization skills. Given the very limited places, competition for them steadily increased, and children spent more time studying. Not only did they attend their required classes, but spent additional hours at 'cram' schools (*juku*). Ironically, once in university little in the way of serious education or training occurred. Corporations conducted their own extensive and specific on-the-job training, while universities served mainly to screen potential applicants.

The 'bubble economy' The Nikkei average index of stocks plunged from a record high of 38 915 in December 1989 to 14 309 in August 1992, a decline of 63.2 per cent. This was an unprecedented drop by post-war standards, and made clear to even the most optimistic observer that Japan's 'bubble economy' had definitely ended. While other countries successfully managed post-bubble recoveries, the Japanese economy displayed a surprising paralysis, going from stagnation to fitful growth and then into recession.

Asset inflation implies an underlying miscalculation of risk. Credit expands rapidly, in part because borrowers undertake increasingly dubious projects encouraged by low interest rates and easy lending regimes. Lenders underestimate the riskiness of providing credit by overvaluing the underlying asset purchased with the loan. In Japan's case, an extended period of success led business leaders and bankers to confuse asset inflation with real economic growth. Since the start of the decade, the Bank of Japan had steadily decreased its discount rate (9 per cent in 1980 to 2.5 per cent in 1987). Even more importantly, to

jump-start domestic demand after the Plaza Accord strengthened the value of the yen, the Bank of Japan used its traditional tool of window guidance (moral suasion) to foist large flows of cash into the hands of the banking establishment. Given that the worst strategy a bank can adopt (other than losing funds) is simply to sit on cash, banks aggressively expanded their lending practices.

The historically low rates achieved in 1987 (2.5 per cent) were sustained for another two years by a central bank determined to demonstrate that Japan was immune to the type of economic instability that plagued foreign countries. Easy credit, combined with rising confidence in the assured destiny of the Japanese economy, led to an unfortunate sense of overconfidence. Borrowers believed that their loans would inevitably be rescheduled. Owing to the widely held view that land prices were incapable of falling, banks did not take the trouble to evaluate with any care the riskiness of the loans, given the widely held expectation that the value of underlying collateral (often real estate) could only appreciate. Government bureaucrats, emboldened by a successful resistance to the 1987 foreign stock exchange crashes, assumed that they could control and rectify any conceivable difficulty that they might encounter. Memories of failure dimmed, remaining in the minds only of the pre-war elderly. Government expenditure and taxes were necessarily low, given the security provided by a reliably growing economy and a private sector that protected jobs. Japan gained a reputation for invincibility, but failed to realize that underlying problems were emerging as a result of this period of prolonged asset inflation. The economy as a whole depended on a narrow group of manufacturing firms that faced increased competition from revived US and European rivals, as well as new East Asian entrants.

Main banks had become ever more aggressive lenders. This was an unforeseen effect of the initial stages of financial deregulation, coupled with the continued success of corporate Japan. The main banks turned elsewhere for lending purposes, given the ability of large corporations to tap credit markets directly (through commercial paper) or the attraction of selling shares in a rising market. As in the United States or Australia, inexperienced lenders facing an increasingly competitive loan market gravitated towards making more questionable loans including murky deals in collaboration with organized crime (*yakuza*). Corporations also realized that money could be made quickly and more easily through speculation rather than by solid investment. Households contributed by pouring in their own net financial assets (13 000 million yen), which also fuelled the rapidly expanding bubble. The inevitable price collapse occurred as the Bank of Japan, finally taking action after a two-year delay, rapidly raised the discount rate from 2.5 per cent in 1989 to 6.2 per cent in mid-1990 and maintained that level for nearly a year.

The underlying weakness in the banking sector would ultimately limit recovery and by 1997 push Japan into its worst post-war recession. Much of the difficulty in implementing any fundamental structural change lay in a refusal on the part of leading members of the 'iron triangle' to accept the possibility that what had worked in the past would not continue to do so in the future. Equally, if not more responsible, was a monetary policy that largely starved the Japanese economy of credit at crucial periods. The Bank of Japan seemed determined to push its agenda of structural reform without regard to the short-term economic fallout. Previous post-war success led the Japanese government and business leaders to feel no sense of urgency. Because of this approach, the Japanese economy would miss out on the economic growth most other economies enjoyed in the 1990s.

1992–2003: the anorexic economy

In 1996, compared with the previous year, real GDP growth of 3.9 per cent was recorded. In 1997 however, GDP expanded by only 0.9 per cent. By 1998 the rate of unemployment had exceeded 4.0 per cent of the labour force (compared with 2.2 per cent in 1992). The second quarter of 1998 yielded an even bleaker result than anticipated. GDP contracted for the third consecutive quarter, making this downturn the worst in Japan's post-war history.

A decline of 0.8 per cent (an annualized decrease of 3.3 per cent) made it clear that Japan could be approaching a dangerous deflationary spiral. Growth essentially stopped between 1998 and 2002, with the economy growing only by a negligible annual rate of 0.2 per cent per annum. Private corporate investment in the second quarter of 1998 had fallen by 5.5 per cent. Between the peak of 1991 and mid-1998, land prices for residential sites had decreased by nearly 50 per cent, while those for commercial property had declined by as much as 80 per cent. Housing starts continued to fall, with housing investment in the second quarter of 1998 down by 1 per cent. On the stock market the Nikkei average fell below 14 000 and started to approach historic lows (eventually dipping below 8000). By mid-1998, the large amounts of funds being invested in ten-year government bonds had driven the yield down to a record low of 0.77 per cent, the call rate being an insignificant 0.25 per cent. Despite tax cuts and fiscal stimulus measures, worried citizens continued to place funds in postal savings accounts. Consumers remained concerned about employment and about their pensions, feeling betrayed by bureaucrats and business leaders whom they had implicitly trusted.

Consumers, who had largely sustained the meagre growth of the early 1990s, had simply stopped spending. They would not resume any significant spending throughout this period with wage growth virtually stuck at zero. To simply maintain their standard of living, Japanese households would start spending out of their savings. From a rate of 11 per cent in the mid-1990s, household saving would drop steadily to rates nearing 3 per cent by the end of this slow growth period.⁹ A zero interest rate policy failed to have any noticeable effect when combined with too tight credit creation. Nor did fiscal policy boost aggregate demand. Government spending deficits were financed by bond issues largely taken up by the banking community.¹⁰ Any potential expansionary tendency of deficit spending was largely nullified, with funds being withdrawn from the private sphere.

Given the bad loans Japanese banks laboured under (at its height an estimated 100 trillion yen worth), the sort of lending and borrowing required for economic expansion simply did not occur. Businesses intent on cleaning up the excess debt on their balance sheets, moved from a negative saving regime that characterized the 'bubble' years to one that was strongly positive. Banks played accounting tricks, rolled over or forgave bad loans, but essentially tied up funds in failing businesses instead of extending new loans to expanding ones.

Despite the apparent seriousness of the economic situation throughout this period, the urgency of the problem was reflected in the words of politicians and government officials rather than by their deeds. Slow growth was not immediately alarming, with the dire warnings focused on an imminent financial collapse failing to materialize. Gross National Income by 2003 was US\$35 497.47 per person, still second highest amongst nations. Continuing trade surpluses created the world's largest foreign currency reserves. Unemployment would creep above 5 per cent at its highest point, but any pain resulting from this persistent slow growth seemed diffused widely. Tokyo, for instance, continued to appear a vibrant, growing metropolis throughout all these economic woes.

Response to the end of the 'bubble economy' Superficially, the economic downturn that began in 1992 appeared to differ little from the distortions representative of any business cycle. An excessive build-up of investment stock would normally imply a decrease in investment (business fixed investment did decline over a three-year period), falling asset prices, and an eventual recovery resulting from depreciation of existing business stock and a much lower level of asset prices. Unfortunately, underlying the expected weak investment, there was a more fundamental problem that curbed any potential recovery.

The banks and the financial system at large symbolized much of what was wrong with the Japanese economy, particularly its corporate governance and accompanying betrayal of trust. Scandals at the largest brokerage house, Nomura Securities, and at one of the major banks at that time, Dai-ichi Kangyo, in late 1995 and early 1996 revealed that a basic 'protection racket' was transferring funds to *yakuza* (organized crime) in the form of loans never intended to be repaid and stock purchases with no downside risk (losses were made good by the brokers). Regulators, such as those at the Ministry of Finance, were clearly more concerned with the best interests of banking officials than with economic growth or welfare. (Bank examiners forewarned the relevant corporate officials of audits, allowing funds to be moved around in such a way as to disguise the weakness of a bank's capital base.) The Japanese bureaucrats, almost totally responsible for policy initiatives, maintained their status quo position in the expectation that asset prices had reached a record low and were about to recover.

The 'convoy' mentality held firm as Ministry of Finance officials made only marginal attempts to prevent any abrupt or considerable disruptions to the financial system. This meant that stronger banks for instance, would be expected to support their weaker counterparts, either via forced mergers or cash infusions. In turn, banks would bail out corporations by rolling over their loans at subsidized interest rates or directing additional funds in their direction. In contrast with how efficient financial markets should work, this convoy system insured that resources flowed to the most inefficient sectors of the economy during a recession. This was an effective recipe for prolonging rather than minimizing the length of any downturn. However, this approach did reduce the burden borne by any one sector or firm. As noted before, such risks and costs were effectively socialized.

To boost the economy and restore confidence, policy-makers fell back on traditional remedies. The export-led growth of the 1970s became a paradigm of post-bubble strategy. (After a long delay, this approach did partially pull Japan out of the worse of its problems, thanks largely to an inexhaustible Chinese market.) Accordingly, current account surpluses rose steadily. However, during the 1990s some of the strength of this strategy was undermined by rising yen values, especially against the dollar (reaching a high point of 80 yen to the dollar) and by the threat of US reprisals.¹¹ Japanese manufacturers responded to the strong yen and high wages by shifting more operations offshore, both to re-export back into Japan and to sell into booming East Asian markets (especially those of Indonesia and Thailand). As the East Asian boom gathered momentum in 1996, 44.1 per cent of Japanese exports went to other Asian countries with 37.3 per cent of imports being of Asian origin. Japanese banks shovelled funds into East Asia in the hope of recouping their domestic losses.

The other policy was one of fiscal stimulus. Budgets that had reverted to surpluses during the era of asset inflation quickly changed direction. As a percentage of GDP, the budget deficit increased from 3 per cent in 1994, to 3.9 per cent in 1995 and then 4.1 per cent in

1996. Unfortunately, the primary driving force behind fiscal stimulus was repayment for political support of the LDP rather than an attempt to revive the economy. Much of the money was spent on dubious construction projects intended to reward key constituencies and more importantly, to float insolvent, but very large, construction companies.¹²

Whatever the actual wisdom of the exact nature of the fiscal stimulus programme, it did seem to yield results. The 3.9 per cent increase in GDP recorded for 1996 easily surpassed the OECD average of 2.7 per cent. Investment surged. What abruptly halted any such recovery was a concatenation of three basic events. The first involved the Ministry of Finance acting on dubious economic principles and backed by insufficient evidence. Assuming that the Japanese economy was solidly established on its course of long-term growth, the Hashimoto government dutifully pushed fiscal consolidation forward. Despite still fragile consumer spending, policy-makers cut government expenditure while increasing consumption taxes. This had predictable results.

At the same time, from mid-1997, the Asian Crisis, as it became known, led to the contraction of the regional export market while loans that were once regarded as a life-saver thrown to the capital base of the Japanese banking system now threatened to turn into a depth charge undermining that base instead. Banks had outstanding East Asian loans totalling \$US265 billion. These largely unrepayable debts were mostly the responsibility of Indonesia, Thailand and South Korea. The Asian Crisis also temporarily removed an investment destination for opportunity-starved Japanese corporations with domestic expansion limited. In 1998, the EPA (Economic Planning Agency) estimated that in total, the 4500 major Japanese companies surveyed planned to reduce direct foreign investment by 57 per cent. That would indicate a fall in such investment from 4.2 trillion yen in 1990 to 1.2 trillion yen in the space of eight years.¹³

The last and ultimately most negative factor, one exacerbated by the previous two, proved to be the emergence and realization of the extent of the bad loan problem, deliberately shrouded until 1997–98 by the efforts of bureaucrats and bankers. Policy under succeeding LDP governments (Hashimoto, Obuchi, Moro and Koizumi) underplayed the seriousness of the banking sector problem while providing some needed emergency funds to keep large banking concerns afloat. Large city banks did not actually go under. The very largest merged into four mega-banks (which became three when the weakest of them, UFJ, merged successfully with the Bank of Tokyo-Mitsubishi in January 2006). This merger movement, encouraged by Ministry of Finance bureaucrats, had more to do with creating banks too big to fail and in that way boosting customer confidence than with any conceivable economies of scale or scope.

Foreign direct investment grew significantly with Renault gaining control of a failing Nissan Motors and successfully turning it around. (Daimler had less joy with running Mitsubishi and has since relinquished interest in that concern.) Prime Minister Koizumi appeared to actually court foreign investment.¹⁴ Working counter to such encouragement, it has still proven difficult for even Japanese, let alone an overseas firm, to launch hostile takeovers against poorly performing firms. The period between 1998 and 2003 alternated between cautious optimism and black-hearted despair. In fact, Japan's failure to either recover some of its former glory or to sink into a total miasma of despair has helped China to become the new economic epicentre in East Asia with Japan going off-radar to some extent. It should be noted that recovery seemed possible in 2000. Share values were rising smartly, growth picked up from its low or even negative base with price deflation

easing. Unfortunately, superficial appearances were misleading. Share values largely reflected an influx of 'stupid foreign funds' gulled by a false belief in a growing recovery. However, any stock rally was bound to falter since the desire by Japanese banks to unload their share holdings led ultimately to an implicit cap on prices. As it turned out, increased foreign holdings merely replaced bank (and other *keiretsu*-type) shareholdings.

Also unchanged was consumer spending (comprising 55 per cent of aggregate demand). Stagnant wages, a sustained drop in housing prices, and the need to support both ageing parents and stay-at-home children, put strains on household budgets. Moreover, an on-again, off-again monetary policy that seemed to tighten credit at the first sign of any recovery doomed Japan's economic prospects.

Future prospects: 2003 and onwards

It must be said that, despite government policies, including the supposed reform agenda put forth by Prime Minister Koizumi, the Japanese economy seems to have finally risen from a decade of enervation, starting sometime during 2003. Two causes sustained this potential recovery. The remarkable growth of China boosted exports. Nearly half of the increase derived from this single source. China (including Hong Kong) became Japan's largest single trading partner, with trade amounting to 22.2 trillion yen or 20.1 per cent of Japan's total trade. This compares with bilateral trade of 20.48 trillion yen with the United States. Moreover, trade with China remained largely complementary. Starting from an initial trade deficit with China, Japan was now moving into a position resembling rough trade parity.

Responding to this steady export expansion, business investment, including business inventories, also grew. In the previous ten years, business focus tended to be limited to reducing costs and paying down corporate debt loads. Net business saving had turned resolutely positive, constraining any expansion of aggregate demand. What limited this recovery was the lack of any clear pickup in consumer spending. With wages remaining stagnant and consumers cautious, a definite trend in the economy seemed initially difficult to discern. Without sustained growth in domestic consumption the Japanese economy was once again in danger of slipping back into the doldrums. However, starting in 2004 and continuing into 2005, domestic demand showed clear signs of economic revival, with domestic consumption finally showing sustained growth. Unemployment in June 2005 dropped to 4.2 per cent, from its peak of 5.5 per cent in 2003. More importantly there were 96 real job offers for every 100 applicants, the highest rate since 1992. Even the long-dormant property market showed incipient signs of life. Land prices in Tokyo rose (2004) for the first time in 14 years. These trends, along with wage growth, could drive the economy via domestic demand.

For example, the 2 per cent growth in 2003 (following a decrease of 1.1 per cent 2001 and minimal growth of 0.8 per cent in 2002) was propelled by a 0.8 per cent contribution from the trade balance. Domestically, almost all of the growth came from business investment (four times as much as the limited change in domestic consumption). In contrast, the 1.9 per cent growth in 2004 saw a minimal trade contribution of 0.4 per cent. The rest came from domestic growth with private business investment and private consumption almost equally matched. A similar trend has occurred in the first two quarters of 2005, though expectations are that growth for 2005 will be only 1.5 per cent. The hope is that disposable income, which had been falling until 2004 and has only been slowly increasing,

will start to pick up. Only then will it become clear whether Japan can sustain a growth rate that is higher than 2 per cent per annum.

Problems and outlook

The OECD has estimated that annual GDP growth in Japan will average only 0.8 per cent per annum. Forecasters for the Ministry of Health, Labour and Welfare are even gloomier, with a forecast of 0.7 per cent per annum until 2015. These bleak outlooks are driven by the fact that the labour force is expected to decrease by 0.5 per cent starting in 2005. This shrinking labour base is not seen as being counterbalanced by increased productivity. So far there has been no sign of any significant up-tick, with productivity growth here stuck at 1.4 per cent.

The decade of anorexic growth that Japan had endured up to 2003 may have some decided effects on the chance for needed productivity growth to make up for Japan's shrinking workforce. The younger generation of workers are receiving insufficient training. In the post-war era, most training was on-the-job, encouraged by stable, long-term commitments between employer and employee. Amongst the current crop of young Japanese, NEETs (not in employment, education or training) account for 850 000 people between 15 and 34. Freeters (young people working short-term, low-skill jobs) are estimated at 4 million or 15 per cent of that group of young workers. In fact the idea of a Japanese workforce enjoying secure jobs is now far from accurate, with 30 per cent of those employed working part-time. This trend is continuing, with firms still cutting costs by replacing permanent positions with part-time ones.

In effect, the idea of creating a middle class society is dying, if not already dead. In 1981 the Japanese Gini coefficient, measuring equality of income distribution, was 0.349 before government redistribution efforts and 0.314 after. By 1999 the numbers were 0.472 and 0.381. While still a bit better than the United States or United Kingdom, Japan is now only the fifteenth most egalitarian country amongst the 20 OECD members. Accordingly, perceptions within Japan had changed greatly. In 1994, surveys found 90 per cent of the population thinking of themselves as middle class. The post-war goal of creating a middle class society had been seemingly achieved. In a similar survey conducted a decade later, 60 per cent now saw themselves as below middle class. In 1995, 600 000 Japanese households needed welfare benefits to survive, with this number jumping to 1 000 000 by the end of the decade. The rising use of the terms *kachigumi* (winners) and *makegumi* (losers) to describe the divisions becoming clear in Japanese society, indicates that the dream of creating a low-risk, middle class society has badly frayed if not disappeared. Also disappearing was the model of dutiful and studious children studying long hours. Discipline within classrooms deteriorated while long-term truancy increased by 80 per cent over the last decade.

This has the potential to create future economic difficulties since a poorly educated or insufficiently trained workforce can hardly be expected to boost productivity growth from 1.4 per cent to a rate over 2 per cent. This failure could turn a manageable demographic adjustment into a much more serious problem. Japan's population is ageing rapidly. Projections have the percentage of people over 65 rising from 17 per cent in 2000 to 23 per cent in 2015. Further projections see this figure peaking at 30 per cent by 2025. This must inevitably put strain on the public budget in terms of increased health care.¹⁵ Higher taxes are not necessarily a problem where income is also rising at a healthy rate. But an anticipated per capita growth rate of 0.7 per cent (GDP/capita) is hardly sufficient.

Part of the problem is that welfare costs are gradually being shifted back to the public sector and away from the corporate or family arenas. Once, the wife of the eldest son was expected to care for her in-laws. Japanese women now are less willing to live up to these expectations. The multi-generational household is also becoming less common as well. The role of women has been changing in Japan, but this change is proceeding quite slowly and from a clearly low base. In 1999, the difference between male and female median full-time earnings as a percentage of male median full-time earnings was 39 per cent, the second largest disparity among developed economies. (Only South Korea had worse results.) Judged by an international gender empowerment index, Japan is at the very bottom of 17 industrialized countries.¹⁶ Even today only 9 per cent of administrators and managers in Japan are women. It is hardly surprising that some of the brightest women (often with good language skills) are opting to work with foreign corporations where they see a chance for real advancement. Clearly one way to overcome the potential workforce problem is to make better use of, by providing more opportunities for, women. The days where women were employed as 'office ladies' are no longer viable.

Conclusion

In the very short term, Japan cannot expect to see a sustained growth rate much beyond 1 per cent. Increasing growth capacity requires more radical reforms, including the selling off of assets, even if the buyers are overseas firms. The biggest challenge consists of the necessity to implement fundamental changes in order to transform the economy from one focused on reducing risk to one where risk-taking is appropriately rewarded. Although major Japanese corporations have been moving away from traditional hierarchic structures featuring job security and seniority systems, change has still been limited. Neither the tax system, nor the financial and social environment that dominates corporate environments, creates sufficient incentives for Japanese managers to actively foster innovation. As long as they avoid bankruptcy, managers with poorly performing firms can still manage to hold on to their positions.

The past decade has demonstrated that neither politicians nor bureaucrats intend to take the lead in this regard. The momentum behind any change must come from the increasing disillusionment of the Japanese people. In a sense, an implicit agreement has been broken. The Japanese had been assured by their business, political and government leaders that, if they were loyal and worked hard, they would be provided for. This assurance vanished abruptly after a very few years of striking success in the 1980s. The Japanese now find that they were being taken advantage of, rather than taken care of.

Notes

1. Until the Meiji Restoration in 1868, Japanese emperors ruled in name only while residing in the ancient capital of Kyoto. The real power remained in the hands of a powerful clan headed by its leader (known in the West as the *shogun*). The Tokugawa *Bakufu*, for strategic reasons, established its working capital in Edo (later Tokyo) away from the ceremonial capital of the Emperor.
2. The period was noted not only for its Westernized factories and culture but for political assassination, the great Kanto earthquake, rice riots and an inability to curb military ambitions.
3. Equally important and far more ruthless was Nobusuke Kishi. A wartime cabinet minister, jailed until 1948, he joined the then Democratic Party in 1952. In 1955 as head of the Democratic Party he engineered the merger with Yoshida's Liberals ensuring conservative domination of Japanese politics.
4. The Viet Nam War would later be highly beneficial from an economic standpoint for Japan. US spending would help accelerate Japan's catch-up policy of development in the 1960s.

5. A decade later this would see the crumbling of the Yoshida Doctrine as calls for the repeal of Article IX became increasingly common amongst the more conservative and right-wing elements of the political spectrum. The mysterious appeal of becoming a 'normal country', though ill-defined, would see the Japanese send non-combatant troops to Iraq (2004–05). These 1500 troops, protected first by Dutch and then Australian soldiers, were no more than symbolic. However, it did represent a potentially major shift for Japanese international policy.
6. The reality differed. Influential bureaucrats had pushed for land reform during the War years. The Allied proposal met with little concerted Japanese opposition.
7. It is unlikely that the industry that did develop would have been as capable of taking advantage of the 'oil shocks' of the 1970s, in the absence of such assistance.
8. As the housing bubble gained impetus, home ownership declined. In 1988, 62 per cent of all households owned their own home, by 1993 only 60 per cent.
9. A common assumption of many writers had been that Japanese households were culturally conditioned to save significant portions of their income. Faced with stagnating real incomes, the Japanese reacted more like Milton Friedman's permanent income hypothesis would have predicted than those devoted to cultural imperatives.
10. Banks could borrow funds at 0 per cent from the Bank of Japan and gain risk-free income from purchased government bonds.
11. As the decade of the 1990s wore on and Japan's economic problems became more apparent, trade issues with the United States became less pressing.
12. By 1998 the total interest-bearing liabilities owed by the 119 largest builders totalled 10 400 000 million yen. Indirectly, this financial support also maintained the viability of barely solvent banks as well. Japan, a country with slightly less than half the population of the United States and covering a considerably smaller geographic area, deployed more cement annually than did the entire US economy.
13. Total foreign direct investment outflows went from 20.5 per cent of the world's total in 1990 to 2.6 per cent in 1999.
14. Foreign direct investment into Japan was negligible before the turn of this century. In 1985 it was 1.1 per cent of total world inflows. By 1999 Japan's share was virtually unchanged at 1.3 per cent of total world inflow.
15. Some of the problems caused by an ageing population may be exaggerated by not fully considering savings due to fewer babies and children in the population. Needed educational facilities, to take one example, would decrease.
16. The index takes into account: seats in parliament held by women (per cent); female administrators and managers (per cent); female professional and technical workers (per cent); women's GDP per capita.

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2 South Korea

O. Yul Kwon

Introduction

South Korea's economic success between 1963 and 1996 is well documented, and stands as proof that a country can lift itself from poverty in one generation. As a result, the South Korean development model had attracted international attention. During three decades of economic expansion, South Korea transformed itself from one of the world's poorest countries to one of the richest, despite a lack of natural resources, a high population density, severe wartime devastation, and heavy defence expenditures. As shown in Table 2.1, economic growth averaged 8.7 per cent per annum between 1963 and 1996. Per capita GDP, just US\$87 in 1962, had increased to US\$10 548 by 1996. Nominal GDP increased from US\$2.3 billion in 1962 to US\$480.4 billion in 1996, establishing the South Korean economy as the eleventh largest in the world. In 1996, Korea became the twenty-ninth member of the OECD.

South Korea's economic miracle came to an abrupt end in November 1997 during the Asian Financial Crisis. Negative growth of 6.7 per cent was recorded in 1998, with unemployment climbing from 2.6 per cent in 1997 to 6.8 per cent in 1998 and the inflation rate rising from 4.5 to 7.5 per cent during the same period. The value of the South Korean currency plummeted from 844 won per dollar in 1996 to 1415 won per dollar in 1997. However, unlike other economies affected by the crisis, South Korea recovered quickly, achieving a 10.7 per cent growth rate in 1999, followed by 8.8 per cent growth in 2000. Once again, South Korea's economic performance stimulated broad international discussion, this time as a model for overcoming financial crisis, rather than as the developmental model of the recent past.

The objective of this chapter is to review and critically examine the South Korean economy's transition from success to financial crisis, and then to resurgence into the new millennium.

Miraculous development over the 1963–96 period

Extensive state intervention

Economic development in South Korea from the early 1960s can be broadly divided into two historical periods: the rapid growth period from 1963–96, and the post-1997 financial crisis period of economic restructuring. During the rapid growth period, the government intervened extensively in the economy. Until the late 1980s, the government rather than market forces controlled the direction and pace of South Korean industrialization. The consecutive five-year plans from 1962 provided clear and consistent signals to both domestic and international economic players.

Under the Park regime in the 1960s, maximum growth was sought through export-led industrialization in light, labour-intensive industries. All policy instruments were mobilized to support this strategy, including tax, trade, credit, foreign exchange allowances and interest rates, as well as a plethora of regulations. The most powerful was the allocation

of funds at preferential interest rates for export and investment in specific industries. In the 1970s, the focus of industrial policy changed to heavy and chemical industries. All policy tools, particularly credit allocation, were reoriented to the six targeted industries of steel, petrochemicals, metals, shipbuilding, electronics and machinery. In the early 1980s, the Chun regime was forced to adopt structural adjustment and stabilization measures in the direction of economic liberalization. Over-investment in heavy and chemical industry and concomitant under-investment in light industries had caused severe economic imbalances. Under pressure from international partners, trade liberalization measures were also undertaken in the mid-1980s.

The Roh Tae-Woo government pursued political democratization in parallel with economic liberalization, ending four decades of authoritarian rule in the late 1980s. The transition from state-led economic management to a free market approach imposed considerable adjustment costs. Labour disputes became rampant and violent, and wages increased in excess of productivity. Inflationary pressures accumulated, external imbalances were aggravated, international competitiveness was reduced and economic growth slowed. In 1993, the first civilian government in three decades was elected under Kim Young-Sam. The Kim government focused on further reforms to open South Korea to globalization, including deregulation of the financial sector and the promotion of foreign direct investment (FDI).

Transformation of the economy

During the period of rapid growth, the South Korean economy was profoundly transformed in many other respects. As shown in Table 2.1, rapid growth in the manufacturing and service sectors saw the share of agriculture in GNP decline drastically from 43.5 per cent in 1963 to 5.8 per cent in 1996. The manufacturing sector grew from 11.6 to 28.9 per cent of GNP, and the services sector increased from 44.9 to 65.3 per cent. Another striking transformation was a rapid expansion of trade. Exports increased from US\$90 million in 1963 to US\$130 billion in 1996. As a percentage of GNP, exports rose from 3.9 to 30.3 per cent, a direct result of increased manufactured exports. By 1996, manufactures comprised 92.9 per cent of total exports, the composition of which had shifted toward heavy and chemical products. The Korean economy is import-dependent on raw materials, crude oil, agricultural products and intermediate capital goods. Consequently, imports also increased from US\$500 million in 1963 to US\$150 billion in 1996. As a percentage of GNP, imports increased from 16.1 to 32.6 per cent over the same period. South Korea has become the world's twelfth largest trading nation as a result of such rapid import and export growth.¹

Rapid increases in saving and investment were another striking feature of Korean economic development. The gross investment rate increased from 17.0 per cent in 1963 to 38.1 per cent in 1996. Such a sustained accumulation of capital would not be possible without a significant increase in domestic saving. The gross saving rate increased from 14.4 per cent of GDP in 1963 to 33.8 per cent in 1996. Over the period 1971–96, labour productivity increased 9.8 per cent per year. Demand for labour has also grown, and employment rose from 7.7 million to 20.9 million over the 1963–96 period, representing a 3.1 per cent annual growth rate. Unemployment declined from 8.2 per cent in 1963 to 2 per cent in 1996.

Another important facet of post-1962 Korean economic development was the concentration of economic power in large, family-owned and managed industrial conglomerates,

Table 2.1 South Korea's major economic indicators, 1963–2002

	1963	1970	1980	1990	1996	1997	1998	2000	2001	2002
Population (millions)	27	32	38	43	46	46	46	47	47	48
An. population growth	2.82	2.21	1.57	0.99	0.96	0.94	0.72	0.84	0.71	0.63
GDP per capita (US\$)	100	247	1631	5891	11422	10371	6863	9821	9025	10005
GDP (US\$ bn.)	2.3	8	61	252	520	477	318	462	427	477
GDP growth rate (%)	9.1	7.5	-2.1	9.0	6.8	5.0	-6.7	9.3	3.1	6.3
Gross savings rate (%)	14.4	18.1	23.2	37.5	33.8	33.4	33.9	32.4	30.2	29.2
Gross invest. rate (%)	17.0	24.3	31.9	37.6	38.1	34.4	21.3	28.3	27.0	26.1
Share of GDP (%)										
Agriculture	43.5	26.5	14.9	8.5	5.8	5.4	4.9	4.7	4.3	4.0
Manufact.	11.6	22.4	31.0	28.8	28.9	28.9	30.9	31.3	30.5	29.2
Services	44.9	51.1	54.1	62.7	65.3	65.7	64.2	64.0	65.2	66.8
Employed (million)	7.7	9.6	13.7	18.1	20.9	21.2	19.9	21.2	21.6	22.2
Unempl. rate (%)	8.2	4.4	5.2	2.4	2.0	2.6	6.8	4.1	3.7	3.3
Inflation rate (%)	20.2	12.8	28.7	8.5	4.9	4.5	7.5	2.3	4.1	2.7
Exchange rate (won/US\$)	130	317	660	716	844	1415	1208	1260	1326	1200
Exports (US\$ bn.)	0.09	0.8	17.5	65.0	130	136	132	176	151	163
Imports (US\$ bn.)	0.50	2.0	22.3	69.8	150	145	90	159	138	148
Trade balance	-0.41	-1.2	-4.8	-2.0	-20	-9	+42	+17	+13	+15
Exports/GDP (%)	3.9	15.7	35.8	30.2	30.3	35.7	51.5	46.4	43.9	41.4
Imports/GDP (%)	16.1	24.8	45.8	31.5	32.6	37.3	39.5	43.9	41.9	39.9
Average annual growth rate (%)	1963–69 9.8	1970–79 9.7	1980–89 8.3	1990–99 6.2	1993–96 8.7	1993–2002 8.2	1998–2002 4.6			
An. product'y growth (%) [†]	n.a	8.9*	9.6	11.2	9.8**	9.4***	8.6			

Notes: [†] Labour productivity is measured as the index of constant GDP divided by the index of labour work hour input.

* Indicates value for 1971–79, ** for 1971–96 and *** for 1971–2002.

Source: Korea National Statistical Office (2004), *Major Statistics of the Korean Economy*, Seoul: KNSO, Bank of Korea (BOK) 2003; Korea Labor Institute (2003); Korea Productivity Center website (www.kpc.or.kr).

known as *chaebols*, characterized by central planning and close ties with government. With the diversification of the economy, *chaebols* rapidly expanded the scope of their businesses. In 1970, the 30 largest *chaebols* had 4.2 subsidiaries each on average. By 1989, this figure had increased to 17.1 (Lee, 1994).² By 1995, total sales of the 30 largest *chaebols* were equivalent to 90 per cent of South Korea's GDP (DFAT, 1996: 1). Unlike Japanese *keiretsu*, centred on banking institutions, *chaebols* cannot hold majority ownership of commercial banks. Ownership control is maintained by means of inter-company cross-ownership, and cross-guaranteeing of debt among subsidiaries.

During the initial stage of rapid growth in the 1960s, little attention was paid to income distribution and social development. However, due to successful land reforms over the 1947–50 period, and the destruction of all physical infrastructure during the Korean War, the population had to start from a similar level of poverty. This resulted in an income distribution among the most equitable in the developing world. In addition, cultural homogeneity, and the lack of entrenched regional, religious, or class differences in South Korean society have provided for a genuine equality of opportunity, particularly in the area of education. South Korea's initial labour-intensive development strategy also contributed to the egalitarian income distribution by providing employment for workers with minimal levels of education.

Contributing factors to South Korea's economic success

State intervention State intervention has been extensive in all sectors of the South Korean economy over the high-growth period. Intervention was implemented through indirect measures such as credit and foreign exchange allowances, interest rate policies, and other regulations not reflected in the state budget. State intervention was easily justifiable in the initial stage of South Korean economic development. Markets were too small and primitive to function effectively, and the institutions required for information and efficient market operation had not yet developed. Other features of underdevelopment, such as a lack of technology and economies of scale, also required government intervention and promotion.

Not only was state intervention justified during the initial stage of South Korean economic development during the 1960s and 1970s, but it worked well until the end of the 1980s because of a clear social consensus on policy goals, high organizational capabilities and a cooperative external environment. Strong nationalism pervaded in South Korea, generating a powerful incentive for citizens to prioritize national economic growth. A number of important institutions were also established. In 1962, the powerful Economic Planning Board assumed the central economic policy-making role, budgetary authority and administrative control over the banking system. Competent technocrats were secured through competitive civil service examinations, and almost every state ministry established its own research centre. The bureaucracy enjoyed a high degree of autonomy from political interference due to the societal respect and prestige associated with the economic ministries.

State control over business was developed through South Korea's unique style of government–business relations. Strong links were established between the government, *chaebols* and trade associations. Close government–business interactions were maintained through a number of councils and forums. Since the late 1980s, state strength has substantially declined due to South Korea's democratization, the increasing size and

importance of the private sector, and the imperatives of globalization. The nature of economic development has evolved from state-directed industrialization to a business-led one.

Export-led industrialization Due to its lack of natural resources and small domestic market, and to the well-established relationship between export expansion and economic growth, export-led industrialization has been fundamental to South Korean development. The focus of this strategy has changed over time. In the 1960s, South Korea's comparative advantage in surplus labour was utilized by the promotion of exports of labour-intensive manufactures. In the 1970s industrialized countries imposed trade restrictions on labour-intensive products, and upward pressure on wages eroded the comparative advantage of labour-intensive industries. South Korea needed to reduce imports of capital goods to rectify chronic trade deficits. Consequently, the composition of exports was restructured toward more sophisticated, value-added products in heavy and chemical industries, and South Korea's trade partnerships were diversified.

Export strategy was again modified in the 1980s. International pressure for South Korea to open its economy also mounted in the 1980s, resulting in further significant import liberalization and aligning its export drive with domestic and international economic developments. In the 1990s, South Korea further opened its economy and reduced export subsidies under the WTO obligations. With rapidly rising domestic wages together with intensifying international competition, South Korea transformed its industrial structure toward high value-added, knowledge- and technology-oriented industries, and focused its exports in these areas.

The policy instruments used to implement South Korea's export expansion strategy changed markedly over the 1963–96 period. In the 1960s and 1970s, numerous export-related incentives were used, including tax and foreign exchange benefits, and the availability of export-loans at artificially low interest rates. The government also established a variety of institutions integral to export promotion, including the export-promotion council, the Korea Trade Investment Promotion Agency (KOTRA) and the Korea Traders' Association. General trading companies, the precursors to *chaebols*, were promoted to take advantage of scale and scope in international trade. During the 1980s and 1990s, minimizing its export subsidies, the government promoted industrial restructuring toward high technology industries in line with the further liberalization of imports, rising international competition and rising domestic wages. It is also important to note that this phenomenal expansion in exports was not only attributable to state policy, but also to private entrepreneurs. South Korean entrepreneurs were successful in exploiting the country's comparative advantage, and capitalizing on opportunities arising in world export markets. Unlike the experience of other developing countries, South Korean businesses have exploited export markets independently of foreign multinationals.

The success of South Korea's export promotion strategy is manifest by an export to GDP ratio that increased from 3.9 per cent in 1963, to 30.3 per cent in 1996. South Korea's share of world exports increased from 0.04 per cent in 1962 to 2.5 per cent in 1996. Export-led development has resulted in a deepening of South Korea's industrial structure. The share of manufactured exports grew from 27 per cent in 1962, to 92.9 per cent in 1996. Attributable to the industrial policy of the 1970s, the share of heavy and chemical industry in exports expanded from 10.4 per cent in 1962, to 72.9 per cent in 1996.

Heavy and chemical industries In the 1970s, South Korea switched industrial policy toward capital- and technology-intensive heavy and chemical (HC) industries. To achieve HC industrial development, the policy task was to mobilize capital, technology, skilled workers, industrial sites and entrepreneurs into the HC industries. To this end, the government implemented four strategic initiatives: a generous incentive scheme, the expansion of educational capacity to supply skilled workers, the establishment of new research institutes and a huge industrial site at Changwon dedicated to the sector (Kwon, 1997).

The incentive scheme includes various types of tax benefits, tariff waves for imports of required inputs, restrictions of competitive products and protection from domestic and international competitors. The most powerful tool, however, was the allocation of investment funds at preferential interest rates. Between 1973 and 1981, around 50 per cent of all investment funds were allocated to policy loans for the HC sector at interest rates substantially less than those available from commercial banks (Kwon, 1997). As a result, capital was rapidly accumulated and capital intensity increased remarkably in the HC industry sector. Employment in the HC industrial sector grew faster than in the total manufacturing sector. Export composition also changed, raising the export share taken by HC industries remarkably at the expense of that for light industries.

South Korea's HC industrial policy, although successful in promoting export expansion and economic growth, has created a different problem: the concentration of economic power to *chaebols*, which have expanded and diversified with the government blessing. This has raised serious equity problems, slowed down the development of small and medium industries and has led to the financial sector being underdeveloped because it was under government control for so long as part of the HC industry policy.

High investment and savings

The rate of gross investment in the South Korean economy increased rapidly from 17.0 per cent in 1963 to 38.1 per cent in 1996 (Table 2.1), fuelling impressive economic growth. The high investment rate was attributable to a high rate of return on capital and low business risk. The rate of return was markedly higher in South Korea during the 1970s and 1980s than in developed economies, although slowing over time (Kwack, 1994). A high return on capital was in turn attributable to low loan interest rates, low wages until the late 1980s and the protection of domestic industries from foreign investment. Prices for investment goods also remained relatively low due to preferential tax and tariff arrangements. On numerous occasions, the government encouraged or coerced companies to invest in priority projects by means of subsidized or guaranteed loans (Stern et al., 1995). The state also bailed out a number of troubled projects, thereby reducing the actual and perceived risk associated with private investment. Macroeconomic stability, indicated by moderately low inflation and a stable exchange rate, also reduced the uncertainty involved in investment.

Sustained capital accumulation in South Korea would not have been possible without significant increases in domestic savings. The gross saving rate increased from 20.8 per cent in the 1960s to 32.9 per cent in the 1980s, one of the highest in the world. During the 1963–96 period, private savings accounted for 78.3 per cent of national savings, of which business savings comprised 57.1 per cent (NSO, 2002). The main objective of South Korean firms during this period was to expand market share for their products. Consequently, they were less concerned with short-term profits and would retain a high proportion as savings.

South Korean household consumption decisions during the rapid growth period were based on relatively stable patterns, and closely related to current rather than projected future income (Collins, 1994; Kuznets, 1994). Thus, as income increased, so did savings. The Confucian cultural trait of frugality would appear to have contributed to the high rate of saving in South Korea. In addition, a large portion of remuneration in South Korea is paid in the form of bonuses, and the marginal propensity to save from bonuses is regarded as high (Song, 1994: 159). Government policy has also contributed to the high national savings rate by maintaining macroeconomic stability, relatively high real interest rates on deposits, stable financial institutions and tax exemptions on credit interest (Nam and Kim, 1995). The lack of a social security system is another factor explaining the high savings rate. Financial security and welfare in South Korea has generally been regarded as a family concern.

Over the period 1963–96, investment exceeded domestic savings except in the four-year period 1986–89 when the latter exceeded the former. The excess was financed by foreign savings. Most foreign savings were in the form of commercial loans, which were attracted to South Korea by government guarantees. Foreign direct investment accounted for a minor portion of foreign savings because of government restrictions on foreign direct investment to limit foreign control of the economy.

Human capital development A remarkable feature of South Korean economic development has been the ability to effectively utilize the nation's abundant human resources. Labour demand increased dramatically during the 1960s as a result of the labour-intensive industrialization strategy. As a result, from a labour surplus in the 1960s, South Korea was transformed to a labour-shortage economy by 1977 (Kim and Lee, 1995). Real wages increased more than productivity increments, thereby raising real unit labour costs. By contrast with this increase in wages ahead of productivity, real interest rates on loans remained artificially low until the early 1980s. The resulting increases in the wage–rental ratio led companies to substitute capital for labour, a trend that continued after 1987 (Kuznets, 1994: 68).

Supply of human resources increased rapidly through demographic growth in the labour force, advancing education, and the mobilization of underemployed farm workers. Between 1963 and 1996, the labour force increased by 2.9 per cent per year. Labour inputs have also increased significantly from an average 47.2-hour working week in 1963–65, to a peak of 56 hours in 1994 (Kuznets, 1994: 9). In 1996, South Koreans worked an average 49.2 hours per week compared with the Asian average of 44.8 hours (*Korea Herald*, 1997).

South Korea's flexible and efficient labour market was a key element in the rapid growth of employment and the economy (Kim and Lee, 1995; Kuznets, 1994: 4). Under authoritarian regimes emphasizing high-growth policies, anti-competitive arrangements such as minimum wages, labour protection laws and union monopolies did not exist. Market forces largely determined wages and employment. However, the 'competitive-looking' labour market was, in reality, under strict government control. Management rights were promoted at the expense of labour, union activities were suppressed and wage guidelines imposed. Taking the government's lead, management applied an authoritarian approach to labour relations. The state often intervened to resolve disputes, leading to a lack of labour-management skill among businesses. The situation changed dramatically with

political democratization and the weakening of government control. In conjunction with the late-1980s labour shortage, numerous disputes across 1987–89 demonstrated that past South Korean labour practices could no longer work.

South Korean education levels have increased remarkably. Highly valued historically under Confucianism, South Koreans see education as directly linked to social status and material success. These attributes are considered in terms of the family, rather than the individual, and parents commonly dedicate large sums to their children's educations. Most South Koreans entering the workforce have received at least 12 years of education. Tertiary education has also expanded exponentially. Enrolments increased from 123 000 in 1965 to 1.9 million in 1996, a 9.3 per cent annual growth rate. Heavy social demand for higher education has led to the enforcement of a strict quota system, inevitably leading to fierce competition for university entrance among pupils in primary and secondary schools.

The South Korean education system has, however, experienced a number of problems. The quality of tertiary education and the development of science and technology, and business and vocational courses have been questioned about their capacity to cope with ever-increasing demand for skilled labour (Kim, 1995). Due to the emphasis on competitive examinations, the education system has also been criticized for encouraging rote learning at the expense of critical thinking and analytical skills.

Cultural traits A large literature exists on the relationship between traditional Confucian culture and economic development (Lee, 1995). Confucian tradition emphasizes harmonious yet hierarchical human relations. The Confucian citizen is held to be diligent, disciplined and hardworking, well-educated, frugal, responsible, loyal to authority and oriented toward social cohesion (Cho, 1994). South Korean scholars in particular, argue that this value system is supportive of economic growth (Cho, 1994). This raises a question of why these values failed to promote economic development throughout South Korea's long history. Park (1995) argues that Confucian culture may serve as a trigger for economic development but only if certain political and economic preconditions are met, including free enterprise, competition, international trade, suitable institutions and a stable and growing middle class. Cho (1994) adds that a misguided focus of social development policy in South Korea had bred the major negative Confucian influence – distinct social stratification and antipathy to manual labour and business. Cho (1994) then argues that these negative Confucian values have lost their strength as the economy develops and a middle class emerges.

Technology development The accumulation of technological capability is another important contributing factor to South Korean economic success. Between 1971 and 1996, labour productivity increased by 9.8 per cent per annum (Table 2.1). Confucian socio-cultural traits, such as competition to improve the relative position of self and family (Jones and Sakong, 1982), together with other traits as mentioned above, have been conducive to the development of education and technological capacity. The role of the business sector has been critical in this area. Potentially risky entrepreneurial initiatives have combined effectively with the centralized, hierarchical management style of South Korean businesses to expand technological capability. Unlike Western companies, family-controlled *chaebols* are not under constant pressure to deliver shareholder profits, and

therefore have been able to re-invest in longer-term technological development. *Chaebols* were also well-positioned to develop the necessary human resources, to identify, negotiate and finance foreign technology transfer, and to secure captive markets for new products. New business risks for *chaebols* could also be hedged against existing enterprises within the conglomerate.

The state also played a crucial role in technological improvement. In the 1960s and 1970s, South Korea, in its catch-up stage of development, was relatively open to importing foreign technology. In order to minimize dependence on foreign multinationals, restrictions were applied to technology licensing and inward FDI. Technology transfer was promoted by the purchase of foreign capital equipment and reverse engineering. However, as the economy advanced, the development of an indigenous technological development capacity became imperative. The government launched a national R&D programme to strengthen indigenous capacity. Various tax and financial incentives were offered, the result being an increase in R&D expenditures as a percentage of GNP from 0.77 per cent in 1980, to 2.3 per cent in 1990.

Despite these significant advances, South Korea still faces enormous challenges in this area. Compared with the advanced industrial economies, the ratio of South Korea's R&D expenditures to GDP is still low. The number of US patents granted to South Korean firms, although rising, remains far behind other developed states (Kim and Sung, 1995: 455). The environment for quality research and education also needs to be improved. Science and technology facilities at universities are regarded as dated and inadequate with high student-staff ratios.

The 1997 financial crisis³

Causes of the financial crisis

Despite over 30 years of almost continuous economic growth, South Korea fell into deep financial crisis in November 1997, necessitating an IMF rescue package. Witnessing the emerging crisis and speculating on depreciation of the won, foreign investors and creditors withdrew investments in South Korean securities and curtailed short-term loans. Consequently, share prices and the value of the South Korean currency plummeted. The Bank of Korea (BOK) made a futile attempt to prop up the won, thereby drastically depleting its foreign reserves. The won depreciated by around 50 per cent and interest rates skyrocketed to over 30 per cent. High interest rates and reduced company profitability precipitated a large number of bankruptcies. This, in turn, induced a banking crisis as foreign debt and non-performing loans escalated. As a result, a number of banks were forced to close. The economy contracted by 6.7 per cent in 1998 with high unemployment and inflation (Table 2.1).

One of the important causes of the crisis was continuing high current account deficits, amounting to 4.9 per cent of GDP in 1996. South Korea's high current account deficits were attributable to a loss of competitiveness in domestic industries, both at home and abroad, because of high factor costs including high wages, real interest rates and real estate prices. This overall loss of competitiveness resulted in declines in export earnings, and in turn, increases in insolvency. Insolvent firms then dumped non-performing loans to domestic banks, laying the foundations for the crisis. Another important cause was a sustained overvaluation of the won due to state interference in the foreign exchange market. The managed and overvalued exchange rate system produced the illusion of

currency stability, thereby contributing to both excessive foreign borrowing and a loss of international competitiveness.

The excessive expansion and diversification of *chaebols* through debt capital was another cause of the financial crisis.⁴ The concentration of economic power in *chaebols* was a product of South Korea's state-directed industrial and export promotion policy. Collusion with government created the perception that *chaebols* were 'too big to fail', and would be bailed out if necessary. This reduced expected business risk, leading *chaebols* to expand themselves by debt capital. Debt capital was also raised by inter-subsidiary loan guarantees within large *chaebols*. The combination of these factors rendered *chaebols* vulnerable to financial crisis. This inherent weakness remained obscured from domestic and international creditors by a lack of transparency and accountability in South Korean business operations.

The South Korean financial crisis was also attributable to the inefficiency and the lack of transparency and accountability of banking institutions and inefficient supervision of them. Banking regulations and supervision were fragmented and inefficient by sharing supervisory roles between the Bank of Korea and the Ministry of Finance and Economy (MOFE). From the 1960s, banks were a vehicle of government industrial policy, under tight government control, and the allocation of credit and the interest rates were regulated extensively by the government. At the same time, the government imposed competition-limiting measures, prohibiting *chaebols* from being controlling shareholders of banks and shielding banks from international competition. As a result, the ownership of banks was so widely diversified that South Korean banks were regarded as 'entities without owners', and were thus accountable only to the government. At the same time, a strong perception emerged that 'the banks will never fail' because of government protection, leading the banking sector to be afflicted by moral hazard. The banking sector thus became inefficient and lacked transparency and accountability. The banking sector was characterized by a lack of independence from *chaebols* because of their strong relations with government. *Chaebols* received the bulk of bank credit but did not release consolidated financial statements. This was all indicative of the banking sector's lack of independence, and its lack of prudence in monitoring major debtors. The above combination of circumstances, together with *chaebols'* insatiable demand for funds, ensured that reckless lending to *chaebols* was bound to arise.

The South Korean financial market was significantly liberalized in the early 1990s, allowing banks greater access to international finance. However, regulatory structures did not adapt to this change, and appropriate institutional constraints were not in place, leading to excessive borrowing from offshore capital markets. Reckless offshore borrowing was bolstered by artificially high domestic interest rates in South Korea. Financial institutions came to rely heavily on low interest, short-term borrowings from abroad. Foreign debt was denominated mainly in US dollars because the South Korean won was not listed in foreign mercantile exchange markets, nor had hedging tools such as options, swaps and derivatives been developed.

The failure of the government to take appropriate advance action was also a major cause of the crisis. South Korea had gradually opened its economy to globalization in the early 1990s. However, structures and institutions that had previously been very successful had not adapted to the new environment. Although problems in the South Korean economy, such as the above-mentioned inflexible labour market and the concentration of

economic power in structurally-weak *chaebols* had been identified for some years, the government failed to take appropriate action.

State intervention worked well until the late 1980s because of a clear social consensus on a national vision of maximum growth, strong organizational capabilities and cooperative external environments. Highly prevailing nationalism generated a powerful incentive for all citizens to assign high priority to national economic growth. Because of its strategic location and its small-sized economy, South Korea's export-led economic development strategy together with state intervention and the protection of domestic industries did not raise serious objections from advanced countries. This enabled South Korean products to penetrate advanced countries, thereby rendering South Korea's export-led industrialization strategy a success.

From the late 1980s, however, adverse changes in the internal and external policy environments eroded the effectiveness of state intervention, which in effect became the major underlying cause of the financial crisis. Government control and protection of *chaebols* led to a lack of transparency and accountability, and encouraged excessive expansion with debt capital. State intervention in financial markets resulted in financial institutions being inefficient, undercapitalized and inflicted by moral hazard. Government protection of domestic industries from international competition resulted paradoxically in their loss of efficiency and competitiveness. Government intervention in the labour market resulted in inefficiency in labour management and labour-market inflexibility. Finally, the government failed to introduce appropriate measures in time to stem the financial crisis, despite the presence of emerging symptoms that were evidence of the looming crisis. The 1997 crisis brought the demise of the old paradigm of dirigist economic policy.

Structural and institutional reforms

The IMF rescue package for South Korea, as performance criteria for the release of successive amounts of financial assistance, consisted of three components: (1) macroeconomic policy, (2) financial sector restructuring, and (3) other structural reform measures. The macroeconomic policy objective was to restrain aggregate demand by means of restraining monetary and fiscal policy, thereby reducing current account deficits and maintaining stable prices. Other macroeconomic measures included the maintenance of a flexible exchange rate without state intervention and restoration of an adequate level of foreign reserves. The South Korean government initially complied faithfully with restraining macro monetary and fiscal policy. However, the restraining policies resulted in a credit crunch, which exacerbated non-performing loans and raised interest rates. International confidence in the South Korean economy was further eroded, thereby inhibiting capital inflows. In September 1998, macroeconomic restraint was relaxed with IMF agreement.

Opening of the South Korean market The crisis forced the South Korean government to adopt trade and capital account liberalization. The government has liberalized trade regulations and harmonized import procedures with international standards in compliance with South Korea's WTO obligations. Capital account liberalization aimed to open the securities market to foreign investors, to allow South Korean companies to borrow from abroad and to eliminate FDI restrictions. The government has made particular efforts to attract FDI. It has switched the emphasis in its FDI policy from 'restriction and control' to 'promotion and assistance'. South Korea has also opened up a number of sectors, including

various service sectors, to FDI and streamlined complicated administrative procedures by dismantling or relaxing the restrictions. It also introduced the so-called 'one-stop' service system for inward FDI. Mergers and acquisitions (M&As) have been promoted in conjunction with liberalization, rendering takeover (including hostile takeover) laws drastically liberalized. The business sectors liberalized since the crisis include financial services, securities markets, commodity exchanges, investment companies and trusts, real estate, golf course operations, grain processing, insurance-related businesses, the distribution sector, petrol service stations, power generation and waterworks.

Financial sector restructuring The financial sector has been restructured to increase the banking sector's independence, consolidate and strengthen the supervision of financial institutions, eliminate insolvent institutions and re-capitalize viable ones. International standards for auditing and disclosure have been adopted to improve the transparency and accountability of financial institutions. To improve management accountability, financial institutions have established elected boards of directors, who are responsible to their shareholders. Restructuring has also opened the financial sector to FDI, M&As, and foreign competition. The presence of foreign capital is expected to enhance competitiveness, transparency, accountability and risk management, while also serving to prevent state intervention. In the course of reforming the banking sector, 631 institutions were closed, with those remaining re-capitalized with 157 trillion won of public funds. Foreign participation in domestic banks' equity capital has increased markedly, with two banks now controlled by foreign shareholders (SERI, 2001).

Reform of chaebols *Chaebol* reform was integral to the IMF package, and crucial to South Korea's international competitiveness. Restructuring has been pursued using the 'five-plus-three-point' principles mutually agreed upon by *chaebols* and government. The 'five principles' refer to management transparency; eradication of cross-debt payment guarantees among *chaebol* subsidiaries; financial structure improvements; core business specialization and improved corporate governance. The aim of the 'three points' was to prevent *chaebol* domination of the non-bank financial sector, to prohibit cross-investment and illegal internal trading, and to prevent abnormal wealth inheritance. Substantial progress has been made in accordance with the agreed reform principles. *Chaebols* have started to provide consolidated financial statements; eliminated cross-subsidiary debt guarantees; reduced debt-equity ratios to 200 per cent; appointed outside directors; removed restrictions on the voting rights of institutional investors and strengthened the rights of minority shareholders.

Due to the abolition of investment ceilings, and permission for hostile M&A takeovers, foreign capital has substantially penetrated the South Korean business sector. Foreign investors will expect management transparency, improved corporate governance and management efficiency, in turn weakening the potential for state intervention and collusion in government-business relations, thereby removing the systematic privileges enjoyed by *chaebols*. In the course of restructuring, 16 of the 30 largest *chaebols* were sold, merged or liquidated, discrediting the perception that *chaebols* were 'too big to fail'. In addition, foreign investors in South Korean financial institutions will strengthen their intervention in, and monitoring of, debtor companies. Those lacking in transparency and accountability, or with low profitability and high debt-equity ratios will have difficulty in raising

bank credit. This will force *chaebols* to concentrate on core competencies and divest themselves of marginal interests.

Reform of the labour market The amended labour laws of February 1998 enhanced labour market flexibility and competitiveness by permitting retrenchments for the first time in South Korean history. It is expected that the changes will also lead to improvement in labour–management relations, with job security rather than wage increases becoming the core area of labour dispute. Revision of the labour laws has reconfigured the South Korean labour market with the number of full-time workers having decreased, while the number of part-timers having increased.

Paradigm shift in economic policy Before to the 1997 financial crisis, the South Korean economic policy paradigm may best be described as extensive state intervention through consecutive five-year plans. Although state intervention was successful until the late 1980s, it was the main underlying cause of the financial crisis, after which the paradigm shifted towards a market-oriented economy. This shift was reflected in the liberalization of domestic industry and in the reform of financial institutions, *chaebols*, the labour market and public sector. The bulk of the policy tools dedicated to state intervention have been rescinded, with a commensurate reduction in the size of the state bureaucracy.

Recovery from the financial crisis

Since early 1999, the South Korean economy made a strong recovery due to a number of factors, including maturity extensions on short-term foreign debt, restored macroeconomic stability, export expansion due to currency depreciation, a more accommodating monetary and fiscal stance from mid-1998, restoration of foreign confidence, and foreign capital inflows. In addition, the underlying fundamentals of the South Korean economy, such as the high savings rate, well-educated workforce, and advanced production infrastructure remained sound. The combination of these factors contributed to a rapid economic recovery by 1999.

Unfinished economic reform

Although substantial progress has been made in financial, corporate, labour and public sector restructuring, it is by no means complete (Ahn, 2001; Jung, 2002). In mid-2000, the economy was considered so fragile that the Kim Dae-Jung administration shifted policy emphasis from reform to growth. In the financial sector, banks that were nationalized through the government bailout still need to be privatized to reduce the potential for bureaucratic interference. Many banks are also too small and inefficient by international standards to take advantage of economies of scale. Hence, further amalgamations should be encouraged.

The *chaebols'* financial structure, although improved, still remains unhealthy. Although debt–equity ratios have decreased below 200 per cent, this was achieved through new stock issues, asset sales and revaluations, rather than debt reduction. The degree of founding-family control has not substantially diminished. Running counter to its reform track, the government has also rescued the ailing Hyundai group. Despite prohibitions on bank ownership, *chaebols* can still own non-banking institutions. Labour market rigidity also remains a problem. South Korean labour laws still discourage dismissals unless a

company is facing a major crisis. Structural reforms of banks and *chaebols* may not be able to proceed successfully unless labour market flexibility improves and union militancy decreases.

In addition, South Korea has not fully opened to the global economy, particularly in relation to inward FDI. Although the FDI regime has been liberalized and streamlined to be consistent with OECD standards, deficiencies remain. These include a lack of transparency and consistency in regulation, policy-making and implementation, bureaucratic intrusion and obstruction, inter-agency turf wars, foreign exchange controls and restrictions on the legal-service markets (Kwon, 2003b).

Prospects for the South Korean economy: growth potentials

Policy framework

The South Korean economy is still in transition from a state-led to a market economy in the emerging globalization era. At this juncture what type of economic policy should be undertaken by the South Korean government? A nation's economic policy is predicated on the main policy objectives and policy environments. Under the Roh regime and beyond, South Korea's key strategic economic objectives are assumed to be sustainable and equitable economic development. One of the most salient trends in the recent past is the intensification of the globalization process. As a result, the global economy has become further inter-related, integrated and competitive. The world economy is also moving towards a knowledge- and information-based economy, characterized by high value-added industries based on creativity, innovation and new technologies.⁵ The rise of China is another important factor influencing South Korean economic policy. China has achieved extremely rapid economic growth rates over the last two decades, largely through low-value creation sectors using cheap labour and FDI. However, it is likely that China will move toward a high-value creation economy, augmenting its position to become the paramount economic player in East Asia and a formidable competitor against South Korea.

Domestically, South Korea's demographic development shows trends of declining growth and ageing of population (Kwon, 2005). Consequently, labour force growth will decline and the social burden of support for the elderly will increase. As prosperity rises alongside globalization, preferences for leisure and quality of life will also increase, causing a reduction in the number of hours worked and in the national savings rate. The national savings rate decreased from above 35 per cent during the 1980s and 1990s to 29.2 per cent in 2002 (Table 2.1), a rate lower than in Japan and Taiwan. The national investment rate is also expected to decline. During the rapid growth period, *chaebols* were the main source of domestic investment. However, the domestic environment conducive to *chaebol* investment has been dismantled. Economic risk and uncertainty has increased with globalization and the revolution in information technologies. While national investment was over 30 per cent in the 1980s, it has declined to below 25.9 per cent in 1998–2002. These decreases in South Korea's savings and investment rates signal the onset of an era of slower economic growth.

The influence of foreign capital in the South Korean economy will continue to rise. Since 1997, inward FDI has increased markedly, as reflected by an increase in the ratio of FDI to GDP from 2.1 per cent in 1995 to 7.9 per cent in 1999 (UNCTAD, 2001). FDI has penetrated every sphere of South Korean business. The numbers of South Korean

companies with a foreign-owned equity stake of more than 10 per cent increased from 4419 in 1997 to 11 515 in 2001 (KOTRA, 2002: 19). Portfolio investment has also sharply increased, and 36.2 per cent of stock market capitalization is owned by foreign investors in 2002 (Crotty and Lee, 2002). Despite the intensification of the globalization process, national culture and tradition continues to play a significant role. The strong South Korean culture has exhibited difficulties in adjusting to the new global economic realities. Enduring Confucian influence encourages state intervention in solving economic problems, rather than relying exclusively on market mechanisms. Furthermore, there are discernable changes in South Korean culture in the recent past, including rising individualism, declining sense of community and trust, and fading future orientation. These will have a negative effect on the future South Korean economy (Kwon, 2005).

The policy framework arising from the above analysis of the South Korean policy environment is clear. First, the underpinning principle of South Korea's economic policy should be the embrace of market principles and global standards geared towards globalization. This requires the government to play a complementary role to the private sector. The state should provide an environment conducive to private sector growth, while also ensuring transparency, accountability and competition in private sector operations. This requires a completion of the ongoing process of economic restructuring and reform.

Second, sources of economic growth in the globalization era are no longer exclusively located within state boundaries. Attracting and retaining mobile resources including FDI is now a critical issue. This can be done by improving social infrastructure, political, social and economic institutions and labour relations, and by changes to cultural and social norms. Third, openness, transparency and accountability are required at all stages of the policy-making process to discourage political and bureaucratic cronyism, and rent-seeking by interest groups. Fourth, South Korean regulatory infrastructure, such as accounting systems, corporate governance and bankruptcy laws must be aligned with international standards, and imposed fairly on everyone. Both entry and operational restrictions on FDI should be eased.

Fifth, the government needs a strategy to ameliorate slowing demographic growth and an ageing population. Such a strategy would stem early retirement and dismissal, and provide re-training for workers. Institutional arrangements are also required to bolster female participation in knowledge- and information-based industries. Sixth, South Korea's xenophobic immigration laws need to be reformed to allow entry for low-skilled workers as well as high-skilled workers such as scientists and engineers from abroad. Seventh, in addition to foreign technology transfer, domestic capability should be further developed through research and education. Eighth, homogeneous South Korean society and culture will need to open up significantly. Traditional South Korean culture is not fully compatible with globalization, where multiculturalism prevails. As a member of the global village, South Koreans must be open and receptive to international cultural norms.

Finally, social development, an area of minimal attention for past policy-makers, should be an integral element of the new economic strategy. Social programmes such as unemployment insurance have not developed in parallel with economic growth, because of not only a low policy priority on it under continuous high economic growth but also the cultural heritage of supporting family members during difficult times. Issues of equity have taken on greater prominence since the 1997 financial crisis, yet income distribution has deteriorated and household poverty has increased (An and Choi, 2003). The crisis and

the ensuing structural changes of the economy have also eroded the culture of family safety nets and lifetime employment. The digital divide is becoming more discernible and should be the focus of greater attention by policy-makers.

Medium- and long-term economic prospects

To assess the prospects of the South Korean economy, an analysis of economic growth potentials is undertaken, which are in turn dependent on external and internal factors. Critical external variables for South Korea include the future evolution of the global economy, and geopolitical developments surrounding the North Korea nuclear issue. The most critical internal variable is the implementation of flexible and adaptive economic policy in line with external and internal policy environments. In the medium term, the potential growth of the South Korean economy will decline due to slower growth in inputs such as labour and capital, declines in national savings and investment rates, continuing labour market rigidity, declining population growth, reduced work hours, an ageing population and an inefficient education system. In addition, it will also become increasingly difficult for South Korea to attract foreign technology or develop new technologies. South Korea is squeezed between China, which is quickly catching up in developing low-tech products, and advanced countries that South Korea itself has difficulty catching up with. In order to improve productivity, an economy must expand R&D expenditures and social capability to develop and adopt new technologies. South Korea's R&D expenditure has increased rapidly over recent years, amounting to 3 per cent of GDP in 2001. However, South Korean productivity is low because of poor social capability, which depends in turn on efficient education, prevention of rent-seeking activities, a strong yet limited and transparent government, stable labour relations and an attractive investment environment (BOK, 2003).

South Korea's potential economic growth rate is estimated at 5 per cent over the 2004–08 period, and 4.9 per cent for the 2004–13 period (BOK, 2003). However, its actual growth could be lower than its potential if the government fails to enact appropriate policy in areas of high technology and knowledge-intensive industries, or fails to complete the post-crisis institutional and structural reforms (Kim, 2005).

Conclusion

The objective of this chapter was to review South Korean economic developments over the last four decades, and to shed light on the medium- to long-term prospects for the economy. During the 1963–96 period, miraculous economic success was achieved against numerous odds. This remarkable economic development was attributable to a number of factors including skilled and abundant labour, high savings and investment rates, high social capability to adopt foreign technologies, conducive external environments and appropriate economic strategy. However, South Korea fell into a serious financial crisis in 1997 as a result of a number of causes, including accumulation of current account deficits, sustained currency overvaluation, a mismanaged, inefficient financial sector afflicted with moral hazard, excessive short-term and foreign-denominated debt, the concentration of economic power in structurally flawed *chaebols* and the contagion effects of the crisis. In particular, state intervention, although it worked well until the late 1980s, lost its effectiveness, and became the major underlying cause of the 1997 crisis. Since then, South Korea has undertaken comprehensive structural and institutional reforms in the financial,

corporate, labour and public sectors, in addition to opening to the global economy. The paradigm for national economic policy has decisively shifted from state intervention to the development of a market economy.

The economy experienced its most serious contraction of 6.7 per cent in 1998, yet began to recover from mid-1999, recording 9.6 per cent average annual growth over 1999–2000. The rapid recovery is attributable to restored macroeconomic stability, export expansion, a broad, though incomplete, range of structural reforms, restoration of foreign confidence and strong underlying fundamentals such as high savings rates, a well-educated work force and advanced production infrastructure.

In terms of a future economic policy framework, the chapter has identified key emerging trends in South Korea's policy environments: the intensification of globalization; the rise of China; demographic changes within South Korea; declining savings and investment rates; rising foreign influence in the economy; a growing digital divide and potential social conflict between indigenous culture and that of the multicultural global village. Under these circumstances, the crux of economic development exists in attracting mobile international resources by improving domestic infrastructure and institutions and by developing domestic technology through R&D and educational improvements. In support of this, the state should play a complementary role to the private sector. South Korea must embrace market principles, undertake comprehensive liberalization, and provide comprehensive infrastructure to safeguard the private sector. In addition, South Korea must complete ongoing reforms while ensuring transparency, accountability and competition in operations of the private sector, and adopt an appropriate human resource policy in line with demographic changes and with required science and technology developments.

The South Korean economy is unlikely to grow at the high rate of the past due to the existence of trends indicative of slower growth potential. South Korea's growth potential is estimated at 5 per cent per annum in the medium term. If, however, the government fails to play its proper role as the policy-maker, the South Korean economy may not be able to grow to its potential.

Notes

1. Korea recorded substantial trade deficits each year, except during 1986–88 when low oil prices, low international interest rates, and a favourable low exchange rate allowed for trade surpluses.
2. According to the Korea Anti-trust Act, there were 43 *chaebols* comprising 672 industrial companies as of 1989 (Song, 1994: 114).
3. This section draws mainly on Kwon (1998, 2003a).
4. This was manifest in the high debt–equity ratio of 449.4 per cent of *chaebols* in 1997.
5. Korea is evolving toward a knowledge-based economy. The IT industry represented 15.6 per cent of GDP in 2001, up from 7.7 per cent in 1997 (MOFE, 2002: 14), and accounts for one-third of aggregate Korean economic growth (Hong, 2002).

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Further reading

- Crotty, J. and Lee, K.K. (2002), 'A political-economic analysis of the failure of neo-liberal restructuring in post-crisis Korea', *Cambridge Journal of Economics*, **26** (5), 667–78.
- This paper evaluates the IMF-led reform in the wake of the 1997 crisis. It argues that the reform is incomplete and unsustainable, thereby leading the economy to a long-term low-investment, low-growth, low-equity economy. The paper argues for a modernization of Korea's traditional state-guided growth model, rejecting the ongoing restructuring.
- Kim, Jong-il (2005), 'Growth potential of Korean economy from growth accounting perspective', *Bank of Korea Economic Papers*, **8** (1), 1–31.
- This paper examines the growth potential of the Korean economy. It identifies rapid increases of factor inputs (labour and capital) as the main sources of the remarkable growth in the last 40 years. It argues that the total factor productivity had remained low during the rapid growth period, and it is thus possible for the economy to achieve an efficiency-based growth by expanding not only the factor inputs but also education and R&D investment.
- Kwon, O. Yul (1997), 'Korean economic developments and prospects', *Asian Pacific Economic Literature*, **11** (2), 15–39.
- This paper reviews the broad literature, both in English and Korean, on Korean economic developments and the major contributing factors over the period 1963–95. It assesses the prospects of the Korean economy as seen in 1996.
- Kwon, O. Yul (1998), 'The Korean financial crisis: diagnosis, remedies and prospects', *Journal of the Asia Pacific Economy*, **3** (3), 331–57.
- This paper identifies the causes of the crisis and concludes that the failure of the institutions and economic structure in adapting to emerging changes in domestic and international environments, underlies the numerous causes identified. The paper also assesses the prospects of the economy as well as successful institutional and structural reforms.
- Kwon, O. Yul (2005), 'A cultural analysis of South Korea's economic prospects', *Global Economic Review*, **34** (2), 213–31.
- This paper analyses cultural effects on economic development in South Korea by introducing the concept of transaction costs as an operational intermediary between culture and economic development. It also examines recent changes in Korean culture after the financial crisis such as a rising individualism, a declining sense of community and trust, and a fading future orientation. In view of these recent changes, Korean culture will have a negative effect on the future economy.
- Kwon, O. Yul, Jwa, S.H and Lee, K.T. (eds) (2003), *Korea's New Economic Strategy in the Globalization Era*, Cheltenham, UK and Northampton, USA: Edward Elgar Publishing.
- Numerous researches have investigated the miraculous economic growth of the Korean economy in the past four decades and the causes of the 1997 financial crisis. However, very few studies have explored the challenges and the changing economic strategies of Korea in the period where the growth paradigm shifted from government-led to market-oriented growth leading to the globalization and information era. This volume provides a comprehensive investigation of a variety of emerging challenges and strategies to meet them. For important policy areas, this book evaluates existing policies and offers proposals for new strategic direction that can achieve sustainable economic growth for Korea. A considerable majority of the contributing authors are involved in formulating economic strategy as policy advisors to the Korean government, and they bring to their chapters extensive experience and insights regarding Korean government policy that are rarely available to readers in such a comprehensive form.

3 Taiwan

Wan-wen Chu

A short political history

Pre-Japanese colonial era

Taiwan was inhabited mainly by aborigines when the Western merchants began to explore this area in the seventeenth century. The Dutch occupied it from 1624–62, for conducting entrepot trade, and were driven out by the Ming loyalist Cheng Ch'eng-kung. Cheng's rule ended in 1683 when his grandson surrendered to the Manchu (Ch'ing) ruler. Though the Ch'ing tried to discourage migration to Taiwan, many Chinese, mainly from Fukien province, migrated to Taiwan and reproduced the traditional mode of agricultural production. By the early nineteenth century, the Chinese population on the island exceeded two million. However, the land-to-population ratio was higher than that of the mainland, and output per capita was hence greater. The economy was quite commercialized from the early days, exporting sugar and rice to the mainland in exchange for textiles, ceramics and sundries. Before the Opium War, the trade was in Chinese hands. Afterward, several treaty ports were opened up in Taiwan, and foreign merchants came in and took over most of the trade. Trade volume increased, especially tea exports to the West. Agricultural commercialization led to the decline of the absentee landlordism and the strengthening of the tenant–landlord system. Thus the land tenure system came close to the semi-modern sharecropping system.

In the late nineteenth century, not long before Taiwan was ceded to Japan in 1895, the Ch'ing dynasty, in response to the pressing external threat, belatedly began to take a more active role in developing the island, and elevated its status from a prefecture of Fukien to a province. One of the enlightened officials, Liu Ming-chuan, governed Taiwan during 1884–91, and he initiated many ambitious modernizing projects, including the construction of a north–south railroad, a cadastral survey and other infrastructure projects. Liu was unable to accomplish much during this brief tenure, and these projects were subsequently completed by the Japanese colonialists.

Japanese colonialism, 1895–1945

A rising modern Japan after the Meiji Reformation defeated Ch'ing China in 1895, and demanded the secession of Taiwan as part of the war payment. Emulating Western imperialism was the goal of the Meiji reformers, and the Chinese market was the major target. Occupying Taiwan and then Korea was part of the big plan of expanding into China. Japan set out to impose colonial modernity forcefully upon the colonies in order to prove that they had the capability to manage colonies and hence were on a par with the Western imperialists.

Soon after taking over Taiwan, the Japanese colonial government undertook cadastral land surveys, and established land property rights. Taiwan was designated as the colony to supply sugar and rice to Japan. The Japanese did not alter the land tenure system however, and the family farm and peasants produced sugar and rice. As for sugar, the modern large-scale Japanese sugar companies handled the refining and exports to Japan,

and sugar refining became the main modern industry in Taiwan. With preferential access, sugar from Taiwan came to occupy 50 per cent and 85 per cent of the Japanese market in 1918 and 1939 respectively.

The colonial government began to promote rice exports to Japan after World War I. Due to prior commercial experiences, the landlords in Taiwan were responsive to the export opportunities. The local rice merchants handled the rice processing, while the Japanese capital monopolized the export trade and obtained most of the profits. During those years, Taiwan maintained a persistent export surplus of around 20 per cent with Japan. Taiwan's agricultural productivity grew while exporting rice to the Japanese market from the 1920s.

The Japanese did not plan to industrialize Taiwan, and therefore in 1939 over 90 per cent of Taiwan's exports were of primary goods. The industrialization after 1937 was war-related and meant to support Japanese military activities in the South Pacific. Major industrial plants included a petroleum refinery, chemicals, power plants, aluminium, fertilizer, salt and machinery. They were all owned and managed by the Japanese. Overall, more than 70 per cent of all bureaucrats and technicians then in Taiwan were Japanese, who left for Japan when the War ended in 1945.

During the colonial period, Taiwan's agricultural sector was transformed. The method of production was modernized, using modern inputs and improved technology. The sector also became highly commercialized, exporting a high percentage of output, mainly rice and sugar, to the protected Japanese market. On the other hand, industrialization was limited, confined mostly to sugar refining, and undertaken mostly by the Japanese firms. Rapid industrial development would be a post-war phenomenon.¹

The rule of the Nationalist government since 1945

Many events occurred in the few years after the Japanese defeat in 1945. The Nationalist government took over Taiwan and the colonial legacy left by the Japanese in 1945. The Japanese export market disappeared overnight, and had to be replaced by the market on the mainland. Though the civil war between the Nationalists and the Communists soon erupted on the mainland, Taiwan was meant to be insulated from the turmoil on the mainland by the separate currency and the monetary system. Nonetheless, the Nationalists eventually took much of the surplus to fight the civil war on the mainland, and spread hyperinflation from the mainland to Taiwan.

The Nationalist government was defeated by the Communists and retreated to Taiwan in 1949. To consolidate Taiwan as their last bastion, the Nationalists immediately implemented rent reduction in 1949, fixing the rent at 37.5 per cent of output, and later implemented the Land-to-the-Tiller land reform programme in 1952.

After the Korean War broke out in 1950, large sums of US aid arrived, along with the Seventh Fleet, and helped to control the inflation, shore up the state-owned enterprises (SOEs), and stabilize the Nationalist rule economically and politically. The bloody suppression of the local uprising in February 1947 and the white-terror purges in the early 1950s also helped to consolidate its rule. The fact that the Japanese colonial government occupied a dominating position in colonial Taiwan allowed the Nationalist government to continue to take the commanding height in Taiwan, not only politically, but also economically and socially. The Cold War and the US support only reinforced its economic dominance and its authoritarian rule.

The defeat of the Nationalist government on the mainland by the Communist-led peasant revolution was inevitable due to the economic disaster of its own making. Its economic failure was partly due to the fact that its bureaucratic capital did not deliver. Chiang Kai-shek did not bring the other powerful cliques, such as the Soongs, who led the failed bureaucratic capital cliques, to Taiwan. After these political purges, Chiang mostly allowed the engineer-technocrats to have autonomy to decide the economic affairs and hence follow a developmental path. Despite retreating to Taiwan, Chiang Kai-shek intended to 'recover' the mainland eventually. Paradoxically this provided the strong political will necessary for supporting the post-war developmental projects. The economic bureaucracy, also a legacy from the mainland period, enjoyed great autonomy in promoting industrialization under an authoritarian rule. As a result, the economy quickly recovered and stabilized in the early 1950s, and began to embark on a route to rapid industrialization, which has continued to the present time. The policy regime switched from import-substitution to export promotion in 1960, and rapid export growth of manufactured goods followed.

The SOEs dominated the industrial sector in the early post-war days, for the major part of the sector consisted of the Japanese industrial enterprises taken over by the Nationalists. However, the Nationalists promoted private enterprises in two significant events early on. From 1950–53, the government helped to set up the textile industry, relying mainly upon private firms. In the Land-to-the-Tiller programme, the compensation given to the landlords partly consisted of shares of the four industrial SOEs. Thus, some of the landlords were transformed into industrial capitalists. Although most of the non-agricultural US aid went to support the large SOEs, especially the utilities and transportation, some part of it was used to promote new manufacturing industries. Many of the projects went to private hands, including the now top conglomerate Formosa Plastic Company. The share of private capital in the manufacturing sector, therefore, increased from 41 per cent in 1954 to 70 per cent in 1966.

To make industrialization possible, the government needed to be able to extract surplus from a very productive agricultural sector. On the one hand, the agricultural sector had made significant gains in productivity during the Japanese colonial period, and continued to do so in the post-war period. On the other hand, the land reform redistributed income in favour of the tenants and hence made the sector better able to bear the heavy fiscal burden.

In the 1970s, the level of US support, which had been crucial for the survival of the Nationalist government in Taiwan, began to lessen, as the US–China relations started to thaw. The US and People's Republic of China (PRC) established diplomatic relations in January 1979, and this inevitably created a legitimacy crisis for the Nationalist regime. At the same time, economic prosperity brought forth a surge of political opposition activities. Chiang Ching-Kuo had begun to take charge before his father, the elder Chiang, died in 1975. He started a process of political reform in the 1970s, in response to the political crisis. Eventually he allowed official opposition to the Nationalist Party in 1986, and lifted martial law one year before his death in 1988.²

Democratization, liberalization and globalization since the late 1980s

Modernization projects had long been the objective pursued by the elite technocrats, and had been in progress throughout the post-war period. Thus, liberalization and transformation of the post-war mercantilist system had also been in the plan. Nonetheless, political and economic reforms were slow. The Plaza Accord in 1985 forced the New Taiwan dollar

to appreciate in 1986, and set in motion the inevitable economic upgrading process. Liberalization of trade, the foreign exchange regime and the domestic market ensued, as did privatization of SOEs.

Politically, the death of Chiang Ching-Kuo in 1988 marked the end of an era, although he himself helped to set the political change in motion. Social movements soon swept the island, and political transition toward democracy went into high gear. The ensuing decade saw constitutional reforms, electoral changes, the development of political parties and the transformation of the Nationalist Party. It seems that Taiwan has successfully evolved into a democracy.

The rise and opening up of the PRC economy across the strait have critical implications for Taiwan's future. China has always insisted that Taiwan should be part of China, a stance supposedly to be defended even at the cost of confronting the United States militarily. On the other hand, Taiwan's main supporter, the United States has wavered on whether to treat China as a partner or a foe, and hence on its attitude toward Taiwan. For Taiwan, the extent of economic integration with the mainland increased precipitously in the 1990s. At the same time, a pro-independence or nation-building (a Taiwan state) political movement gathered momentum and began to dominate Taiwan's post-liberalization politics, creating high tension across the strait. The Nationalist Party itself has split due to internal divisions over this issue, and hence was voted out of office for the first time in 2000. However, the society remains divided on how to handle its political relations with mainland China, while the economic ties continue to deepen.³

Economic progress and structural change

The speed at which Taiwan industrialized its economy has been one of the fastest among the latecomers in the post-war period. It essentially transformed itself from an agricultural economy to an industrialized one within a very short period of time. Along with fast growth, structural change has been swift, but full of imbalance.

According to Maddison (2001), Taiwan's per capita income in 1950 was only \$936 (see Table 3.1), measured in 1990 international dollars (PPP), which was far lower than that of not only Latin America but also the Philippines, and less than one-tenth of that of the United States. By 1998, by Maddison's estimates, Taiwan's per capita income increased 16 times, while Latin America's rose only 2.3 times. According to the US government's estimates, Taiwan ranked thirty-fourth in the world in terms of per capita PPP GDP in 2004, right after the OECD countries, Hong Kong and Singapore, and nineteenth in the world in terms of the size of GDP.⁴

Taiwan's industrial prowess operates mostly behind the scenes, because its leading firms are mostly subcontractors for firms in the advanced countries. In recent years, due to successful industrial upgrading, Taiwan has become one of the world's largest producers of information technology (IT) products, semiconductors, liquid crystal display units, and artificial fibres. The government's Industrial Development Bureau lists 18 products in which Taiwan's output ranked top in the world in 2003. The list includes 14 IT and electronics products, such as notebook computers (64 per cent of global share) and motherboards (79 per cent), as well as bicycles and plastics.⁵

As Taiwan's economy approaches maturity, economic growth has been slowing in the last couple of decades. At the height of post-war growth, in the 1960s and 1970s, the overall annual growth rate averaged close to 10 per cent. Since the new century began,

Table 3.1 Growth of per capita GDP (1990 international PPP \$)

	1950	1998	Growth Factor, 1950/1998
Western Europe	5013	18 742	3.7
United States	9 561	27 331	2.9
Japan	1 926	20 410	10.6
Latin America	2 554	5 795	2.3
Eastern Europe & former USSR	2 601	4 354	1.7
Africa	852	1 368	1.6
East Asia (excluding Japan)	661	3 535	5.3
Singapore	2 219	22 643	10.2
Hong Kong	2 218	20 193	9.1
Taiwan	936	15 012	16.0
South Korea	770	12 152	15.8
Mainland China	439	3 117	7.1
Philippines	1 070	2 268	2.1

Source: Maddison (2001).

growth has slowed significantly and averaged only 2.6 per cent from 2001 to 2004, signalling the arrival of a different stage of development (see Table 3.2). The year 2001 was also the first and only year in the post-war period when the economic growth rate was negative.

Industrial production has been the driving force right from the beginning of the post-war period. The share of agricultural production in GDP decreased from 38 per cent in 1953 to 28.5 per cent in 1960, to 15.5 per cent in 1970 (see Table 3.3) and to below 10 per cent after 1978, while the share of manufacturing in GDP increased from 12.9 per cent in 1952 to 19 per cent in 1960, to 29 per cent in 1970 and reached a peak at 39.4 per cent in 1986. After 1986 the share of manufacturing began to decline and reached 25 per cent by 2004. During the same period after 1986, the share of services began to rise from around 48 per cent in the 1950s to 68 per cent by 2004 (see Table 3.3). The shifting pattern of GDP composition among the primary, secondary and tertiary sectors in Taiwan closely resembles that of the more advanced countries, indicating the steady advancement of Taiwan's economy. The changes in the employment composition run pretty much parallel to those of GDP.⁶

Liberalization and upgrading

Just when the share of industry in GDP began to decline after 1986, the economy began its enormous transformation. That is, the New Taiwan dollar appreciated 40 per cent against the US dollar, the wage level rose significantly and the government started implementing broad economic liberalization in earnest after 1986.

Before then, Taiwan's economy had been operating under a rather stable export-promotion regime, in which the foreign exchange rate was kept stable and undervalued, and the domestic market was protected. At the same time, overall macroeconomic stability was maintained, with a low inflation rate, except during the oil crisis, and balanced budget and balance of payments surplus. The success of this regime however, brought its own demise, and made overall economic upgrading necessary by the later half of the 1980s. Trade surplus and exchange reserves began to accumulate due to the success of

labour-intensive exports in the 1980s, while the wage rate continued to increase. The imbalance between the progressive export sector and the protected domestic sector left the increasingly wealthy domestic consumers ever more unsatisfied.

As economic liberalization began in a major way after 1986, the major part of labour-intensive production moved overseas. Two kinds of exports took its place. One was the upstream input, the growth of which originally took place via secondary import-substitution. For example, fabrics and artificial fibres became major exports after the downstream apparel production moved out. The share of the textile industry, a leading sector in the earlier period, in the manufacturing industry, declined from 20 per cent in 1971 to 2.3 per cent in 2004. The other major exports came from the newly emerged high-tech industry, which became the major force in exports.

The entry strategy of Taiwanese firms into the high-tech industry has been one of playing second mover or doing subcontracting. Lacking frontier technology, the firms enter when the product becomes mature, and earn profits based upon efficient and low-cost manufacturing and timely delivery. They have to absorb the technology and expand production quickly. These firms have mostly relied upon locally trained engineers, as well as some returnees from abroad. The support of the education system, the accumulated manufacturing experiences and the local production networks provided the necessary conditions for the emergence of these firms. On the other hand, the government's industrial policy helped to set up the right environment and the crucial institutions, and assisted the advancement of the industry along the way. As a result, the main players in Taiwan's IT industry are the large nationally owned firms, not foreign capital, and they have been able to capture a large share of global IT production, and now rank fourth in the world in terms of IT production values, after the United States, Japan and China. Domestically, the share of the IT and electronics sector in total manufacturing rose from around 13 per cent in 1990 to 36 per cent in 2004.

The share of heavy industrial goods in total exports increased from 46 per cent in 1990 to 76.5 per cent in 2003, and the share of high-technology-intensive goods rose from 27 per cent in 1990 to 46 per cent in 2003. The changing product mix of Taiwan's exports from the late 1980s till the present shows that broad-based industrial upgrading indeed has taken place in this round of industrial transformation.⁷

Globalization

The pace of globalization has been swift in Taiwan since the late 1980s. The flow of inward and outward foreign direct investment (FDI) increased significantly. Inward FDI now mostly flows into the modern service sectors, as entry restrictions continued to lessen. By the time Taiwan formally entered the WTO in 2002, the domestic market had already gradually become quite open.

Outward FDI mostly took place from the late 1980s on. The first wave was that of the labour-intensive production moving offshore, first to the ASEAN countries and later to the mainland. In the last few years, the high-tech industry also began to move mass production lines to the mainland. For example, the ratio of overseas production of Taiwan's IT industry increased from 43 per cent in 1998 to 78 per cent in 2003. The high-tech firms are now under intense pressure to upgrade their operations again. At the moment, they tend to undertake mass production on the mainland, and do development work and pilot runs at their Taiwan headquarters. Many of them have also begun to increase marketing efforts in the advanced countries and China.

Table 3.2 *Leading economic indicators I, 1951–2004 (%)*

Year	Growth Rates Of						Consumer Price Index
	Real GDP	Population	GNP per Capita	Gross Fixed Capital Formation	Industrial Production	Exports	
Annual average							
1951–60	8.1	3.6	4.5	14.1	11.9	22.1	9.8
1961–70	9.7	3.1	6.8	15.4	16.5	26.0	3.4
1971–80	9.8	2.0	7.7	13.8	13.8	29.5	11.1
1981–90	8.0	1.4	6.8	6.8	6.2	10.0	3.1
1991–2000	6.4	0.9	5.4	8.5	5.1	10.0	2.6
2001–04	2.6	0.5	2.7	–2.2	4.3	6.5	0.3
1951–2004	8.0	2.1	6.0	10.6	10.4	18.4	5.4

Source: Council for Economic Planning and Development (CEPD), various years, *Taiwan Statistical Data Book*.

Table 3.3 *Leading economic indicators II, 1952–2004*

Year	GDP Per Capita (US\$)	Gross Fixed Capital Formation as a % of GNP*	Exports as a % of GNP*	Trade Balance (US\$ million)	GDP by Industry (%)		
					Agriculture	Industry	Services
1952	196	11.3	8.0	–71	32.2	19.7	48.1
1960	154	16.6	11.5	–133	28.5	26.9	44.6
1965	218	17.0	19.4	–106	23.6	30.2	46.2
1970	389	21.7	30.4	–43	15.5	36.8	47.7
1975	970	31.3	39.9	–643	12.7	39.9	47.4
1980	2 348	30.7	52.6	78	7.7	45.7	46.6
1985	3 243	18.5	53.3	10 624	5.8	46.3	47.9
1990	7 918	21.9	45.6	12 498	4.2	41.2	54.6
1995	12 488	24.6	47.2	8 109	3.5	36.4	60.1
2000	13 912	23.1	53.7	8 310	2.1	32.4	65.5
2004	13 529	19.4	64.3	6 124	1.7	29.6	68.7

Note: *Before 1960, GDP figure was used.

Sources: CEPD, various years, *Taiwan Statistical Data Book*.

The destination of Taiwan's outward FDI has become increasingly concentrated on mainland China, taking up over 70 per cent of the total outflow. The situation in the export trade is similar. Exports to mainland China now account for over one-third of Taiwan's exports, surpassing that of the US market. In sum, though Taiwan's economy has become increasingly globalized, the external relationship has been dominated by the

cross-strait relation. It is foreseeable that economic dependence on mainland China will only intensify in future, a problem the Taiwan government is yet to come to terms with politically.

Social progress

Chang (2005) compared the initial conditions of the developing countries at the beginning of the post-war period, to examine whether East Asia was more favourably endowed than others. He found that the conditions really varied among the Asian, African and Latin American countries, and that the only condition in which the East Asians were clearly superior was the social infrastructure, that is, the literacy rate and life expectancy. In this regard, Taiwan had a favourable starting position and has improved on that continuously since then (Table 3.4).

The relevant indicators indeed show good progress. Life expectancy for females and males increased from 60.3 and 57.4 in 1952 to 79.4 and 73.6 in 2004 respectively. The literacy rate increased from 63.6 per cent in 1952 to 97.2 per cent in 2004. Taiwan's income distribution had been relatively equal until recently, if compared with most other developing countries. The ratio of the top fifth's household income to the bottom fifth's was 5.25 in 1966, which fell to 4.17 in 1980, but rose to 5.55 in 2000, and increased sharply to 6.07 in 2003.

Several related policies helped to bring about these beneficial results in the earlier period. Aspects of economic development helped to render income distribution more

Table 3.4 *Social indicators, 1952–2004*

Year	Population (1000 persons) (1)	Labor Force Participa- tion rate (%) (2)	Unemp- loyment rate (%) (3)	Life Expectancy (4)		Infant Mortality (5)	Literacy Rate (%) (6)	Ratio of top Fifth's Income to Bottom Fifth's (7)
				Male	Female			
1952	8 128	66.5	4.4	57.4	60.3	44.7	63.6	—
1960	10 792	62.4	4.0	62.3	66.4	35.0	78.7	—
1965	12 628	58.2	3.3	65.1	69.7	24.1	81.2	5.25*
1970	14 676	57.4	1.7	66.7	71.6	16.9	87.6	4.58
1975	16 150	58.2	2.4	68.3	73.4	12.6	87.1	4.18**
1980	17 805	58.3	1.2	69.6	74.6	9.8	89.7	4.17
1985	19 258	59.5	2.9	70.8	75.8	6.8	91.5	4.50
1990	20 353	59.2	1.7	71.3	76.8	5.3	93.2	5.18
1995	21 304	58.7	1.8	71.9	77.7	6.4	94.4	5.34
2000	22 216	57.7	3.0	72.7	78.4	5.9	95.6	5.55
2004	22 615	57.7	4.4	73.6	79.4	5.3	97.2	6.07***

Notes: *1966 data, **1976 data, ***2003 data.

Sources: (1)–(2), (7) CEPD, various years, *Taiwan Statistical Data Book*. (3) DGBAS, various years, *Statistical Yearbook of the Republic of China*; DGBAS, various years, *Social Indicators of the Republic of China*. (4) Ministry of the Interior, <http://www.moi.gov.tw/stat/>. (5) Department of Health, 1995, 2003, *Health and Vital Statistics*. (6) Ministry of the Interior, <http://www.moi.gov.tw/stat/>; *Statistical Yearbook of Interior of the Republic of China*, 1995, 2002.

equal. First of all, land reform helped to build the basis for social and income equality. Labour-intensive export production provided ample jobs for the young leaving the agricultural sector. Industrial districts had also been quite dispersed and spread jobs widely, until recently when the electronics boom concentrated new high-tech jobs in the north of the island. Implementation of industrial policy relied mostly on SOEs, not on large private firms like *chaebols* in South Korea, hence leaving room for the small and medium-sized enterprises (SMEs).

In sum, export-led growth made income distribution more equal in the 1960s and 1970s. But, in the later period, globalization and industrial concentration in electronics led to increased geographical concentration of employment in the northern part of the island, and a higher skill premium for the better educated, thus a worsening of income distribution.

Education policy emphasized mass education in the early period, vocational education in the later period, and higher education only recently. In the earlier period, the education policy served economic development well, by supplying a large number of good quality unskilled and semi-skilled workers, and ample supply of competent engineers. The higher education system has greatly expanded since the 1990s, with the percentage of senior high school graduates enrolled in schools of higher education increasing from 26.3 per cent in 1952, to 42 per cent in 1970, to 44 per cent in 1990 and to 80 per cent in 2004. Whether this recent change in the education system will help to facilitate Taiwan's next round of economic upgrading remains to be seen, however. The results of educational reforms and the pace of further liberalization and privatization of education in the future have been the subjects of heated debate in recent years.

The media and publishing industry became very active after martial law was lifted in 1987. For example, the number of publishing companies increased from 564 in 1960, to 2011 in 1980 and to 7810 in 2002. Despite industry growth, whether or how much the quality of cultural services provided has improved has also been disputed.

Health policy focused on the public health programme in the early period, emphasizing the control of the spread of communicable diseases and implementation of the birth control programme. With economic progress, the number of health personnel per 10 000 persons increased from 11.4 in 1961 to 77.9 in 2002, and the number of beds per 10 000 persons increased from 3.7 in 1961 to 59.3 in 2002. A universal health care plan was put into effect in 1998, as the major social welfare programme offered in Taiwan to this day.

Even though Taiwan's per capita income has approached the advanced country level, the size of the social welfare programme remains relatively small. The share of government expenditure was only about 22 per cent of GNP in 2003. Besides the universal medical insurance programme, there are few other social welfare programmes to provide the necessary social safety net in a changing society, in which the traditional family has come to provide fewer and fewer supportive functions.

The tax burden has been relatively light and has even been decreasing recently. The ratio of tax revenue to GDP has declined from 19.6 per cent in 1980 to 12.7 per cent in 2003. The budget had been more or less in balance before the late 1980s. Since then, the fiscal deficit has been increasing rapidly; its share in total government revenue has averaged around 20 per cent since the 1990s and shows no signs of improving yet, probably due to the effects of globalization and democratization.

Major policies

Taiwan's post-war industrialization has been very much a state-led development. When the Nationalist government took over Taiwan, it had almost all the essential policy tools at its disposal. And the government indeed had used these tools to promote economic growth single-mindedly.⁸

Right from the beginning, industrialization had been the clear objective. In the 1950s, besides trying to restore the economy to its pre-war level, the government promoted import-substitution industrialization due to severe foreign exchange constraints. The government push-started the cotton textile industry, the major target industry, by bearing most of the risks and responsibilities itself. A few other industries were also promoted.

The government had noticed that promoting exports was another way to lessen the foreign exchange constraint. Besides, the scale of the domestic market was obviously too small to allow for the realization of scale economies of the industry and to sustain growth. For example, the textile industry reached self-sufficiency within just a few years and began to accumulate excess capacity. The government then had to design schemes, that is, getting the prices 'wrong', to prod the firms to export.

The switch to export-promotion policy regime, therefore, seemed a logical next step for a government eager to find ways to sustain growth and push industrialization. The Foreign Exchange Reform and the 19-point Programme for Economic and Financial Reform were put into effect in 1958 and 1960 respectively; measures included reforming the foreign exchange regime to adopt a unitary exchange rate, export promotion programmes, and other fiscal reforms. The switch was not as drastic as it seemed, for the extent of trade liberalization was limited and the domestic market continued to be protected to a great extent. But exports indeed began to grow very rapidly. Taiwan's cotton textile products were subject to import restraint in the US market as early as 1962. This occurred before apparel exports began to take off in the late 1960s, showing the beneficial effects of import substitution.

To promote overall economic development, the government enacted the all-important Statute for Encouraging Investment in 1960. The Statute remained in effect till 1990 and replaced by the Statute for Promoting Industrial Upgrading.

The promotion of heavy industry was also in the plan, while light industry only began to grow in the 1950s. The automobile industry made a start in 1956. Plans for the steel and petrochemical industries began to be discussed in the 1950s as well. Due to difficulties in obtaining technology and capital, the first naphtha cracking plant did not begin operation until 1968, and the first integrated steel mill appeared only in 1977. Both were undertaken by SOEs, socializing investment risks then deemed unbearable by the private sector. This was also a form of secondary import-substitution policy, that is, the upstream production was set up with government help to supply inputs to the exporting downstream industries.

Moreover, in response to the first oil crisis and the political crisis caused by the thaw in the US-PRC relations, the Nationalist government pushed the Ten Construction Projects in the 1970s, which included six major infrastructure projects, one nuclear power plant and three industrial projects – the integrated steel mill and expansion of the petrochemical and the ship-building plants. It helped to sustain and deepen industrialization.

Right after the plan for the heavy industry was more or less in place in the late 1960s, the government began to plan the next growth industry – electronics. Adopting a different

policy approach this time, the government set up the National Science Council and public research laboratories, like the Industrial Technology Research Institute (ITRI), in the early 1970s, and started the first IC (integrated circuit) project in 1976. Later, these consecutive IC projects were spun off from ITRI, and the spin-offs, mainly United Microelectronics Corporation in 1980 and Taiwan Semiconductor Manufacturing Company in 1987, now comprise the main part of Taiwan's IC industry.

This policy environment had also supported the spectacular growth of Taiwan's information technology (IT) industry. A policy network was in place to import-substitute key components after local production of mature IT products became possible. Thus, by now, the majority of the world's IT products are made by Taiwanese firms, even though they remain subcontractors without brand names.

In sum, until 1986, except for the high-tech industry, which relies on a different set of policies, the overall industrial policy was export promotion but accompanied by secondary import substitution and protection of the domestic market. Most of the banks were publicly owned, therefore, the government could direct credits to support its industrial policy. Nonetheless, the Nationalist government had been much more restrained in this regard when compared with that of South Korea probably due to historical experiences. The government had also successfully managed to maintain macroeconomic stability throughout the years, by keeping the budget mostly in balance and the inflation rate low. Starting from 1986, Taiwan's economy began its great transformation. Although circumstances made the transformation inevitable, the government still tried to guide the process with developmental intentions.

Broad economic liberalization began in 1986. The Plaza Accord forced the New Taiwan dollar to appreciate from 1986. The foreign exchange and the trade regime both began to be liberalized at that time. Foreign investors and new local entrants were gradually allowed into many previously restricted domestic markets. The transformation of the two major service sectors, the financial and communication sectors, however, was highly regulated to allow learning periods for local firms.

The government continued to push upgrading after economic liberalization, by subsidizing R&D and sponsoring cooperative research, among other measures. There are indications that Taiwan's technological effort has made significant progress.

The flow of outward investment from Taiwan has increased significantly since liberalization from the late 1980s onward. Besides some investment for R&D and marketing in the advanced market, the outflow was mainly for relocating manufacturing to low-cost areas, moving first to Southeast Asia in the early 1990s and then mainly to mainland China. More recently, Taiwan is aiming for more and more outward investment to mainland China for the local market.

All in all, the extent of economic integration with the mainland economy in terms of trade, investment and human resources has become so great that the mainland is already the most important economic partner for Taiwan. For political reasons, the government, both the Nationalists in the 1990s and the current DPP government since 2000, adopted a policy of 'restraint' toward the mainland, forbidding direct links and restricting trade and investment, with the intention of curbing the advancement of economic integration. The policy has not been effective in this globalized world, especially because the Chinese economy has continued to grow rapidly. This is probably the first time in the post-war period that the economic policy has neither been developmental nor forward-looking.

Prospects

Taiwan has successfully upgraded its economy by moving from mid-tech industries into mature high-tech and modern services in the last couple of decades, as documented by Amsden and Chu (2003). It now faces a new set of challenges as it enters the next round of industrial upgrading.

The electronics sector makes up about 40 per cent of Taiwan's manufacturing value-added and exports, but now faces slower growth and declining profit margins as the global high-tech industry reaches maturity. Many leading firms have diversified into other product lines, including cell phones, hand-held and mostly liquid crystal displays, but problems of low profit margins and excess capacity still prevail. Most firms have also moved mass production lines to mainland China, and have expanded capacity greatly after relocation, exacerbating the excess capacity problem. The ratio of overseas production of IT products has increased quickly from 43 per cent in 1998 to 78 per cent in 2003.

At the firm level, besides seeking new growth areas, these leading firms have to globalize their operations by managing across borders, undertaking R&D at home and abroad, building up brand names, and marketing abroad. At the national level, Taiwan has to find the next growth industry. It has to make sure that the large amount of investment already devoted to the bio-med field is prudently allocated, so that it will bear fruits in the future.

In the meantime, the government's greatest challenge is to find a way to ease political tension across the strait, to allow Taiwanese firms to find growth opportunities on the mainland while upgrading operations at home. The successful industrialization experiences in the past should give the next round of upgrading a good chance to succeed, but only if the political crisis can be solved in time.

Taiwan also needs to address the growing inequality in recent times and the problems associated with an ageing population. Thus, Taiwan has to face the challenge of balancing the need for a broad-based social safety net with the need for fiscal prudence.

Notes

1. For discussion of the Japanese colonial period, see Cumings (1984); Gold (1981); Ho (1978) and Myers and Peattie (1984).
2. For general discussion of the overall development in the earlier post-war period, see Amsden (1979); Cumings (1984); Gold (1981); Ho (1978); Lin (1973) and Wade (1990).
3. For discussion of the more recent transformation, see Chu (2002).
4. The World Bank's *World Development Indicators 2005*, does not include Taiwan, therefore we need to use estimates from other sources. The US government's estimates are taken from: <http://www.cia.gov/cia/publications/factbook/rankorder/2004rank.html>. It estimates Taiwan's 2004 GDP per head (PPPS) to be \$25 300, which is close to that of EIU's (Economist Intelligence Unit) estimate of \$24 500 for Taiwan in 2003. The EIU's estimates are taken from <http://www.economist.com/countries>. The ranking adopted here should be consistent with that of the World Bank (2005: Table 1.1), in which Singapore, at \$24 180, ranked thirtieth in 2003.
5. Industrial Development Bureau (2004), *An Introduction to Industries of the Republic of China*, Taipei: IDB, pp. 14–15.
6. See Galenson (1979); Gold (1981); Ho (1978); Lin (1973) and Wade (1990) for discussion on economic growth in the earlier post-war period.
7. See Amsden and Chu (2003) for a discussion of the economic upgrading and globalization in the last two decades.
8. For discussions of major policies, see Amsden (1979); Amsden and Chu (2003); Chu (2001); Gold (1981); Ho (1978); Hsueh, Hsu and Perkins (2001) and Wade (1990).

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A comprehensive survey of the government's role in Taiwan's economic development.

4 Singapore

Chia Siow Yue

A short political history

Singapore is a small island and city-state. It has a land area of 699 square kilometres and a total population of 4.3 million. It has no natural resources except for a strategic geographical location astride the major shipping route linking East Asia and Oceania to Europe. Yet Singapore has achieved substantial and visible economic and social progress since political independence in 1965. Per capita income reached S\$41 513 in 2004, one of the highest in Asia. The UNDP ranked Singapore twenty-first in per capita GDP and twenty-fifth in the Human Development Index in 2003.¹ The *World Competitiveness Yearbook 2005* ranked Singapore as the third most competitive economy in the world.²

The history of modern Singapore began in 1819 when Stamford Raffles of the British East India Company annexed the island and established it as a free port. The island was reported to have only 150 inhabitants. The free port grew with immigration and became the entrepot of Southeast Asia and a British military base in the Far East.

Singapore fell to the Japanese during World War II. In the post-war period, political parties emerged in the anti-colonial struggle. The People's Action Party (PAP) under Lee Kuan Yew won the May 1959 general elections and formed the first national government of Singapore. The PAP had three main agendas – merging with Malaysia, fighting communism and communalism, and reviving the economy. The PAP campaigned hard for merger and Singapore joined the Federation of Malaysia in September 1963. However, it was a stormy relationship and Singapore left Malaysia to become an independent republic on 9 August 1965.

Singapore adopted the parliamentary system with general elections every four to five years. The PAP won all of the parliamentary seats in the general elections from 1968 to 1980. In 1981 an opposition member was voted into Parliament in a by-election. In the subsequent general elections from 1984 to 2001, the PAP won an overwhelming majority of parliamentary seats. Political analysts attributed the predominance of the PAP in the general elections since 1959 to four factors – ability of the PAP to overcome the various crises that beset post-independent Singapore; successful resolution of the twin threats of communism and communalism; legitimacy obtained on the basis of its successful economic management; and absence of a credible opposition.³

The authoritarian style of the political leadership has led critics to question the practice of democracy in the city-state. The political leadership transitions have been seamlessly smooth. Lee Kuan Yew served as Prime Minister from 1965 to 1990; he stepped down in favour of Goh Chok Tong, who, in turn, stepped down in 2004 in favour of Lee Hsien Loong as part of the PAP's self-renewal process. A constitutional reform in November 1991 led to an elected presidency with powers over fiduciary matters and key appointments in the civil service and statutory boards. The PAP has been trying to loosen its authoritarian style over the years with establishment and encouragement of grass root organizations and feedback on public policy issues. At the same time, political continuity

has allowed the political leadership and policy-makers to have a long-term vision for Singapore and to adopt and implement long-term policies.

A major characteristic of Singapore politics is the emphasis on meritocracy and probity. PAP candidates for parliamentary elections and subsequent ministerial appointments are selected on the basis of ability and character integrity through a stringent party selection process. Also, the best and most able are recruited into the bureaucracy. Singapore's success in combating political and bureaucratic corruption and ensuring accountability may be attributed to several factors – the high moral code of the first generation PAP political leaders, transmitted to subsequent generation leaders; strict selection criteria for PAP candidates seeking election into Parliament; strict code of conduct for the bureaucracy and severe penalties imposed on those caught for corrupt practices; a policy framework that minimizes non-transparent exercise of discretionary power and an efficient public service that negates the need for bribery to facilitate decision-making or bypass the system; and high public salaries that reduce the need to engage in moonlighting and corrupt practices to make ends meet.

Economic progress and structural change

Economic performance

Singapore enjoyed an average annual GDP growth rate of over 8 per cent during the four decades from political independence between 1965 and 2004. The heavy dependence on external demand gives rise to volatile GDP growth rates. Double-digit growth rates were registered annually between 1966 and 1973, driven mainly by high growth in export manufacturing and exportable financial services. Negative growth was experienced in 1964, 1985, 1998 and 2001. The Asian Financial Crisis in 1997 and a maturing economy, dampened economic growth in subsequent years. For 2004, GDP growth recovered to 8.4 per cent.

Singapore's economic growth (Table 4.1) can be sub-divided into the following sub-periods:

- *1960–64, pre-independence period:* GDP growth averaged 5.1 per cent a year and the unemployment rate was double-digit. The twin economic pillars were entrepot trade and the British military base. The government embarked on import-substituting industrialization in 1960 to provide a new economic pillar and create employment. The manufacturing share of GDP grew from 11 per cent in 1960 to 14 per cent in 1964. Merger with Malaysia in September 1963 led to economic confrontation by Indonesia that seriously affected the entrepot trade and led to GDP contraction in 1964.
- *1965–78, export manufacturing phase:* GDP growth averaged 10 per cent a year, the unemployment rate fell to 3.6 per cent and manufacturing sector's share of GDP grew to 24 per cent by 1978. Separation from Malaysia and political independence in August 1965 ended Indonesia's economic confrontation and led to the resumption of entrepot trade, as well as Singapore's switch in industrial strategy from import substitution to export orientation, spearheaded by foreign direct investment (FDI). Britain withdrew its military base from Singapore by 1971. The base had employed some 40 000 workers and was a sizeable contributor to GDP. The government focused on attracting FDI by improving the investment climate. In 1972

Table 4.1 *Key indicators of Singapore's economic performance*

Year	GDP at 1995 Market Prices (S\$ million)	Annual % Change	Per Capita GNI (S\$)	Unemp- loyment Rate (%)	Exports, Annual % Change	Consumer Price Index 2004=100	Sing. Dollar per US\$ Exchange Rate	% of Population Living in HDB Housing
1965	8 891.0	na	1 618	na	8.2	33.3	na	23
1970	16 207.2	12.8	2 825	8.2	0.3	35.4	na	36
1975	25 258.8	9.3	5 996	4.5	-9.9	55.3	na	55
1980	37 958.6	8.5	9 971	3.5	34.0	65.7	na	74
1985	51 702.0	6.4	14 676	4.1	-2.3	77.0	2.2002	84
1990	77 298.9	8.4	22 549	1.7	9.3	82.0	1.8125	87
1995	118 962.7	9.0	34 601	2.7	13.7	93.0	1.4174	86
1998	138 637.4	-0.8	36 027	3.2	-1.0	95.9	1.6736	86
1999	148 108.1	6.8	36 163	3.5	5.7	96.0	1.6949	86
2000	162 379.0	9.6	39 405	4.4	22.4	97.2	1.7240	86
2001	159 212.3	-2.0	37 228	3.4	-8.3	98.2	1.7917	85
2002	164 255.2	3.2	37 065	5.2	2.7	97.8	1.7906	85
2003	166 491.8	1.4	37 853	5.4	12.1	98.3	1.7422	84
2004	180 496.0	8.4	41 513	5.3	20.9	100.0	1.6903	84

Sources: *Singapore 2005 Statistical Highlights*; *Singapore Yearbook of Statistics*, various years; *Economic Survey of Singapore*, various years.

the National Wages Council was formed to provide for orderly wage increases in a full-employment economy.

- *1979–85, tight labour market and recession*: GDP growth averaged 7.3 per cent a year. The growing labour shortage as well as competition for FDI and markets from neighbouring countries with abundant low-wage labour pressured Singapore into economic restructuring. Measures included a three-year wage correction policy and companies were encouraged to automate, mechanize and computerize their operations. Labour development through education and training was emphasized. In 1985 Singapore was hit by a recession caused by rising domestic production costs, slump in the construction sector and fall in external demand. Labour costs had become uncompetitive, with sharp wage increases and high Central Provident Fund (CPF) contribution rates imposed on employers.
- *1986–97 economic recovery*: GDP growth averaged 8.6 per cent a year during this period. Counter-recessionary measures included reductions in labour costs and government user rates and charges. These helped Singapore to recover cost competitiveness and the GDP rebounded in 1987. With economic recovery, the government returned to economic restructuring, with emphasis on technology development, and committed S\$2 billion under the 1991–95 National Technology Plan and another S\$4 billion under the National Science and Technology Plan from 1996 to 2000. Manufacturing and services were promoted as twin pillars of the economy. The government also launched a regionalization drive to tap the potential of the Asian market.

- *1997–2004, Asian Financial Crisis and recovery:* GDP growth reached 8.6 per cent in 1997 before Singapore succumbed in 1998 to the effects of the 1997 Asian Financial Crisis. Singapore's economic and financial fundamentals were sound, but it suffered the contagion effect as well as falls in global demand for electronics. The economy suffered another contraction in 2001 as it was hit by weaker global demand and continuing slump in the electronics industry.

Structural transformation

The Singapore economy has transformed from a regional entrepot into an export manufacturing platform and a services hub and is now moving towards a knowledge-based economy. Table 4.2 shows the structural changes in national income and employment between 1965 and 2004. The government played a very active role in guiding Singapore's rapid transformation. Various government policies in this regard are discussed later in the chapter.

Total factor productivity

A number of empirical studies have highlighted the low total factor productivity (TFP) growth in Singapore. Young (1992) attributed it to the industrial targeting policies of the government.⁴ Krugman (1994) criticized Singapore's investment-driven growth. Lall, Tan and Beng (1996) attributed Singapore's low TFP growth to a possible data problem, in particular, errors in estimating the capital stock and real GDP, and the low level of indigenous R&D activity. R&D activities are mainly carried out by foreign MNCs in their home countries and are significantly affected by home country characteristics.

Employment and unemployment

Singapore had double-digit unemployment rates in the late 1950s and first half of the 1960s as growth in labour supply from rapid population growth exceeded the capacity of the stagnating entrepot trade to provide sufficient employment opportunities. Rapid economic growth during 1966–73 as well as falling birth rates led to disappearance of the labour surplus and the emergence of labour scarcity, and Singapore became increasingly dependent on foreign labour. Economic restructuring led to large job retrenchments and rising unemployment in recent years. At the same time, Singapore continued to depend on foreign labour because of skills and job mismatches. By the 1990s foreign labour accounted for some 25 per cent of Singapore's total workforce.

Savings and investment

Singapore had negative national savings in 1960–61 but savings grew rapidly in subsequent decades to reach a peak of over 50 per cent of GDP in the 1990s, levelling off to over 44 per cent in 2004 (see Table 4.3). The sharp turnaround is due to the rapid growth in public sector savings and mandatory CPF contributions.

The public sector experienced persistent and growing surpluses arising from government budget surpluses and operating surpluses of statutory boards, and profits of government linked companies. Statutory boards are created by Acts of Parliament and perform functions that are more explicitly economic development in nature.⁵ Government-linked companies or public enterprises are either wholly or partially government-owned. Government-operating revenue was persistently in excess of operating expenditures and the operating surplus was more than sufficient to finance development expenditures for most years.

Table 4.2 *Singapore – economic structure*

Percentage Distribution of Gross Value-added								
Year	Goods-producing industries			Service-producing industries				
	Total	Manufac- turing	Con- struction	Total	Whole- sale & retail trade	Financial services	Business services	Transport & communications
1965	26.2	14.4	6.2	70.8	23.7	4.4	9.4	11.5
1970	30.9	18.6	6.9	66.1	24.5	4.9	9.3	10.9
1975	34.2	22.3	7.9	63.0	21.6	6.9	8.8	11.0
1980	37.3	27.3	6.3	60.4	17.2	8.2	8.7	13.6
1985	34.0	20.9	10.2	62.1	12.8	11.0	11.0	12.8
1990	33.0	25.5	5.3	62.9	13.7	10.7	12.0	12.9
1995	33.9	25.0	7.1	62.6	13.5	11.1	13.4	12.1
2000	34.6	26.6	6.3	62.0	12.7	11.3	13.7	11.7
2004	33.8	27.7	4.3	63.0	14.3	11.3	12.7	11.0

Percentage Distribution of Working Persons				
Year	Professional, technical & managerial occupations	Clerical, sales & service occupations	Manufacturing sector	Financial & business services sector
1965	na	na	na	na
1970	10.3	42.8	22.0	3.5
1975	13.5	42.6	26.2	6.1
1980	18.0	28.1	30.1	8.0
1985	21.7	30.1	25.5	8.9
1990	24.2	25.7	28.9	11.3
1995	35.9	24.1	23.7	15.4
2000	35.8	21.2	20.8	15.4
2004	42.6	24.2	17.3	17.5

Sources: *Singapore 2005 Statistical Highlights*; *Singapore Yearbook of Statistics*, various years; *Economic Survey of Singapore*, various years.

The largest source of government revenue is from taxation, more specifically income tax. Taxes levied on import and consumption of tobacco, liquor, petroleum and cars are to achieve social objectives like curbing smoking and drinking and to reduce traffic congestion and pollution. The tax base is shifting from direct income tax to indirect consumption taxes. The second largest revenue earner is investment income. The government also levies charges for goods and services provided on a cost recovery basis with subsidies only to education, health care and housing.

Prudent fiscal policy has contributed to budgetary surpluses and macroeconomic stability. The consumer price index remains stable for most years, except for periods of high imported inflation such as caused by sharp increases in world price of rice and oil. The government's domestic debt consists mainly of government securities sold to the CPF. Singapore has no external official debt since 1990, while official foreign reserves have grown rapidly to reach S\$183 billion or US\$113 billion by 2004.

Table 4.3 Singapore – savings and investment

Year	Gross National Savings/GDP Ratio (%)	Gross Fixed Capital Formation/GDP Ratio (%)	Government Deficit (–) or Surplus (\$ million)	Domestic Public Debt (\$ million)	External Public Debt (\$ million)	Central Provident Fund Amount (\$ million)
1965	12.6	21.1	na	na	na	359
1970	21.2	32.5	na	1 843	174	778
1975	30.8	35.9	na	5 155	543	3 245
1980	35.6	40.7	na	13 733	937	9 551
1985	46.4	42.2	na	31 568	596	26 830
1990	45.5	32.3	na	51 358	68	40 646
1995	51.8	33.4	14 826	86 508	0	66 035
2000	45.3	29.8	13 658	134 370	0	90 298
2004	44.4	24.0	10 128	186 598	0	111 874

Sources: Singapore 2005 Statistical Highlights; Singapore Yearbook of Statistics, various years.

The CPF scheme was first set up by the British colonial government in 1955 to provide funds for old age retirement. Over the years, the CPF has replaced the pension system in the public sector.⁶ Contribution rates and ceilings have been raised, and the overall scope and benefits expanded to include retirement, home ownership, health care, family protection and asset enhancement. CPF rates reached their highest level in 1984–85, when it formed 50 per cent of payroll and gave rise to an active debate on whether Singaporeans were saving excessively. With the onset of recession in 1985 and recognition that high labour costs were a major contributory factor, the employer's contribution rate to the CPF was reduced from 25 per cent to 10 per cent. It was announced then that the long-term objective of the government was to maintain the combined CPF contribution rates for employers and employees at 40 per cent. Current contribution rates stand at 38 per cent for workers aged 50 and below.⁷

Han (1996) argues that compulsory savings through the CPF are no longer excessive in view of provisions for housing and health care in addition to taking care of retirement needs. A concern over the government management of the CPF, with low returns on CPF savings for individuals and depriving the private sector of access to a large pool of national savings, was partly resolved by allowing CPF members to invest their CPF funds in trustee stocks and shares. With the expanding uses of the CPF and longer life expectancy, there is also a growing concern that the financial provisions for old age have been diluted.⁸

The high rate of national savings has made possible the high rate of capital investment within Singapore and growing outward investment. Gross fixed capital formation as a percentage of GDP has grown from 21.1 per cent in 1965 to over 40 per cent in the early 1980s. It has been on a declining trend since the 1990s and reached 24 per cent in 2004, due largely to sharp declines in investment in construction works by the public and private sectors. A notable feature of Singapore's capital investments is the large proportion invested in residential housing. Singapore has also invested heavily in transportation and communications infrastructure with world-class airport, seaport and local land transport

and telecommunications systems. These have contributed to industrial and business efficiency as well as improved living standards directly.

International trade and investment

Singapore has an extremely open economy with trade in goods and services being over 300 per cent of GDP.⁹ For the first two decades, Singapore had a deficit in trade in goods and in the current account, while the trade in services enjoyed a surplus. Since 1985 the current account has been experiencing a rising surplus, reaching S\$47 billion in 2004 (Table 4.4) or 26 per cent of GNP. The current account surplus was initially due to the surplus in trade in services, but increasingly in the 1990s was due to the surplus in trade in goods.

Singapore's net exports of services rose to S\$7.5 billion in 1993, thereafter declining to S\$830 million in 2004. In 1965, more than half of service exports were from the British military base while the major service import was shipment payments to foreign companies. Singapore's service exports reached S\$70 billion in 2004, as compared with S\$333 billion for exports of goods. Major service exports are transportation, travel, financial and insurance services. Major service imports are also transportation, travel, insurance, as well as other business services and royalty payments.

Singapore's major trading partners are ASEAN countries (mainly Malaysia and Indonesia), China, United States, EU and Japan. The share of entrepot exports has been declining while the share of domestic exports in total exports has risen from only 25 per cent in the mid-1960s to 55 per cent in 2004. Entrepot exports have shifted from traditional Southeast Asian primary commodities to machinery and equipment, reflecting the growing industrialization of Southeast Asia. The growth and changing composition of domestic exports reflects the growth and increasing capital and technological intensity of Singapore's manufacturing sector. Major domestic exports are mineral fuels (mainly refined petroleum products), chemicals and chemical products, and machinery and transport equipment, which together accounted for 86.9 per cent of domestic exports in 2004. The share of mineral fuels has been declining from 43.2 per cent in 1970 to 20.2 per cent in 2004, while

Table 4.4 Singapore – trade in goods and services and balance of payments

Year	Trade in Goods, Net (S\$ million)	Trade in Services, Net (S\$ million)	Trade in Goods & Services, Net (S\$ million)	Current Account Balance (S\$ million)	Capital Account, Net (S\$ million)	Official Foreign Reserves (S\$ million)	Domestic Exports as % of Total Exports
1965	na	na	na	na	na	1 069	25.4
1970	-2 619.4	778.2	-1 841.2	-1 750.8	na	3 098	38.5
1975	-5 692.7	4 318.0	-1 374.7	-1 385.2	na	7 486	59.1
1980	-5 981.4	3 885.1	-2 096.3	-3 375.8	30.2	13 758	62.3
1985	-3 339.9	2 570.5	-769.4	128.2	-136.0	27 071	64.9
1990	-2 959.1	7 557.6	4 598.5	5 659.2	-39.6	48 521	65.9
1995	9 158.4	9 948.4	19 106.8	20 873.5	-103.0	97 337	58.8
2000	21 947.8	1 889.2	23 837.0	20 556.7	-280.5	139 260	57.2
2004	52 754.3	829.9	53 584.2	47 122.5	-308.4	183 844	54.9

Sources: Singapore 2005 Statistical Highlights; Singapore Yearbook of Statistics, various years; Economic Survey of Singapore, various years.

the share of chemicals has risen from 2.4 per cent to 17.2 per cent and the share of machinery and transport equipment has risen from 10.8 per cent to 49.4 per cent. Domestic exports of refined petroleum products are based on imported crude. Domestic exports of machinery and transport equipment reached a peak of S\$85.9 billion in 2000 and accounted for 68.8 per cent of total domestic exports. Major domestic exports in this category include electronic valves, data processing machines, electronic parts and components, communications equipment and electrical circuit apparatus. There is an active production network in East Asia and growth in intra-industry and intra-firm trade in East Asia.

Table 4.5 shows the stock of Singapore's inward and outward FDI. By 2004, the inward stock stood at S\$244.4 billion, while the outward stock stood at S\$153.5 billion. Inward direct investments far exceed outward direct investments, but the gap is narrowing with the rapid growth of overseas investments in the past decade. In 2004 the inward flow reached S\$27 billion against an outflow of S\$18 billion.

Singapore has one of the highest inward FDI penetrations in the world, with a ratio of inward FDI stock to GDP of 135 per cent in 2003. Sectorally, the largest concentrations

Table 4.5 Singapore – stock of foreign direct investment

Year	Inward FDI Total (S\$ million)	Major Investing Countries				Major Sectors	
		UK	US (% of total)	Japan (% of total)	Netherlands	Manufacturing (% of total)	Financial services (% of total)
1970	1 398.3	30.3	18.4	8.2	0.8	50.0	19.1
1975	4 649.5	28.1	18.3	9.7	2.4	50.3	21.7
1980	11 201.7	26.3	22.5	11.7	1.9	56.6	16.5
1985	22 354.9	16.1	26.7	14.1	3.5	50.5	28.0
1990	53 151.5	12.1	17.8	20.6	8.0	41.4	33.9
1995	92 840.7	10.4	17.4	19.4	5.0	38.2	37.3
2000	195 023.7	4.6	16.3	15.0	15.0	36.1	35.9
2004	na	na	na	na	na	na	na

Year	Outward FDI Total (S\$ million)	Major Destination Countries				Major Sectors	
		China	Malaysia (% of total)	Hong Kong (% of total)	Indonesia	Manufacturing (% of total)	Financial services (% of total)
1976	1 015.1	na	na	na	na	na	na
1981	1 677.7	–	60.0	10.8	2.4	na	na
1985	2 257.2	2.6	43.1	20.4	2.9	na	na
1990	13 621.7	1.8	20.5	16.6	1.7	17.6	53.6
1995	49 570.8	7.5	20.9	13.5	7.9	25.1	48.1
2000	98 291.1	16.0	9.9	8.7	5.6	25.4	48.3
2004	na	na	na	na	na	na	na

Sources: Singapore 2005 Statistical Highlights; Singapore Yearbook of Statistics, various years.

of inward FDI stock are in manufacturing (37.6 per cent of total in 2003) and in financial and insurance services (34 per cent). Singapore is host to over 5000 foreign multinational companies (MNCs) that use the city-state as a base for their global and regional operations. In the 1960s the largest foreign investments in the manufacturing sector were in the highly capital-intensive petroleum refineries using imported crude from the Middle East and supplying refined products to the Asia Pacific markets. From the late 1960s a growing stream of US, European and Japanese MNCs invested in the electronics industry, producing consumer and industrial electronic products and parts and components. In the 1990s the chemicals and pharmaceutical industries grew, with investments from Europe and the United States. Singapore's position as a financial centre attracted a host of foreign banks and financial institutions. FDI and foreign MNCs have enabled Singapore to become an export manufacturing platform and a services hub and expand beyond its small domestic base. The EU is the major investor in Singapore, mainly from the Netherlands, United Kingdom and Switzerland, followed by the United States and Japan. Together these three sources of investments accounted for 63.4 per cent of total inward FDI stock.

Singapore's outward direct investment stock is concentrated in financial and insurance services (55.7 per cent of total in 2003), followed by manufacturing (20.8 per cent). Outward investments are undertaken by foreign MNCs based in Singapore, government-linked companies (GLCs) and the Singaporean private sector in response to labour shortages and rising wages at home and the rapid growth in business opportunities in Asia. Outward investments are less concentrated by country, with the largest share to Asia (49.3 per cent), mainly ASEAN countries, China and Hong Kong. The tax havens in the Caribbean/Latin America region ranked second with 27.7 per cent.

Social progress

Demographic transition, ageing and ethnic composition

Historically, the development of Singapore as a trading port attracted large numbers of immigrants from Malaya, Indonesia, China and India. By the 1947 census, the population had grown to almost a million and Singapore became a society of immigrants. With immigration controls imposed after World War II, population growth slowed from an annual average of 4.4 per cent between 1947 and 1957, to below 2 per cent in subsequent decades. In 1947, the sex ratio was 1217 males per 1000 females, reflecting the dominance of male migrants. The ratio improved in subsequent decades to 1026 males in 1990, as natural increase replaced immigration as the major source of population growth.

Singapore went through the demographic transition from high to low population growth, with declining mortality and fertility rates within a short time-span. Mortality rates, including infant mortality and maternal mortality, declined sharply in the post-war years with improved public health and nutrition, and stabilized at under 0.5 per cent in recent decades. Life expectancy at birth climbed to 79.3 years by 2004, with 77.4 years for males and 81.3 years for females. Fertility has been declining since the early 1950s. Falling fertility is attributed to the modernization process, more particularly the increasing education of women and their labour force participation, growing knowledge and availability of contraceptives, as well as anti-natal policies, introduced since the mid-1960s, aimed at discouraging the high frequency of births and encouraging the spacing of births.¹⁰ By the mid-1970s it became increasingly evident that fertility declines were more rapid than

projected. The total fertility rate declined rapidly from 4.66 in 1965 to 2.07 in 1975 and 1.82 in 1980. Since then, pro-natal measures were put in place and included tax incentives to encourage educated and working women to have children, improved child care facilities and child care subsidies. As the total fertility rate continued to decline to 1.25 in 2003–04, the government introduced a new package of policies in August 2004 aimed at helping Singaporeans to get married, have children, raise and care for children and balance work and family life.¹¹

Singapore's population and labour force are rapidly ageing. While child dependency has declined rapidly from 82.8 per cent in 1965 to 28 per cent in 2004, old-age dependency has risen from 4.8 per cent to 11.1 per cent over the same period, and is projected to rise very rapidly in the early part of the twenty-first century.¹² An ageing population will escalate health care costs, while an ageing labour force could impede economic restructuring.

The immigration waves in the pre-war period resulted in a multi-ethnic, multi-lingual and multi-cultural Singapore society, with Chinese in the majority (around 77 per cent) and Malays and Indians sizeable minorities (around 15 per cent and 7 per cent respectively). Since 1959, the government has launched a series of policies and measures to promote multi-ethnic harmony and national integration.¹³

Poverty incidence and income inequality

Absolute poverty is no longer a serious issue in Singapore. The Singapore political leadership has repeatedly rejected the European model of a 'welfare' state, arguing that government handouts would destroy Singapore society. It views social security as the responsibility of the individual, family, community and government in that order. It stresses the 'workfare' state where everyone who contributes to the nation's growth will get part of the benefits. Anti-poverty efforts are targeted at generating economic growth and employment. Nonetheless, the government uses several policy instruments to reduce poverty and income inequality. Traditional instruments are progressive income tax and public expenditures on housing, education and health care, and welfare payments based on stringent criteria. Since 1990, the government has adopted additional targeted instruments to help the low income groups.¹⁴ A Ministerial Committee on Low Wage Workers formed in June 2005 to improve employability and income security for low-wage workers and to help their families break the poverty cycle, noted that household incomes have risen significantly across the board in the past 40 years, and for the bottom 20 per cent of households the quality of life has improved, as measured by ownership of consumer durables, home ownership rates and significant asset ownership in the form of residential properties and CPF savings.

The first study on poverty in Singapore by Goh (1956) found that 19 per cent of the urban households comprising 25 per cent of the urban population were below the poverty line, which was established at S\$102 per month for a household of four persons. Lim and Associates (1988) estimated a new poverty line for 1982–83 of S\$680 per household or S\$170 per capita using data from household expenditure surveys. Extreme poverty incidence declined from 19.2 per cent of households in 1953–54 to 0.3 per cent in 1982–83, while moderate poverty incidence declined from 30.8 per cent in 1972–73 to 7.4 per cent in 1982–83. Chia (1995), using population census data for 1980 and 1990, found that the number and proportion of households earning less than S\$1000 had declined. Supporting

data on housing and consumer durables ownership provided additional evidence of improvements in living standards for the lowest 20 per cent of Singapore households.

On income inequality, Rao (1996), using data from the household surveys for 1972–73 and 1987–88, found the Gini ratio was stable at around 0.41, although the level of inequality tended to be higher for smaller household sizes and lower for larger household sizes. Using labour force survey data, Rao also found labour force Gini ratios for 1966–93 having a U-shaped trend. The overall expansion of employment opportunities during the 1970s resulted in a drop in the labour force Gini to levels of 0.42–0.43 during the late 1970s and early 1980s; since then, the Gini had stabilized at around 0.47. Using data from the 1990 Population Census, Chia (1995) noted that household income inequality had declined by 10.4 per cent between the 1980 and 1990, with Gini ratios of 0.48 in 1980 and 0.43 in 1990. The ratio of incomes of the top 20 per cent to the bottom 20 per cent of households also fell from a multiple of 14.2 in 1980 to 11.4 in 1990. Further, the share of total household income from work commanded by the top 20 per cent fell from 52 per cent to 48.2 per cent, while those in the bottom 20 per cent rose from 3.6 per cent to 4.2 per cent. While both the Gini ratios and decile shares point to falling income inequality in the 1980s, Chia cautioned that the data were based mainly on income from work and the income gap would widen if household assets were included in the computations. Likewise, the real income gap would be narrower if adjustments were made for differential taxes paid by income groups, and government subsidies to housing, education and health care and other income transfers to the lower income group.

Income inequality appears to have worsened in Singapore in the 1990s, with incomes of professionals and skilled workers growing faster due to a global shortage of such workers, while incomes for unskilled workers were depressed by competition from low-wage workers from countries like China, India and Viet Nam. The progressivity of income tax has been reduced with the lowering of tax rates for upper income groups and introduction of the regressive goods and services tax.

Literacy and education

The literacy rate increased from 60.2 per cent in 1965 to 94.6 per cent in 2004, and the goal of universal primary education has been achieved. The mean years of schooling has risen to 8.8 years and the combined gross enrolment ratio rose to 87.4 per cent by 2004. The population with university education has risen from less than 2 per cent in the 1960s to 16.3 per cent by 2004. By the close of the 1990s, nearly 60 per cent of the primary one age cohort was in tertiary education either at polytechnics or universities. Total government expenditure on education has increased from S\$130 million in 1965 to S\$6.3 billion in 2004. In 1965, over 60 per cent of recurrent expenditure on education was channelled to the primary level, but by 2004 this share had declined to 21.7 per cent. In contrast, the share of tertiary education had risen to 34.3 per cent.

Public housing

Up to the 1950s, a large part of Singapore's immigrant population lived in unhygienic squatter huts, resulting in public health hazards and high mortality rates. The government established the Housing and Development Board (HDB) in 1960 to build low-cost high-rise housing units for sale and rental to lower-income households. By 2004 the HDB built 877 000 public flats housing 84 per cent of the population, transforming the physical

landscape of Singapore and providing sharp improvements in the living environment and sanitary conditions. The achievement of the public housing programme has been an important factor contributing to the social and political stability over the past decades. In land-scarce Singapore, residents have changed their lifestyles from low-rise to high-rise living. In fact, with rising affluence, there is a growing trend of households upgrading from smaller two- to three-room to larger four- to five-room HDB flats and from the subsidized public housing to the more expensive unsubsidized private housing.

Major policies

Modern governments have taken on many functions beyond providing law and order, defence and basic infrastructure. They include macroeconomic stabilization, economic development and equitable income distribution. Hong Kong and Singapore offer two contrasting city-states in Asia in the role of the government in the economy. Hong Kong is almost completely *laissez faire*, while in Singapore the government plays a much larger economic role.

Macroeconomic stabilization: fiscal, monetary and exchange rate policies

In Singapore, the effectiveness of fiscal policy as a stabilization or demand management tool is limited because of its highly open current and capital accounts. First, any fiscal stimulus would be ineffective because of high import leakage. Second, fiscal policy to stimulate aggregate demand in non-traded goods would also be ineffective, as a budget deficit would lead to a higher domestic interest rate, capital inflows, currency appreciation, fall in net exports and hence output. Fiscal policy in Singapore is used more to promote non-inflationary economic growth – government savings accumulated through prudent fiscal-policy-financed infrastructure development, public housing and education to stimulate economic growth and enhance the quality of life. Fiscal incentives have been widely used to attract investment, and promote economic restructuring and outward investment. Corporate and personal income taxes have been progressively reduced since political independence. Corporate income taxes have fallen from 40 per cent in 1965 to the current 20 per cent; in addition, there are many income tax exemptions and concessions for investors. To encourage work effort and savings, personal income taxes have also been reduced, with the highest marginal tax rate falling from 55 per cent in 1965 to the current 20 per cent. A goods and services consumption tax was introduced in 1994 to gradually reduce the dependence on direct income taxes.

Government-linked companies (GLCs) and statutory boards were created from the late 1960s to jump-start industrialization. In the 1985 recession, in an effort to promote private sector development, the government declared its intention to divest some GLCs. Critics argue that GLCs, together with the public sector, crowd out private enterprise. However, this does not seem to be the case. The GLCs in Singapore are run on commercial principles, and the government used the profits in a judicious manner to invest in improving physical and human capital to attract private investment. Furthermore, profitably run GLCs reduced government's dependence on tax revenue and allowed the government to give fiscal incentives to the private sector. GLCs continue to have a significant presence in Singapore's corporate sector and currently the total number is estimated to be in the hundreds.¹⁵

The Monetary Authority of Singapore (MAS) has focused on exchange rate policy for macroeconomic stabilization, leaving the money supply and interest rate to be determined

by the market. The Singapore dollar exchange rate is based on a managed float system. MAS manages the float within a target band based on an undisclosed trade-weighted basket of currencies of Singapore's major trading partners. Teh and Shanmugaratnam (1992) explain why exchange rate is chosen. First, the openness of Singapore with high import contents implies that contractionary monetary or interest rate policy can only have a limited cooling effect on consumption and investment, while an appreciating exchange rate will directly reduce imported inflation. Second, given the high capital mobility of Singapore, any attempt to manage domestic rates independent of foreign rates will cause enormous capital flows and hence significant changes in the exchange rate. Third, financial development of Singapore in the 1970s and 1980s was associated with significant growth in money supply that makes it extremely difficult to decide what the appropriate monetary growth rate target is. Fourth, the small size and high capital mobility of Singapore's financial markets implies that the Singapore interest rate, after adjustment for expected exchange rate changes, has to follow foreign interest rates closely. Finally, the reduction of the volatility of the exchange rate arising from exchange rate targeting may reduce uncertainty and hence promote trade.

Manufacturing and services development: trade, industrial and investment policies

The key elements of Singapore's industrial strategy are strong government policy intervention initially to jump-start industrialization and, increasingly, to encourage specific types of activities; reliance on a free-trade regime and foreign direct investment; investment in physical infrastructure and human capital to ease supply constraints; maintenance of a stable macroeconomic environment and industrial relations; and liberal use of fiscal incentives to lower the tax burden on businesses.

Between 1960 and 1965 the government adopted the conventional import-substitution strategy of industrialization. The case for industrial protection rested on the infant-industry argument, and the prospects of a larger market in the Malaysian federation. Political independence in August 1965 necessitated the switch towards export manufacturing for efficiency and sustainable growth.¹⁶ With the dearth of domestic industrial entrepreneurs and the lack of industrial technology, Singapore opted for FDI to spearhead the export manufacturing drive. The Trade Development Board (TDB) was established in 1983 to help local enterprises develop export markets.

The 1986 *Economic Committee Report (ECR)* argued that Singapore had to move beyond being a production base to being an international business centre and attract foreign MNCs to establish operational headquarters in Singapore to undertake product development, manage treasury activities and provide administrative, technical and management services. Singapore also had to become an exporter of services, such as tourism, banking and offshore-based activities.

The 1991 Strategic Economic Plan (SEP) called for the promotion and development of Singapore as a total business centre and the development of high-tech and high value-added manufacturing and services as twin engines of growth. The SEP's Manufacturing 2000 programme spelt out the strategies for manufacturing development, aimed at sustaining manufacturing at not less than 25 per cent of GDP.¹⁷ A key element is development of industry clusters, particularly in chemicals, shipbuilding and repair, electronics and biomedical sciences. The SEP's International Business Hub 2000 programme focuses on development of Singapore as a services hub. The 2003 *Report of the Economic Review*

Committee notes Singapore's competitive advantages as a services hub in Asia. The Report also recommends that Singapore identifies and develops niche areas and new manufacturing clusters. Also, Singapore has to move beyond manufacturing and become an innovative creator of products and businesses, through strengthening interlinkages between industry, R&D and intellectual property protection. Singapore should also promote cooperation and co-development of products and processes between research institutes and local enterprises to bridge the gap between research and commercialization.

Singapore's FDI strategy is widely acknowledged as being exceptionally successful. A conducive investment climate has been created by a judicious combination of government policies and tax incentives – no restrictions on equity ownership, no foreign exchange controls, and no limit on repatriation of capital, dividends, interest and royalties; no restrictions on foreign borrowings from the domestic capital market and no regulations governing transfer of technology; extensive use of tax incentives; provision of physical infrastructure such as industrial estates, transportation system; labour policy covering education and training to ensure workers are equipped with required skills.

The contribution of FDI to the Singapore economy is manifested in the rapid growth and competitiveness of export manufacturing, and the rapid growth of Singapore as a financial centre and a services hub. However, the high dependence on inward FDI is not without negative impacts. FDI dominance can crowd out domestic enterprises. Foreign enterprises have the competitive advantage of brand names, access to parent-company technology, finance, management and marketing resources. Crowding out can also occur from the competition for factor resources, particularly labour. Foreign employers can attract the most able and the best and bid up wages of skilled professionals. Crowding out also occurs on the policy front when local enterprises are neglected as government policies and promotional efforts are targeted at foreign MNCs.

Labour, wages, and human resource development

Singapore government's intervention in the labour market has been extensive, covering policies affecting the demand and supply of labour, wages, skills development and industrial relations. On labour demand, it has encouraged economic restructuring by promoting investment in high value-added and high-tech manufacturing, and high value-added services. The high wage policy of 1979–81 was specifically aimed at discouraging labour-intensive manufacturing. The government has also encouraged relocation of labour-intensive operations to Southeast Asia, China and India. However, labour-intensive firms in the non-tradable sector cannot relocate overseas and became increasingly dependent on imported foreign labour. Foreigners currently account for 25 per cent of Singapore's workforce. The Ministry of Trade and Industry (MTI) has shown that the contribution of foreign workers (on employment and work permits) to GDP was 30.7 per cent between 1986 and 2000.

On labour supply, the government has been promoting female labour force participation, encouraging the elderly to remain in the workforce and importing foreign labour. Female labour force participation rates have been increasing dramatically with modernization, rising levels of education and job opportunities for women and rising wages in the labour market, and this trend will continue.

Mandatory retirement practices, enforced since colonial times at age 55 was changed by the Retirement Age Act in April 1993 that raised the retirement age to 60; this was

subsequently raised to age 62. One problem associated with employment of older workers today is that many of them have relatively little education, need extensive retraining, and jobs need redesigning.

Before 1972, wages in Singapore were mainly negotiated between unions and management. In 1972 the National Wages Council (NWC), a tripartite body with representation from employers, unions and government, was formed to ensure orderly wage increases. Although not mandatory, the NWC quantitative wage guidelines were influential in determining annual wage adjustments in the public and private sectors. Two labour levies were also introduced in the 1970s – a 4 per cent levy on employers to contribute to the Skills Development Fund, and a 2 per cent payroll tax. Also, CPF rates were raised further.

By 1985, high wage costs had contributed to the high cost of doing business in Singapore and, in conjunction with several other factors, led to a recession in 1985. NWC's quantitative wage guidelines were discontinued to complement the government's policy measures to revive the economy. In addition, the employers' CPF contribution rate was cut from 25 per cent to 10 per cent from April 1986. For 1986–87, nominal wage earnings grew 2.0 per cent a year and real earnings grew 2.5 per cent. NWC qualitative wage recommendations since 1988 are based on a flexible wage system.

Human capital investment encompassing the rapid expansion of primary, secondary, vocational and technical education began in earnest only after political independence to meet the requirements of nation building and the labour needs of the industrial and post-industrial economy. Rapid expansion of tertiary education took place only from the 1980s. Enrolment rates for all courses at the tertiary level have risen steadily. The government has targeted that 20 per cent and 40 per cent of each cohort should be university and polytechnic graduates respectively (*Straits Times*, 12 March 1994). Tertiary enrolment in polytechnics and universities in 2004 reached 122 144 students. In the current shift towards the knowledge-based economy, greater emphasis is given to science-based education and to changes in educational curriculum and methodology to inculcate self-learning, independent and critical thinking and creativity and innovation.

The Skills Development Fund was established in October 1979 to encourage employers to invest in the skills upgrading of the workforce. The Fund is financed through the Skills Development Levy imposed on employers. The original levy rate of 4 per cent was imposed on the payroll of workers earning not more than S\$750 per month. The rate currently stands at 1 per cent of payroll and the wage ceiling stands at S\$2000. Firms can recoup their levy payments only if they train, raising the incentive for those firms that have a predominantly low-skilled labour force.

The Manpower Development Assistance Scheme (MDAS) was set up in April 2000 and the Lifelong Learning Endowment Fund (LLF) in March 2001. The MDAS is targeted at industrywide initiatives aimed at enhancing the employability of lower-educated workers and developing the labour needed for strategic industries. The LLF is to enhance the employment and employability of Singaporeans through initiatives that promote and facilitate the acquisition of skills. Besides employer-based training, LLF can be used to support individual-based or community-based training. Economic restructuring and corporate rationalization in recent years have led to massive job redesigns and retrenchments and rise in structural unemployment. There is growing national and individual concerns over the unemployability of retrenched and ageing workers. This led to the establishment of the

Workforce Development Agency (WDA) in September 2003 to act as a catalyst for workforce development, by developing a comprehensive, market-driven and performance-based adult continuing education and training framework.

Local enterprise, innovation and research and development

Unlike the NIEs (newly industrializing economies) of Hong Kong, South Korea and Taiwan, Singapore chose to depend on foreign MNCs to spearhead its industrialization drive. After decades of industrialization, Singapore's numerous domestic enterprises continue to play a marginalized role as the corporate scene is dominated by MNCs and GLCs. The 1988 SME Master Plan marked the first coordinated national effort to upgrade small and medium enterprises (SMEs) and promote domestic entrepreneurship. A plethora of SME assistance schemes were hatched and implemented.

The *Singapore Competitiveness Committee Report* recommends a number of strategies to strengthen local enterprises. The *SME 21 Report* outlines three strategic goals for SMEs – to nurture innovative high-growth world-class SMEs able to compete in the global marketplace; enhance the productivity of SMEs and create a knowledge-based pro-enterprise environment. A multi-agency SME 21 Implementation Committee was formed, led by the Singapore Productivity and Standards Board (later renamed Spring Singapore), with participation from the government, chambers of commerce, industry associations and private business. Spring Singapore administers a series of assistance schemes for local enterprises.

The Singapore economy has traditionally depended heavily on foreign MNCs to introduce and transfer advanced and sophisticated technology. The small domestic market and lack of local technology-savvy entrepreneurs limited the capability of Singapore to explore the option of promoting indigenous R&D during early stages of economic development. The current stage of technological intensity in Singapore has yet to become a main driver in Singapore's economic growth. However, in the knowledge-based economy, domestic technological and innovative capabilities become increasingly necessary.

The National Technology Plan 1991 concentrated on that part of research directed towards economic upgrading. Realizing that successful industry-driven R&D needs the private sector to undertake the bulk of these activities, the government decided to play a more proactive coordinating and facilitating role to promote private efforts. A plethora of R&D assistance schemes emerged. The budget for the National Technology Plan 1991 was S\$2 billion and this was raised to S\$7 billion for the National Science and Technology Plan 2005. Despite the quantum jump, Singapore's R&D efforts remain modest in absolute terms, reflecting the small size of the economy and its strong service orientation. The R&D statistics for 2003 show the following – 662 organizations performing R&D (617 private); research scientists and engineers per 10 000 of labour force is 79.4; R&D expenditures amount to 2.15 per cent of GDP; patents applied for 1001 (73 per cent private sector) and patents awarded 460 (15 per cent private sector).

Since August 2004, the Ministerial Committee on Research and Development (MCRD) has reviewed the R&D strategies and directions for Singapore and concluded that there is an urgent need for bold reforms to transform Singapore into an R&D-driven, innovative, knowledge-based economy. Singapore needs to refocus its research and innovation agenda and MCRD recommends that national R&D efforts should be driven by five key strategic thrusts:¹⁸

- provide more resources for R&D;
- focus on selected areas of economic importance;
- balance between investigator-led and mission-oriented research in selected strategic areas;
- encourage more private sector R&D;
- strengthen the nexus between R&D and business.

To operationalize the above five key strategic thrusts, MCRD recommends that a high-level Research, Innovation and Enterprise Council (RIEC) be established to advise the Singapore government on national research, innovation and enterprise strategies. To support the work of the RIEC, a National Research Foundation (NRF) would be established with key responsibilities to implement the strategic thrusts and to fund longer-term research in strategic areas. The NRF will be provided with funding of S\$5 billion for FY2006–10. This, together with the increased budget for A*Star (the Singapore government agency in charge of innovation and R&D) and the Academic Research Fund, will more than double the total public sector R&D budget from just under S\$5 billion for FY2001–05 to almost S\$12 billion for FY2006–10.

Challenges and prospects

On the eve of political independence in August 1965, sceptics questioned and believers worried over the future of the small city-state and its political and economic viability. The track record of the past 40 years has proven both sceptics and believers wrong. For the former, the Singapore nation-state and economy has not collapsed. For the latter, success in political and economic terms has far exceeded expectations. Singapore as a political and economic entity is recognized and respected the world over. Singapore by the first decade of the twenty-first century has improved its national balance sheet considerably.

However, Singapore views its future with continuing concerns over the sustainability of its economic growth and international competitiveness in the face of intense global competition and a maturing economy and rapidly ageing population. The guiding principles of its political leadership remain ‘the world does not owe us a living’ and ‘we must be relevant to the world or we get marginalized’.

The phase of investment-driven growth has ended and Singapore must depend increasingly on innovation-driven growth. Singapore has to accelerate the development of three capabilities – produce a more educated and skilled workforce; produce more dynamic and innovative domestic entrepreneurs and produce more indigenous innovations and R&D to strengthen core capabilities. Domestic capabilities, where inadequate, have to be enhanced and leveraged by accessing international skills, talents, entrepreneurship and innovations.

Singapore is located in the midst of a booming Asia. It can play a key role in facilitating and financing economic development in the region, and in the process re-energize itself. Singapore can leverage on the dynamism of Asia, with a more developed, prosperous, open and stable Southeast Asia, China and India. Singapore’s strategy is not to compete but to complement the regional economies. These complementarities are reinforced by outward investments and various regional and bilateral economic partnership agreements. Its trade, investment, transport and communications and business networks link the region with the world.

Notes

1. See United Nations Development Programme (2005), *Human Development Report 2005*, New York: UNDP.
2. Published by the International Institute for Management Development (IMD).
3. See for example, Quah (1986) and Ganesan (1999).
4. Young noted that Singapore had one of the highest rates of structural transformation in the world and workers did not benefit from learning by doing because they were moving to new technologies before mastering existing ones, that is, the premature movement up the technology ladder led to a fall in measured productivity.
5. Statutory boards are wholly government-owned and may receive grants, loans and subsidies to enable them to achieve some non-economic objectives like the provision of public housing.
6. Only officers of the elite Administrative Service continue to receive retirement pensions. The CPF is the social security system for the bulk of Singaporeans.
7. Being 13 per cent from employers and 20 per cent from employees. Contribution rates for older workers have been scaled back to encourage employers to employ older workers and to incentivize older persons to continue working.
8. Furthermore, many individuals who withdrew their CPF savings upon reaching age 55 have not been able to manage their financial nest-eggs well and could become destitute in their twilight years. In recent years the government has also resorted to topping up the CPF balances of Singaporeans as part of redistribution of good growth results.
9. Trade exceeds GDP due to large amount of re-exports that are not included in GDP.
10. They include higher accouchement charges at government maternity wards for higher-order births, lower priority in public housing and primary school registration, lower tax allowances for higher-order births, liberalized abortion on demand, restricted maternity leave and post-partum counselling for sterilization or birth spacing.
11. It remains to be seen whether the new measures will succeed in reversing the fertility downtrend.
12. In 1990 there were roughly 13 per cent of persons over the age of 60 for every 100 persons aged 15–59. Shantakumar (1996) expected that by 2020 it would rise to 39 per cent.
13. These include education policy, housing policy, political representation, compulsory military service.
14. These include education and health care top-ups, and housing assistance. In addition to heavily subsidized education for all, the Edusave scheme transfers sums of cash into the accounts of school children to be used for approved educational expenses, and aims at providing for equality of education opportunities. In addition to health care subsidies in public hospitals and clinics, the Medifund scheme helps poor Singaporeans pay for their medical bills at approved hospitals and medical institutions. Some 84 per cent of the population live in public housing, including home ownership for 82 per cent. To enable the low income groups achieve home ownership, the HDB (Housing and Development Board) buys three-room HDB flats on the open market and sells them at subsidized rates to low income families, and also allows existing HDB tenants to buy their two-room and three-room rented flats at a discount.
15. See Ramirez and Tan (2004).
16. Incidentally, this was against the advice of the World Bank, which wanted Singapore to link its economy and industries to the Malaysian market.
17. Singapore's economic planners were anxious to avoid the de-industrialization and hollowing out that had been happening to Hong Kong. It was argued that industrial manufacturing capability represented the essential component of any advanced economy, and a strong manufacturing base provided anchor for other advanced capabilities in science and technology, logistics and operations management.
18. See speech by outgoing Singapore Deputy Prime Minister and incoming Chairman of National Research Foundation, Dr Tony Tan, on 11 August 2005.

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5 Hong Kong

Kui-Wai Li

A short political history

The Hong Kong Island was ceded to Great Britain in perpetuity at the end of the Opium War in the unequal Treaty of Nanking on 28 August 1842. The Kowloon Peninsula was subsequently leased in perpetuity to Great Britain on 26 March 1860. In June 1898, the New Territories were leased to Great Britain for a period of 99 years. To the British Empire, the Hong Kong colony was useful as an important trading and re-export hub between China and Western countries, and between Great Britain and Southeast Asian countries.

Politically, the British colonial government practised administrative absolutism that produced a high degree of administrative efficiency. As the highest authority in the colony, the Governor was supported by the Executive Council, while the Legislative Council was involved with the law-making process. Free political elections were entirely absent, and a widespread welfare system had never been pursued. By adopting a British legal system, the rule of law in Hong Kong provided security to property and ensured equality in front of the law. Civic and professional institutions tended to receive a high degree of public trust, and often acted as ‘check and balance’ on the administration of the Hong Kong colonial government.

Hong Kong’s stability had been subjected to prolonged tests and threats in the last century, resulting in large inflows of refugees from mainland China. Externally, the two World Wars of 1914–18 and 1939–45 imposed hardship on the people of Hong Kong. In mainland China, the historical sequence began with the outbreak of the Chinese Revolution in 1911, followed by the prolonged Japanese occupation in the 1930s and 1940s, the ideological clash between communists and the Nationalist government before 1949, and the Cultural Revolution in much of the 1960s. In all these unsettled periods, Hong Kong acted as a ‘shelter’, receiving a large number of natives fleeing from mainland China. In pursuit of political stability and economic opportunities, Hong Kong has been a popular destination for Chinese refugees.

Hong Kong’s sovereignty reversion was raised in the late 1970s. The Sino-British negotiations over the sovereignty reversion of Hong Kong took place between 1982 and 1984. The Central People’s government in Beijing promised to adopt the ‘one country, two systems’ approach in the administration of post-1997 Hong Kong. Hong Kong shall retain its capitalist system for 50 years, until 2047. The Sino-British Joint Declaration concluded on 19 December 1984 and led to the establishment of the Basic Law in 1990 that provided the constitution for post-1997 Hong Kong. The conclusion of the Sino-British negotiations over the political future of Hong Kong led to economic revival in Hong Kong, with a rapid wealth appreciation that was blended under ‘stability and prosperity’. The rapid growth that followed, however, was soon fuelled with speculation in stocks and properties in the early 1990s, resulting in the economic bubble that eventually burst after the outbreak of the Asian Financial Crisis in 1997–98.

After 1 July 1997, when Hong Kong became the Special Administrative Region (SAR) of the People's Republic of China, Hong Kong experienced three closely intertwined problems. First, sovereignty reversion involved the change of Hong Kong's sovereignty from Great Britain to the People's Republic of China. The newly established Hong Kong SAR government is charged mainly with governance, implying that it can mediate between the central authority in mainland China and the people of Hong Kong, and shall maintain Hong Kong's prosperity and stability. Leadership by the Chief Executive, members of the legislature and all top government officials, should be considered in the overall picture of governance.

On the political scene, however, people in Hong Kong have become more sensitive and have made political demands, including universal suffrage. Political parties have become more organized, while politicians and pressure groups have become more vocal. Many political demands often mixed the issue of sovereignty with governance or vice versa, causing controversies and civic debates that resulted in large and peaceful demonstrations. The heated public controversy over Article 23 of the Basic Law, which required the Hong Kong SAR government to legislate 'laws on its own to prohibit any act of treason, secession, sedition, subversion against the Central People's government' (Basic Law, 1991), stirred up public displeasure that led to a peaceful mass demonstration on 1 July 2003, followed by the resignation of government officials. Theoretically, the sovereignty issue can solely be handled by the Central People's government in Beijing. The Hong Kong SAR government shall concentrate on the governance issue.

Second, Hong Kong since 1997 has experienced both external and internal crises that resulted in unintended consequences and shocks. The sequence began with the Asian Financial Crisis in 1997 that led to the speculation of the Hong Kong currency in summer 1998, the bird flu in late 1997 and the repeated incidences in subsequent years. Then came the 11 September terrorists attack in New York and Washington DC in 2001, followed by the war on terrorism, the severe acute respiratory syndrome (SARS) in May 2003, and the calamitous earthquake on 26 December 2004 in Indonesia and the aftermath of the tsunamis in Thailand, Sri Lanka, Malaysia and India.

Amidst these economic shocks, Hong Kong was plunged into political uncertainty following the sudden resignation on health grounds in early March 2005 of Mr Tung Chee-hwa, the Chief Executive, whose term would have expired in July 2007. Mr Tung was soon elevated to Deputy Chairman in the Chinese People's Political Consultative Conference (CPPCC) in Beijing. It immediately sparked another controversy on whether the next Chief Executive, Mr Donald Tsang, would serve the remaining two years of office, or a new term of five years. Debates concentrated on the interpretation of the different articles in the Basic Law. The constitutional crisis was ultimately avoided when Beijing decided in favour of the remaining two years' term, and the election for the next Chief Executive in July 2005 was left to the 800-strong Election Committee.

Thirdly, the Hong Kong economy in the period 1998–2003 experienced a severe and unprecedented economic recession. The economic hardship resulting from the burst of the economic bubble led to wealth depreciation and investment failures. The Hong Kong SAR government was often inappropriately blamed for private investment failures. Different sectors demanded compensation, and pressured the Hong Kong SAR government to provide subsidies. At the outbreak of the bird flu, for example, the chicken farmers demanded compensation. When the property bubble burst, negative asset holders

demanded assistance from the government, while developers pressured the government to withdraw land sale and supply of low-cost housing units for the middle-income households. The film industry, owing to its low business revenue, secured fiscal assistance from the Chief Executive. The private sector expected rescue from the government, while at the same time the government had to aid the poor and needy individuals who were marginalized by the economic downfall, even though the government was also faced with lumping fiscal deficit.

In sum, the operation of the Hong Kong SAR government in the first few years after 1997 was characterized by the emergence of shocks, crises and fragmentations. The cumulative impact of these hit Hong Kong hard. Given the massive economic optimism in the pre-1997 years, everyone expected the post-1997 economy would keep rising. Experience, however, showed that an economic bubble would usually burst at the occurrence of a sudden shock or trigger.

After sovereignty reversion in 1997, the Central People's government in Beijing has been supportive of the economic problems in Hong Kong and sympathetic to the magnitude of the impact Hong Kong suffered from the recession and crises. The Central People's government has adhered to the constitutional agreements stated in the Basic Law, has followed closely the economic events in Hong Kong and provided Hong Kong with appropriate assistance. It has been pointed out repeatedly by Beijing leaders that the prosperity of the Hong Kong economy is important in the overall economic reform of the mainland economy, and that Hong Kong should concentrate on promoting economic activities. Economic recovery and a structurally balanced Hong Kong economy will benefit both Hong Kong and the mainland.

Economic progress and structural change

Hong Kong has come a long way economically. By looking at the post-war economic development of Hong Kong and the three other East Asian economies of Singapore, Taiwan and South Korea, Li (2002) argued that Hong Kong's economic success has exhibited the paradigm of 'economism'. In addition to adopting a capitalist market economy, which gave primacy to growth more than equity, the open economy has been supported by consistent domestic economic policies. In other words, the government provided 'economic fertilizers' to businesses and individuals, and the political scene has generally been pro-growth. The economism paradigm advocates the virtues of 'more or less', relative economic outcomes, where all individuals enjoy some economic gains in the process of development, rewards are endowment-based, and distribution is largely left to market forces.

The Heritage Foundation in Washington DC regarded Hong Kong for a number of consecutive years as the freest economy in the world. The *Index of Economic Freedom*, published by the Heritage Foundation annually, emphasized macroeconomic stability with clear policies on exchange rates, property rights and freedom in ownership and transactions, a transparent government without debt or prolonged fiscal deficits and economic openness. As a world trader, the World Trade Organization (WTO) shows that Hong Kong in 2002 ranked eleventh and tenth in world merchandise exports and merchandise imports, respectively. In commercial services, Hong Kong in 2002 ranked ninth and sixteenth in services exports and services imports, respectively.

Hong Kong satisfies a number of criteria as an international financial centre, such as a stable exchange rate and geo-financial position. Hong Kong's position as an international

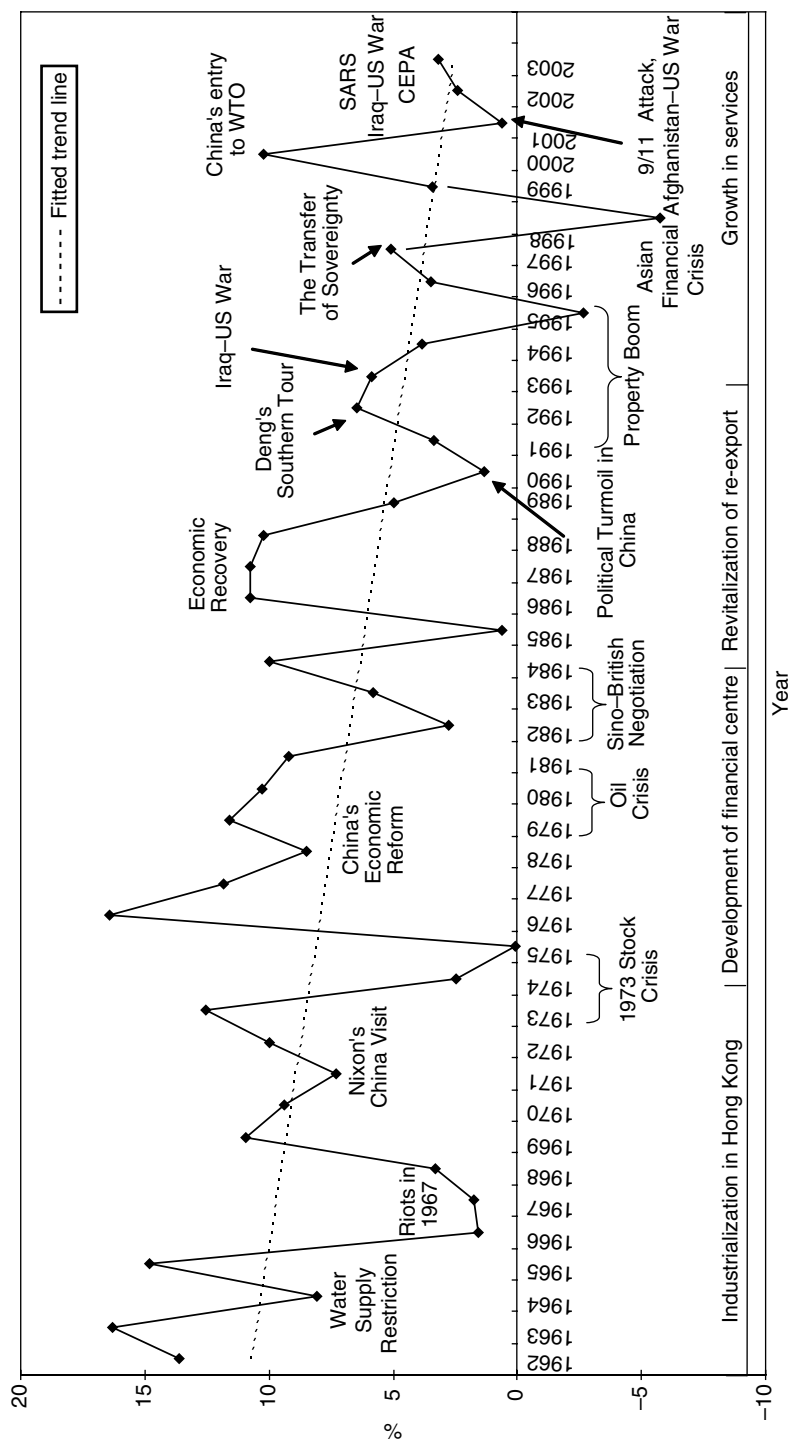
financial centre can best be seen by comparing Hong Kong's financial statistics with other world financial markets. In terms of total market capitalization, Hong Kong ranked tenth in 2000, but ranked sixteenth in both total values traded and number of listed companies (Standard and Poor, 2001). In 2001, Hong Kong ranked seventh in the global reported foreign exchange market turnover (daily average in April, Bank for International Settlements, 2001). In the international trading of currencies, the Hong Kong dollar ranked ninth in April 2001 in the percentage share of average daily turnover of currencies (Bank for International Settlements, 2001).

Hong Kong's real gross domestic product (GDP) growth rates since the early 1960s experienced different periods of economic boom and bust, as shown in Figure 5.1. The shortage of water in the early 1960s and the riots in 1967 lowered the GDP growth rates. The 1973 world stock market crash generated a major blow to Hong Kong. The Sino-British negotiations over the sovereignty of Hong Kong that took place during 1982–84 disrupted economic growth in the early 1980s. The economic recovery in 1985 as a result of the successful conclusion of the negotiations on the political future of Hong Kong produced a period of 'prosperity and stability' that lasted until the outbreak of the Asian Financial Crisis in 1997–98. There was a V-shaped rebound after the Asian Financial Crisis, but the 11 September attack in New York in 2001 sent a wave of economic shocks to the rest of the world. The outbreak of SARS in the spring of 2003 weakened the economy considerably, as unemployment peaked to 8 per cent in mid-2003. Hong Kong's market economy began to recover in late 2003 after the announcement of the individual visa scheme (IVS) that permitted visa-free travel to Hong Kong from selected regions on the mainland and the conclusion of the Closer Economic Partnership Agreement (CEPA) on trade liberalization between Hong Kong and the mainland.

Growth data in Figure 5.1 shows a downward-sloping fitted trend line. The continued rise in GDP over the decades has meant that the base for the statistical measurement is larger and lower overall growth rates in the 1990s are natural. After the past decades of economic growth, Hong Kong has become a mature economy that would normally experience a growth rate of about 5 per cent. Figure 5.1 also labels the different periods of economic development in Hong Kong since the 1960s. Beginning with industrialization of the 1960s, Hong Kong became first a banking centre and then a financial centre from the 1970s. Economic reform in mainland China revitalized Hong Kong's re-export trade, which eventually led to growth in services, especially producer services, as more industries migrated from Hong Kong to Southern China.

Major macroeconomic indicators are shown in Table 5.1. Hong Kong's GDP per capita has grown more than threefold between 1980 and 2000. The growth of real GDP matched the growth trend of fixed capital formation in much of the 1970s and 1980s. By the mid-1990s (1994–97), however, the two-digit investment growth resulted only in low real GDP growth rates. Investment dropped severely after 1998. Domestic exports from Hong Kong that consisted of indigenous manufactured industrial outputs have been falling since the early 1990s. Hong Kong's exports survived largely due to the re-emergence of re-exports in the 1980s, though re-export facilities in Southern China have increasingly imposed competitive pressures on Hong Kong's future re-export position.

Hong Kong has been faced with trade deficits, but the balance of payments has been rescued by capital inflows. Along with the growth in re-export trade there has been a rapid growth in service exports. Trade-related services, transport and travel are the three largest



Source: Census and Statistics Department, Hong Kong SAR.

Figure 5.1 Hong Kong's real GDP growth rate: 1962–2003

Table 5.1 Hong Kong's macroeconomic indicators

Year	GDP Per Capita (US\$)	Growth Rates of					Trade Balance (HK\$ billion)†	Total Export/ GDP Ratio	Unemploy- ment Rate	Inflation Rate	Savings Deposit Rate
		Real GDP*	Fixed Capital formation	Domestic export	Re-export	Services export					
Average											
1981-85	5801	5.58	7.20	14.64	29.28	16.00	-6.1	77.30	3.82	7.94	7.24
1986-90	10 281	7.54	22.10	12.14	32.35	18.58	-1.22	102.78	1.66	8.4	3.91
1991-95	19 106	5.36	16.58	0.56	22.04	13.30	-59.48	118.07	2.18	7.32	3.04
1996-2000	21 217	3.64	1.26	-4.62	4.90	3.56	-101.54	113.66	4.16	-0.06	4.25
1981-90	8041	6.56	14.56	13.39	30.80	17.29	-5.63	90.04	2.74	8.17	5.50
1991-00	21 662	5.10	7.96	-2.03	13.47	8.43	-80.51	115.86	3.17	3.63	3.64
2000-2004	23 773	4.76	2.74	-5.48	10.28	9.92	-75.35	133.22	6.40	3.96	0.59

Notes:

Savings deposit rate is period average percentage per annum.

Inflation rate is the percentage change of GDP deflator.

* = at 2000 price. † = at prevailing market price.

Sources: Hong Kong Annual Digest of Statistics, Census and Statistics Department, various years; Hong Kong Monetary Authority, Hong Kong SAR.

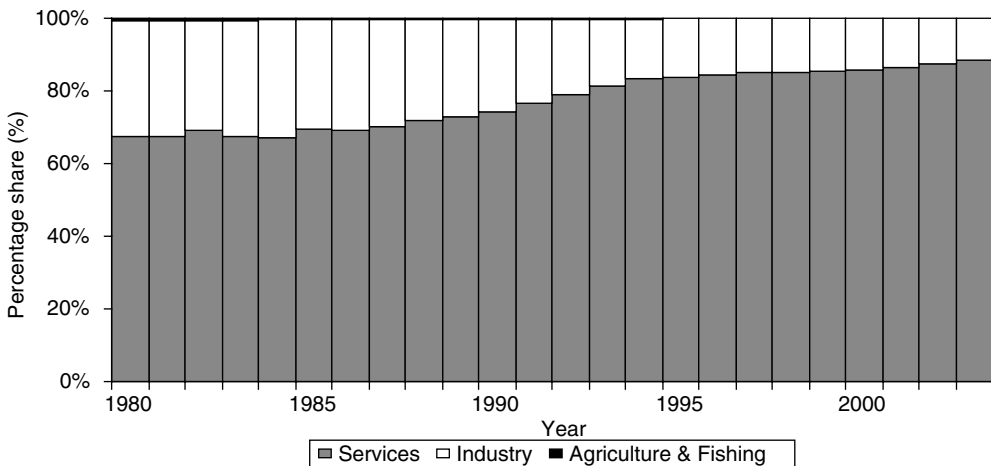
service exports. The tradable sector in Hong Kong has shifted from manufacturing to services. Hence, despite the fall in domestic exports, Hong Kong's total export-to-GDP ratio has exceeded unity since 1988.

Economic buoyancy in much of the 1980s and 1990s can be seen from the low unemployment rate that was below 2 per cent for a number of years before it edged upwards and became severe in 1998. The low unemployment rate and rapid economic growth were accompanied by a high inflation rate. With the relatively low savings deposit rates, as shown in the last column of Table 5.1, Hong Kong had negative real interest rates for a prolonged period until 1998, when economic recession resulted in deflation. The prolonged negative real interest rate was thought to have contributed to the economic bubble, characterized by heavy speculative activities in stock and property markets before 1998.

The low cost of production in Southern China has attracted investments from the manufacturing sector in Hong Kong. Although real wages on the mainland are also rising, they are still much lower than Hong Kong. As a result of the flight of investment from Hong Kong to the mainland since the early 1990s, Hong Kong has experienced a process of 'industrial hollowing' and a structural transformation to a service-based economy. The percentage share of industry in GDP at factor cost, as shown in Figure 5.2, has declined from about 30 per cent in the early 1980s, to 12.3 per cent in 2002. This trend was matched by the corresponding rise in the service sector, whose share in GDP increased from less than 70 per cent in the early 1980s to 87.5 per cent in 2002.

Sources of Hong Kong's growth

The economic growth of Hong Kong has largely been supply-driven. Although social security and welfare provision in Hong Kong were scarce before the 1960s, the Chinese migrants considered Hong Kong a stable place where their individual economic drives and benefits through hard work, self-reliance, ingenuity, business-driven mentality and entrepreneurship could be extended. Thus, Hong Kong received not only a large



Source: Census and Statistics Department, Hong Kong SAR.

Figure 5.2 *Production-based GDP – percentage share by economic activity*

low-skilled labour force, but also people with marked potential for upgrading and positively inclined to respond to market signals. New migrants learned to respond with creativity and determination to challenges, and they either joined the labour force to work for industries and commerce, or came with capital that industrialized the Hong Kong economy. Economic openness ensured inward capital and external demand for manufactured goods and services exports.

Table 5.2 provides some estimates of sources of economic growth, based on neo-classical production function. As can be seen, output, capital and labour in the whole two decades have grown by 5.34 per cent, 7.71 per cent and 1.82 per cent, respectively. Output has experienced the highest growth in the 1986–90 period, with an average annual growth rate of 8 per cent. Capital has experienced a higher growth rate in the 1980s than in the 1990s, and the first half of the two decades has shown better performance than the latter half of the 1980s and 1990s. Shares of factor payment between labour and capital remained constant over the years.

The factors that contributed to output growth included total factor productivity (TFP), which shows an average of 0.86 per cent in the entire period (1981–2000), but had a much higher performance in the 1986–90 period (with 3.98 per cent) than in other periods. The period 1996–2000 experienced poor performance with an average negative annual growth rate of –0.89 per cent. In all periods, capital input contributed more to output than labour input. Hong Kong experienced high productivity growth in the second half of the 1980s, which was the period after the conclusion of the Sino-British Joint Declaration and the restoration of economic stability, but before heavy speculative activities began in the early 1990s. When the economy was overheated in the 1990s, productivity fell considerably, and growth in this period was due more to the expansion of capital (3.97 per cent). In the Asian Financial Crisis period (1996–2000), a negative productivity rate (–0.89) was experienced.

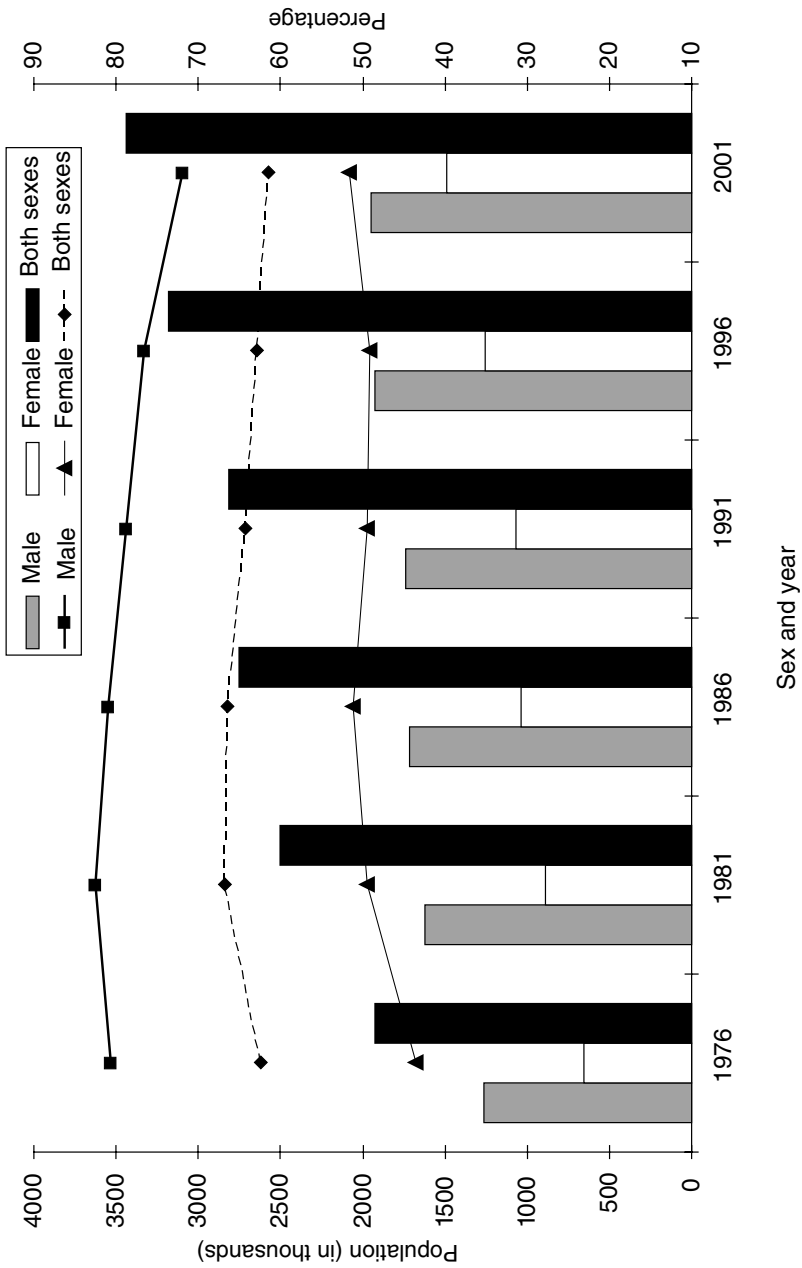
Figure 5.3 shows that total labour force has been rising over the years, but the labour participation rates have edged downwards slightly over the decades.

Table 5.2 Hong Kong's productivity accounting: 1981–2000 (percentage average annual growth rates)

	Output	Capital	Labour	Share of payment		Contribution to output by		
				Labour	Capital	TFP	Labour input	Capital input
1981–85	5.25	8.71	2.61	55.46	44.54	–0.07	1.45	3.88
1986–90	8.04	7.50	1.11	53.91	46.09	3.98	0.60	3.46
1991–95	4.97	8.45	1.17	53.05	46.95	0.38	0.62	3.97
1996–2000	3.15	6.18	2.40	56.64	43.36	–0.89	1.36	2.68
1981–90	6.64	8.10	1.86	54.69	45.31	1.95	1.02	3.67
1991–2000	4.06	7.31	1.78	54.85	45.15	–0.22	0.98	3.30
1981–2000	5.34	7.71	1.82	54.77	45.23	0.86	1.00	3.49

Note: The sum of the last three columns should equal to the first column, the decimal figures may result in the difference. Any difference results from rounding off.

Source: Li (2005: Table 3.4).



Source: Census and Statistics Department Hong Kong SAR.

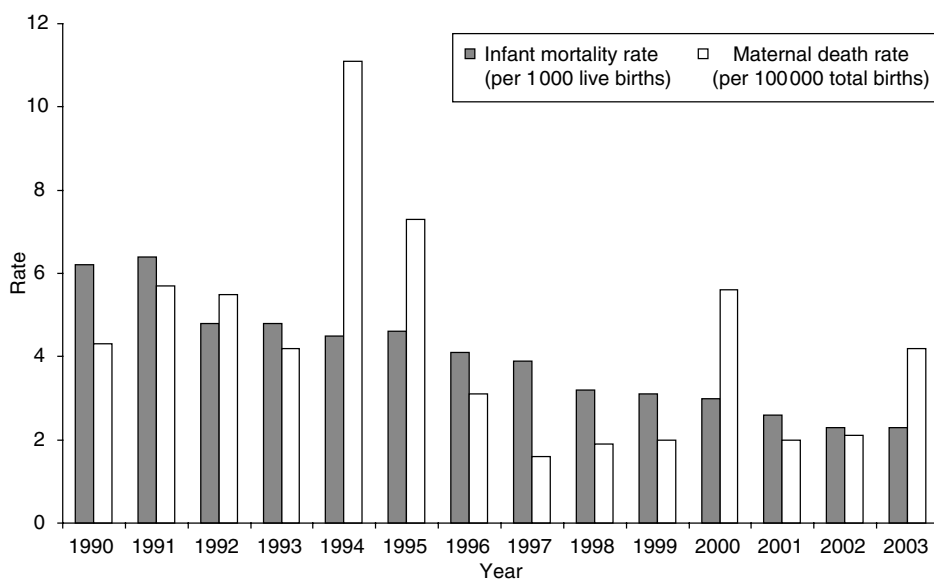
Figure 5.3 Total labour force and labour participation rate

Social progress

Hong Kong has also made significant progress in social affairs in the last few decades, and a number of social indicators have caught up with other mature economies. Figure 5.4 shows the infant mortality and maternal mortality rates since 1990. The infant mortality rate has definitely improved, and, with the exception of 1994, 1995, 2000 and 2003, the maternal mortality rate has remained low.

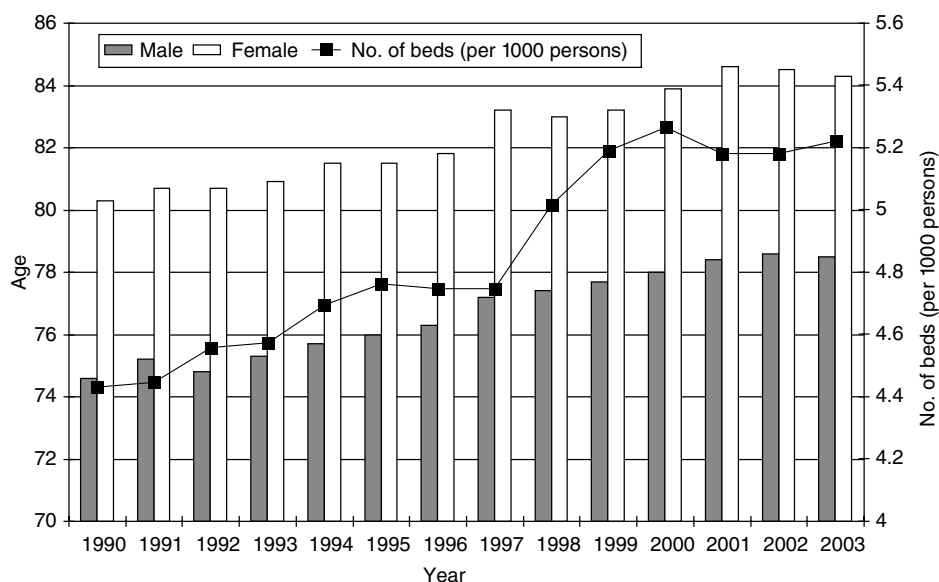
Figure 5.5 shows the life expectancy rate of males and females, and the number of hospital beds per 1000 residents. The life expectancy of males in Hong Kong has always been shorter than females. The fall in the life expectancy of both males and females in 2003 will probably remain a mystery. It could be due to an unreported sudden increase in the death rate from SARs. The number of hospital beds per 1000 residents increased from about 4.4 in 1990 to 5.2 in 2003. The literacy rate of the total population who have attained at least primary education, especially in the female population, improved considerably (Figure 5.6).

Despite social improvements, income equality has not been a high social priority. The reasons include the change in population size, especially in the inflow of mainland immigrants who tended to rely more on social welfare assistance and joined the low-income echelon of the population. The fall in income in the economic recession after the Asian Financial Crisis undoubtedly enlarged the low-income population, which resulted in the deterioration in income equality. Table 5.3 compares Hong Kong's Gini coefficients with two other East Asian economies of Singapore and South Korea. As can be seen, Hong Kong's income inequality is the highest, though the number of observations differed among the three economies. Li (2002, 2005) pointed out that the Gini coefficient measure gives a discrete and relative picture. Comparisons based on the Gini coefficient are made on an interpersonal basis, and since individuals are rewarded by their endowment, income



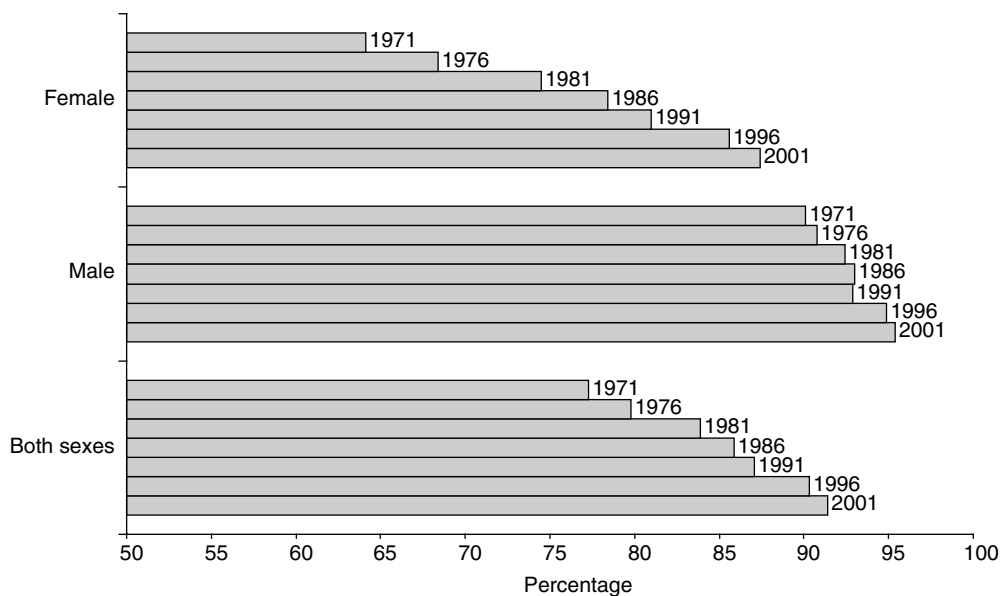
Source: Census and Statistics Department, Hong Kong SAR.

Figure 5.4 Infant mortality rate and maternal mortality rate



Source: Census and Statistics Department, Hong Kong SAR.

Figure 5.5 Life expectancy and number of hospital beds



Source: Census and Statistics Department, Hong Kong SAR.

Figure 5.6 Percentage of population attained at least primary school level

Table 5.3 The Gini coefficients of the three Asian economies

Hong Kong		Singapore		South Korea	
1971	0.409	1973	0.410	1970	0.333
1973	0.398	1978	0.370	1971	0.360
1976	0.409	1980	0.407	1976	0.391
1980	0.373	1983	0.420	1980	0.386
1981	0.452	1988	0.410	1982	0.357
1986	0.420	1989	0.390	1985	0.345
1991	0.476	1998	0.425	1988	0.336
1996	0.518			1996	0.295
2001	0.525			1998	0.316
				2000	0.352
Average	0.442	Average	0.405	Average	0.347

Sources: Deininger and Squire (1996); Birdsall and Haggard (2000); *Key Indicators of Developing Asian and Pacific Countries*, Asian Development Bank; Census and Statistics Department, Hong Kong SAR.

inequality is inevitable. On the contrary, income inequality should be seen from an intra-personal point of view, namely, a person's income is compared over time.

The Gini coefficients of the three economies shown in Table 5.3 exhibit a U-shape; namely, some improvement in income equality was made as income increased but inequality deteriorated afterwards. In other words, as income has risen in these three economies between the 1970s and 1990s, their Gini coefficients did not show a constant improvement. This performance has disputed a popular misconception that income equality will always improve as income rises.

In Hong Kong, the low-income or economically needy individuals are taken care of through government welfare expenditure. The Public Assistance (PA) scheme, first introduced in 1971, was replaced by the Comprehensive Social Security Assistant (CSSA) scheme in July 1993, with the intention of providing a safety net for individuals or families who are unable to support themselves financially. The CSSA covered three non-able-bodied categories (old age, permanent disability and temporary disability/ill health), three able-bodied categories (single parent family, low earnings and unemployment), and all the remaining uncategorized cases. The 1993 CSSA scheme payments, which were more relaxed than the PA scheme, are categorized into three types: the standard rates, supplements and special grants. All CSSA recipients are eligible for free medical treatment at public hospitals and clinics free of charge.

Although there are eligibility conditions applied to the CSSA scheme recipients, statistics from the Welfare Department (see, for example, Li, 2005: Section 4.7) showed that the situation in the period 1993–2002 was worse than the earlier period 1980–92, as shown by the large average percentage increase. In the number of CSSA cases, the 1980–92 decade experienced a growth rate of 4.7 per cent, as compared with a growth rate of 13.3 per cent in the 1993–2002 decade. Between the increase in non-able-bodied and able-bodied cases, able-bodied cases increased much faster, though their percentage share was lower. The number of non-able-bodied CSSA cases increased by 130.2 per cent between 1993 and 2002, giving an average annual increase of 9.9 per cent, which was twice as large when compared with the decade of 1980–92.

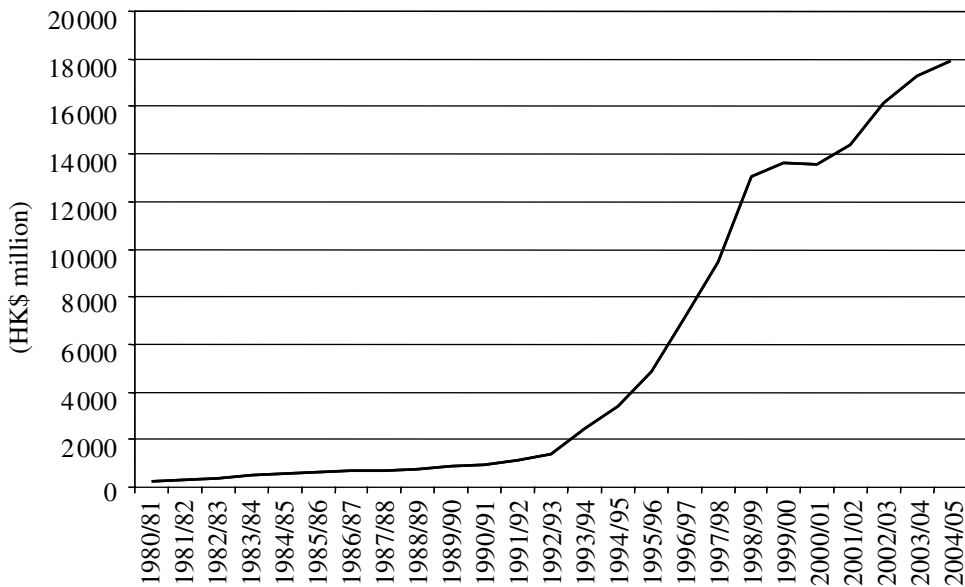


Figure 5.7 Total CSSA expenditure

The total spent on welfare rose by 570.8 per cent between the 1993–94 and 2002–03 fiscal years, and its share in total government recurrent expenditure increased from 2.13 per cent in 1983–84 to 8.15 per cent in 2002–03 fiscal years. Figure 5.7 gives a drastic picture when looking simply at the amount spent between the two decades of 1980s and 1990s. Their pace of increase is even faster than the rise in Hong Kong's nominal GDP over the two decades. Actual statistics showed that total welfare expenditure doubled in about three years between 1980–81 and 1983–84. It more or less doubled again by 1990–91, taking about seven years this time, probably due to the strong economic recovery since 1985. The 1990–91 expenditure was quickly doubled again in 1993–94, taking only three years this time. The mid-1990s was an economic boom time, yet it took only two years from the 1993–94 for expenditure to double again in 1995–96, due obviously to the introduction of the CSSA scheme. In the next two years (1997–98), welfare expenditure was doubled once again, due to the economic hardship brought about by the Asian Financial Crisis. Thus, in the 18 fiscal years between 1980–81 and 1997–98, total welfare expenditure doubled five times, giving an average growth rate of 3.6 years in each round. Between 1997–98 and 2003–04, welfare expenditure rose by 83.3 per cent.

One reasonable question is whether the CSSA recipients are doing better or worse than a similar household in the lowest 25 per cent of the income bracket in Hong Kong. The comparison between CSSA recipients and the median income of the lowest 25 per cent income household with three and four members showed that by 1997–98, CSSA recipients were on average doing better than a household in the lowest 25 per cent income category. In a three-member and a four-member household, by 2003–04, the average CSSA recipients were 28 per cent and 15 per cent, respectively, better off than a similar household with an income falling within the lowest 25 per cent category. In the 11 fiscal years between 1994–95 and 2004–05, the CSSA recipients were better off on average by 8.3 per cent.

It is true that governments have to assist and help the economically weak individuals and households, but the more preferred strategy is to introduce a virtuous circle, and not a vicious circle, in government expenditure. A virtuous circle encourages incentives and attracts more inward investment and provides proactive solutions. Economically weak individuals are assisted through the active process of employment. Thus, a revision in the welfare policy is urgently needed in Hong Kong. For example, other than looking at the eligibility criteria, an effective system can be constructed along with the Mandatory Provident Fund (MPF), bearing in mind that the growing ageing population in Hong Kong will require more government expenditures eventually. While welfare advocates always urge for more, it has to be debated on both the theoretical level (on economic responsibility division) and practical level (the actual fiscal burden).

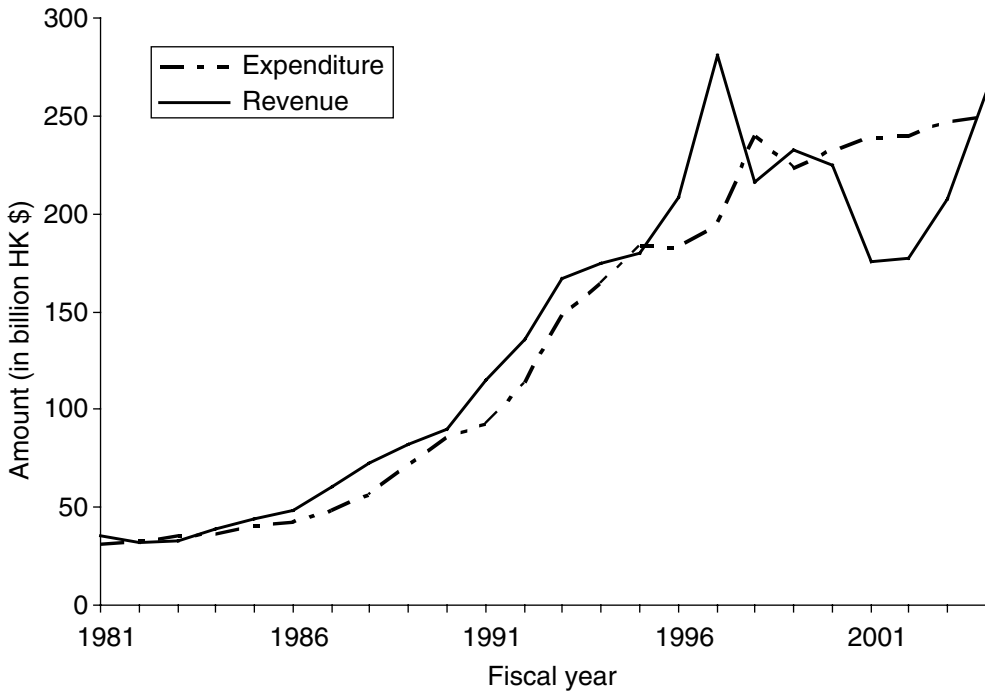
Major policies

By and large, the post-1997 Hong Kong SAR government has adhered to the free market system with little intervention. Hong Kong's fiscal policy has been used to promote economic growth. The fiscal measures have been pro-business and emphasize the importance of the private sector. Hong Kong prides itself on having a relatively efficient and small public sector, with a simple and low taxation system. Article 107 of the Basic Law (1991) says that '[T]he Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, and avoid deficits and keep the budget commensurate with the growth rate of its Gross Domestic Product'. Effectively, the Hong Kong SAR government has to pursue a balanced budget, though debates arise as to whether a balanced budget is meant to be on an annual basis or over a business cycle.

There are only a handful of major tax items, and the low tax rates and simple tax system are welcomed by businesses and individuals. The fiscal practices of the Hong Kong government has consistently emphasized the theme of 'investing for the future'. Infrastructure development have been considered an instrument in widening the economic base and facilitating business transactions. Government expenditures on education and training are means for individuals to enrich their endowments, which, in turn, permits them to gain economic security.

Hong Kong experienced large fiscal surplus in a number of years between the 1980s and 1990s, and the reserve balance kept rising until the outbreak of the Asian Financial Crisis, as shown in Figure 5.8. The economic size of the Hong Kong government has been small by international standards. Between 1986 and 1997, the highest total public expenditure to GDP ratio was 17.5 per cent, and the average of the 12 years was 16 per cent. Due to economic recession since 1998, the total-public-expenditure-to-GDP ratio exceeded 20 per cent, reaching a peak of 21.6 per cent in 2003, giving an average of 21.25 per cent for the six years of 1998 to 2003 (Li, 2005: Table 4.5). The Financial Secretary pledged to reduce the total public expenditure to GDP ratio down to below 20 per cent once the economy recovered.

The economic downturn resulting from the Asian Financial Crisis in 1998 exposed the structural imbalance in the Hong Kong economy, and the Hong Kong SAR government experienced severe fiscal deficits. The prolonged fiscal deficit has led to the debate on whether Hong Kong is facing a structural deficit. Li (2005: Chapter 4) outlined a number of other reasons, including the rapid expansion in the expenditure on health and social



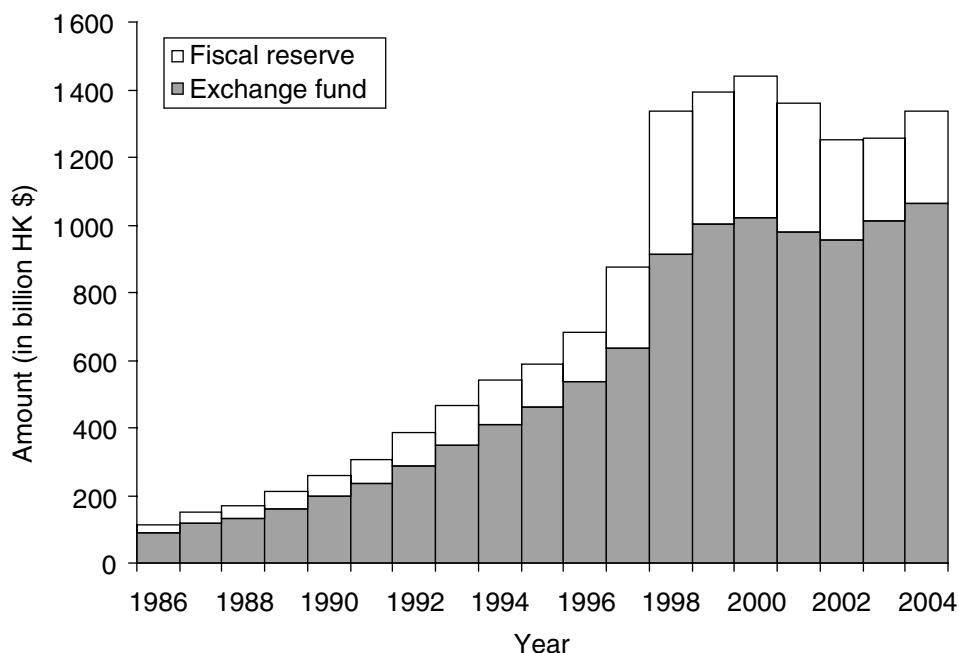
Source: Census and Statistics Department, Hong Kong SAR.

Figure 5.8 Government fiscal balances (HK\$ million)

welfare from the mid-1990s, the large provisions in fiscal concessions during the economically strong years, tax narrowness resulting from the provision of large tax exemptions, the lack of deployment in other/new policy instruments, and the inability to cut expenditure during recession. The Financial Secretary decided to raise the revenue equivalent to HK\$20 billion through the issue of bonds in 2004, but by 2005, economic recovery eased the pressure on fiscal deficit considerably. Debate on the broadening of the tax base has been discussed for a number of years, including the introduction of the goods and sales tax (GST).

Hong Kong is a highly externally oriented economy, and the stability of the currency is crucial. A currency board system of a linked exchange rate to the US dollar has been adopted since 1983 at a fixed rate of HK\$7.8 to US\$1. The major feature of a currency board system is the full backing of the monetary base by the reserve currency (US\$). Williamson (1995) pointed out four advantages of the currency board: (1) assured convertibility, (2) discipline over fiscal policy, (3) certainty of a balance of payments adjustment mechanism and (4) public confidence. The three disadvantages include: (1) the inability of the monetary policy, (2) absence of a lender of last resort and (3) that an emergence of a sudden shock may require adjustments. Figure 5.9 shows the level of exchange fund and fiscal reserve in Hong Kong. Hong Kong's reserve has also been ranked highly in the world.

Since the inauguration of the linked exchange rate in 1983, Hong Kong suffered two currency attacks in 1987–88 and 1997–98. The currency attack in 1987–88 was due largely to the



Note: The large rise in exchange fund in 1998 was due to the inclusion of the land fund cumulated before July 1997 for the Hong Kong SAR government.

Source: Hong Kong Monetary Authority, Hong Kong SAR.

Figure 5.9 Exchange fund and fiscal reserve (HK\$ million)

weak US dollar, and currency speculators expected a revaluation of the Hong Kong currency. There was a large amount of capital inflow in 1987–88 in Hong Kong dollar deposits, and the Hong Kong government purchased a total of US\$2.7 billion and US\$3.1 billion in 1987 and 1988, respectively, in order to rescue the exchange rate (Nugee, 1995). The speculation cooled off when the Hong Kong authority eventually declared a negative interest rate policy. The 1998 currency attack took place at the peak of the Asian Financial Crisis, and the US currency remained strong for some time. Between October 1997 and August 1998, speculators borrowed heavily and dumped the Hong Kong dollar in the market, thus creating an excess supply shock. The interest rate was pushed drastically upwards, and the inter-bank rate rose in vain as speculators used New York and Melbourne to facilitate their hedging activities in Hong Kong. The stock market continued to plummet in 1998. On 14 August 1998, more than HK\$80 billion (US\$10.34 billion) was deployed to acquire a substantial equity portfolio to reduce supply and that prevented the Hang Seng Index from diving below 7000 points (from the peak of 16000 points in July 1997). The act of government intervention drove the speculators away, defended the peg and restored currency stability.

Various suggestions have been made to strengthen the Hong Kong dollar peg since the currency attack in 1998, including de-linking the peg, pegging to a basket of currencies, widening the exchange rate band and so on. The Hong Kong authority insisted that the linked exchange rate system promoted currency stability for Hong Kong. The question is

whether an alternative exchange rate regime will serve Hong Kong better. By mid-2005, when the renminbi was under pressure to revalue, and to avoid further speculative attacks on the Hong Kong currency, the Hong Kong Monetary Authority (HKMA) eventually took a realistic step. On 18 May 2005, the HKMA introduced refinements to the operation of the linked exchange rate system that included the widening of the strong-side convertibility from 7.8 to 7.75 and the weak-side convertibility from 7.8 to 7.85, and within the 'convertibility zone', the HKMA 'may choose to conduct market operations consistent with Currency Board principles'. This effectively relaxed the fixed rate to a narrow range within which the HKMA can smooth the functioning of the peg and remove market anomalies.

Prospects and development

Should Hong Kong aim at economic recovery that depends mainly on demand-driven policies, or pursue supply-side policies of economic restructuring that strengthens the economic base? The demand-driven school (Wong and Tao, 2000) argues that the pursuit of a free market enabled the Hong Kong economy to recover along with the rest of the world according to cyclical movements. The linked exchange rate shields Hong Kong from a loss in competitiveness because price differentials eventually adjust through the current account. Hong Kong's advantage lies in its ability to produce and provide economic clusters to businesses that have kept Hong Kong competitive despite the low production costs north of the border.

The supply-driven school (Dodsworth and Mihaljek, 1997; Li, 2002, 2005) acknowledges the importance of the free market, but notes the post-Asian Financial Crisis structural imbalance, and believes that Hong Kong's competitiveness can further be eroded if new comparative advantages are not forthcoming. As the economic situation improves in Southern China, Hong Kong's experience of 'industrial hollowing', resulting from migration of manufacturing investment to Southern China for cost advantage could repeat itself in a number of service industries. Dodsworth and Mihaljek (1997: 63) and Li (2005: Chapter 3) showed empirically that the non-tradable sector is generally less competitive as non-tradable services have a higher cost and a lower productivity than tradable industries and services. Li (2005) argued that while economic recovery is a 'surety', given the openness of the Hong Kong economy, restructuring in the form of resource expansion would uplift the Hong Kong economy. Hence, the supply-side economic strategy can ensure success once demand rises in the long run.

A number of structural reforms have been suggested in Li (2005). For example, in the case of resource economics, Hong Kong has rightly engaged in promoting human capital and a knowledge-based economy, but should give more effort in expanding other related resources, typically land and inward investment. While labour-intensive industries will not return to Hong Kong, high-technology, high value-added industries can be expanded if more land resources are made available. Another suggestion is the establishment of a border industrial zone that can attract overseas as well as mainland capital in combination with Hong Kong's other production advantages in design, marketing, logistics and so on.

Since China's economic reform in 1978, Hong Kong has been acting as an 'economic foster' in the form of mediator and financier. The Chinese economy has expanded significantly, and China has become a member of the World Trade Organization in 2001.

Further industrialization and urbanization in the next few decades will transform China into a more mature market economy.

Economic integration with the mainland economy has become a new source of economic vigour for the Hong Kong economy. With the conclusion of the two Closer Economic Partnership Agreements in 2003 and 2004, over 200 manufactured export items from Hong Kong do not face import tariffs, thus encouraging industrialists to invest in Hong Kong to make use of the trade agreements. Investors from mainland China will also consider Hong Kong as an investment destination. For example, statistics from the United Nations Conference on Trade and Development (UNCTAD) shows that mainland China's outflow of direct investment totalled US\$12 118 million in 2000–03. Mainland China will soon be a major player in foreign direct investment in Asia. Hong Kong is certainly to gain from the growth in China.

The Pan-Pearl River Delta (Pan-PRD), commonly known as the '9 + 2', consisting of nine southern and coastal provinces in mainland China (Guangdong, Fujian, Jiangxi, Hunan, Guangxi, Hainan, Sichuan, Guizhou and Yunnan), Hong Kong SAR and Macau SAR, was formally established in June 2004 with the aim of producing further cooperation and integration among the members of the Pan-PRD. Largely led by Guangdong Province, cooperation will be both intra- and inter-regional. On the intra-regional basis, economic cooperation will be based mainly on the comparative advantage of individual provinces. Energy- or resource-surplus provinces will help resource-deficit provinces. Intra-provincial trade is expected to rise. Southeast Asia is another crucial area in mainland China's overall development. The Pan-PRD region will be designated to promote inter-regional activities with Southeast Asia.

Situated at the mid-point of these two regions (Pan-PRD and Southeast Asia), and together with its mature economy, Hong Kong can and will provide valuable lessons for the neighbouring economies. For example, Li (2005: Chapter 8) proposed a 'complement-competitive' model of economic integration within the Pan-PRD region. Various economic activities in Hong Kong are regarded as the reference point for economic development in the PRD region. PRD industries and services that are below the international or Hong Kong standard will look to Hong Kong for reference and a catch-up path. These industries and services will be complementary to the Hong Kong economy. On the contrary, those PRD industries and services that have reached international or Hong Kong standard can be competitive to the Hong Kong economy in acquiring a share in the international market.

Figure 5.10 depicts the concept of the model. The vertical axis represents the international standard (IS), while the horizontal axis indicates various industries and services (IND). The complement curve shows those industries and services below the international standard, while the competitive curve shows those above the international standard. In the process of integration, Hong Kong will gain area A, but may lose area B. The dynamics of the model are shown by a broken arrow. Dynamically, as the standard of industries in PRD improves, more industries and services will travel from the complement curve (area A) to the competitive curve (area B).

The challenge facing Hong Kong is to encourage the expansion of area A, so that more industries and services in PRD need Hong Kong as a reference in their catching up process. For area B, Hong Kong has to attract these industries to use the various business clusters that are provided in Hong Kong. Li (2005) concluded that the 'complement-competitive'

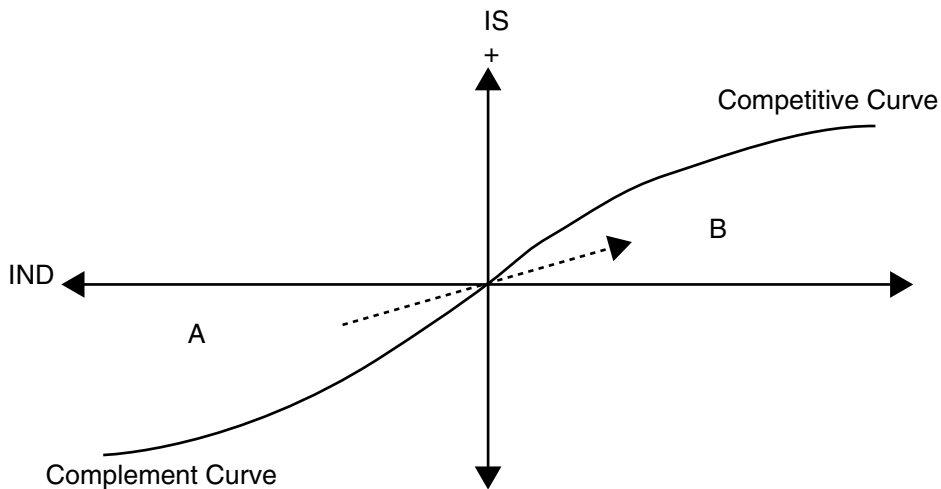


Figure 5.10 The complement-competitive model

model boils down to a strategy of ‘need’ (in the case of complementary industries) and ‘use’ (in the case of competitive industries). For example, various professional services, such as banking, need Hong Kong to attain a higher standard. On the contrary, light manufacturing industries in PRD can use Hong Kong’s port facilities, insurance and so on. A supply-driven strategy, as Li (2005) concluded, will enlarge Hong Kong’s economic capacity that can be utilized extensively in the process of economic integration with the mainland economy.

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Further reading

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Jao, Y.C. (1997), *Hong Kong as an International Financial Centre: Evolution, Prospects and Policies*, Hong Kong: City University of Hong Kong Press.

Dr Jao is an authority on Hong Kong's banking and finance. This book gives an excellent analysis on the economics of the financial sector in Hong Kong over the last few decades.

Sung, Yun-Wing (1991), *The China-Hong Kong Connection: The Key to China's Open Door Policy*, Cambridge: Cambridge University Press.

This book provides an excellent foundation on the economic integration between the Hong Kong economy and mainland China, despite its publication in the early 1990s.

6 Malaysia

Ahmad Zubaidi Baharumshah

A short political and economic history

Malaya came into existence after gaining political independence from the British rule in August 1957. It consisted then of 11 states in Peninsular Malaya. As Great Britain was divesting the last remnants of its empire in the region in the early 1960s, Malaya was transformed into Malaysia with the addition of the states of Sabah, Sarawak and Singapore in the confederation. In 1965, Singapore left the federation and became an independent country. The process of integrating Sabah and Sarawak with the peninsular economy has been a continuing political and economic challenge. Yet much has been achieved in this direction in the past decade.

Malaysia's historical march towards economic growth started with rubber in the early twentieth century, after some decades in the late nineteenth century of trying one plantation crop after another without much success. By 1929, British Malaya had attained the highest per capita GDP of any country (or territory) in Asia (Drabble, 2000). The development of the automobile industry in industrial countries, especially in the United States, created an almost insatiable demand for natural rubber for the production of tyres. Although dependence on primary export products often creates a boom and bust cycle, the rubber industry, combined with the expansion of the tin mining industry, made Malaya one of the most prosperous economies in the colonial world.

The tax revenue from rubber and tin during the colonial years allowed the country to make social progress in spite of many emergent problems of the colonial period (booms and busts, including the Great Depression). However, a major consequence of the economic boom in the colonial period was massive immigration from China and India, which provided cheap labour for the expanding export economy. Initially the Chinese and Indians were assumed to be temporary labourers who would eventually return to their homelands; however, most did not. For most of the colonial era, the latent ethnic tensions were largely held in check through some institutional (for example, monarchy and political institutions) and geographical segregation. In the colonial period, the British representative suppressed the race supremacy and possible riots by strict enforcement of laws. Geographical segregation like having the Malays in rural areas, the Indians in the rural plantation (rubber estates), and the Chinese in the urban commercial areas, was another approach adopted by the British to avoid potential social tension and conflicts in multi-ethnic society.

The Asian colonial world was forever shattered by the rapid Japanese conquest of Southeast Asia in the opening weeks of the Pacific War. After the end of World War II, the British colonial regime regained control for 12 shaky years, but a new international environment and a resurgent nationalism put colonialism on the defensive. There was a peaceful transition to independence for Malaya in 1957 as the threat of political instability subsided with the defeat of a communist guerilla insurgency. Successful elections (local) were held in the mid-1950s. These events eventually paved the way for the formation of the federation of Malaysia in 1963.

The major challenge for modern Malaysia has been to create a common patrimony among the major Malays, Chinese and Indian ethnic groups who are largely divided along economic, social, cultural and religious lines.¹ The leaders of these major three ethnic groups agreed at the time of independence to a *modus vivendi*: recognition by the Chinese and the Indians of the primacy of the Malay political power and of special rights and privileges for Malays, in return for full citizenship rights and a voice in government. This bargain also meant that the Chinese would continue to have economic dominance as long as they did not challenge the political dominance of the Malays (Bowie, 1991). The Malaysian Chinese Association (MCA), the Malayan Indian Congress (MIC) and the United Malays National Organisation (UMNO) formed the alliance to preserve this separation principle with a view to maintaining racial harmony. The importance of the alliance was seen as a mutual deterrence model of conflict management in a multi-ethnic society (Esman, 1972: 74).

The communal settlement of 1957 contributed to Malaysia's economic growth in the first decade of its independence in at least three ways. First, and most significantly, it ensured that the Chinese economic dynamism was not interrupted. Second, it shielded the state from rent-seeking activities during the import-substituting phase of the 1960s. Third, it provided the stability that many decolonized nations like the Indian sub-continent did not enjoy. As it turned out, this made Malaysia attractive to foreign investment at the time when many multinationals were looking for offshore production platforms.

However, the ethnic settlement perpetuated 'separate and unequal' development of the three ethnic communities. For example, during this period the mean household income of the bottom 40 per cent (mostly rural Malays) declined by as much as 11 per cent (Snodgrass, 1980). In the 1960s, an average Malay employee earned about RM1770, whereas a non-Malay counterpart earned on average about RM3200 (Fong, 1989; Lin, 1994). The disparity in income has disillusioned many Malays about the benefits of independence and caused resentments. From their point of view, the earlier arrangement should result in a positive sum game in which all participants gain. At the same time the small number of new generation Malay entrepreneurs felt the Chinese competitive edge and began to question the validity of the 1957 bargain in achieving the social agenda. This was compounded by fact that the young non-Malays became more resentful of Malay 'special rights' and felt a keen sense of discrimination. The growing ethnic tension culminated in the violent riot of 13 May 1969.

The event of 1969 represented a major watershed in Malaysia's economic and political history. Politically, the riot meant an end of the earlier communal settlement on the separation of economic and political roles along ethnic lines. A host of constitutional amendments were adopted, forbidding public discussion, even in Parliament, of sensitive ethnic issues. From the economic perspective, it ended the *laissez faire* approach to commerce and industry and started a more activist economic policy, enshrined in the 1970 New Economic Policy (NEP). In the post-1969 era, the government was given an important role to undertake investments in physical and social capital, apart from providing support to the private sector. An important lesson learned from the crisis is that private-sector-led growth development strategy failed to bring about equitable income distribution among the ethnic groups and region.

The primary thrust of the NEP was to 'accelerate the process of restructuring Malaysian society to correct economic imbalance, so as to reduce and eventually elim-

inate the identification of race with economic function' (the Second Malaysia Plan, 1971–75: 1). The state became the main instrument for this economic reorganization. With a view to increasing the Malay (or Bumiputera) share in business and employment a large number of state corporations were set up along with the introduction of quotas on enrolments of different ethnic groups in public educational institutions. To encourage Bumiputera participation in business, the government also used a preferential credit system to channel funds to Malay business and to preferred industrial sectors. In short, the government began to embark on programmes of positive discrimination to uplift the condition of ethnic Malays as well as other disadvantaged groups under the NEP.

This positive discrimination policy was largely successful in both uplifting the Malays economically and keeping racial tensions at bay as the economy continued to grow as a result of windfalls from the oil price shocks and resource booms of the 1970s. That is, due to good fortune, the re-distributive measures of the NEP did not result in a zero sum game. The Bumiputera economic gains came mostly from an expanding 'cake'. As the economy continued to prosper, the NEP was seen as an instrument for shared growth.

In 1991, the government launched the National Development Policy (NDP) as a continuation of the NEP. The objective of this policy is similar to those stipulated in the NEP, and the continued rapid economic growth helped implement NDP. In sum, it is reasonable to conclude that NEP and the NDP successfully dealt with social, cultural and religious difference to make Malaysia attractive for investors, which in turn, helped implement positive discrimination programmes.

The good fortunes of rapid growth came to a halt when the Asian Financial Crisis hit Malaysia in 1997. But by then Malaysia had a stable political institution that was able to weather the rough time. The crisis threatened the political stability for a brief period; but once again Malaysia succeeded in handling both economic and political crises reasonably successfully.

Economic progress and structural change

Independence era

Before independence the Malaysian economy was based predominantly on primary products and international trade. In 1957, the primary sector, consisting of agriculture and mining, was a major contributor to GDP and employment, accounting for about 46 per cent of GDP and 61 per cent of employment. Agriculture, comprising principally rubber cultivation and to a small extent palm oil plantations, rice cultivation, fishery and forestry activities, was the most important economic activity then, accounting for about 39 per cent of GDP and 58 per cent of the labour force. Mining, mainly tin, contributed about 6 per cent to GDP and 3 per cent to employment.

The contributions of the secondary sector, consisting of some light manufacturing and labour-intensive industries, building and construction, both to GDP (11 per cent) and employment (9.6 per cent) were relatively small. The secondary sector was about a quarter of the size of the agricultural output and one-sixth of the size of the agricultural employment. Manufacturing activities during this period were mainly small scale, centred on repair of agricultural and mining equipment, processing of agricultural products, as well as production related to transportation. There were hardly any large-scale manufacturing activities during the early period of independence. The poor performance of the

manufacturing sector during this period was due to inadequate technical knowledge, a low level of human capital and the limited size of domestic market.

The GDP share of the tertiary sector, on the other hand, was quite high (43 per cent) in 1957. Most services, such as banking and finance, were channelled to trade, which alone contributed about 15 per cent to GDP. The sector consisted of private and public services such as health, and education contributed about 11 per cent to GDP.

Indeed, the most striking feature of the Malaysia economy at independence was its heavy reliance on trade or the export sector. The average ratio of gross export earnings to GDP over the period 1947–60 was 0.48, making Malaysia the most open economy in the world. Due to this high dependence on commodity trade and wide fluctuations in commodity prices during these periods, the economy experienced great instability in its export earnings. The second important feature of the Malaysian economy during early independence was its high population growth. During the 1950s, the population grew at the rate of 3 per cent per annum. The high population growth in the face of economic slowdown increased the rate of unemployment (from 2 per cent in 1957 to 7 per cent in 1967 and 8 per cent in 1970).

Another distinctive feature worth mentioning is the uneven distribution of income. There were wide disparities between rural and urban sectors, between inhabitants of Peninsular Malaysia and East Malaysia and between various races in Malaysia. For instance, in 1957, the average annual income per head of the Malays was RM367, which was only about 43 per cent of the average annual income per head of the Chinese and 55 per cent of the Indians. The difference is probably due to the type of employment (or industry) by the major ethnic groups in the country. Programmes to address disparities in income distribution among the races started as early as in 1950 with the establishment of the Rural and Industrial Development Authority (RIDA), which was subsequently incorporated into the various development plans of Malaysia (for example, national economic policy).

The Malaysian economy 1960–2004

From the 1960s until the late 1980s, Malaysia experienced an increase in the scope of manufacturing activities. Malaysia successfully shifted its dependency from primary to secondary exports. The growth of manufacturing evolved from two successive strategies: (1) the import substitution strategy, actively pursued in the first Malaysia Plan and (2) the export promotion strategy, implemented during the beginning of the Second Malaysia Plan.

Economic growth and structural change Shortly after its independence, Malaysia experienced a strong recession that reduced GDP by 2.4 per cent in 1961. Malaysia's GDP grew at an average rate of 3.2 per cent between 1960 and 1965 and then at 7.7 per cent between 1971 and 1976 (Table 6.1). In the 1980s, the Malaysian economy grew at a lower average rate of 5.1 per cent between 1981–85 and 6.6 per cent between 1986–90. The slow growth during this period was primarily due to the global recession in 1985–86. The recessions were related to adverse developments in terms of trade and export markets (commodity crisis of 1985). In general, Malaysia's performance during 1970–96 had been impressive, with the economy growing at an average rate of 7 per cent per annum. Real per capita income increased from RM1937 in 1970 to RM12 892 in 1996, the year before the crisis.

Table 6.1 Gross domestic product by sector and growth, 1960–2005

	1960	1965	1970	1975	1980	1985	1990	1995	2000	2001	2002	2003	2005
Real GDP growth rate (%)	–	6.4	4.4	1.0	7.2	–1.2	8.6	9.4	8.5	0.32	4.1	5.2	5.6
GDP per capita (\$)	274.5	304.0	363.9	703.9	1742.8	2038.5	2470.1	4297.9	3926.7	3746.0	3970.9	4247.2	–
Inflation rate (%)	0.06	–0.1	1.8	4.5	6.7	0.35	2.6	3.5	1.5	1.4	1.8	1.1	1.7
Agriculture	40.5	31.5	30.8	27.7	22.8	20.7	18.5	13.1	8.7	8.5	9.1	8.6	(4.8)
Mining and Quarrying	6.1	9.0	6.3	4.6	10.0	10.4	9.7	7.3	7.3	7.2	7.2	7.2	(1.5)
Manufacturing and Construction	8.6	10.4	13.4	16.4	20.0	19.6	30.1	36.5	35.2	33.4	33.3	34.0	(3.7)
Services	44.8	49.1	51.3	49.5	47.2	49.3	41.8	43.1	44.8	47.3	46.4	50.2	(5.8)
Exports of goods and services (% of GDP)	56.2	47.6	46.1	45.5	57.5	54.9	74.5	94.1	124.4	116.4	114.8	114.3	(7.7)
Imports of goods and services (% of GDP)	43.7	43.2	44.4	47.2	55.0	49.7	72.4	98.0	104.5	98.0	96.5	93.3	(6.7)

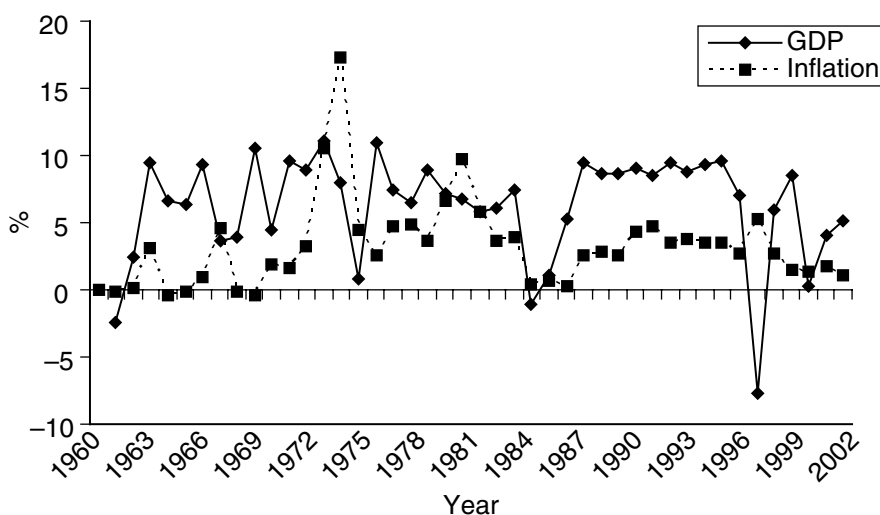
Note: Real GDP growth rate was calculated as the log difference after deflating the nominal GDP with GDP deflator. Exports and imports of goods and services are percentage of GDP.

Sources: IFS Statistics of International Monetary Fund (IMF).

With the recovery of the world economy, the Malaysian economy grew rapidly in the 1990s, attaining an average rate of 9.1 per cent between 1991–95. Growth during this period was spurred by the influx of foreign direct investment (FDI) mainly from Japan and the United States and high domestic investment (savings) rates. Since 1970, Malaysia has remained one of the top 12 recipients of FDI among the developing nations. FDI inflows provided the necessary capital for investments. Additionally, foreign capital brought advanced technology and managerial skills. In the past few decades Malaysia's saving rates were among the highest in the world, about 26 per cent in 1975 and 43 per cent in 2003.

The growth momentum, however, was disrupted by the severe contraction of 7.6 per cent in 1998 due primarily to the Asian Financial Crisis (Figure 6.1). The GDP growth between 1995 and 2000 averaged 4.7 per cent per annum, falling sharply compared with the first half of the 1990s. It is worth mentioning that Malaysia's response to the crisis was different from the other Asian countries. For example, Indonesia and Thailand were forced to embark on an IMF-mandated programme consisting of floating exchange rates and tightened monetary and fiscal policies. By contrast, Malaysia followed an independent route. It imposed controls on capital flows, fixed the ringgit to the US dollar and lowered the interest rate. Efforts by the government to stimulate the economy from mid-1998 succeeded in generating a high average growth rate of 7.2 per cent during the period 1999–2000. Despite the unprecedented uncertainty in the global economy, as well as uncertainties arising from wars in Afghanistan and Iraq, and the outbreak of the severe acute respiratory syndrome (SARS), Malaysia managed to grow at an average rate of 4.5 per cent per annum during the period 2000–03.

During the 1960s Malaysia's industrial development reflected its comparative advantage. Industrial development progressed from rudimentary processing of natural resources and simple consumer goods for domestic consumption to advanced products such as consumer electronics. The transformation of the Malaysian economy into an



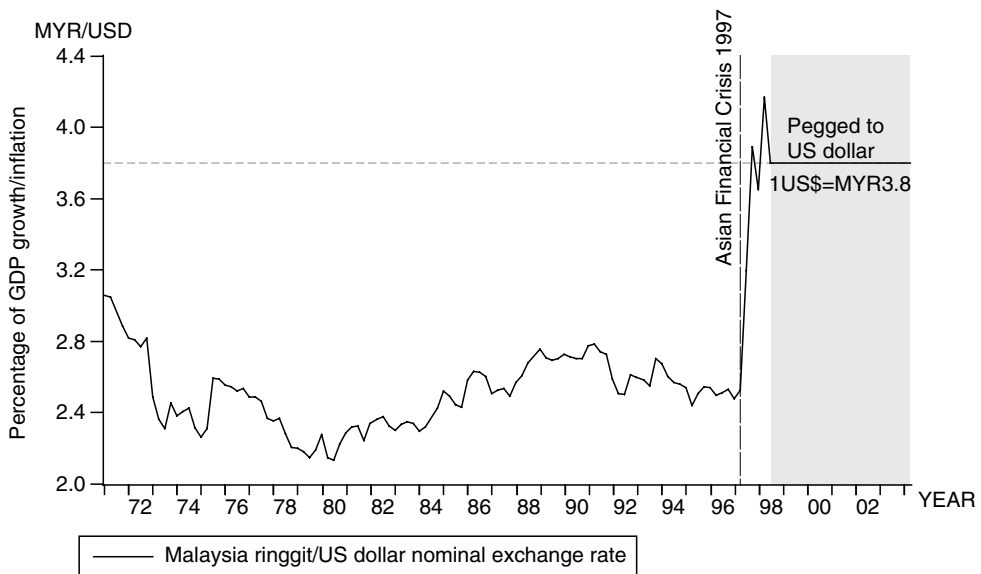
Source: IFS database of International Monetary Fund (IMF).

Figure 6.1 GDP growth rate and inflation, 1960–2003

industrial-based economy began effectively in the late 1970s with the adoption of an export-promotion strategy. This was achieved through the establishment of labour-intensive industries such as textiles and electronics, in addition to rubber and palm oil processing and wood-based industries, for exports. Thus, economic growth in Malaysia was accompanied by considerable changes in the sectoral composition of GDP. The share of the manufacturing sector in GDP increased from 8.6 per cent in 1960 to 34 per cent in 2003. The share of the agricultural sector in contrast declined from 40.5 per cent in 1960 to 8.6 per cent in 2003 (Table 6.1). The share of mining and quarrying fluctuated over time, reflecting to a large extent the variations in tin prices. It grew from 6.1 per cent in 1960 to around 10 per cent in 1980; but then declined to 7.2 per cent in the latter half of the 1990s. The service sector is increasingly becoming an important component of GDP. Its share increased from 44.8 per cent in 1960 to 50.2 per cent in 2003. This points to the future sources of growth in the Malaysian economy.

Inflation and the Malaysian ringgit Throughout Malaysia's history, inflation remained mostly at a single-digit level. The inflation rate has been low compared with the other ASEAN countries. The ringgit (RM) was relatively stable and remained strong against the currencies of major trading partners between 1960 and 1971 (Figure 6.2). The collapse of the Bretton Woods system in 1971 forced most nations to resort to alternative systems of exchange rate management, either a float or a managed float. Malaysia followed a managed float system, where the ringgit was pegged to a basket of currencies that was heavily weighted to the US dollar.

After 1971, the value of the ringgit fluctuated against the US dollar. In the 1980s the ringgit started to appreciate steadily against the US dollar due to the inflows of foreign



Source: Computed by the author.

Figure 6.2 Plot of RMR/US\$ nominal exchange rate

capital (mainly FDI). However, between 1996 and 1998 the ringgit depreciated due to the Asian Financial Crisis. Malaysia stopped the slide by taking drastic actions (although late) to fix the ringgit against the US dollar and introducing controls on capital outflows against the advice of the international financial institutions and mainstream economists. Defying the prediction of dire economic consequences by so-called market economists, these measures helped stabilize the currency, and the economy recovered quickly.

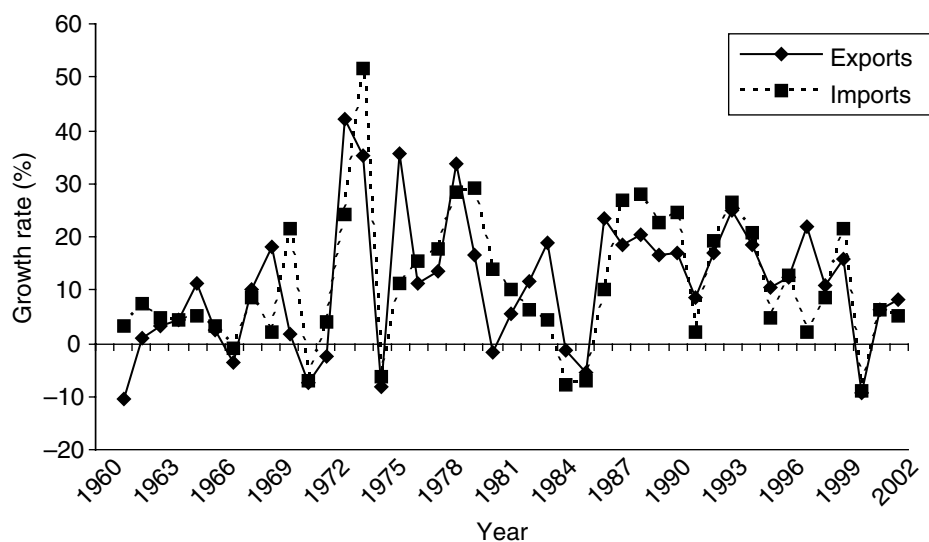
Balance of payments During 1956–60, Malaysia maintained a positive current account balance, which turned negative in the next half of the 1960s, partly because of the nature of the import-substitution programme. The rapid increase in imports of intermediate and investment goods in the 1960s eroded the surplus on Malaysia's merchandise account, while growing service payments, including investment income outflows, became sufficiently large to bring about a current account deficit in the later half of the 1960s. The current account deficit for the first half of the 1970s was reversed in the second half despite the continuing growth of imports and service payments resulting from the commodity boom of the late 1970s, involving better prices as well as increased production of petroleum and palm oil.

In the first half of the 1980s the situation reversed, with the current account deficit growing from US\$285 million in 1980 to US\$3497 million in 1983 and reduced to US\$122 million in 1986. The merchandise account suffered deficits of US\$105 million in 1981 and US\$753 million in 1982. This was attributed to declines in exports and increased imports. However, in most years in the 1980s Malaysia had a trade balance. The current account balance remained negative during the period 1990–97. The current account surplus recorded in the post-1998 period was due to increased exports of goods and services especially the manufactured goods and the falling of imports due to the depreciation of the ringgit.

The deficit in the current account did not create a balance of payments crisis as Malaysia continued to receive large flows of both direct investment and long-term capital. The long-term capital flows were negative only between 1986 and 1989 and from 1999 to 2002.

Imports and exports The United States has been the prime export market for Malaysia, while Japan served as a source of imports. Having declined from 56 per cent in 1960 to 46 per cent in 1970, the share of exports of goods and services in the GDP reached 124 per cent in 2000 and declined to 114 per cent in 2003 (Table 6.2). Import shares increased from 44 per cent in 1960 to 105 per cent in 2000 and declined to 93 per cent in 2003. The high export/GDP and import/GDP ratios reflect the degree of openness and external trade of the Malaysian economy. It is worth noting that the high trade-to-GDP ratio in the recent years is due to a significant quantity of re-exports and intermediate imports. This also reflects the large presence of export-oriented multinational corporations in the country.

As can be seen from Figure 6.3, the export and import growth exhibited a similar pattern. The growth was sluggish after independence and negative for exports (–10.5 per cent in 1960). In 1970 exports grew at 2 per cent and recorded the highest growth in 1973 (35.5 per cent). However, the export growth continued to decline since then and reached 8 per cent in 2003. Imports grew at an average rate of 3 per cent in 1960 and 22 per cent in 1970 and the highest growth was in 1974 (51.7 per cent). As with the export growth,



Note: Growth rate of exports and imports were calculated as log difference (i.e. $\log \text{Exp} - \log \text{Exp}(-1)$).

Source: IFS database of International Monetary Fund (IMF).

Figure 6.3 Growth of exports and imports, 1960–2003

the growth of imports steadily declined to reach 5 per cent in 2003. This is a reflection of maturity of the Malaysian economy, and Malaysia seems to be able to sustain its growth based on the strength of the domestic economy.

Savings and investment Malaysia has one of the highest savings and investment rates in the world. Table 6.2 shows that the gross national savings ratio rose from 16 per cent in the 1960s to 39 per cent in 2000; but it declined slightly to 37 per cent in 2003. The domestic savings ratio was 47 per cent in 2000 and it declined to 42 per cent in 2003.

The gross domestic investment ratio rose from 15 per cent in the 1960s to its peak of 44 per cent in 1995; but declined to 21 per cent in 2003. In the early independence era, the government budget balance was positive (0.49 per cent in the 1960s). The government budget balance became negative in the late 1970s and during the recession period of 1985–86. It was considerably higher in 1980 (–13.2 per cent) and in 1985 (–7.4 per cent). In the 1990s the government budget deficit decreased and became positive in 1995 and thereafter in the 2000s the deficit increased to about 6 per cent on average. As shown in Table 6.2, the gap between gross national savings and gross domestic investment rose sharply in the early and mid-1990s. During this period, the gap was financed mainly from foreign capital. In the aftermath of the 1997–98 crisis, investment plunged and the gap turned positive from then.

Social progress

In terms of population Malaysia is a relatively small country. The Malaysian population increased from 8.14 million in 1960 to 24.4 million in 2003. The average annual population

Table 6.2 *Savings and investment as percentage of GDP, 1960–2004*

	1960s	1970	1975	1980	1985	1990	1995	2000	2003	2004
Gross national savings	15.8	17.1	20.6	29.3	25.6	30.2	35.0	38.5	37.2	38.4
Government budget balance	0.49	0.29	-8.5	-13.2	-7.4	-2.0	0.8	-5.8	-5.3	-
Gross domestic savings	-	-	25.8	32.9	32.7	34.4	39.7	47.1	42.9	43.8
Gross domestic investment	14.8	17.7	25.1	31.1	29.8	33.0	43.6	25.6	21.4	-
Gross capital formation	15.7	16.9	30.4	27.6	32.42	32.4	43.6	27.1	21.8	22.5

Sources: Balassa (1991), Asian Development Bank key indicators, various issues (1985, 1990, 2003 and 2004).

Table 6.3 Social indicators, 1970–2005

	1970	1980	1990	1995	1996	1997	1998	2000	2001	2002	2004	2005
Population (million)	10.9	13.8	17.85	20.4	20.9	21.4	22.0	23.0	23.5	24.0	25.58	26.13
Population growth rate (%)	2.38	2.60	2.62	2.61	2.58	2.54	2.47	2.24	2.11	1.99	–	–
Inequality (Gini coefficient)	–	–	42.9	44.2	44.2	44.2	44.2	–	–	–	–	–
Life expectancy (F) years	–	–	73.5	74.2	74.3	74.5	74.0	75.0	75.1	75.3	75.6	76.1
Life expectancy (M) years	–	–	68.9	69.4	69.4	69.6	70.0	70.2	70.6	70.7	71.1	71.7
Infant mortality (1000 births)	–	–	15	11	11	6.6	6.2	7.8	6.3	5.7	5.8	5.4
Maternal mortality (1000 births)	–	–	8	3.9	4.1	4.1	4.6	4.4	4.4	4.4	–	–
Access to drinking water (% population)	–	–	81.0	88.0	89.0	95	92.0	92.0	93.0	93.5	–	–
Poverty incidence (% population)	49.3	29.2	17.1	8.7	8.0	8.5	6.8	5.5	4.5	5.1	4.3	–
Adult literacy (% age 15 and above)	–	–	80.3	87.0	84.0	93.3	93.7	93.8	93.9	94.0	95.1	–
Primary school enrolment (% of population)	–	–	99.8	96.4	96.2	96.2	95.9	96.8	97.0	97.8	92.8	–
Education expenditure (million RM)	521.1	3 104.3	6 596	10 603	12 489	12 881	13 443	20 022	24 785	29 418	–	–
Primary health care expenditure (million RM)	183	796	1 777	2 772	3 474	3 727	4 047	5 403	6 250	6 655	–	–

Note: Population growth rate is the annual change.

Sources: Asia Regional Information Centre (ARIC), aric.adb.org. The Malaysia Economy in Figures (various issues), Asia Development Bank, key indicators, 2003.

growth rate was 2 per cent in the 1970s and 3 per cent in the 1980s (Table 6.3). The population growth rate trended downward from 1996 to 2003.

With rapid economic growth, absolute poverty in Malaysia declined quite dramatically. The percentage of people living below the poverty line dropped from 49 per cent

(about half of the population) in 1970 to 5 per cent in 2001. The number of poor households decreased from 1.1 million to about 346 000 over the same period. The contribution of economic growth to poverty reduction could easily be verified by matching the trends in both variables. In addition, the poverty alleviation was a result of articulated government policies and programmes targeting the poor especially among the rural Malay population. An example of such a programme is the Rural and Industrial Development Authority's (RIDA) aim to increase the number of Malays in commerce and industries. These programmes guaranteed the population a minimum access to basic needs to ensure survival. A study by the World Bank (1993) found that rapid growth in the manufacturing sector absorbed women and Malays into the labour market and helped to alleviate poverty. However, Malaysia did not do as well in reducing income inequality. The Gini coefficient, in fact, edged up from 42.9 in 1990 to 44.2 in 1998. The official data also revealed that urban–rural income disparity ratio increased from 1.20:1 in 1990 to 2:1 in 1997.

As expected, with the decline in absolute poverty, the life expectancy rose. The average lifespan for women in 1990 was 73.5 years, while for men it was 68.9 years. The infant and maternal mortality rates also fell. In 2002 the infant and maternal mortality rates were 5.7 children and 4.4 persons per 1000 births respectively. About 81.0 per cent of the population had access to safe drinking water in 1990, which increased to 94.5 per cent in 2003. The literacy rate and primary school enrolment rate are also high – around 94 per cent and 98 per cent, respectively.

Government expenditure on education and training has been increasing, rising from RM521.1 million in 1970 to RM3104.3 in 1980. In the 1990s the government expenditure on education and training doubled. The Malaysian government's commitment to human development was clearly evident in the education expenditure, which rose to RM29 418 million in 2002. Similarly, the expenditure on primary health care has been on the increase since 1955, from about RM58.1 million to about RM183 in 1970, RM796 in 1980 and RM1777 in 1990. In 2000, the expenditure stood at RM5403 million and according to the figure from the Asia Development Bank, the Malaysian government spent about RM6655 million on primary health care in 2002.

Major policies

Industrialization policies

The impressive growth trends of the Malaysian economy over the past decades came as a result of articulated and integrated government policies, pursued by a stable government. In the early period, as Malaysia's exports came mainly from agriculture, government policies focused mainly on agriculture, especially on the development of palm oil exports and on import substitution in rice. Palm oil was given particular importance in the framework of land development programmes, while increased irrigation permitted double cropping of rice, primarily in the MADA (Kedah) and KADA (Kelantan) areas.

Agricultural policies were complemented by industrial policies. The Pioneer Industrial Ordinance of 1959 provided income tax exemption to new manufacturing establishments approved as pioneer firms. Further dividends paid from tax-exempt income were also exempted from income taxes by shareholders. The period of tax exemption depended on the size of the firm. Small firms received exemption for two years; medium-size firms for three years and large firms for five years. The Pioneer Industries Act 1965 added a further

category of four years' tax exemption. Losses incurred during the tax exemption period could be carried forward to the post-exemption period.

The Investment Incentive Act of 1968 lengthened the period of tax exemption. An extension of an additional year was granted to firms fulfilling certain conditions, bringing the maximum period of tax exemption to eight years. As a result of tax exemptions the number of pioneer firms increased from 18 in 1958 to 399 in 1984, producing one-third of manufacturing output in that year. Priority firms were established in a wide variety of industries – including food products, wood manufacture, textiles, petroleum and coal products, chemicals and metal products.

The Investment Incentive Act 1968 also provided tax incentives for firms that did not qualify for pioneer status. A tax credit was granted for 25 per cent of the capital expenditure, with an additional 5 per cent if the plant is located in a development area, if it manufactured a priority product or if it had a 50 per cent Malaysia content. Furthermore, tax-exempt capital allowance was increased to 60 per cent to encourage the setting up of modern factories. Finally, accelerated depreciation allowances were also introduced to encourage investment.

The 1971 Labour Utilisation Act provided tax exemption on the basis of the number of workers employed. The tax exemption period was set at two years for firms with 51–100 employees, three years for firms with 101–200, and four years for firms with 201–350 employees. An additional year of tax exemption was provided if the factory was located in a development area, if manufacturing a priority product, or if it has 50 per cent Malaysia content.

These policies did not discriminate between production for domestic and for foreign markets. As noted by Bautista (1992), in the early import-substitution phase, Malaysia had low tariff protection to domestic industries, foreign exchange controls were not imposed and few quantitative restrictions were adopted. The tariffs remained moderate compared with most other developing countries. For example, in 1980 the unweighted average tariff was 12 per cent, compared with 63 per cent in the Philippines (Balassa, 1991). This was very important for the continued expansion of Malaysia's exports, which contributed to the rise of a significant manufacturing sector.

Globalization and integration policies

Sachs (2000) identified Malaysia as belonging to the list of countries with the most successful export-promoting policies. Malaysia opened itself to FDI relatively early in the 1960s. FDI increased rapidly in Malaysia until the early 1980s, but declined afterwards. According to the balance of payments statistics, it was \$500 million in 1978 and surpassed one billion dollars annually between 1981 and 1983. FDI in Malaysia has been comparable to that in Singapore and exceeded other East Asian developing countries.

Today, its market-oriented economy, combined with an educated multilingual workforce and a well-developed infrastructure, has made Malaysia one of the largest recipients of FDI among developing countries. The Institute for Management Development (IMD) in its 2004 *World Competitiveness Yearbook* ranked Malaysia as the fifth most competitive country in the world (for countries with a population of greater than 20 million), ahead of countries such as Germany, United Kingdom, Japan and mainland China.

In addition, according to the latest Offshore Location Attractiveness Index compiled by the global management-consulting firm A.T. Kearney, Malaysia is among the top three

contenders for offshoring business in the world. In its report, A.T. Kearney considers Malaysia a 'natural choice' for offshore services in view of its low costs, particularly for infrastructure, the most attractive business environment among emerging markets and high levels of global integration.

Supportive government policies

A major factor that has attracted investors to Malaysia is the government's commitment to maintaining a friendly business environment. This is evidenced in the liberal equity policy. Until recently, foreign investors in Malaysia's manufacturing sector could hold 100 per cent equity only in projects that exported at least 80 per cent of their production. However, effective from 17 June 2003, 100 per cent foreign equity holding is allowed for all investments in new projects, as well as investments in expansion/diversification projects by existing companies irrespective of their level of exports. In addition, foreign companies in the manufacturing sector are allowed to employ expatriates where certain skills are not available in the domestic economy. A company with foreign paid-up capital of US\$2 million and above is allowed up to ten expatriate posts, including five key posts that can be permanently filled by foreigners.

A well-developed financial system and banking sector has also enhanced Malaysia's position as a dynamic export base in Asia. Sophisticated financial facilities are available through domestic and foreign commercial banks and their nationwide network of branches. Before independence, banks in Malaysia were largely foreign-owned and were closely linked to the London financial market. After independence, government encouraged the development of indigenous banking and by the mid-1980s, banks owned domestically accounted for about two-thirds of the commercial bank credit. In addition, the government has been able to maintain macroeconomic stability as evidenced from low inflation and a stable exchange rate.

Prospects and challenges

The last decade has seen a deepening and widening of Malaysia's industrial base as well as further development of its services sector. As such, a strong foundation has been laid for the economy to move forward into the new globalized environment. The service sector needs more push in the area of improved delivery and technology. As Malaysia's industrialization is entering the second stage, consumption rather than investment is more likely to be an important driving force for economic growth. Hence, tax incentive might be necessary to stimulate aggregate demand. However, the tax system must become more equitable and more efficient so that it stimulates productive investment instead of corporate takeover, windfall profits and transfer of factories to cheap labour countries like China and Viet Nam.

In the coming decade, an important policy component in Malaysia's development plans should be to enhance the knowledge content of the economy with the dominance of information and telecommunications (ICT) as the enabling technology. Intensive research and technology development will need support from the venture capitalists. To this effect, a greater emphasis needs to be placed on human resource enhancement, as availability of skilled and knowledgeable workers are major prerequisites to transforming Malaysia from a production-based into a knowledge-based economy. Malaysian businesses have to implement more innovation, research and development to compete in both domestic and international markets with the emergence of a 'new economy'.

Malaysia, so far, has enjoyed remarkable political stability except for some periods of very brief uncertainty. Ever since its independence, Malaysia has been governed by a national coalition (Barisan Nasional) of UMNO, MCA and MIC, representing three major ethnic groups. Recently it has successfully managed the succession of power from its longest-serving prime minister to his deputy. Its democracy, though limited by Western standards, seems to be working well. But the society still remains divisive – both regional and household inequality is still high, and the demand for stricter Islamic rules has not died out. These divisions may remain latent as long as the economy continues to grow rapidly. But as the recent Asian Crisis revealed, at the slightest prospect of a collapse, these tensions may flare into open violence along ethnic, religious and regional lines, which could push the country into a period of serious political and economic turmoil. Thus, the main challenge facing Malaysia is twofold – maintaining economic growth and healing the social fault-lines.

Note

1. The discussion that follows draws heavy on Chowdhury and Islam (1996).

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Further reading

- Jomo, K.S. (ed.) (1992), *Industrializing Malaysia: Policy, Performance, Prospects*, London: Routledge.
- This book critically analyses the industrialization process in Malaysia. Several issues on foreign capital, technology transfer, free trade zones, industrial linkage and the labour market in the manufacturing sector are considered in this volume.
- Jomo, K.S. (ed.) (1994), *Malaysia's Economy in the Nineties*, Kuala Lumpur: Pelanduk Publications Sdn. Bhd.
- This book is a collection of essays from a number of perspectives, by Malaysia's leading economist. The volume examines the Malaysian economy as it enters the mid-1990s. The articles critically analyse the role of government, the impact of privatization, trade and foreign direct investment.
- Onwuka, K.O. and Baharumshah, A.Z. (2004), *Regional Trading System and the Location of Foreign Direct Investment: Some Further Evidence from ASEAN-5, FEA Regional Conference, Universiti Malaya, Malaysia*, 19–20 January, 2004.

This article investigates the location of FDI in ASEAN countries over the past four decades or so and finds that multilateral and regional trade liberalization significantly affect inflows of FDI to the region. The findings also suggest that factors like wage rate, employment level, human capital and initial capital are crucial for the location of FDI in the fast-growing ASEAN countries.

Ramon Navaratnam (2003), *Malaysia's Economic Challenges: A Critical Analysis of the Malaysian Economy, Governance & Society*, London: ASEAN Academic Press.

This book explores the country's economic policy: its implementation, impact and effectiveness. Several aspects on institutional issues are presented. The author draws lessons from the 1997 financial crisis and suggests how public and private sectors can gain from the challenges ahead. It is essential reading for those interested in the recent financial crisis and what Malaysia needs to do for a better tomorrow.

7 Thailand

Somboon Siriprachai

A short political history

Like any other traditional society, from the time of Sukothai (the first kingdom and first city of Thailand, circa 1260–1350 AD) to the coup d'état of 1932, the king was at the centre of Thai political structure. The king held extensive power – responsible for the administrative, judicial, military, religious and cultural life of the country. He also appointed central and provincial officials, issued edicts on a variety of subjects, made decisions on legal issues, oversaw preparations for war, protected the Buddhist faith and provided generous support for the arts, which was essential for any king of Thailand. Many Thai monarchs were leading intellectuals and poets, and others, for instance King Mongkut (1851–67) and King Chulalongkorn (1868–1910), preserved Thailand's independence from the West in an era of colonial expansion. The journey of modern Thailand began when King Chulalongkorn initiated the reform programme, which included the introduction of Western-style education and public health systems, railways and public security apparatus such as police.

Under the *Sakdina* (Thai feudalism) regime, which had survived for centuries, the Thai monarchy was unable to present its great power in the twentieth century. By the 1920s, the storm of change in the political system was emerging among military officers, civilian officials and students who had studied abroad, particularly in France. The coups of 24 June 1932 brought the military to a dominant position in the Thai political structure, and the Provincial Constitution of 27 June 1937 ended the absolute monarchy. The critical event took place on 2 March 1935 when King Prajadhipok abdicated the throne. The throne was vacant between 1946 and 1950. After that, King Bhumibol Adulyadej returned to Bangkok in 1950 and was very popular with the Thai people.

The '1932 revolution' also opened Thai politics to a new group of people, mainly bureaucrats, who originated from the great reforms of King Chulalongkorn. The bureaucracy was the major source of employment for educated Thais and became the main source of power in Thai politics for decades. Some observers regard the Thai bureaucracy as a social system with its own values. Between 1932 and early 1973, Thai politics was a matter of competition between bureaucratic cliques for the control of the government. There is no doubt that the most powerful group was the army, which was well-organized and well-established, and as a result, had come out on top of the political competition. Some political writers term this period as a semi-democratic era.

Thailand has had a bicameral system since 1932, with a constitutional monarchy. Although King Bhumibol Adulyadej had ensured some degree of political continuity, there have been 17 military coups (the last in 1991) since 1932. A genuine civilian government was restored in 1973, but over the following decades, administrations were always short-lived and unstable (see Table 7.1).

The critical change occurred in January 2001, when the newly formed Thai Rak Thai (Thai Loves Thai, TRT) party under the leadership of a former policeman and telecommunications tycoon, Thaksin Shinawatra, won a resounding victory in the general election.

Table 7.1 Government changes in Thailand

Prime Minister	In Office	Duration (months)	Means of Selection
Manopokon	1/1932–6/1933	12	Coup
Phahon	6/1933–9/1938	63	Parliament ^a
Phibun	12/1938–8/1944	68	Parliament
Khung ^b	8/1944–8/1945	12 + 2 + 4	Parliament
Thawi	8/1945–8/1945	0.5	Interim
Seni	9/1945–1/1946	4	Interim
Pridi	3/1946–8/1946	4	Parliament
Thawan	8/1946–11/1947	15	Parliament
Phibun (2)	4/1948–9/1957	114	Coup
Phot	9/1957–12/1957	3	Interim
Sarit ^c	2/1959–12/1963	58	Coup
Thanom	12/1963–10/1973	10 + 118	Succession
Sanya	10/1973–2/1975	16	Interim
Khukrit ^d	3/1975–1/1976	10	Parliament
Seni (2)	4/1976–10/1976	7	Parliament
Thanin	10/1976–10/1977	12	Coup
Kriangsak	11/1977–2/1980	28	Coup
Prem	3/1980–8/1988	100	Parliament
Chatchai	8/1988–2/1991	30	Parliament
Anand ^e	2/1991–2/1992	12 + 3	Interim
Suchinda	3/1992–5/1992	2	Coup ^f
Chuan	9/1992–6/1995	33	Parliament
Banharn	7/1995–11/1996	16	Parliament
Chavalit	11/1996–11/1997	12	Parliament
Chuan (2)	11/1997–2/2001	39	Parliament

Notes:

a. Parliament was restored through a coup.

b. Khung was again prime minister from January to March 1946 and from November 1947 to April 1948.

c. Thanom was prime minister for 10 months while Sarit was treated for cirrhosis in the United States.

d. Seni was prime minister for about 20 days before Khukrit.

e. Anand was again prime minister from June to September 1992.

f. Suchinda was chosen by Parliament but his selection was the result of a coup.

Sources: Ockey (1996: 345–60, 347) and my observations since the Banharn.

The Thaksin government is the first administration to complete a four-year term. Furthermore, in the 2005 elections, the Thai Rak Thai Party won an unprecedented second term, and could form a single party government. Thus, this represents a new era of Thai politics to the extent that the Parliament is controlled by a dominant political force (see Table 7.2). The Thai Rak Thai Party won 377 seats in the lower house to enable it to govern alone, while over the last decades a government coalition had been in place.

The political market in Thailand has become chaotic again in early 2006, when Thaksin sold his telecom company – Shin Corp – shares to Singapore's state-owned Thamasek Holdings for a tax-free \$1.9 billion. The deal to avoid paying tax on capital gains made a large number of people angry and disappointed. Anti-government protests grew rapidly,

Table 7.2 *Parliamentary forces (number of seats in the House of Representatives, February 2005 elections)*

Political Parties	Total	Constituency	Party List ^a
Thai Rak Thai (TRT)	377	310	67
Democrat Party (DP)	96	70	26
Chart Thai (CT)	25	18	7
Mahachon	2	2	0

Note: a. Elected by proportional representation.

Source: Election Commission.

leading to many big demonstrations by the middle classes and professionals in Bangkok. Opponents of the billionaire leader accused him of abusing the country's system of checks and balances and bending government policy to benefit his family's business. Instead of using Parliament to respond to the opposition's demand, he dissolved the Parliament and called a snap general election, which was boycotted by all main opposition parties. Although the Thai Rak Thai Party was returned to power, the no votes (abstentions) were substantial, in particular in Bangkok and in the south. This tainted Thaksin's legitimacy and to defuse the political crisis, Thaksin handed over the premiership to his deputy. What role Thaksin plays in the future remains to be seen.

Economic progress and structural change

Economic growth between 1855 and 1950

The Thai economy stagnated for at least 100 years (1855–1949). The growth rate of per capita income over this period averaged just 0.2 per cent per year (Manarungsan, 1989). Why did the Thai economy stagnate for such a long period? Some attribute this to the unequal relationships with the colonial powers. For example, Ingram (1971) and Feeny (1982) suggest that Thailand remained *de jure* independent, but the economy *de facto* was similar to a colonial economy. The unequal Bowring treaty that the British Empire set up for Thailand in 1855 turned the Thai economy into a colonial economy. It prohibited high import duties (maximum 3 per cent of imports and exports) under which Thai domestic industries could not have been created. The cheap imports replaced local industrial products easily, while the country was severely weakened by limited government revenue from trade tax. Feeny (1982) goes further by arguing that the Thai elites chose to use all scarce resources to invest in railways instead of putting money into irrigation projects, which would have improved productivity in the agricultural sector, especially in rice production.

The second explanation lies in the fact that Thai *Sakdina* (Thai feudalism) did not create any institution to nurture the entrepreneurial class. Most entrepreneurs working in Thailand at that time came from Europe and China. Chinese merchants were very active in the Thai economy in all aspects of life. The Chinese traders and unskilled workers migrated to Thailand to earn money and then send this back to mainland China. According to Ingram (1971), the amount of such money sent back to China was quite substantial, and rendered the Thai economy stagnant in terms of capital accumulation.

The Thai miracle since 1950

The Thai economy turned the corner in the 1950s. It grew by 6.2 per cent annually between 1950 and 2003 (Table 7.3a). During the decade (1987–96), before the crisis, the economy was growing at 9.2 per cent per annum. The economy contracted by –6.1 per cent during 1997–98. It managed to come out of the crisis quickly and the economy has been growing by over 6 per cent. As can be seen from Table 7.3b, Thailand's average inflation rate remained moderate throughout these years.

It is quite surprising that frequent military coup d'états did not have the same pernicious effect on growth, as they did in some Latin American countries. As pointed out rightly by Feng (2003), political instability did not translate into economic uncertainty, largely because the overthrown governments and the coup leaders both shared the same commitment to a market economy, and left the difficult job of managing the economy in the hands of technocrats from the Ministry of Finance and the Bank of Thailand (Christensen and Siamwalla, 1993). Additionally, the monarchy in Thailand as a traditional institution keeps national conflicts at a low level. Thus, a country with many coups d'état was still capable of managing growth quite well as its fundamental principles of macroeconomic stability remained intact.

Sources of growth Table 7.4 summarizes the findings of growth accounting studies for Thailand. Thailand ranks second among East Asian economies with respect to the contribution made by total factor production (TFP) growth per worker over the period 1970–85.¹ However, rapid accumulation of capital made the highest contribution. This is quite evident from the sharp increase in the investment ratio from a very low level in the 1950s to very

Table 7.3a Thailand rates of growth of GDP and GDP per capita, 1951–2003

Period	Real GDP Growth	Real GDP Growth Per Capita
1951–86 (Phase I) pre-boom	6.5	3.9
1987–96 (Phase II) boom	9.2	8.0
1997–98 (Phase III) crisis	–6.1	–7.1
1999–2003 (Phase IV) post-crisis	4.0	3.3
Whole period 1951–2003	6.2	4.2

Sources: Warr (2005), based on Bank of Thailand; data for 1951 to 1980; and National Economic and Social Development Board (NESDB); data from 1987.

Table 7.3b Main economic indicators, 1950–99

	1950–59	1960–69	1970–79	1980–89	1990–96	1997–99
Growth rate real GDP	5.4	8.0	7.1	7.3	8.5	–2.4
Savings/GDP ratio	11.5	20.6	21.8	25.1	34.1	31.0
Investment/GDP ratio	13.6	20.8	23.8	28.6	40.7	24.3
Inflation rate	5.1	2.2	8.0	5.8	5.1	4.7

Sources: Ingram (1971: 222), based on data from NESDB and Bank of Thailand.

Table 7.4 Growth accounting for Thailand

Study	Period	Growth Concept	Growth Rate	Capital Accumulation	Labour Input	Quality of Labour	TFP Growth
Young (1995)	1970–85	Output per worker	3.7	–	1.8		1.9
Collins and Bosworth (1996)	1960–94	Output per worker	5.0	2.7	–	0.4	1.8
Sarel (1997)	1979–96	Output per capita	5.24	2.13	1.09	–	2.03
Tinakorn and Sussangkarn (1996)	1978–90	Output per worker	7.6	2.9	2.0	1.5	1.2
Tinakorn and Sussangkarn (1998)	1981–95	Output per worker	8.12	5.04	0.96	0.84	1.27

Source: Jansen (2004).

high levels in the late 1980s and 1990s (Table 7.3b). The savings/GDP ratio jumped from 11.5 in the 1950s to 34.1 during 1990–96. The Thai capital accumulation was largely domestically financed until the mid-1980s, and household savings played a major role. Since the middle of the 1980s, however, corporate and foreign savings have assumed a significant role.

Table 7.5 shows that the contributions owing to labour became rapidly superseded by an increase in quality. Quality-adjusted contribution of labour input increased from 4.4 percentage points (25.1 per cent–20.7 per cent) during 1980–85, to 12.1 percentage points (21.4 per cent–9.3 per cent) during 1986–95. What is striking is that the quality-adjusted contribution of TFP was at a rate of 31.3 over 1986–90, but it was almost negligible in the later period of 1991–95. Therefore, total factor productivity was exhausted over 1991–95 before the crisis broke out in 1997.

One empirical study (Jansen, 1989) identified sources of growth on the demand side into three categories: domestic demand, import substitution and export demand. Between 1960 and 1970, domestic demand contributed 89.1 per cent to economic growth, with 11.4 per cent stemming from export demand and the rest, –0.6 per cent, from import substitution. During 1985–88, export demand contributed significantly to economic growth with 45.3 per cent, while import substitution contributed negatively (–23.4 per cent). The contribution of domestic demand, however, remained high at 78.1 per cent. Thus, the Thai economy by the late 1980s still remained largely domestic demand-driven.

Structural change

The Thai economy has undergone rapid transformation during the past three decades. The role of the agricultural sector, which has been the main contributor to GDP, has been steadily declining. Between 1970 and 1990, the growth rate in agriculture was about 4 per cent per annum. It was estimated to be the lowest between 1986 and 1990 and it is interesting to note that the growth rate in the agricultural sector became unexpectedly negative in

Table 7.5 *Sources of growth by sectors, 1981–95 (percentages)*

	Land	Capital	Labour		TFP	
			Unadjusted	Quality-adjusted	Unadjusted	Quality-adjusted
1981–85	2.9	62.2	20.7	25.1	14.1	9.7
Agriculture	4.0	11.7	21.6	41.8	62.7	42.5
Industry		86.2	28.0	42.7	–14.2	–28.9
Manufacturing		68.3	31.9	57.1	–0.2	–25.5
Services		74.9	34.0	52.3	–8.8	–27.2
1986–95	–0.3	61.6	9.3	21.4	29.4	17.3
Agriculture	–0.9	90.6	–7.1	–4.2	17.4	14.5
Industry		64.1	27.3	36.5	8.6	–0.5
Manufacturing		59.4	28.1	37.1	12.5	3.5
Services		65.7	24.6	33.0	9.7	1.3
Of which: 1986–90	–0.2	47.6	13.1	21.3	39.6	31.3
Agriculture	–0.9	59.3	23.3	35.6	18.3	6.0
Industry		49.0	24.3	26.6	26.7	24.4
Manufacturing		47.6	27.0	26.0	25.4	26.4
Services		52.1	18.9	32.6	29.0	15.3
Of which: 1991–95	–0.5	78.6	4.8	21.5	17.1	0.4
Agriculture	–0.8	117.3	–33.2	–38.3	16.7	21.8
Industry		84.5	31.5	49.9	–15.9	–34.4
Manufacturing		75.6	29.7	52.4	–5.3	–28.0
Services		82.3	31.7	33.5	–14.0	–15.8

Sources: Jitsuchon (2002), drawn from Tinakorn and Sussangkarn (1998), Tables 8, 13, 14, 15, 16; Ockey (1996: 345–60, 347), and my observations since the Banharn.

1987 and 1990. Thailand did not participate in the Green Revolution by adopting high-yield rice varieties such as IR-8. Thailand has typically expanded cultivated areas as a source of agricultural growth stemming from the resource endowment; abundant land itself permitted the Thai farmer to expand land frontiers instead of improving productivity. Land productivity (yield per *rai*; one *rai* = 0.16 hectares or 0.4 acres) has been very low and stable, while labour productivity (output per farmer) has increased significantly (see Timmer, 1991).

In contrast, the growth of the manufacturing sectors has been more impressive. By 1980, the manufacturing activities in both import-substituting and local manufacturing sectors became the largest contributors to the economy. Indeed, this post-World War II transformation can be attributed to heavy taxation of the staple primary crop – rice – in the form of export premiums or ‘rice premiums’. This taxation substantially affected most Thai farmers for longer than anyone can image (see Siamwalla, 1975; Thanapornpun, 1985). It was negative protection for Thai farmers who have provided cheap food and labour for the manufacturing sector in Bangkok. Rice is certainly a ‘wage good’ in the sense that workers spend most of their wage income on rice.² The heavy rice taxation was first imposed when Great Britain demanded that Thailand pay its war indemnity in rice and the Thai Rice Office was urgently established to ensure its obligations were fulfilled. Later, the Thai government’s intention to collect an extra profit from a multiple exchange

Table 7.6 Sectoral growth and shares (%)

Period	1957–73	1974–85	1980–96	1997–2001	2002–03
Sectoral growth					
Agriculture	5.0	3.7	3.1	2.1	4.9
Non-agriculture	9.6	7.4	11.8	0.7	7.6
Industry	9.7	7.1	12.3	2.0	8.6
Service	8.3	3.7	8.3	–1.7	4.4
Total	7.8	4.7	9.2	–0.1	6.1
Sectoral share					
Agriculture	24.5	17.7	12.3	10.1	10.1
Non-agriculture	25.3	33.8	45.5	51.0	53.2
Industry	14.7	22.0	29.6	35.2	37.3
Service	50.2	48.5	42.2	38.9	36.7
Total	100.0	100.0	100.0	100.0	100.0

Source: NESDB.

rate led to rice premiums becoming an important source of government revenue between 1955 and the early 1960s (Ingram, 1971).

As can be seen from Table 7.6, the share of agriculture in GDP declined from 24.5 per cent during 1957–73 to only 17.7 per cent during 1974–85. With impressive growth rates, the manufacturing sector experienced rapid structural changes over two decades (1960–80). Import-substituting industries in food processing (food, beverages, tobacco, and snuff) expanded in the early 1960s to 1970s, but food processing as a single major contributor to the manufacturing value-added declined from 34.6 per cent in 1960 to 20.1 per cent in 1978. In addition, several new manufactured products emerged, for instance, tapioca processing, canned food, animal feed, dairy products, etc., while textiles, paper and paper products, rubber products and chemical products became more important. The structure of the manufacturing sectors changed in 1985 when food products no longer dominated the sector. By 1985, the shares of food products, textiles, wearing apparel, beverages, transport equipment, tobacco, non-metallic mineral products and petroleum products were 15.4 per cent, 14.9 per cent, 11.4 per cent, 8.1 per cent, 7.4 per cent, 5.6 per cent, 6.0 per cent, and 4.1 per cent, respectively.

Macroeconomic performance

Inflation As mentioned earlier, price stability in Thailand over the last 50 years has been remarkable. Only in 1973–74 and 1980–81 did the inflation rates exceed 10 per cent. Rice is the main staple food, and its price has always been insulated from the world market price by using various policies since World War II. This wage good has been kept low and stable over the last 50 years, and this contributed significantly to sustained price stability in Thailand (Christensen and Siamwalla, 1993; Siamwalla and Setboonsarng, 1989).

Government budget and external debt After 1950, the Thai government always had budget deficits. However, this was not financed by borrowing from the central bank. Instead the budget deficit was often financed by public external debt (Ingram, 1971; Warr

and Nidhiprabha, 1996). Although this mode of financing deficits was non-inflationary, it created another problem. The total external debt jumped from 16.6 per cent of GNP to 51.3 per cent in 2004. The total debt service ratio used to be at the highest level standing at 27.4 per cent in 1985, though it levelled off after 1987, but it jumped to more than 20 per cent in 1998 after the economic crisis. The total debt:service ratio has declined to a manageable level, at 8.4 per cent in 2004.

Compared with other developing countries, the recent budget deficit of Thailand was not so desperate given the moderate economic growth. Economic growth has been 5–6 per cent per annum over 2002–04, indicating that economic growth has turned out to be normal since 2002, which is the last year that budget deficit was reeled in at –1.4 per cent. However, it is very difficult to be sure that the current recovery has been due to expansionary fiscal policies, as the recovery has been aided by external environment as in other Asian countries. Economists in Thailand are concerned about the Thaksin government's non-budgetary expenses, which are not subject to parliamentary scrutiny. Thus, it may be susceptible to corruption and political pork-barrelling. In 2004, the non-budget deficit was 3900 million baht and it is likely that this deficit will be broadened under the neo-populist policy (Table 7.7).³

Most of the time the current account deficit was within a moderate level of less than 4 per cent of GDP. However, it jumped to –7.9 per cent of GDP in 1995–96. This indicates that perhaps the rapid growth before the crisis was not sustainable. Since 1990, Thailand's terms of trade deteriorated, which may also have contributed to the rise in current account deficits. This deterioration of Thailand's external position might have led to the speculative attack on the Thai baht in early 1997.

Trade and balance of payments

Thailand became a major rice exporter in the 1950s. No less than 50 per cent of the total value of exports was attributed to rice, while four major crops – rice, rubber, tin and teak – comprised 83.1 per cent of the total exports. Thus, exports of manufactured goods were negligible in 1950 (Falkus, 1991; Ingram, 1971).

Over the 1960s and 1970s, the structure of international trade changed considerably. Diversification began dramatically in the early 1970s, both within and outside the agricultural sector (into a wide range of crops). This was partly due to problems associated with the oil shocks and the realization of the limits of import-substituting industries. The share of merchandise exports rose dramatically from 2.4 per cent in 1961 to 10 per cent in 1971 and 35.8 per cent in 1981. In the mid-1980s, manufactured exports, for the first time, surpassed traditional agricultural products (rice, rubber, maize, sugar cane and tapioca) in terms of value. Manufactured exports grew at 35.7 per cent per annum on average between

Table 7.7 Deficit in non-budgetary balance (millions of baht)

	1997	1998	1999	2000	2001	2002	2003	2004
Deficit in non-budgetary balance	13.0	–4.2	–34.4	–1.8	9.8	1.8	7.6	–3.9

Source: Bank of Thailand.

1985 and 1990. The principal items of manufactured exports were textiles and garments, canned foods and canned fish, gems and jewellery and integrated circuits.

Although Thailand has had a high growth rate of manufactured exports since the mid-1980s, the growth rate of imports was still higher than that of exports in terms of value. Major items of imports included raw materials (including petroleum), capital goods (machineries) and chemical goods. This suggests that Thailand might have tried to exploit import-substitute-then-export (ISTE) strategies in manufacturing.

The current account deficits increased from 7.9 per cent of GDP in 1989 to 12.4 per cent in 1990.⁴ The prolonged deficit of current accounts was caused by rapidly rising imports of capital goods, intermediate goods and raw materials. This indicates that import dependence did not decline despite decades of import-substituting industrialization (ISI). Although international trade has played a vital role in the Thai industrialization process since the 1980s, the legacy of ISI could still be noticed in some industries, such as the iron and steel and automobile industries.

The persistent current accounts deficits and rapidly increasing foreign debt were certainly major problems and Thailand had to go to the International Monetary Fund (IMF) and the World Bank for balance of payments support and adjustment assistance in 1984. The unfavourable terms of trade led to the largest trade deficit that the country had ever experienced since World War II. The deficit rose from 5.8 per cent in 1978 to 9.8 per cent of GDP in 1983. The prices of rice and other traditional crops were dramatically declining, while the Thai government and public enterprises had been heavily burdened with accumulated debts in the 1970s.

The rise of the US dollar in 1981, and the deterioration in the balance of payments inevitably encouraged speculation that the Thai baht would be devalued. Finally on 15 July 1981, the baht was devalued by 8.7 per cent, and the daily fixing method was abolished. The Thai government had to devalue again on 2 November 1984, and the rate was set at 27 baht per dollar.⁵ It should be made clear that the value of the baht had increased with the dollar value since 1981, which in turn made the baht overvalued compared with other important currencies such as the British pound and German mark (Meesook, Tinakorn and Vaddhanaphuti, 1988). Not surprisingly, the overvaluation was harmful to the export-promoting trade strategy. As raised by Meesook et al. (1988), the most important factor causing the Thai authority to devalue emerged from import taxes that gave rise to protected firms. It is strongly evident that the overvalued exchange rate was biased against export producers, especially primary commodities producers such as rice farmers. In fact, before May 1981, the Bank of Thailand had been reluctant to devalue the baht, albeit the significant appreciation of the real exchange rate. This was because devaluation in the Thai context was not just politically sensitive, but should have been avoided if there was a choice.

Trade and industrialization policies

Like most other developing countries, Thailand began its industrialization with import substitution. During the import-substitution period, the Thai government was strongly biased against the agricultural sector, while it tyrannically protected and created a number of incentives for promoted industrial firms (mostly big foreign firms in Bangkok). Export tax was imposed on agricultural products such as rice, rubber, logs and wood.⁶ On the other hand, the manufacturing activities were not subject to taxes and were highly

protected by quantitative restrictions. The heavy tax on the agricultural sector might have encouraged resource-based activities using static comparative advantage.⁷ In addition, the Board of Investment (BOI) granted tax concessions on imported machinery, equipment, raw materials and other intermediate inputs.⁸

By the early 1970s, the Thai policy-makers began to realize the adverse effects of an import-substitution strategy that relied heavily on imported inputs, especially capital goods. As resources were transferred to the promoted firms through the provision of relatively cheap machinery and intermediates, it made sense for the promoted firms to prefer more capital-intensive technologies. Furthermore, the framework of quantitative allocation systems by state bureaucrats encouraged rent-seeking activities and corruption. As a consequence, the import-substitution strategy failed to reach the government's objectives, and did not conform with the country's factor endowment, namely cheap labour. The import-substitution strategy also failed to create forward and backward linkages in industrial sectors.

The Thai technocrats (mostly in the National Economic and Social Development Board NESDB), introduced an export-promotion strategy to stimulate manufactured exports in the early 1970s as part of the Third National Economic and Social Development Plan (1972–76), which specified the promotion of manufactured exports as the main industrial strategy.⁹ In 1972, the investment promotion law was replaced by the National Executive Council Announcement No. 227, intended to give greater incentives for export industries. These included exemption from export duties and business taxes for export products of promoted firms. In addition, imported material inputs and imported products to be re-exported were exempted from import duties and business taxes when the income was derived from export activities. Promoted firms were permitted a 2 per cent deduction on the increases of income over the previous year for income tax purposes. It should also be noted that BOI had considerable discretionary authority to determine the list of activities and/or the list of firms eligible for promotion privileges. For instance, the 1972 Investment Promotion Law and the 1977 revision of the Industrial Promotion Act empowered BOI to grant and provide privileges to promoted firms.

Although the government had made more attempts to promote exports of manufactured goods by revising the Investment Promotion Law in 1972, and again in 1977, the structure of incentives provided by the law still favoured the import-substitution industry, and was at best biased against the agricultural sector.

The Fifth National Plan (1983–86) and the Sixth National Plan (1987–91) were probably responsible for the impressive export-led growth. The former initiated the restructuring of local industries to encourage competitiveness in production, emphasized export production and industrial rationalization, and highlighted the strategic importance of machinery and agro-industries. The serious push for export-oriented industrialization was partly encouraged by the success of the export-led development of newly industrializing economies (NIEs), such as Singapore, Taiwan and South Korea. It was also pushed by the IMF and the World Bank as part of their structural adjustment programmes to help Thailand overcome its balance of payment crises in the late 1970s and early 1980s.

Export-oriented industrialization has effectively occurred since the mid-1980s, in accordance with major changes in the world economic environment. In particular, after the Plaza Accord of September 1985, the currencies of the Asian NIEs, except that of Hong Kong, appreciated vis-à-vis the US dollar, which was substantial against the deutsche-

mark, and became more so against the yen. This immensely benefited the Thai economy to the extent that export-promotion policies became effective due to the devaluation of the baht against the US dollar, as the Thai baht was closely tied to the dollar. Hence, the year 1985 was a turning point for the Thai economy. Also, the external environment became better; interest rates and oil prices declined, while the price of traditional commodity exports began to recover. Demand for Thai exports quickly picked up after the two devaluations in 1981 and 1984, jumping to 20.7 per cent in 1986, 28.8 per cent in 1987 and 33.9 per cent in 1988. The international setting, namely, currency realignment, led to the fall of the value of the US dollar and the rise of the yen, and immediately benefited Thailand's economy. Japanese manufacturers began to relocate their production base in Thailand. Moreover, Thai macroeconomic performance has also been impressive in terms of international standards.

By the late 1980s Thailand was considered to be one of the most attractive investment locations in Southeast Asia due to both economic and non-economic factors. The country had a very high economic growth without much inflation, unstable exchange rates or political turmoil (Mackie, 1988). Furthermore, the private-enterprise economy, positive attitude towards foreigners, and increasingly export-oriented strategy induced foreign investors to relocate industrial plants in Thailand. In particular, Thailand is a more attractive country for Japanese firms as a place for investment in Southeast Asia because of abundant, cheap and hard-working labour.

It should be noted that during the three consecutive years (1986–88), foreign direct investment increased dramatically: 67 per cent in 1986, 360 per cent in 1987, and 140 per cent in 1988. Notably, in 1987, Japanese investment approved by BOI exceeded the cumulative investment in Thailand since the 1960s. Taiwan is the next big foreign investor. Japanese foreign firms relied heavily on both natural resource-based and labour-intensive industries: electrical appliances, electronics, transportation equipment, metal products, textiles, agricultural and fishery products, etc. Taiwanese investments concentrated on labour-intensive light manufacturing such as sports goods, toys, shoes, bags, plastics and some agro-industries such as frozen shrimp, etc.

Some critical observations about the Thai miracle

Environmental consequences

The growth rate of Thai exports has far exceeded that of world exports since 1984. It is often claimed that the economy of Thailand demonstrates a pattern of export-driven economic growth like the first generation East Asian NIEs. However, unlike the East Asian NIEs, the Thai manufactured exports are mainly resource-based. Certainly, Thailand's export-oriented industrialization relies very much on labour abundance and natural resources. There has been very little technological breakthrough, or human capital (skill) formation (Dahlman and Brimble, 1990; UNIDO, 1992). Furthermore, the contribution of exports to growth declined from 28.8 per cent in 1989 to only 11 per cent in 1990 (Santikarn Kaosa-ard, 1992). It simply implies that Thai manufactured exports have not matured.

An obvious casualty of high economic growth is the environment. There has been severe deforestation and environment degradation, for instance, pollution (Brander, 1992). One recent study of the Thailand Development Research Institute (TDRI) indicates that the quantity of hazardous waste produced reached 6 million tons by the year

2001 compared with 1.1 million tons in 1986. Most of this waste is generated directly by the manufacturing sector. Furthermore, a high number of recurring serious accidents indicates that the Thai bureaucrats are too incompetent to cope with problems emerging from rapid industrialization.

Ninety million *rai* (one *rai* = 0.16 hectares or 0.4 acres) of forest were cleared between 1960 and 1990 at the average of three million *rai* per year. Less than 28 per cent of the country (about 90 million *rai*) is now under forest cover (Panayoutou and Parasuk, 1990). As a result, Thailand ranks as one of the most rapid deforestation countries in the post-war period, with forest cover declining from 50 per cent of land area in the early 1960s to approximately 20 per cent in the mid-1980s. This figure is 15 per cent in 1986 according to unofficial estimates. Not surprisingly, deforestation proceeded so rapidly that by 1968 Thailand became a net importer of wood.

One factor that contributed to deforestation in Thailand is the property rights in land. Although illegal logging by people with political connections is commonly accepted as the main culprit, titled land has been more significant than other factors. General patterns encouraging deforestation include illegal encroachment by landless and small farmers actually clearing land with the expectation that they would then revive title to the newly cleared land (Siamwalla, 1991). The Thai state appears to be too weak to enforce the law of the land and secure property rights, which can only be done by political and judicial organizations that effectively and impartially enforce contracts across space and time. Land property rights in Thailand have been very insecure and chaotic.

Urban bias and lopsided development

As mentioned earlier, the Thai development strategy displayed an urban bias. Various levies on agricultural produce, especially the rice tax, and an overvalued exchange rate, disadvantaged the agricultural sector. One surprising feature of agricultural growth is that Thailand was probably the only country in Asia where cultivated land per agricultural worker actually increased until 1977 (Siamwalla, 1991). This also means that agriculture has been able to absorb a large number of labour, especially seasonal labour. Thailand still has a larger proportion of its labour force (Table 7.8) in this sector than other Asian countries with a similar income level. The expansion of cultivated areas without a corresponding increase in productivity is irrational to say the least. The agricultural sector, employing almost 64 per cent of the labour force, produced less than 13 per cent of GDP (in 1990). This paradox implies that there is a very low level of productivity in the agricultural sector (Ezaki, 1990).

A major problem confronting Thai industrialization is that the employment share of manufacturing industry did not accompany its production share. For example, in 1990, manufacturing contributed 26 per cent to GDP, but employed only 10 per cent of the labour force. It can be concluded that this weak labour absorptive capacity has become a serious obstacle to agricultural modernization and has resulted in the swelling of urban poor who migrate from rural areas in search of jobs in Bangkok. With no skills these migrant labourers seek employment in the informal sector at a very low wage. As pointed out in many studies, low productivity and low wages in the urban informal sector in Bangkok push down the real wage. The rural-urban migration in Thailand is crucial for many farmers who seek jobs in the slack season, and this earning becomes more significant over time. The migration of the agricultural labour force has not ceased. This has been accentuated by the

Table 7.8 Labour force (millions)

	2000	2001	2002	2003	2004 ^a
Employed	31.29	32.10	33.06	33.84	34.73
Agricultural	13.83	13.61	14.04	13.88	13.63
Non-agricultural	17.46	18.49	19.02	19.96	21.09
Unemployed	1.19	1.12	0.82	0.75	0.74
Seasonal inactive labour force	0.74	0.59	0.38	0.31	0.25
Total labour force	33.22	33.81	34.26	34.90	35.72
Unemployment rate ^b	3.6	3.3	2.4	2.2	2.1

Notes:

a- Preliminary.

b- Percentage of labour force.

Source: Bank of Thailand.

failure of the Thai government to insulate their domestic markets from international price fluctuations; the price of agricultural products has been declining since the 1980s.

In sum, as Sussangkarn (1992) rightly points out, such an uneven development in production between agricultural and industrial sectors is a crucial cause of the worsening phenomena of income distribution in Thailand. It may be concluded that neither import substitution in the manufacturing sector nor the degree of outward orientation performed well in the condition of labour abundance between the 1950s and 1980s.

Lagging human capital development

Thailand lags behind other countries in the region and has the worst secondary enrolment ratios in Asia (Sussangkarn, 1992). The Thailand Development Research Institute finds that in the year 2000, 70 per cent of Thailand's workforce had only primary education or less (six years). This means Thailand can have a comparative advantage only in unskilled labour.

When the industrialization process starts, the size of the unskilled and low-skilled labour force should become smaller compared with high-skilled labour, including office managers, professionals and white-collar workers. This enhances a country's social capacity to acquire and make use of advanced technology, which, in turn, brings about productivity growth. Thai economic development over the last half a century seems to have failed to adequately develop social capacity as the technical competence of the people appears very weak (Dahlman and Brimble, 1989; UNIDO, 1992). This can be attributed to the absence of a targeted industrial policy linked closely to technical education in the secondary and vocational training schools.

Inadequate infrastructure and legal system

A sudden high rate of economic growth has created a demand for infrastructure. However, the Thai government severely cut its public infrastructure investment in the 1980s in order to meet its structural adjustment obligations with the IMF. This has meant serious bottlenecks when economic growth began to accelerate in the early 1990s, as manifested by rising current account deficits and inflation. Perhaps the root cause of the speculative attack on the baht in 1997 can be found in this (Chowdhury, 1999).

The private sector did not come forward to fill the gap created by the decline in public infrastructure investment. This was mostly due to the failing of the legal system, which allows an effective implementation of private contracts as well as contracts between the private sector and the state. In the case of Thailand, the role of the state is not only ambiguous, but it is also very vague. In some economic sectors, for instance, the state can enforce the law and maintain political stability, but in many cases, the state is too weak to protect private property rights, or even public property. The laws are manipulated by political entrepreneurs and state bureaucrats. There is a consensus among lawyers in Thailand that Thai administrative laws lack automatic application and transparency and allow state officials to have full discretionary power. In particular, in the case of subordinated legislation the use of discretionary power is vested exclusively in the responsibility of the bureaucrats (Sathirathai, 1987). Many young Thai lawyers also observe that Thailand's administrative law code makes the bureaucracy autonomous from legal challenges. However, since 1997, the new Constitution has paved the way to make the Thai administrative court possible and played a vital role in controlling the abuse of government power. The accountability of power is still limited (Treerat, 2004).

Corruption

The above also encouraged corruption among the state officials. This has been compounded by the unholy alliance of bureaucracy with political entrepreneurs. One common phenomenon in Thailand is that political entrepreneurs (for example, elected politicians) notoriously tend to administer or control productive sectors, which resulted in their unlimited power over allocation and management of economic activities. For instance, export quota allocation of cassava and textile products was delegated by the leader of a political party to a minister. Vote-buying is pervasive in modern Thai politics (Parnwell and Rigg, 1993; Samudavanija, 1989, 1992; Tamada, 1991). This, in turn, determines what kinds of economic policy are to be implemented by the elected politicians who occupy office as ministers. As a result of being under a long authoritarian regime since 1947, the Thai parliament as an institution has played an insignificant role in scrutinizing the activities of the bureaucracy (Thanapornpun, 1990). Since 1997, only two politicians have been found guilty and sent to prison by the Criminal Court for Politicians in Positions founded under the 1997 Constitution (see Treerat, 2004), although it is widely believed that corruption and rent-seeking activity are rampant.

Income inequality

Although absolute poverty (Table 7.9) declined with rapid growth, Thai society has become more unequal. The Gini coefficient rose from 0.41 in 1965 to 0.50 in 2004 (Table 7.10). Rural poverty, which declined significantly, still remains four times the urban poverty rate.

Although the impressive objective of eradicating poverty in rural areas was explicitly coined as the slogan for the national plan, like the 'year of the farmer' in the early 1980s, or the land reform implemented in the early 1990s, the effectiveness of these policies in alleviating poverty was still very limited. It can be said that the Thai governments have been inclined to subsidize urban workers by providing food subsidies via a cheap rice policy.

Table 7.9 Thailand: poverty incidence, 1962–2002 (headcount measure, percentage of total population)

	Aggregate	Rural	Urban
1962	88.3	96.4	78.5
1975	48.6	57.2	25.8
1981	35.5	43.1	15.5
1986	44.9	56.3	12.1
1990	27.2	33.8	1.6
1996	11.4	14.9	3.0
2002	9.8	12.6	3.0

Sources: Development Evaluation Division, National Economic and Social Development Board (2000); Bangkok and Krongkaew (1993).

Social progress

Life expectancy in Thailand has increased substantially since World War II. In 1985, it stood at 66 years at birth, and gradually increased to 69 years at birth in 2002. The infant mortality rate per 1000 live births has also fallen from 40 in 1985 to 24 in 2002. The adult illiteracy rate (among people aged 15+) declined from 10 per cent in 1985 to 4 per cent in 2002. Beginning in 1990, a new measure of development, the human development index (HDI), has been calculated and published each year by the United Nations Development Programme in its annual *Human Development Report*. The Thailand HDI index behaved peculiarly over the last 15 years; the HDI was up and down. In the year 2003, it was ranked at 73, compared with the years 1990 and 1999 when it was ranked at 78 and 66 respectively. In a normal case, the trend should have been getting better, but Thailand failed to keep the human development index moving in the right direction. The economic crisis that took place in 1997 might have contributed to this unwanted trend (see Table 7.11).

What is striking is how much Thailand's HDI ranking exceeds its PPP GDP per capita ranking since its value is determined by taking the PPP GDP ranking minus the HDI ranking. Paradoxically, the GDP per capita (PPP US\$) rank minus HDI rank in 1999 and 2003 was –3 and –7 respectively. An increase in negative value indicates by how much Thailand's HDI ranking fell short of its PPP GDP per capita ranking. That is, Thailand has failed to achieve human development that can be expected given its level of economic progress. Thus, Thailand's PPP GDP per person ranking tends to overstate the broader level of development as measured by deploying the HDI index.

The HPI-1 is used for developing countries, while HPI-2 is used for developed (OECD) countries. HPI is a composite index measuring deprivations in three basic dimensions captured in the Human Development Index – a long and healthy life, knowledge and a decent standard of living – and also capturing social exclusion. The first is the percentage of people who might not be expected to survive to age 40. The second is the adult illiteracy rate. The third is the percentage of people without access to safe water, health care services and underweight children under five.

Table 7.10 *Income distribution of Thailand*

	1975-76	1981	1986	1988	1990	1992	1994	1996	1998	2000	2002	2004
Share of income												
Quintile 1	6.05	5.45	4.47	4.53	4.23	3.98	4.16	4.27	3.89	3.89	4.10	4.20
Quintile 2	9.72	9.26	7.85	7.98	7.43	6.93	7.52	7.69	7.19	7.19	7.80	7.80
Quintile 3	14.02	13.69	12.30	12.38	11.58	10.96	11.78	11.91	11.39	11.39	12.30	12.30
Quintile 4	20.97	21.08	20.43	20.71	19.49	18.80	19.88	19.74	19.70	19.70	20.50	20.30
Quintile 5	49.24	50.52	54.98	54.40	57.26	59.43	56.66	56.39	57.77	57.77	55.20	55.20
Gini coefficient	0.426	0.442	0.496	0.489	0.515	0.536	0.516	0.509	0.525	0.525	0.501	0.499
Q5/Q1	8.1	9.3	12.3	12.0	13.5	14.9	13.6	13.2	14.9	14.9	13.5	13.1

Sources: Tinakorn (2002) for 1975/76-2000; Office of National Statistics for 2004.

Table 7.11 HDI and HPI of Thailand

	1990	1999	2003
HDI value	0.783	0.757	0.778
HDI rank	78	66	73
PPP GDP ranking–DI ranking ^a	23	–3	–7
HPI value ^b	n.a.	n.a.	12.8
HPI rank ^b	n.a.	n.a.	28

Notes:

a. If positive, this indicates that the HDI ranking for the country is higher than the per capita PPP GDP ranking (PPP GDP rank–HDI rank > 0); if negative, the HDI ranking for the country is lower than the per capita PPP GDP ranking (PPP GDP rank–HDI rank < 0). In 1990 HDI rank minus GDP rank, but in 1999 and 2003, PPP GDP ranking minus HDI ranking instead.

b. Human poverty index.

Sources: UNDP, *Human Development Reports* 1990, 2001, 2003.

Concluding remarks

Thailand began its industrialization process with import substitution and later shifted to an export-oriented strategy. The main problems are inequality in income distribution with a more skewed pattern, an imbalanced structure of employment and production, concentration of manufacturing in Bangkok, a low level of enrolment in secondary school, and so on. The trend is not merely less impressive, but it also seems to have worsened. Export-oriented strategy is merely a trade policy, and it is not the equivalent of development strategy as such. The most serious problem lies in the role of the Thai state, which practises a *laissez-faire* philosophy. The Thai state wishes that the magic of the market could lower income inequality and maintain high economic growth. In fact, manufactured exports reap profits with the help of the Thai state through BOI and other protective institutions, while the agricultural sector bears the burden of industrialization. Foreign investment helps to hasten economic growth and induce the rural poor to migrate to the city. There is little doubt that Thailand appears to enjoy high growth compared with other developing countries in Asia, but lags behind in the real meaning of economic development.

Economic development, which is a historical process, is closely related to the initial conditions that are pertinent to Thailand in terms of land abundance. As a result, the Thai elites were keen to tap natural resource rents to such an extent that resources have dwindled to a critical level. It is often cited that there is a need for new technologies that will raise the agricultural and industrial sectors to a high level in order to sustain economic growth. In fact, Thai society must also traverse a particular dynamic path. In order to do so, it needs a benevolent state to pave the way to a new key institution to bring about economic growth and equity. However, attempts to find such an institution have so far not been successful due to Thailand's historical and institutional context, which appears to have hindered rather than promoted any positive substantial changes in the last 50 years.

Thailand needs to be more proactive in moving towards more skill and technology-intensive activities as it faces competition from other labour surplus countries in the region. This would require investment in higher and technical education and research and

development. For well-known reasons of market failure in education and R&D, the state needs to be active in these areas.

Since 2001, the political market has been changed to be more stable under the Thai Rak Thai Party, led by Prime Minister Thaksin Shinawatra (a billionaire telecommunications magnate). This new party won strong support among Thai voters, in particular, rural voters. The fact is that the party has retained a large majority in the parliamentary elections since February 2005. This can be seen as a very new political platform in Thai politics in which only one party can form a civil government. It is believed that the Thaksin administration is continuing a series of neopopulist policies, the so-called Thaksinomics. For instance, 'One *Tambon* (village) One Product' project, the suspension of farmers' debts, the establishment of a people's bank, the 30-baht medical scheme for all Thai people to get access to medical treatment, and other numerous support measures for small enterprises, were also adopted in the first term. The second term agenda includes Megaprojects (very large infrastructure projects) and pro-poor policies. Furthermore, the Thaksin administration has been very active in following the ideology of the Washington Consensus in terms of full trade liberalization. On this external front, the incumbent government is extremely active in negotiating and signing bilateral free trade agreements with developing and developed countries. However, the negotiation of a free trade agreement between Thailand and the United States has become a big controversial issue in the country.

The vital issue for the next few years will be centred on the Megaprojects and pro-poor policies, which badly need to be financed by substantial government expenditure. As mentioned before, the Thaksin administration has been keen enough to use non-budgetary expenditures to finance all these neopopulist projects, which might result in a debt crisis if economic growth collapses due to subdued export growth. Moreover, under the Thaksin government, the role of the press has been restrained. This compounds the administration's questionable credential in controlling rampant rent-seeking and corrupt activities. The Thaksin family itself has become embroiled in corruption scandals involving the sale of its telecom business, which has sparked widespread political unrest.

Notes

1. According to the much-cited studies of Young (1995), the contribution of TFP to growth in East Asia over the period 1960–85 varied from 2.5 per cent in Hong Kong to 0.1 per cent in Singapore. Sarel (1997) puts this range from 2.23 per cent for Singapore to –0.78 per cent for the Philippines.
2. By using an export tax return, such as export bans and quotas, the price of rice was always kept below the world market price. Thus, the premium became not just a source of government revenue, but also prevented Thai farmers from gaining business. Additionally, rice being the main wage good (a staple), the policy of keeping rice below the world price helped the government to maintain a low wage rate policy (see Siamwalla, 1995).
3. Non-budget policy means that the expenditure proposals do not need to be scrutinized by Parliament. They can be implemented directly by the incumbent government.
4. The current account deficit was 5.2 billion baht in 1970 (3.5 per cent of GDP), 42.4 billion in 1980 (6.4 per cent of GDP).
5. The rate was set at 21 baht per dollar during 1955–81 (before 12 May 1981). On 12 May 1981, the Bank of Thailand devalued the baht 1.1 per cent to 21 baht per dollar and on 15 July 1981, 23 baht per dollar.
6. The export tax on rice conditionally ceased in 1986 because of the sluggish price of rice in the world market.
7. This partly explains why Thai farmers preferred extending cultivated land instead of intensifying the cultivation methods.
8. The prime minister is the Chairman of BOI and the minister of industry is the Vice-chairman.

9. The stated objectives in this plan were to correct the balance of payments problems and to increase overall employment through policy measures to promote exports and adjust the import structure.

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Further reading

- Glassman, Jim (2004), *Thailand at the Margins: Internalization of the State and the Transformation of Labour*, Oxford: Oxford University Press.
- Glassman's book is important in several ways. First, Glassman develops a Marxist analysis and raises significant questions regarding the concept of weak and strong states. Glassman prefers an approach that recognizes the internationalization of both capital and state. Second, Thailand's industrialization is analysed in its regional context, meaning that Thailand's development is part of processes that also involve Japan, South Korea, Taiwan and China. Finally, Glassman claims that the chronic decline in profit due to very fast increases in real wages in excess of labour productivity growth is the main fundamental cause of the Thai crisis in 1997.
- McCargo, Duncan and Ukrist Pathamanand (2004), *The Thaksinization of Thailand*, Copenhagen: Nordic Institute of Asian Studies.
- This book examines Thaksin's background, his business activities, the emergence of Thai Rak Thai, and his relationship with the military.
- Ockey, James (2004), *Making Democracy: Leadership, Class, Gender, and Political Participation in Thailand*, Honolulu, Hawaii: University of Hawaii Press.
- This book is a collection of articles, published elsewhere. One key theme is a critique of modernization theory which has been dominant in explaining democratization in the Third World. In his view, the emergence of democracy in Thailand does not conform to modernization theory. In fact, he argues that domestically-oriented political participation in Thailand has always been strong at the local level, thus providing a strong basis for democratization.
- Pasuk, Phongpaichit and Chris Baker (2004), *Thaksin: The Business of Politics in Thailand*, Chiang Mai: Silkwood Books.
- This book is about how the Thai prime minister of Thailand, Dr Thaksin Shinawatra (Chinnawat), became the prime minister from being a businessman in telecommunication. The book proceeds chronologically from Thaksin's early years until his rise to the premiership of Thailand. It claims that the Thaksin phenomenon is not only unprecedented but may also be a threat to Thailand's democratic consolidation.

8 The Philippines

Joseph Anthony Y. Lim

Pre-war economic history

The Philippines was a Spanish colony for more than 300 years from around 1565 to 1570 (the conquest period) to 1898. Spain subjugated a diverse and divided set of peoples ranging from large Muslim societies to scattered animist tribes in both upland and lowland areas. The Spanish colonial authorities and friars ruling the land vigorously effected the Catholicization of the country, but hardly educated the main bulk of the population. Economically, the archipelago, especially the main port of Manila, was initially used in the seventeenth and early eighteenth centuries as the Asian end of the Manila–Mexico galleon trade, where exotic products from China and other parts of the Far East were traded with Spanish and Latin American products. In the eighteenth and nineteenth centuries, the Philippines participated in international trade with the Spaniards, forcing the natives to produce tobacco, sugar and coconut products. The Spaniards implemented a feudal landed system, initially administered by friars and Spanish colonial authorities, but which in the late nineteenth century began to be leased and managed by Spanish and Chinese *mestizos* (people who have a mixture of Spanish/Chinese and Filipino native blood). These *mestizos* were used by the Spanish authorities and friars as the educated Filipino elite class to help to administer the natives. Many peasant landholdings were either appropriated through land grabbing, indebtedness or sold to the elite class. The feudal landed system became the precursor of the current unequal land system in the Philippines that had bred centuries of peasant unrest and clamour for land reform.

The Filipino elite and the Filipino masses together launched a moderately successful revolution against the Spanish authorities, but the Spanish-American War of 1898 brought the Americans into the country before the Filipino revolutionaries were able to wrest complete control of the archipelago from Spain. (A Philippine republic was proclaimed by Philippine revolutionary forces on 12 June 1898.) The arrival of US forces led to the bloody decade-long Philippine-American War, which ended with the Americans taking over the country until the Japanese invasion in 1941. The Americans implemented ‘free trade’ in the country, but this hardly helped the Philippine economy since there were no real industries before the 1940s, except for the export crops and scattered manufacturing sectors. The Americans bought the friar lands, which eventually ended up in the hands of the Filipino elite. The agrarian and land problems were not tackled and the inequitable situation persisted.

In 1935, the Philippine Commonwealth was established, with the Americans promising the Philippine elite in the newly constituted Philippine executive and legislative branches that eventually full Philippine independence would be granted. The Americans established public schools in the populated areas, but strictly controlled nationalist ideas and sentiments.

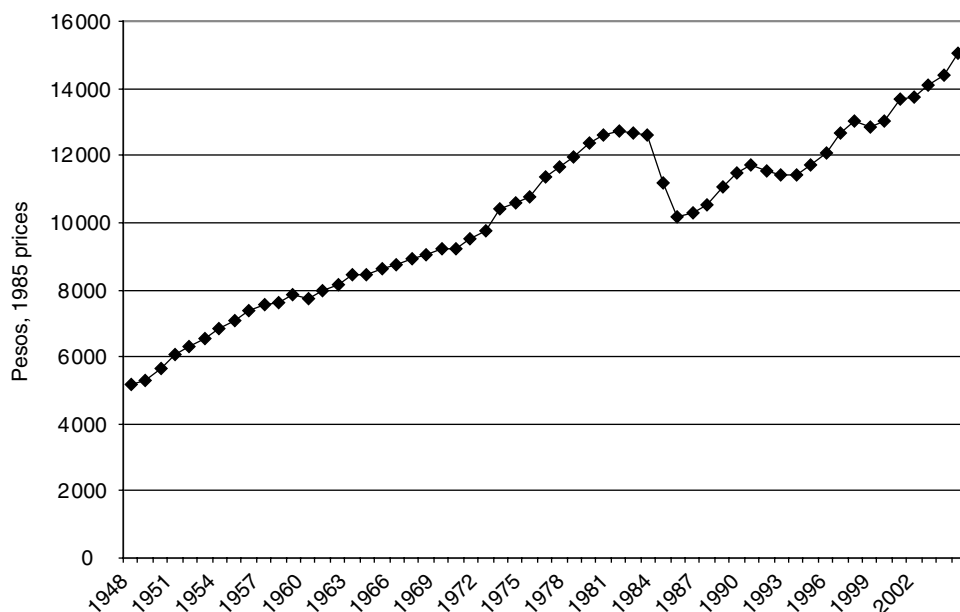
The defeat of the Japanese forces by US and Filipino guerrilla forces in 1945 led to the United States’ granting of Philippine independence on 4 July 1946.

Periodic recessions and stagnation

The modern post-war economic history of the Philippines is one that is marked by frequent economic and political crises that led to periodic economic downturns or stag-nations. As can be seen from Figure 8.1, between 1946 and the early 1980s, there was a steady increase in GNP per capita, except in the slight stagnation/recession years of 1958, 1960 and 1970. But beginning in 1983 to the present, the Philippine economy has been very volatile and has been experiencing periodic recessions and stagnation – in 1983–85, 1991–93 and 1998. These periods, especially the economic collapse in the mid-1980s, killed the chances of the Philippines to join the ranks of Singapore, Hong Kong, Taiwan, South Korea, Malaysia, Thailand and China in becoming an East Asian success story.

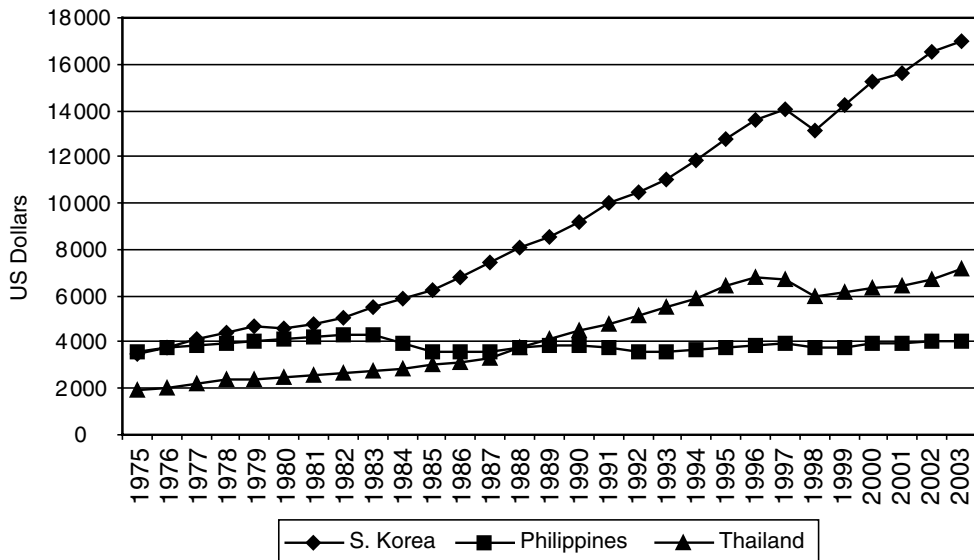
Figure 8.2 shows gross domestic product (GDP) per capita in purchasing power parity (PPP) 2000 US dollar prices for the Philippines, South Korea and Thailand. From a starting base in 1975, where this measure of Philippine GDP per capita was higher than that of South Korea and Thailand, the Philippines was quickly overtaken by South Korea in 1977, and by Thailand in 1989. In terms of constant 2000 purchasing power parity US dollars, the Philippines seems to have been stuck at a per capita GNP of US\$4000 or below from 1984 to 2003.

Figure 8.3 shows that the Philippines' economic problems are related to depleting inter-national reserves (expressed in Figure 8.3 in number of months of imports), or balance of payment difficulties. Thus, as we shall see below, significant drops in international reserves immediately precede or accompany economic crises in 1949, 1957–61, 1969–70, 1983–85, 1990–91 and 1997–98.



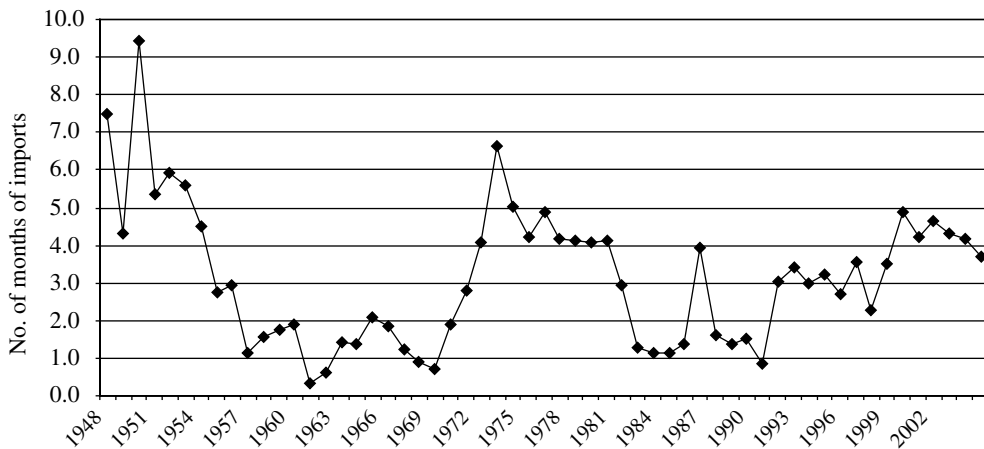
Sources: National Statistics Coordination Board (NSCB), Philippines; International Monetary Fund (IMF), *International Financial Statistics* (IFS); author's calculations.

Figure 8.1 GNP per capita 1985 prices



Source: World Bank, *World Development Indicators*, various years.

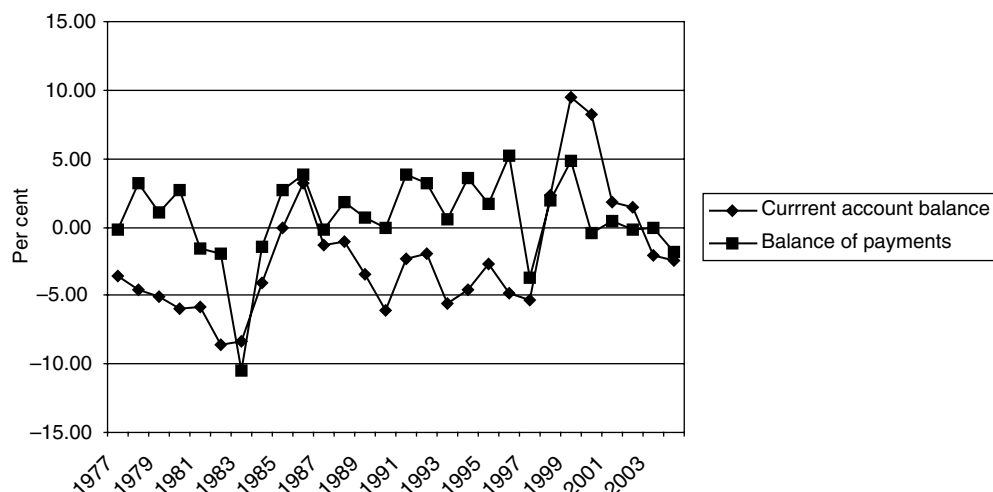
Figure 8.2 GDP per capita, PPP (constant 2000 international \$)



Sources: IMF, *International Financial Statistics* (IFS); author's calculations.

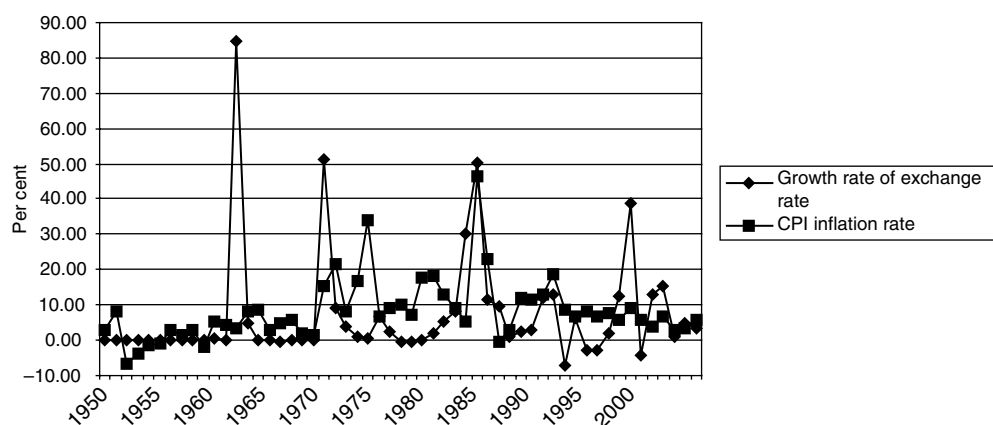
Figure 8.3 International reserves in months of imports

Figure 8.4 shows the current external account and the external balance of payments (as percentages of GDP) from 1977 to 2004. The main pattern had been the following. During the good growth years, the current account (made up essentially of the trade balance plus remittances of Philippine overseas workers less interest payments for foreign debt) deteriorates due to the import and debt dependence of the economy. This is propped



Source: IMF, *International Financial Statistics* (IFS); author's calculations.

Figure 8.4 Current account and balance of payments, % of GDP

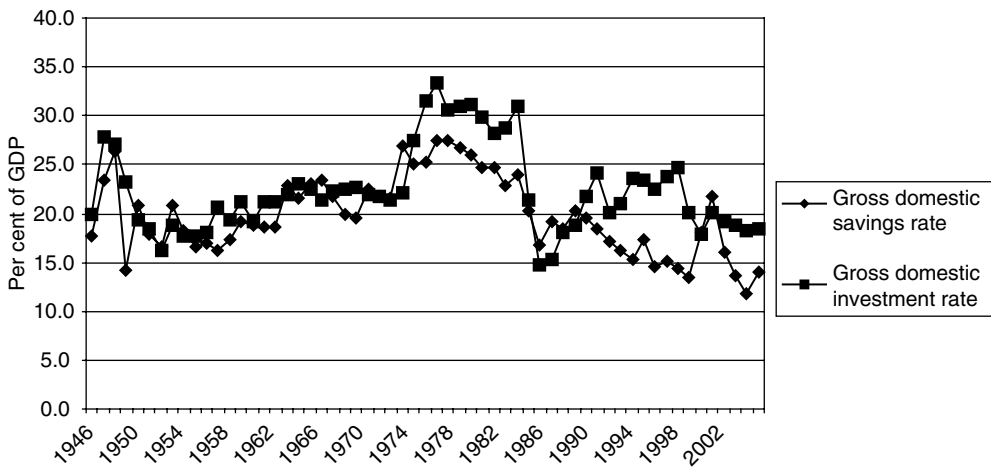


Source: IMF, *International Financial Statistics* (IFS).

Figure 8.5 Growth rates of exchange rate and consumer prices

up by net capital flows (mainly in the form of foreign loans and slight foreign investments in the 1970s and 1980s, plus portfolio flows during the 1990s). But the current account deterioration ends up in an economic crisis, which leads to capital flight and a fall in the balance of payments as well. This is clear for the years 1984 and 1998, and, to a lesser extent, 1991 (all crisis and recession years).

Figure 8.5 shows that the exchange rate depreciates during each foreign exchange crisis, as in 1962, 1970, 1983–85, 1990–91, 1998, 2001–02. The devaluations are usually accompanied in the same year or the following year by substantial inflation rates of consumer



Source: National Statistics Coordination Board (NSCB); author's calculations.

Figure 8.6 Gross domestic savings and gross domestic investment, % of GDP

prices. Figure 8.5 also shows that the inflationary periods (above 10 per cent) are caused by either major devaluations or world oil price shocks – the latter happening in 1973–74, 1979–80, and 1990–91 (and is happening again from 2005).

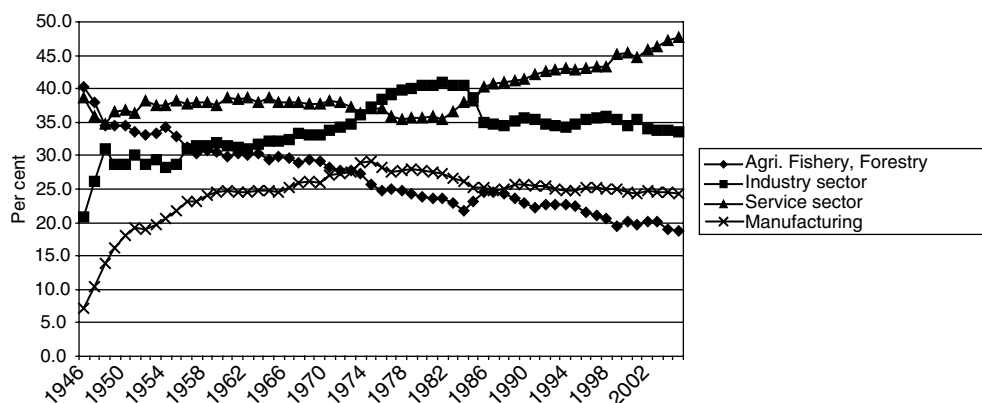
Current account deficits that trigger economic crises are signs of a structural problem in the Philippines and is manifested in the perennial investment–savings gap as shown in Figure 8.6. The large gap before the economic collapse in the mid-1980s and again before the Asian Crisis recession of 1998, show the structural problem of the Philippines as partly one of very low savings compared with the financing needs of investments. This problem has reappeared in recent years as the Philippines has entered another savings–investment deficit period.

A macroeconomic history: 1946–2005

1946–61: post-war rehabilitation, crisis and import-substitution period

The rehabilitation of a war-devastated Philippines relied completely on US Marshall Aid. The first balance of payment crisis of the Philippines occurred in 1949 when the Marshall Aid money was spent by the government and the private sector on high import spending. A political crisis also ensued as the Hukbalahap (a powerful Filipino guerrilla force with a communist bent, focusing on peasant grievances and unrest) started a rebellion when they were not allowed to participate in the new Philippine government.

With a foreign exchange crisis and a rebellion in Central Luzon, just outside the gates of Manila, the strategy of the Philippine government and its US ally consisted of the following: (1) import and foreign exchange controls that stimulated Philippine industries and led to a strong decade-long import substitution period; (2) the promotion and successful election of a populist president, named Ramon Magsaysay, to stave off mass support for the communist rebels; (3) the opening up of Mindanao (the second largest island in Southern Philippines, which was largely a Muslim-dominated area) to Christian settlers to ease the land problems and peasant unrest in the other parts of the country. The influx



Source: National Statistics Coordination Board, Philippines.

Figure 8.7 Shares of agriculture, industry, service and manufacturing

of Christian settlers into Mindanao continued till the 1970s and sowed the seeds of the current Palestinian-type religious conflict in southern Philippines.

The highest growth rates in Philippine history were recorded in the first half of the 1950s with the rise of import-substitution industries. The Philippines was largely seen as the front-runner to achieving successful development in East Asia. Figure 8.7 shows the significant jump of the share of manufacturing from 7 per cent of GDP in 1946 to close to 25 per cent by the end of the 1950s. This accompanied the start of the significant decline in the share of the agricultural sector that continues to the present.

However, the expected successful 'take-off' of the economy under this industrialization strategy failed to materialize, as the strategy failed to achieve backward linkages due to a domestic market that remained small due to a lack of re-distributive efforts (especially a lack of genuine re-distributive agrarian reform), a lack of cohesive industrial strategy, and corrupt practices in the issuance of import licensing, as alternating governments used this monopoly power to expand their rent-seeking activities. But perhaps the strongest manifestation of the failure to take off was the strategy's continued dependence on imported raw materials, intermediate inputs and capital equipments. This import dependence and an overvalued peso made sure that trade and current account deficits became the rule. Figure 8.3 shows the resulting decline in international reserves throughout the 1950s, culminating in the intense balance of payment crisis from 1957 to 1961. Pressures to devalue the peso became difficult to stave off.

1962–70: trade and foreign exchange liberalization, entry of IMF and another BOP crisis

A regime defending the import-substitution strategy was replaced in 1962 by a new government calling for trade and foreign exchange liberalization.¹ The peso was devalued and IMF help was sought, and, from this period on, the IMF would be instrumental in designing economic policies for the Philippines. It is ironic that the Philippines, which has been and remains the most obedient to traditional, conservative economic policies of the multi-lateral institutions among the countries in the region for the longest period, would

become, starting in the 1980s, one of the least economically successful among the non-transition economies in the region.

The improvement of the balance of payments and international reserves (see Figure 8.3) was short-lived from 1962 to 1965. The first Marcos government immediately undertook high infrastructure spending with borrowed money from the World Bank and other multilateral institutions.

The Philippines entered another BOP crisis in 1969–70 as foreign debt began to bunch up and as trade deficits continued. Marcos campaigned for a second term with the promise not to devalue the peso, and won his second elected term in office in 1969.

In 1970, the Philippines immediately entered another IMF-sponsored structural adjustment programme that called for another big devaluation, and a stronger outward-oriented strategy.²

Authoritarian rule and martial law: 1971–81

Marcos's martial law government (the writ of habeas corpus was suspended in 1971 and martial law was declared in 1972) made a strong attempt to impress the world with high economic growth, using borrowed multilateral funds and petrodollar money from foreign banks in the period of 'debt-driven growth'. The infrastructure spending spree continued until the late 1970s.

This period survived the first oil price shock in 1973–74. It was also marked by an inconsistent implementation of an outward-looking strategy combining export promotion with the protection of economic sectors run by close Marcos allies. Unlike South Korea, there were no performance-based incentive schemes for both the export-oriented and domestic-oriented firms.

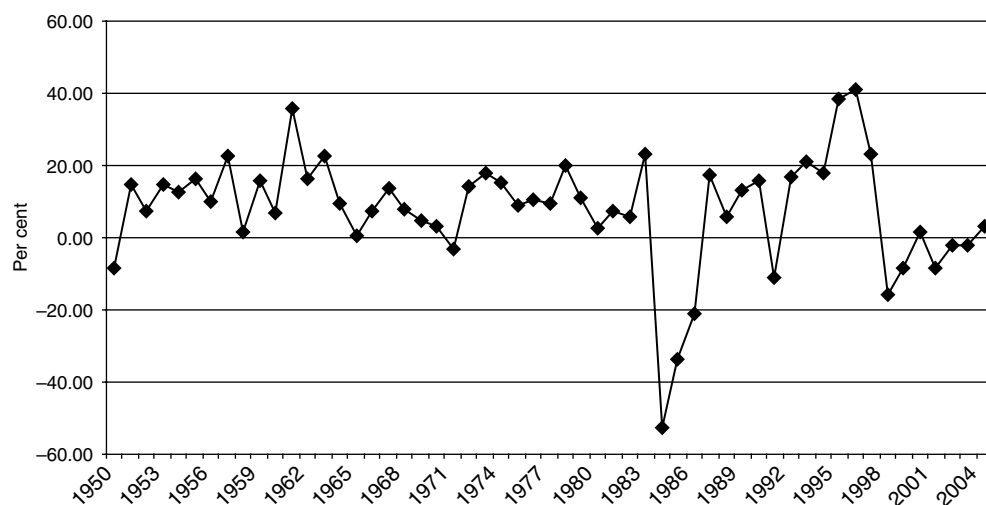
1981–83: economic slowdown; 1984–85: economic collapse

The foreign debt crisis that started in Mexico and Brazil in 1982 took its toll in the Philippines as long- and medium-term debt access was virtually cut off and short-term debt instruments were obtained at exceedingly high interest rates. In July 1983, the peso was allowed to depreciate by 10 per cent to ease the foreign exchange pressures. On the local front, increasing unrest and disenchantment with Marcos's dictatorial style and cronyism (as the economic conditions became more difficult) was turning into a slowly igniting powder keg.

These set the stage for the worst BOP and economic crisis in the third quarter of 1983, two years after the start of the world recession and about a year after the eruption of the Latin American foreign debt crisis in Mexico and Brazil. In October 1983, a moratorium on external debt payments was declared.

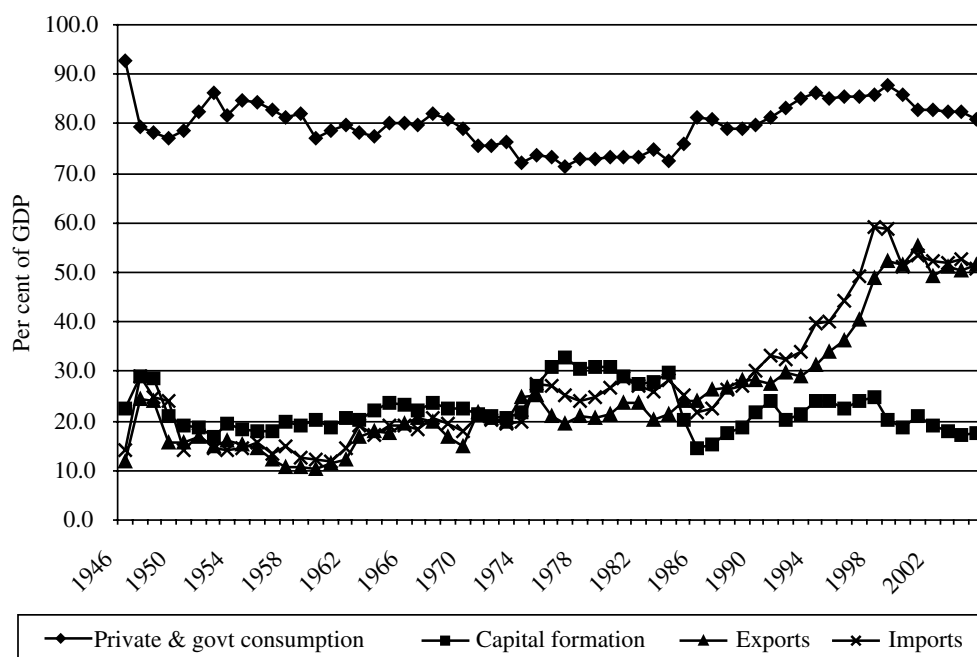
The policy-makers followed a very monetarist response prescribed by IMF programmes. Draconian tightening of liquidity and credit was effected from 1984 to 1986 to stem capital outflows and to control rising prices resulting from the sharp currency devaluations. Figure 8.8 shows that cutbacks in the real value of domestic credit to the private sector (as a response to financial crises) became very severe starting in 1984. The same policy was repeated in succeeding crises such as in 1991 and 1998.

Credit tightening, loss of confidence and the sharp devaluation led to closures of firms and work stoppages in key industries. The effect of this depression was perhaps more than what Indonesia experienced in 1998. Gross domestic savings and gross capital formation



Source: IMF, *International Financial Statistics* (IFS); author's calculations.

Figure 8.8 Growth rate of real domestic credit to non-financial private sector



Source: National Statistical Coordination Board (NSCB).

Figure 8.9 Demand component shares of GDP

fell precipitously (Figure 8.6), never to recover the rates achieved in the early 1980s. Decapitalization occurred as investments fell short of the amount needed to meet depreciation needs. As Figure 8.9 shows, the biggest victim from the demand side of the severe economic collapse of the mid-1980s was the investment (capital formation) share. This share had gone up to around 30 per cent in the late 1970s and early 1980s (close to the investment share of the successful economies of East Asia). The economic collapse brought this down to less than 15 per cent in 1985. Ever since then, the periodic recessions/stagnation (in 1991–93 and 1998) and the volatile economic and political situation in the Philippines prevented this share from recovering to its pre-economic collapse levels before 1984.

As investment share fell drastically in 1984–85, the share of consumption increased. This is the same phenomenon as the collapse of the share of gross domestic savings shown in Figure 8.6. The increase in consumption share and fall in savings share is easily explained by the fact that for lower income economies (like the Philippines and Indonesia), recessions usually lead to smaller declines in consumption compared with savings (decreases in incomes lead people to cut more on savings than on consumption).³ Data on poverty and income distribution of the Philippines also show that poverty rates and income distribution worsen with recessions, as they definitely did in the economic collapse of 1984–85.

Also victims of the economic collapse in the mid-1980s were the industrial and manufacturing sectors. Manufacturing reached its peak in the mid-1970s while industry's share grew until the early 1980s. The economic collapse in the mid-1980s led to the collapse in the shares of the industrial and manufacturing sectors (Figure 8.7), including the collapse of the construction sector. The boom–bust cycles and crisis-ridden economies in the succeeding decades ensured the stagnation of the industrial and manufacturing sectors' shares. There is even a slight downward trend in industrial and manufacturing share during the next few decades, as Philippine manufacturing and industry did not compete well with foreign products in the globalization period. Just like agriculture, the industry sector failed to 'take off' before its share declined. A clear evidence of the industrialization failure can be traced to the industrial and manufacturing decline in the mid-1980s, and its stagnant growth in the decades thereafter.

GNP per capita contracted by almost 20 per cent from 1983 to 1985. This brought the economy back one full decade and, as mentioned earlier, killed the country's chances of becoming an East Asian success. The assassination of Marcos's main political opponent and the ensuing protests and civil unrest led to capital flight, massive devaluation and inflation.

Even with the sharp economic and monetary contractions in 1984–85, the inflation rates rose to enormous heights, fuelled partly by the devaluation processes, and partly due to the perverse rise in prices of credit-dependent firms because of sharp interest hikes and credit shortage brought about by the extreme monetarist policy. It was only in 1986, when the economy hit rock bottom, that inflation fell to zero and (briefly) negative levels. External deficits also improved as imports collapsed together with the economy.

Deteriorating financial conditions, very similar to what happened to the hard-hit countries in the Asian Crisis, brought non-performing assets into the lap of the Central Bank and state-owned banks. It took a long while to finally dispose of these assets, to rehabilitate the financial sector and government financial institutions, and finally, to re-establish a new Central Bank that was not seriously debt-strapped.

1986–89: recovery period; 1990–93: slowdown, recession and power shortages

The Marcos government, hit by political and economic turmoil, was overthrown by a people-power revolution following a presidential election largely perceived to be rigged by Marcos. Marcos's main opponent in the election, Corazon Aquino (the widow of slain oppositionist Benigno Aquino) assumed power.

It is important to note that the crisis prompted policy-makers under the new government to seriously institute structural adjustments as pushed by the IMF and the World Bank. The disastrous Marcosian interventions were seen as proof that market liberalization, deregulation and privatization would be the appropriate economic policies. Among these were the lifting of import restrictions in May 1986, tax reforms and large-scale privatization of state-owned enterprises (Lim and Montes, 2000). The economy slowly and partly recovered towards the end of the 1980s with the IMF's assistance, but not without a lot of difficulties with the debt overhang and political instabilities.

In the 1986–89 recovery period, replacement investments and consumption were the primary sources of growth followed by significant increases in public investment financed by domestic borrowing. Private investment also began to rise starting in 1986 until 1991 when another recession occurred.

In the later part of the 1980s, increases in investment rates and the government's pump-priming programme allowed capacities and demand to grow. However, the growing fiscal and external deficits became unsustainable in 1989 and 1990, especially since the debt overhang of the foreign debt crisis continued, with the government assuming most of the private debts. To steer the economy away from the external and fiscal crisis (accompanied by rising double-digit inflation rates), the government, again under IMF supervision, adopted a tight monetary policy, cut spending and raised indirect taxes. Monetary cutbacks were undertaken and interest rates climbed back to over 20 per cent in 1990 to 1991, while fiscal spending was also cut to trim the budget deficit (and pay the debts). Monetarist policies made sure again that domestic credit would fall in 1991 amidst outgoing external debt flows due to the overhang (see Figure 8.8). Thus, a recessionary situation was created.

The series of right-wing military coup attempts against the Aquino government, culminating in a nearly successful one in December 1989, further eroded business confidence. This and the high oil prices and devaluations, partly attributed to the first Gulf War, aggravated the demand cutbacks and led to a slowdown beginning in 1990. In 1991, economic recession occurred with GDP declining.

Economic recovery was not in the near horizon as power shortages, a result of lack of economic foresight and management, which started in the late 1980s, intensified in 1992 and lasted until the first half of 1993.

1993–98: tariff reduction and capital account liberalization; growth followed by contagion from the Asian Crisis

A new administration under Fidel Ramos, which started in 1992, moved from lifting import restrictions (which was virtually completed in the early 1990s) to genuine tariff reduction. This was facilitated by locking the country into international agreements committed to opening up the economies to international trade and investment regulation: the ASEAN Free Trade Area (AFTA), World Trade Organization (WTO) and the Asia-Pacific Economic Cooperation (APEC). Throughout the 1990s, the Philippines unilaterally reduced the tariffs of many items and set them even below the bound rates required in the agreements.

Figure 8.9 shows that export and import shares grew at an unprecedented pace during the opening up (globalization) period, starting in the late 1980s up to the Asian Crisis, with their share exceeding 50 per cent since 1998. But the post-Asian Crisis period saw a stop in the upward trend of the trade shares and a stabilization of the export and import shares at just over 50 per cent.

Capital account liberalization was initiated in 1991 and fully achieved in the last quarter of 1993. A new Central Bank was formed with its large debts erased (and assumed by the national government).

The fast-track building of hydroelectric plants (which would later lead to higher electricity costs for the country), the success of the Brady Plan in reducing foreign debt payments, the creation of the new debt-free Central Bank and the recovering economy during the first four years of the Ramos administration, provided the backdrop of the 'irrational exuberance' and 'over-optimism' that capital account liberalization can bring about. The stock market boom and the 'emerging market' syndrome started in 1993 and continued until the Asian Crisis, with the stock market index peaking in early 1997, a few months before the outbreak of the crisis.

During this period, high growth was spurred by credit expansion, looser interest rates and improving fiscal position. Real appreciation of the peso occurred as capital inflows intensified until the second quarter of 1997. The switch to positive fiscal balances, falling inflation rates and continuing foreign capital inflows fuelled even more optimism for the Ramos growth strategy.

But all indicators were not bright. First, the external sector continued to register sizeable current account deficits during this period (see Figure 8.4). On the other side of the coin, the investment-savings gap in the mid-1990s widened (Figure 8.6).

As is well known by those acquainted with the Asian Crisis, the foreign inflows that came in were largely in the form of short-term debts and portfolio investments that poured in after the capital account liberalization. These unhedged dollar borrowings (used to finance real estate, construction, speculative and manufacturing activities), as well as 'hot money', provided the classic key ingredients to the Philippine participation in the Asian Crisis. This included the rise of speculative bubbles in the financial and real estate sectors, and their bursting once the Thai devaluation and financial outflows infected the region.

The crisis, in addition to the El Niño weather phenomenon that had detrimental effects on agriculture, halted the growth episode and GDP growth declined in 1998. The Philippines reacted to the Asian Crisis in typical fashion, as did most of the other affected countries. Attempts to defend the currency by using international reserves, raising Central Bank repurchase rates and liquidity reserve ratios failed to stem the daily currency depreciations, but only hastened the loss of confidence and the deterioration of the quality of loan portfolios. In addition to the very strong monetary tightening in 1998, the IMF programme required the economy to attain a fiscal surplus during the crisis, which obviously could not be complied with and eroded confidence even more. These responses, as in the other countries, ensured a recession in 1998 and the weakening of the financial and real sectors.

The politically volatile current period: 1999–August 2005

Political volatilities during the Estrada administration ensured that the recovery from 1999 to 2001 would be lacklustre, with GDP growth rates averaging less than 4 per cent for these three years.

2001 was a low-growth year as the Estrada government was rocked by a scandal involving illegal gambling that reached the president himself, who was forced out of office by another people's revolt, finally backed by the military forces. He was replaced by the Vice-President, Gloria Macapagal-Arroyo. The Arroyo government in turn has been rocked by coup rumours and political scandals.

The low confidence in the Philippine economy is shown by the developments in balance of payments and exchange rate movements (Figures 8.4 and 8.5). Despite current surpluses from 1999 to 2002, the balance of payments was below current account balances, indicating net capital outflows during this period. The exchange rate was volatile during this period, with a tendency for depreciation, despite worldwide appreciation of currencies vis-à-vis the dollar.

The inability to return to the high growth period of the mid-1990s happened despite lower interest rates and looser monetary policies. It must be pointed out that with the lower inflation figures and low financial confidence that resulted after the Asian Crisis, it is understandable that the monetary policy had been quite lax in the late 1990s till the present.

GDP growth quickened in 2002 and 2003 to more than 4 per cent, reached a high of 6.2 per cent in 2004, but quickly slowed back to below 5 per cent in 2005. But despite these improvements, major structural and governance problems facing the country remain, as will be discussed in a later section.

Social indicators and social policies

Social indicators compared with neighbouring countries

As can be seen from Table 8.1, the performance of the Philippines, as compared with Indonesia, South Korea and Thailand, in social developments is mixed. The Philippines

Table 8.1 Some social indicators of Indonesia, Korea, Philippines, Thailand

Social Indicator	Indonesia	Korea	Philippines	Thailand
	(2002)	(1998)	(2000)	(2000)
Income share held by highest 10%	29	22	36	34
Income share held by highest 20%	43	37	52	50
Income share held by lowest 10%	4	3	2	3
Income share held by lowest 20%	8	8	5	6
Poverty headcount ratio at US\$2 a day (PPP) (% of population)	52	2	47	32
	(2002)		(1998)	(1995)
Malnutrition prevalence, weight for age (% of children under five)	27	n.a.	32	18
	(2003)	(2003)	(2003)	(2003)
Life expectancy (years)	67	74	70	69
	(2002)		(2000)	(2000)
Literacy rate (percentage of age 15 and above)	88	n.a	93	93

Source: World Bank, *World Development Indicators*.

and Thailand have the most unequal distribution compared with the other two countries in the region. The relatively bad income distribution in the Philippines is the result of the lacklustre performance of agrarian reform programmes, the regressive nature of the Philippine tax system, the government's inadequate social services and the lack of social insurance and public safety nets for the population.

With respect to the poverty rate, the World Bank's poverty measure – the percentage of the population living below US\$2 (purchasing power parity) income – reveals that the Philippines and Indonesia have high poverty incidences compared with South Korea and Thailand. The Philippines is not doing well here considering that Indonesia is classified by the World Bank as a low-income country, while the Philippines, like Thailand, is classified as a lower middle-income country.

The Philippines fares worst among the four countries with respect to the prevalence of malnutrition among children under five years of age. However, the Philippines does well in other social indicators such as life expectancy and literacy rates. The mixed results for the Philippines are a manifestation of the Philippines' inability to go into rapid economic development and take-off as other countries in East and Southeast Asia, the government's inability to provide social insurance and public safety nets, which are mitigated to some extent by the existence of private 'social safety nets' consisting of the extended family system and the remittances of Filipino overseas workers to their families.

It must also be pointed out that the Philippines does comparatively well with some gender indicators, with female life expectancy higher than the male and female literacy rate equal to that of the male. However, female labour force participation rates are much lower than the male (though increasingly higher over time) and female unemployment rates are higher than the male. The more professional jobs (managers, engineers, doctors) are also dominated by males while many lowly paid service workers (such as salespersons in retail trade, domestic workers, public school teachers) are dominated by women.

Social policies and fiscal constraints

The Philippines does not have many public safety nets or social insurance schemes for the poor and vulnerable. There are no unemployment benefits. Social security and health insurance have limited coverage and are available mainly to permanent workers in the formal sector. However, the majority of Filipino workers are either in the informal sector or are casual workers in the formal sector, and therefore are not covered by social security and health insurance.

The recent development plans of the government paid more attention to social justice and protecting the poor and vulnerable. Some of the plans and programmes of the government include policies to reduce the cost of medicines, coming up with an outpatient health insurance scheme for indigents, and increased social welfare services. However, these programmes still have not had a significant impact.

One of the main problems is the tight fiscal constraint binding the government. Table 8.2 gives us the real national government expenditures per capita on the different expenditure items.

One can see that:

1. Each economic crisis and recession is accompanied by fiscal cutbacks, which aggravate the difficulties of the poor and vulnerable during economic crises and recessions.

Table 8.2 Real national government expenditures per capita in 2000 pesos

Particulars	1980	1985	1990	1993	1997	1998	2000	2001	2002	2003	2004
Economic services	2444	1204	1920	1561	2223	1957	2207	1712	1747	1862	1709
Social services	1257	924	1745	1562	2680	2649	2811	2633	2662	2604	2542
Education, culture, and manpower development	740	625	1192	941	1602	1616	1542	1473	1448	1414	1308
Health	229	191	283	169	239	205	193	165	167	136	147
Social security and labour welfare	69	34	75	79	342	344	349	335	420	429	455
Housing and community development	0	0	10	0	0	0	47	50	9	33	16
Land distribution (CARP)	139	39	24	40	41	42	109	30	33	10	75
Other social services	79	35	161	8	13	11	13	33	11	10	11
Subsidy to local government units	0	0	0	326	443	431	558	546	574	572	530
Defence	639	415	517	483	493	477	478	397	449	487	434
General public services	865	721	1099	1166	1561	1531	1617	1455	1535	1548	1415
Total expenditures excl. net lending & interest payments	5205	3264	5282	4772	6956	6614	7113	6198	6394	6501	6100
Net lending	104	149	135	64	23	5	35	85	30	62	58
Interest payments	551	852	2528	1846	1315	1509	1860	2202	2147	2482	2651
Total	5860	4265	7945	6682	8295	8128	9007	8484	8571	9044	8808

Note: The current expenditures were deflated using the consumer price indices, based on 2000 prices.

Source: Department of Budget and Management.

The impact is reduced social and economic services at the time they are most needed. This was most severe in the 1984–85 economic collapse.

2. A significantly higher real expenditure per person in social services, especially in the mid-1990s onward, compared with previous periods. The improvement holds mainly for education as well as social security and labour welfare. Per capita spending on health services, however, had declined substantially in recent years compared with pre-Asian Crisis periods and compared with the 1980s.
3. Spending for economic services also improved in the mid-1990s but this was only temporary. The fall in real spending for economic services per person after the Asian Crisis led to lower real spending per person in 2001–04 compared with the 1980s. This reflects the deteriorating state of physical infrastructure in the country, especially in the countryside and far-flung areas.
4. The recent fiscal crisis had reduced both social and economic spending per person

from the 2000 level. The current period is therefore a rare occurrence when economic growth is accompanied by fiscal constriction.

5. Interest payments on a per capita basis had reached a previous peak in 1990 and were reduced until 1997, before the outbreak of the Asian Crisis. The Asian Crisis reversed this trend and interest payments per capita are again growing amidst the current fiscal crisis, and had surpassed the 1990 level.

The crux of the current fiscal crisis is that the government's debt service – comprising principal and interest debt payments – reached 86 per cent of government revenues in 2004 – the highest level recorded. If this continues, the government will be forced to: (1) continue cutting spending on social and economic services, and (2) keep on incurring debt, which will further inflate debt service in the future. The drastic increase in value-added taxation, though painful, is addressing the inability of the government to raise funds for its expenditures, especially through direct and progressive taxation.

Prospects and challenges

The Philippines started in the post-war period as the most promising country to achieve economic 'take-off' and success. Whatever are the causes of failure, the Philippines' modern economic history proves two things: (1) market liberalization, deregulation and privatization do not provide necessary and sufficient conditions for economic take-off, and (2) economic success and development (including gaining a competitive edge in the world market) is not just a passive opening up process but requires strong and sound physical, social and political infrastructures. The political and the economic are crucial, inseparable processes that make or break a country's economic development. This section highlights some of the major challenges for the Philippines economy.

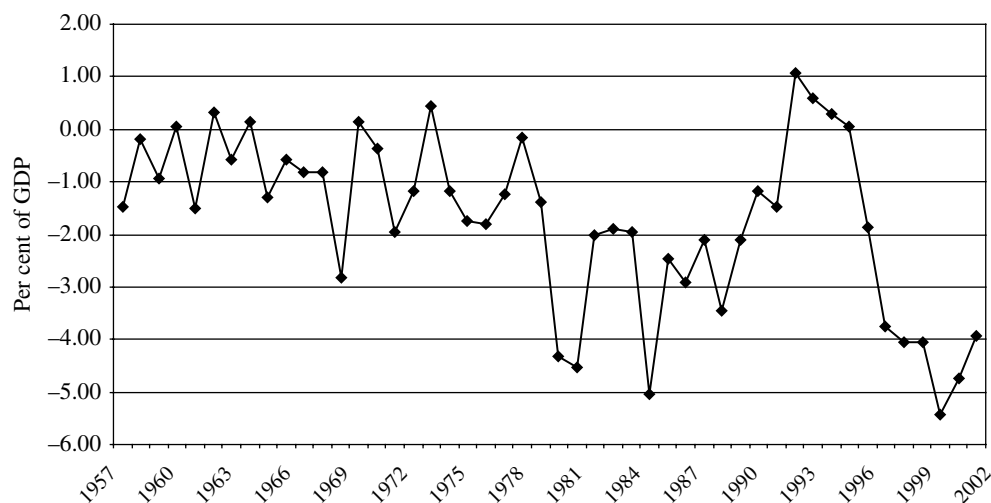
A fiscal crisis

The biggest economic challenge to the current Philippine macroeconomy is the inability of government to reduce the fiscal deficits and a growing public debt that may become unmanageable in half a decade.

It is clear that the Philippines had very little experience with fiscal surplus (Figure 8.10). This, however, was achieved by the Ramos administration before the Asian Crisis (1994–97). The Asian Crisis brought fiscal deficits back. The fiscal deficits in Figure 8.10 from 2000 onwards underestimate the problem, and do not include the deficits of government corporations, which ballooned recently due to big losses, especially from the National Power Corporation (and add at least one percentage point to the total public deficit). These losses are absorbed by the national government. Furthermore, total public debt grew to around 100 per cent of GDP. Thus the improvements in the fiscal deficits in 2003 and 2004 have not removed the perception of an impending crisis.

Another fact that reinforces the perception of an impending crisis is the fact that the economic recovery from 1999 to the present failed to improve tax efforts. The revenue effort, which peaked at around 20 per cent of GDP in 1996 and 1997, has consistently fallen since then and was below 15 per cent in 2002 and 2004. The falling tax and revenue effort, despite significant GDP growth, forced the government to undertake substantial tax reforms to respond to the continuous downgrading of the sovereign debt from the rating agencies.

Until the time of this writing (September 2006), treasury bill rates have not gone up



Sources: IMF, *International Financial Statistics* (IFS); author's calculations.

Figure 8.10 National government balance, % of GDP

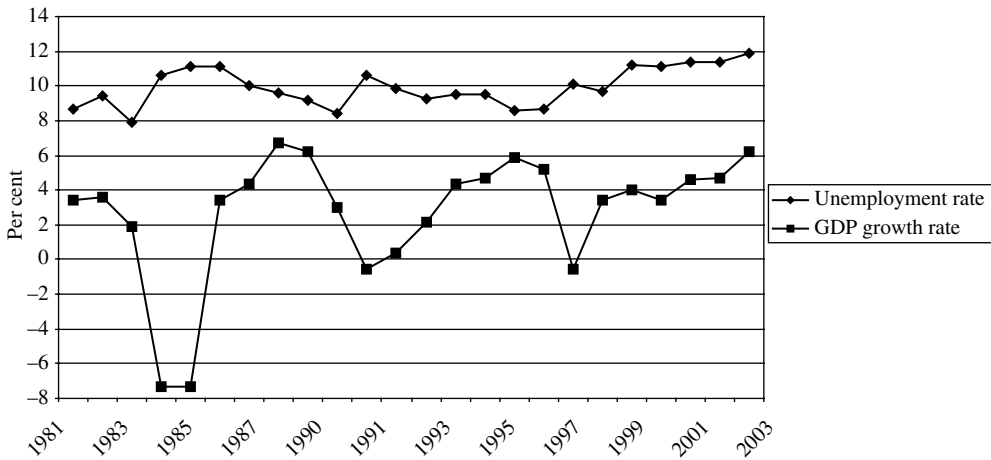
much despite continuing fiscal deficits due to the high liquidity in the system (banks prefer to invest in government securities rather than in financing loans). The tax reforms, especially the increase in value-added tax rates from 10 per cent to 12 per cent and, particularly, removing the exemptions not only of services but also of oil, gasoline and electricity from value-added taxation (timed when world oil prices are growing), had brought about some increase in government revenues in the second and third quarters of 2006. However there is a perception that the fiscal crisis is being solved more by a large dependence on the increased value-added taxation instead of more progressive taxation that would rely more on the big corporations and the rich and wealthy.

Persistently high unemployment

An equally serious problem that is not being emphasized by mainstream economists and the government as much as the fiscal crisis is the persistently high unemployment rate since the Asian Crisis. High unemployment persisted in the latest economic recovery period of 2000–04 even as GDP growth increased. This is in contrast to past periods when economic recovery always improved the employment situation.

A major trend in the employment picture is the downward employment absorption capacity of agriculture, and the stagnant and low employment absorption capacity of industry (mainly manufacturing and construction). The only sector adequately absorbing the growing labour force is the service sector.

It must be pointed out that the industrial and agricultural sectors are the main tradable sectors. With increased trade liberalization, globalization and competition among countries, these sectors are now exhibiting increasing labour productivity as output increases are not matched with equivalent employment increases. Thus, the biggest absorber of employment is services, which is largely a non-tradable sector. Unemployment remains



Sources: National Statistics Office (NSO); Labour Force Survey (LFS); National Statistics Coordination Board (NSCB).

Figure 8.11 Unemployment rate vs. GDP growth rate

persistently high, at close to 12 per cent in 2004. This is consistent with Figure 8.7, which shows that the agricultural share has been on a long-run decline, and the industrial sector's share is stagnant with a slight downward bias. The only main sector that increased its share in GDP is the service sector. This is a heterogeneous sector that includes the wholesale and retail trade sectors, the financial sector, the public sector and personal services involving much of the underground economy.

The crux of the matter is that the Philippines had to increase its labour productivity in its tradable sectors in order to be competitive in the world market. While in the past labour productivity (defined as GDP per employed person) moved in pace with GDP per capita, the increase in labour productivity in 2000 to 2004 was much faster than that of GDP per capita. This explains the high and persistent unemployment rate in the country (Figure 8.11).

Apart from trade liberalization and globalization, three other factors may be contributing to the persistently high unemployment rates. First, high population growth and high labour force entry due to a very young population widened the gap between labour supply and labour demand. It is not surprising that the highest unemployment rates are registered for the youths and workers reaching college levels. Second, as explained more fully earlier, the lacklustre recovery of the financial sector and domestic credit may have limited the financing of working capital and hiring of new workers, especially in the industrial and agricultural sectors. Third, the series of political shocks and instabilities in the country during the Estrada and Arroyo governments (and continuing until today) may have deterred long-term employment of additional and more permanent workers.

Mainstream economists, however, are still prescribing increased and intensified trade liberalization to solve the country's unemployment, external deficits and macroeconomic problems (see Balisacan and Hill, 2003).

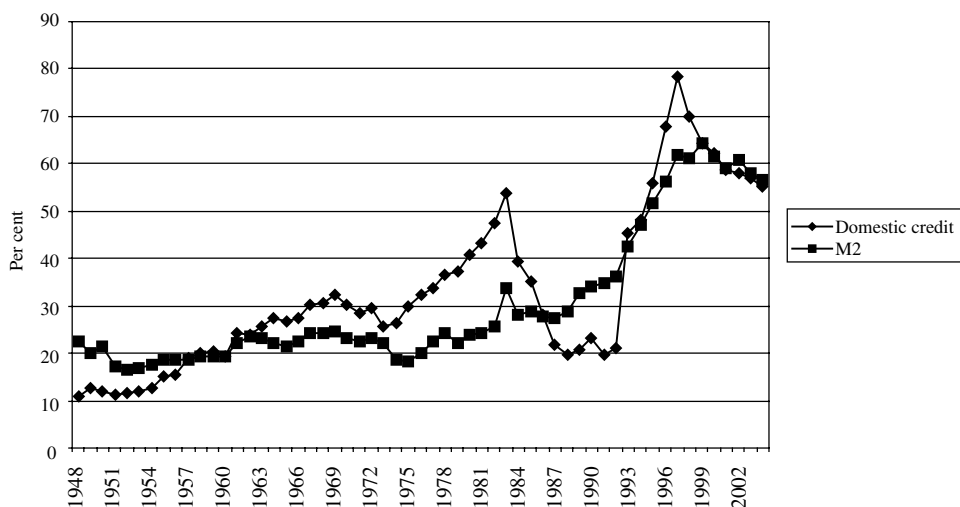
High oil prices

The volatile world oil price movements starting in 2004 and lasting through August 2006 increased the average inflation rate in the Philippines from a low of 3 per cent in 2002 and 2003 to 8.3 per cent in the January–June period of 2005. This has slowed down to less than 7 per cent in the first three quarters of 2006 due to tight controls on transportation fares and an appreciating currency. The soaring world prices of oil in the recent period encompassing 2004 up to August 2006 had forced the government to study strong energy conservation schemes and to develop programmes employing alternative fuel energy sources. So far economic growth for the first half of 2006 had not suffered from the high oil prices.

Low financial confidence

Even if the Philippines' financial sector was not as hard-hit during the Asian Crisis in comparison to the other countries, the post-Asian Crisis period has been marked by low financial confidence due to the trauma of non-performing assets suddenly exploding, and due to stringent financial supervision to achieve higher capital adequacy ratios and loan loss provisions.

It is clear that the Philippines had not achieved substantial financial deepening as M2 (money plus quasi-money) and domestic credit hovers at only around 55 per cent of GDP in 2004 (Figure 8.12). The lack of financial deepening is partly caused by the various recession and monetary tightening periods. Another big reason is the decline in financial confidence due to the financial crises, as evidenced in the decline of domestic credit (as a percentage of GDP) from the mid-1980s till 1992 due to the financial and economic collapse of 1984–85. It is happening again in the post-Asian Crisis period, as both domestic credit and M2, as percentages of GDP, declined from 1998 to the present.



Sources: IMF, *International Financial Statistics* (IFS); author's calculations.

Figure 8.12 Domestic credit and M2 as percentage of GDP

Political crises and more volatile exchange rate movements

In 2005, a more positive outlook (a 6.2 per cent GDP growth rate and Congress's passing of key tax reform laws) brought 'hot money' back in the first quarter and the peso finally joined other Asian currencies in appreciating against the dollar.

All this changed starting in June 2005, as President Arroyo's family members were being implicated (again) in the illegal gambling business, and President Arroyo herself was supposed to have been wiretapped during the 2004 presidential election canvassing period, and recorded on tape requesting an election official to ensure her election victory by at least a million votes. Calls for resignation and impeachment of the president are now a common daily occurrence, and brought the country into a long-drawn, volatile and confidenceless period. The peso again began to depreciate in the third quarter of 2005 and portfolio capital started making its exit. This was aggravated when the Supreme Court ordered a temporary restraining order on the expanded value-added tax law passed by Congress to tackle the fiscal crisis (this was lifted in February 2006). Despite a sharp strengthening of the peso starting December 2005 due mainly to remittances of Filipino workers and expected increase in the value-added taxation, GDP growth in 2005 had slowed down to below 5 per cent (from 6.2 per cent in 2004), reflecting the political crisis engulfing the Arroyo government, the stagnation effects of spiralling oil prices, weather disturbances and weaker export demand for semiconductors. But the first half of 2006 saw GDP growth recovering to 5.5 per cent as president Arroyo apparently survived repeated pressures to resign and escaped impeachment due to a majority vote of her party in Congress, and as increased value-added tax revenues reduced the fiscal pressures. The higher growth however failed to improve employment rates significantly.

One saving grace: the remittances of Filipino overseas workers

The large savings–investment deficit in recent years is not as serious as it looks due mainly to the remittances by overseas Filipino workers. The net factor income from abroad became positive in the early 1990s and soared to more than 7 per cent of GDP by 2004. This even increased substantially starting late 2005, appreciating the peso from P56 to a dollar in the third quarter of 2005, to below P53 to a dollar by the end of 2005 and to P50.2 in mid-September 2006.⁴ These foreign remittances had kept current account and balance of payment deficits still within reasonable bounds in recent years. The GDP growth rate of 5.5 per cent in the first half of 2006 is further strengthened by the Filipino overseas workers' remittances, bringing GDP growth for this same period to 6.6 per cent.

The remittances of Filipino overseas workers not only is saving the country from entering another balance of payment crisis, but is also helping a sizeable portion of Filipino families cope with economic difficulties, and is providing a private 'social safety net' for them as fiscal tightness prevents the government from providing public safety nets. The overseas workers phenomenon, however, also has some negative effects. The health sector is facing serious shortages of personnel as nurses, doctors and caregivers are leaving the country en masse. Furthermore, the large outflow of Filipino workers is just a reflection of the economy's weak employment absorptive capacity, especially of educated workers.

Notes

1. This new government was led by President Diosdado Macapagal, the father of the current Philippine president.
2. So that the campaign promise not to devalue would appear to have been kept, Marcos did not use the word 'devaluation' but said the peso was placed under a 'floating rate' regime.
3. This contrasts with the situation in more affluent South Korea and Thailand, where the Asian Crisis and recession led to declines in the consumption share and increases in the savings share (savings was used as a coping and risk-reducing response to the crisis).
4. The appreciating peso is not just due to inflows of remittances but also due to higher international inflows of short-term capital and the overall weakening of the dollar with all other countries in the world.

References

- Balisacan, Arsenio and Hal Hill (eds) (2003), *The Philippine Economy: Development Policies and Challenges*, Quezon City, Philippines: Ateneo de Manila Press.
- Lim, Joseph and Manuel Montes (2002), 'Structural adjustment after structural adjustment, but why still no development in the Philippines?', *The Asian Economic Papers*, 1 (3), Summer.

Further reading

- Balisacan, Arsenio and Hal Hill (eds) (2003), *The Philippine Economy: Development Policies and Challenges*, Quezon City, Philippines: Ateneo de Manila Press.

This volume contains a set of economic articles that represent the mainstream economists' view of the current Philippine economy. The papers blame rent-seeking and corrupt activities, excessive state interventions, wrong policies in the past (for example, overvaluation of the peso, monetization of fiscal deficits), weak and inadequate institutions and governance structures (including weak and ineffective regulatory frameworks) for the Philippines' economic woes. It prescribes a faster and more consistent commitment to privatization, deregulation and trade liberalization as the correct path for the Philippine economy.

- Corpuz, Onofre (1989), *The Roots of the Filipino Nation, vols. 1 and 2*, Quezon City, Philippines: Aklahi Foundation Inc.

This two-volume work of Dr Corpuz intertwines the economic, political and social history of the Philippines from pre-colonial times to the US occupation period. This book situates economic events and trends in the historical, social and political setting to give a better feel of the early economic foundations of the Philippine economy.

- Corpuz, Onofre (1997), *An Economic History of the Philippines*, University of the Philippines Press.

This book gives a detailed economic history of the Philippines during pre-colonial, Spanish and American periods. Important accounts include: (1) the rise and developments of the *encomienda* system – the precursor of the current unequal land ownership in the Philippines; (2) the galleon trade between Manila and Acapulco, and development of commodity export crops during the Spanish colonial period; (3) the free trade imposed by the US colonials in the early twentieth century.

- Lichauco, Alejandro (1973), *The Lichauco Paper: Imperialism in the Philippines*, Monthly Review Press.

The most radical view of the Philippine economy in this list of further reading, this book claims that it is the Philippines' abandonment of its nationalist, import-substitution and protectionist economic programmes and its capitulation to foreign economic and political domination (including to multilateral agencies like the IMF) that brought about its economic downfall.

- Lim, Joseph and Manuel Montes (2002), 'Structural adjustment after structural adjustment, but why still no development in the Philippines?', *The Asian Economic Papers*, 1 (3), Summer.

This paper tries to explain why more intense opening up of the Philippine economy and obedient subscription to IMF programmes – compared with its East Asian neighbours – may be partly the reason the Philippines had lagged far behind the countries in the region. Stabilization programmes as well as lazy liberalization, deregulation and privatization, without proper state direction, regulation, infrastructure building and promotion of productivity and technological improvements, had led to the Philippines' inability to address successfully its savings and foreign exchange constraints and bottlenecks, as well as lack of confidence in the Philippine economy.

9 Indonesia

Thee Kian Wie

A short political history

On 17 August 1945, two days after the Japanese unconditional surrender to the Allied Forces, Sukarno and Hatta, Indonesia's two most charismatic leaders, proclaimed Indonesia's independence. Disregarding this proclamation, the Netherlands was intent on reclaiming its colony from the Japanese. In the following four years, heavy fighting broke out between Dutch troops and the fledgling Indonesian army and irregular troops.

Through the mediation of the United Nations, the Netherlands and Indonesia called a truce in 1949. The Indonesian and Dutch delegations got together in a Round Table Conference (RTC) in The Hague, in the autumn of 1949 to discuss the terms of the Dutch transfer of sovereignty to Indonesia. The official transfer of sovereignty from the Netherlands to Indonesia took place on 27 December 1949.

The achievement of political independence, however, was not accompanied by economic independence. The Dutch delegation at the RTC had extracted a concession from the Indonesian delegation that their extensive business interests could continue to operate without hindrance in an independent Indonesia. This problem as well as the Dutch refusal to hand over West Irian (Dutch West New Guinea) to Indonesia doomed from the start amicable relations between the Netherlands and Indonesia. The deteriorating relations between the two countries in late 1957 led to the takeover of all Dutch companies in Indonesia, and their subsequent nationalization in 1959. Hence, with one sweep, the vast Dutch business interests, which had operated in Indonesia since 1870, were swept away. The nationalized Dutch companies were subsequently turned into state enterprises, which accounts for the large number of these enterprises in Indonesia.

Arguing that parliamentary democracy was unsuitable for Indonesia, President Sukarno, in July 1959, re-introduced the Constitution of 1945, under which he became head of state as well as head of government. Vested with greater executive powers, President Sukarno introduced 'Guided Democracy' and 'Guided Economy', under which Indonesia would pursue an Indonesian-style socialist pattern of development. Because of Sukarno's obsession with 'completing the national revolution' and opposing the Western capitalist countries, which in Sukarno's view still had imperialist intentions, he neglected Indonesia's serious economic problems.

To liberate West Irian from the Dutch and confront militarily the young Malaysian federation, which Sukarno viewed as a neo-colonialist creation to undermine Indonesia, Sukarno purchased much weaponry from the Soviet Union and the other East European socialist countries. These and other expenditures on prestige projects led to a growing budget deficit, which were financed by the simple device of printing money. The rapid increase in money supply caused runaway inflation, which by the mid-1960s became an unprecedented hyperinflation.

Growing polarization between pro-communist and anti-communist groups, notably the army, led to dangerous political tensions. On 30 September 1965 a coup took place,

allegedly by leftist junior military officers at the instigation of the Indonesian Communist Party (PKI). The coup was quickly put down by General Soeharto's troops. In the ensuing months bloody repression took place against members of the PKI and their alleged supporters. There were widespread student demonstrations against President Sukarno, who was suspected of being involved in the failed coup, as he adamantly refused to ban the PKI. Amidst student demonstrations, power was transferred from President Sukarno to General Soeharto in March 1966.

General Soeharto was installed as Indonesia's second president in 1968, which ushered in the era of the 'New Order'. Inheriting an economy in shambles and hyperinflation, Soeharto turned to five young economists from the Faculty of Economics, University of Indonesia, for economic advice. He also rejoined the United Nations, the World Bank and the IMF, which Sukarno had left in a huff in early 1965.

With political stability, sound economic policies and the assistance of the international aid community, Indonesia during the next three decades experienced an unprecedented rapid and sustained economic growth. This saw a rapid decline in poverty and a rise in standard of living of the Indonesian people (see, Mishra, 1997; Thee, 2002a: 198–203). However, during the last decade of Soeharto's rule, the regime became increasingly corrupt and oppressive. The Asian economic crisis that struck in mid-1997 exposed the weaknesses of the regime. What began as a financial crisis, quickly turned into full-blown economic and political crises, which forced President Soeharto to step down in May 1998.

The ignominious fall of Soeharto's self-styled 'New Order' ushered in a new phase in Indonesia's political history. From a highly authoritarian and centralized state, Indonesia became a democratic and decentralized state, in which the national parliament assumed much greater power against a weakened presidency. Mishra (2001) termed the process 'systemic transition', similar to the experience of East European countries following the fall of the Berlin Wall. During the politically unsettled period 1998–2004 Indonesia had three presidents, Dr B.J. Habibie, Abdurrahman Wahid and Megawati Sukarnoputri, all of whom served only for a relatively short period.

Two general elections were held in 1999 and 2004 reasonably peacefully, and both were regarded as free and fair by the international community. In fact, in 2004 for the first time in Indonesia's history, direct presidential elections were held. Susilo Bambang Yudhoyono (popularly known as SBY) was elected as Indonesia's first directly and popularly elected president with a clear mandate of 61 per cent of the popular vote, which was much higher than his opponent, incumbent president Megawati Sukarnoputri, who only received 39 per cent of the popular vote.

In early 2001, regional autonomy was granted to the 300-plus districts and municipalities, which made Indonesia a decentralized state with greater power vested in the regions. The march towards democracy continued with the first direct elections of governors, district heads and mayors in 2005.

Although these direct elections were marred by irregularities and vote-buying, Indonesia is irrevocably on the way to becoming a truly democratic and decentralized country. The remarkable political development, however, has not been accompanied by a speedy economic recovery and subsequent robust economic growth, as experienced by South Korea and Thailand, the two other East Asian countries worst affected by the Asian economic crisis. This is, however, not uncommon if one looks at East European countries that experienced systemic transition as the society seeks for a new social

compact and political legitimacy (Mishra, 2001). Thus, the ability to forge a new social compact and consolidate democracy will determine whether Indonesia will grow into a prosperous and just society, or whether it will continue to be the 'sick man' of Southeast Asia along with the Philippines.

Economic conditions in Indonesia during the early independence period, 1950–65

When Indonesia finally achieved its effective independence over the whole territory of Indonesia (except the disputed territory of West Irian) on 27 December 1949, the Indonesian government faced serious economic problems as a result of Japan's occupation of Indonesia (1942–45) and the armed struggle against the Dutch (1945–49). During this period much physical infrastructure and productive facilities were either destroyed or seriously damaged. In its assessment prepared to qualify for the United States' Marshall Aid, the Java Bank (the bank of circulation during the Dutch colonial period) estimated that in monetary terms the physical damage due to Japanese occupation and war amounted to around US\$2 billion in 1938 prices, an amount that was about equal to total GDP in that year (Booth, 1996: 403). The report also contained an estimate of the level of output in some of the most important sectors and sub-sectors as a percentage of pre-war levels (Table 9.1).

As can be seen from Table 9.1, the smallholder tree crop sub-sector and the mostly Dutch- and other foreign-owned establishments in estate agriculture and mining suffered the most. Although the food crops sub-sector suffered the least, rice output in Java (historically the rice belt of the country), as well as in other rice-producing regions (South Sulawesi, Bali and Lombok) experienced a sharp decline in rice output. Given the decline in rice output and the neglect of health facilities for the people during the Japanese occupation and the armed struggle against the Dutch, it was not surprising that absolute poverty, malnutrition and mortality during this period greatly increased (Burger, 1975: 161–3).

With the decline in tree crops and estate agriculture, Indonesia's exports suffered seriously. Among agricultural exports, sugar, which during the 1920s was Indonesia's most important export crop, experienced the largest decline. The sharp decline in sugar exports was caused by the unwillingness of peasants in Java to lease their land to the Dutch sugar estates. During the Dutch colonial period, these peasants were often coerced to lease their land to the sugar companies. Moreover, during the Japanese occupation and the armed struggle against the Dutch many sugar factories suffered great damage.

Table 9.1 Level of post-war output as a percentage of pre-war levels

Sector/Sub-sector	Post-war Level of Output (% of Pre-war)
Food crops	70–75
Smallholder tree crops	30–35
Estate agriculture	20–25
Fisheries	50
Mining	20
Manufacturing	30–35

Source: Booth (1996: 403).

In 1950–51 Indonesia's exports of rubber, oil and tin experienced a surge because of the 'Korea boom' when the United States bought up large supplies of these commodities to build up stockpiles of strategic commodities. The 'Korea boom' however, proved to be of short duration, as much of the windfall revenues of this boom was frittered away in wasteful consumption. By 1954 the increase in the export volumes of most primary commodities, including agricultural and mineral exports, was primarily due to the post-war economic recovery in Europe and Asia.

Economic consequences of the Round Table Conference

Besides the difficult tasks of restoring macroeconomic stability, particularly lowering the government budget deficit and inflation, and rehabilitating the damaged physical infrastructure and productive apparatus, the Indonesian government in the early 1950s also faced great difficulties as a result of the unfavourable terms imposed on Indonesia at the Round Table Conference (RTC) in the autumn of 1949. The Dutch delegation at the RTC was not prepared at all to give any concession on the financial and economic issues. As a result, the Financial-economic Agreement (Finec) reached at the RTC greatly benefited the Netherlands at the cost of Indonesia.

The Finec ensured a guarantee by the Indonesian government that it would allow Dutch business to continue operating in Indonesia without any restrictions. It also contained a provision that nationalization of Dutch companies would only be allowed if it was considered necessary for Indonesia's national interest and if both parties – Indonesia and the Netherlands – would agree to this measure. The amount of compensation to be paid by the Indonesian government would be decided by a judge on the basis of the real value of the company (Meier, 1994: 46–7).

Another controversial item in the Finec was the provision that Indonesia would have to take over the foreign and internal debt of the Netherlands Indies government, amounting to the equivalent of US\$1.13 billion (Kahin, 1997: 26). This amount was smaller than the amount of 6.3 billion guilders originally demanded by the Dutch delegation (Meier, 1994: 47). However, even the agreed amount was still a large burden for a young nation just emerging from eight years of harsh occupation and war.

Economic policies in the early 1950s

The unfavourable provisions of Finec meant that Indonesia's political independence was not accompanied by economic independence. This clearly limited the freedom of action of the government to pursue economic policies based on the national interest, since the Dutch business controlled the modern sectors of the economy (the export-oriented large estate and mining sectors, the modern manufacturing industries, banking and inter-island shipping). According to the late Professor Benjamin Higgins, United Nations consultant to the Indonesian government in the early 1950s, Dutch business activities in Indonesia generated about 25 per cent of GDP and employed about 10 per cent of the total labour force. Moreover, about 6000 Dutch officials, whose political loyalty to independent Indonesia was doubtful, still occupied important functions in the government bureaucracy (Higgins, 1990: 40).

Despite the constraints imposed by Finec, the Indonesian government was determined to increase greater national control over the economy. As the Finec allowed nationalization under certain conditions, the Indonesian government in 1951 decided to nationalize

the Java Bank (De Javasche Bank), the private bank of circulation during the Dutch colonial period. The nationalization proceeded smoothly with the purchase of the Java Bank shares owned by domestic and foreign investors. In 1953 the Java Bank was converted into Indonesia's central bank under the name Bank Indonesia.

Other Dutch companies operating in strategically important fields, such as public utilities (gas, electricity and water supply), were also nationalized. Similarly, the Royal Dutch Netherlands Indies Airline (KNILM) was converted into Garuda Indonesian Airways (GIA), a joint venture between the Indonesian government and the Royal Dutch Airlines (KLM), with each party holding 50 per cent of the shares. In 1953 the Indonesian government bought up all the shares owned by KLM, and thereafter GIA became a state-owned airline, with the KLM only providing technical assistance to GIA.

To counter Dutch control over foreign trade, the Indonesian government formed two state-owned trading companies, the Central Trading Company (CTC) and Usaha Indonesia (USINDO). They were assigned to export agricultural and manufactured products and import raw materials for various industrial plants. These trading activities were financed by loans from a state-owned bank, the State Industrial Bank (BIN), which was set up to finance the establishments of new industries.

To confront the oligopolistic powers of the 'Big Five' Dutch trading companies, the Indonesian government in 1950 also launched the 'Benteng' (Fortress) Programme. The Indonesian government made this Benteng Programme the focus of its efforts to 'Indonesianize' the economy by developing a strong indigenous Indonesian business class. This goal was to be achieved by the control over the import trade through the allocation of import licences and import credit to indigenous Indonesian businesspeople.

Although on paper the requirements that had to be met by the prospective importers were quite stringent, in practice, the Benteng Programme turned out to be ineffective. Many indigenous importers did not take advantage of the opportunities opened up by the Benteng Programme to gain skills and valuable business experience in the import trade. They sold their import licences to ethnic Chinese businesspeople. Thus, instead of developing a strong indigenous business class, the Benteng Programme developed a group of unproductive 'rent-seekers' and parasites (Sumitro, 1986: 35). As a result, in the second half of the 1950s the Benteng Programme was discontinued.

After the mid-1950s the relations between Indonesia and the Netherlands deteriorated rapidly because of the Dutch government's adamant refusal to transfer sovereignty over West Irian to Indonesia. When the Indonesian government in November 1957 failed to persuade the United Nations General Assembly to adopt a resolution calling on the Dutch government to negotiate a settlement with Indonesia on the West Irian issue, anti-Dutch demonstrations broke out in Jakarta. In December 1957 workers of militant labour unions affiliated with the Indonesian Communist Party (PKI) and the Indonesian Nationalist Party (PNI) began taking over Dutch enterprises and business offices.

The Dutch inter-island shipping company KPM (Royal Mail Steam Packet Company), a prime symbol of Dutch economic dominance, was the first to be taken over by the workers. In the following two weeks this action was followed by similar takeovers of other Dutch enterprises. Although the Indonesian government had not initiated these, it did not attempt to resist these 'takeovers' (Glassburner, 1971: 92).

However, concerned about the economic and political chaos caused by the takeovers, General Nasution, the army chief of staff, took control of these events on 13 December

1957 by issuing an instruction to the army to manage the seized enterprises. In order to avoid confrontation with the army, the PKI and SOBSI (the PKI-affiliated labour union) promised to support the army's action by keeping the seized enterprises operating (Ricklefs, 1993: 261).

In February 1959, the formal takeover of all Dutch enterprises was legalized by an act of Parliament, and the nationalized companies were turned into state-owned enterprises. Thus, with one radical action, the powerful Dutch business presence, which had operated in Indonesia since the second half of the nineteenth century, was eliminated.

Rehabilitation of the physical infrastructure and the productive apparatus

One of the major tasks faced by the Indonesian government in the early 1950s was the rehabilitation of the damaged physical infrastructure and productive apparatus of the country. Increasing the output of food crops to the level reached before the war did not require large expenditures on the rehabilitation of the irrigation system, except in areas where the irrigation network suffered great damage. As a result, during the period 1950–56 rice output rose by 30 per cent. This rapid increase was possible to some extent because of the conversion of land in Java from sugar cane cultivation into rice planting. The increase in rice production was also possible due to 'double cropping'.

However, the steady increase in rice was not sufficient to keep pace with the increase in population. As a result, the import of rice rose steadily from more than 600 000 tons in 1956 to about one million tons in 1961 and 1962 (Mackie, 1971: 26).

Only two tree crops, rubber and copra, were able to reach the pre-war levels. Unlike Malaysia, however, where extensive replanting of high-yielding varieties of rubber took place, both in the large estates and smallholdings, the Indonesian government did not encourage the rubber smallholdings, which accounted for the bulk of rubber output, to do replanting. Hence, it was not surprising that after the war, Malaysia surpassed Indonesia as the world's largest rubber producer.

In contrast to the foreign-owned estates, which experienced great difficulties in achieving the pre-war levels of production, the petroleum industry fared better. Oil exploration had remained suspended since the Pacific War. In 1959 the Indonesian government signed exploration agreements with a number of foreign oil companies. New agreements were also signed with Caltex, Stanvac and Shell, which had operated in Indonesia since before the war. Sustained exploration for oil reserves in Indonesia was important to sustain oil production, as the oil fields in Indonesia, while large in number, are small and shallow compared with the large oil fields in the Middle East.

Despite the unsettled political conditions in Indonesia in the late 1950s and early 1960s, oil production rose from an annual average of 18 million tons in the late 1950s to around 22–23 million tons during the period 1962–64. One observer (Hunter, 1965: 70) believed that without Indonesia's military confrontation against the newly established Malaysian federation in 1963, which was supported by Britain and the United States, and thus adversely affected British and US oil companies, Indonesia's oil production might easily have reached 30–35 million tons a year.

Industrialization plans

Like many other newly-independent countries in the 1950s, the Indonesian government put a high priority on industrialization. During the colonial period, there were only

resource-processing facilities for the export crops, such as sugar factories and oil palm and petroleum refineries, and light consumer goods industries, such as the weaving, rubber tyre and cigarette industries.

During the depression decade of the 1930s the Netherlands Indies government had promoted a limited degree of import-substituting industrialization. However, after independence Indonesia was still largely an agrarian economy with agriculture accounting for about 56 per cent and manufacturing for only around 8–10 per cent of net domestic product during the period 1951–59 (Paauw, 1963: 176–7).

To provide guidelines for industrial policy, in March 1951 Sumitro, the then Minister of Trade and Industry, appointed an Industrialization Committee. In August 1951 the Committee submitted its report to the government. The committee listed three goals of Indonesia's industrialization: a more balanced economic structure, absorption of population growth and increasing national income. Despite the political and ideological differences between the various political parties, they all agreed that the 'key industries', mostly still dominated by Dutch companies, should be put under public ownership (Dick, 2002: 176).

Based on the report of the Industrialization Committee, Sumitro, the Minister of Trade and Industry, launched an ambitious industrialization plan, the Economic Urgency Plan in 1951. Under this plan the manufacturing sector would play a crucial role as the engine of growth. For this reason the Economic Urgency Plan was also referred to as the Industrial Urgency Plan. At first this plan was designed for only three years (1951–53), but subsequently extended to 1955.

The ambitious Economic Urgency Plan proposed to develop large-scale, medium-scale and small-scale industries. However, developing small-scale industries was considered more important than large-scale industries, as the latter were mostly Dutch-owned. Despite measures to improve the efficiency and performance through simple mechanization by lending simple pieces of equipment to small and cottage industries on easy repayment terms, little progress was made in advancing the development of small-scale industries.

Although during the plan period of five years a few industrial plants were built, the implementation of the plan was unsatisfactory. In assessing the progress of the large-scale industry programme, Sumitro stressed bad organization, incompetent management, cumbersome government administration and financial regulations, and lack of technical experts as the major reasons for the lack of progress. The disappointing results, together with growing concerns about inflationary pressures caused by large government expenditures, led to the scrapping of the plan in 1956. In its place Indonesia's First Five Year Development Plan for the period 1956–60 was introduced.

The First Five-year Plan was never seriously implemented, as the Draft Plan submitted to the Parliament in 1956 was only approved in 1958. By then the Five-year Plan had become largely irrelevant. The Indonesian government also became preoccupied with serious political and economic crises, including the takeover of Dutch enterprises and the uprisings in the provinces of West Sumatra and North Sulawesi against the central government.

President Sukarno in July 1959 suspended the Parliament and restored the 1945 Constitution. Under this Constitution, President Sukarno appointed himself as both the head of government and head of state. It also marked the introduction of 'Guided Democracy' and 'Guided Economy', under which Indonesia would pursue a 'socialist'

pattern of development, referred to by President Sukarno as 'socialism à la Indonesia'. It marked the end of sound economic policies, pursued by the pragmatic economic policy-makers in the early 1950s. Foreign policy also became increasingly anti-Western and anti-capitalist as closer relations with the Soviet bloc countries and China were sought.

In line with the new era of 'Guided Economy', President Sukarno appointed a new National Planning Council headed by Mohammad Yamin, a prominent national leader. The Planning Council was given the task of drawing up a new 'Eight-year Overall Development Plan'. Unlike the First Five-year Plan, which was a purely economic document, the Eight-year Plan was a political and economic document, as it outlined the kind of society the plan was expected to achieve. However, the vast expenditures required for the military campaign to reclaim West Irian in 1961–62, the military confrontation with Malaysia (1963–66), and the protracted political turmoil made implementation of the plan impossible.

Hyperinflation and economic decline

Under President Sukarno's increasingly strident anti-Western and anti-capitalist stance, economic policy since the late 1950s became more subordinate to political strategy. Political success, and nothing else, Sukarno believed, would ultimately solve Indonesia's economic problems (S.A., J.G., L.C., 1965: 1). Increasingly preoccupied with 'completing the national revolution', Sukarno resorted to deficit financing through printing money. As a result, inflation began to accelerate at an alarming rate from the early 1960s. The rate of inflation rose from 19 per cent in 1960 to a peak of 636 per cent in 1966 (Table 9.2).

The hyperinflation during the first half of the 1960s caused severe hardships for the people, particularly fixed income earners and the large number of low-income people. It was therefore not surprising that by the mid-1960s the incidence of absolute poverty was very high, as 61 per cent of Java's population was estimated to be very poor. The percentage of very poor population in the regions outside of Java was estimated at 52 per cent (Hill, 1996: 52).

After the economy had recovered briefly by the mid-1950s, it began to stagnate from the late 1950s, and then experienced negative growth in the early to mid-1960s. In 1963 the Indonesian economy contracted by –3 per cent. Hence, the final years of President Sukarno's reign were characterized by serious economic and political crises, which set back the modest post-war economic recovery, achieved during the first half of the 1950s.

Table 9.2 Money supply growth and price inflation 1960–66

Year	Money Supply Growth (%)	Price Inflation (%)
1960	39	19
1961	42	72
1962	99	158
1963	95	128
1964	156	135
1965	280	595
1966	763	636

Source: Grenville (1981: 108).

The political tensions by the mid-1960s eventually led to the fall of Indonesia's first president, once hailed as Indonesia's 'Great Leader of the Revolution'.

The Indonesian economy during the Soeharto era

When General Soeharto took over executive power from President Sukarno in March 1966, the economy was in shambles. Indonesia was bankrupt, as it could not repay its large foreign debt of US\$2.4 billion, and hyperinflation exceeded 600 per cent. While industries operated at less than 20 per cent of capacity, shipping, rail and road transport equipment were run down. To make matters worse, corruption in the government bureaucracy was rampant.

Economic policies

Facing the urgent need to tackle these serious economic problems, General Soeharto formed an economic team of five young economists – Widjojo, Ali Wardhana, Sadli, Emil Salim and Subroto. Soeharto asked his economic team to draw up a Stabilization and Rehabilitation Programme. The main objective of the Stabilization Programme was the restoration of macroeconomic stability by stopping the runaway inflation. To achieve this goal, the new government in 1967 enacted a 'balanced budget' law to ensure fiscal discipline. This law prohibited the financing of budget deficits through money creation. To make this policy more feasible, the estimated revenues in the balanced budget would also include revenues from foreign aid.

In a marked contrast with the Sukarno regime, the 'New Order' regime of Soeharto from the outset forged cordial relations with the Western countries, including the United States. It rejoined the IMF and the World Bank, which Sukarno left in 1965. This ensured a steady flow of aid from the West and Japan to underwrite its balanced budget principle. This eliminated the need for the government to finance its deficits through borrowing from the central bank and hence helped bring down inflation.

Pleased with Indonesia's abandonment of its anti-Western policies, the international aid community responded favourably to Indonesia's request for rescheduling its debt repayments. In December 1966 representatives of the new government reached an agreement in Paris with the Paris Club creditor countries to reschedule its debt service payments. At the initiative of the Dutch government, an international aid consortium for Indonesia, the Inter-governmental Group on Indonesia (IGGI), chaired by the Netherlands, was established in 1967.

The 'New Order' government also decided to abandon the 'inward-looking' policies of the Sukarno government by pursuing 'outward-looking' policies, particularly through more liberal trade and foreign investment policies. To attract new foreign direct investment, a new Foreign Investment Law was enacted in January 1967. This Law contained tax holidays and guarantees that nationalization would not take place unless deemed in the national interest, and then only with full compensation under the rules of current international law. The new liberal foreign investment policy succeeded in attracting new foreign investment inflows into the country, particularly into the oil sector, other mining projects and the manufacturing sector.

However, the Indonesian government was keenly aware of the force of economic nationalism. Hence the Foreign Investment Law also contained several restrictive provisions. For instance, foreign companies were not given national treatment, and were not

permitted to establish subsidiaries to market their products, but had to sell their products through local distributors. Foreign companies were also not allowed to borrow rupiah funds from the state banks. After the riots directed at the 'over-presence' of Japanese investment projects in January 1974, restrictions on foreign investment steadily increased.

In 1968 a Domestic Investment Law was also enacted, which contained the same provisions for investments by domestic investors. However, compared with foreign investors, domestic investors received more incentives. For example, domestic investors could borrow from the state banks, while foreign investors could not.

The 'New Order' regime also moved swiftly to abandon the multiple exchange rate system of the past and introduced a unified exchange rate system. At the same time, it abolished all controls on capital flows or foreign exchange transactions. With the aim of achieving a 'market-consistent' rate, the rupiah was devalued a number of times, and in August 1971 Indonesia pegged its currency to the US dollar. The peg remained more or less stable over seven years. But this caused a real appreciation of rupiah due to the inflationary impact of balance of payments surplus caused by the first oil price boom of 1973–74. This caused difficulties for non-oil exports, and hence the rupiah was devalued by 50 per cent in November 1978 to improve the export competitiveness of Indonesia's non-oil exports.¹ To deal with the rising current account deficit caused by the end of the oil boom in 1982, the rupiah was devalued again in March 1983. In September 1986 the rupiah was again devalued following an even steeper decline in the price of oil in early 1986.

Three large devaluations (November 1978, March 1983 and September 1986) were seen as destabilizing for business. Thus, Bank Indonesia (BI) adopted a managed float policy since the devaluation of 1986. Under this policy the rupiah was allowed to depreciate by 4–5 per cent annually to offset the differential between Indonesia's higher inflation rate and the lower inflation rates of its major trading partners. By keeping inflationary pressures under control and pursuing an active managed float, the government was able to prevent the real effective exchange rate from appreciating and to keep local costs in line with those of its major international competitors.

In the early 1990s the managed float exchange rate policy incorporated movements against a basket of currencies. One of the main aims of this was to maintain the rupiah's competitiveness against a basket of currencies. The BI intervened in the foreign exchange market by buying and selling rupiah in an 'intervention band' around an 'administratively set' central rate. To allow market forces a greater role in setting the exchange rate, BI widened its intervention band six times from 1992 to 12 per cent, effective from July 1997. The system collapsed with the Asian Crisis and Indonesia moved to a floating exchange rate regime in August 1997.

While the Stabilization Programme focused on the restoration of macroeconomic stability, the Rehabilitation Programme focused on the rehabilitation of physical infrastructure and productive facilities. The government gave special attention to the repair of infrastructure connected with food production and distribution, such as irrigation and roads and bridges. The First Five-year Plan (Repelita I) for 1969–70–1973–74, launched in April 1969, gave priority to agricultural development, particularly the food crop sub-sector.

In the course of the 1970s, Indonesia experienced two oil booms in 1973–74 and 1978–79. These substantially increased its export revenues and government revenues. Thus, the Indonesian government in the second half of the 1970s was able to undertake

substantial public investments, including in social development (primary schools and health clinics all over the country), physical infrastructure and the manufacturing sector. After the first phase of 'easy' import substitution was completed in the mid-1970s, the government in the late 1970s embarked on an ambitious second phase of import substitution. Based on a long-range industrial strategy outlined by Soehoed, the Minister of Industry during the period 1978–83, a plan was designed to establish upstream industries, including 52 large-scale, resource-processing, basic industries. According to Soehoed, these basic industries had to be under government control, as they would need large amounts of capital still beyond the capacity of the private sector, while the gestation period could be quite long and profit margins quite low. In Soehoed's view, once a foundation of basic industries had been established with the aid of rapidly growing oil revenues and foreign aid, industrial development would accelerate by itself (Soehoed, 1988).

While the oil boom lasted, this long-range industrial strategy – referred to as the 'structuralist approach to industrialization' – could be pursued without much regard to its economic costs. However, once the oil boom had ended in 1982, the government was forced to adopt an export-promoting industrial strategy. To this end the government since the mid-1980s began to introduce a series of deregulation measures that included trade reforms to reduce the 'anti-export bias' of the protectionist trade regime and liberalization of the restrictive foreign investment regime to encourage more export-oriented investments. These deregulation measures proved to be quite successful as reflected in the surge from 1987 onwards of manufactured exports, particularly low-skill labour-intensive exports, in which Indonesia had a strong comparative advantage. Manufactured exports kept growing, albeit at a slower pace than during the late 1980s and early 1990s until the Asian Crisis.

As the oil revenue declined, the government introduced tax reforms towards the end of 1984. The reforms were largely successful in raising non-oil domestic tax revenues both as a share of total government revenues and relative to GDP. By 1989–90, non-oil domestic revenues amounted to 11 per cent of GDP compared with 7 per cent in 1984–85. This rapid increase was mainly due to a substantial increase in the new value-added tax and improvements in income tax collection.

Deregulation measures were also introduced in the financial sector. Under the October 1988 financial deregulation measures, domestic banks were allowed to open new offices, new private banks were permitted, foreign banks were allowed to operate outside of Jakarta and non-bank state enterprises were permitted to deposit up to 50 per cent of their funds with private national banks. Reserve requirements for commercial banks were also reduced from 15 per cent to only 2 per cent of their liabilities. These measures resulted in a rapid expansion of the banking sector. Many observers, notably Cole and Slade (1999: 108), believe that this expansion went too fast while appropriate prudential regulations lagged behind. According to them, the weaknesses of the financial sector as exposed during the Asian Financial Crisis can be traced to this mismatch.

Economic and social transformation under the New Order regime

The tight fiscal and monetary policies and the pegging of exchange rate to the US dollar soon bore fruits, as hyperinflation was quickly brought under control. By 1970, inflation fell from over 630 per cent in 1966 to only 9 per cent, one of the fastest turnarounds in modern economic history (Table 9.3).

Table 9.3 *Money supply growth and price inflation, 1965–70*

Year (%)	Money Supply Growth (%)	Price Inflation
1965	280	595
1966	763	636
1967	132	112
1968	120	85
1969	61	10
1970	36	9

Source: Grenville (1981: 108).

Upon its recovery from the severe economic and political crisis in 1965–66, Indonesia experienced a period of rapid economic growth from the late 1960s for the next three decades. It experienced a brief period of economic slowdown in the early 1980s as a result of a sudden decline in oil revenue. However, following the restoration of macroeconomic stability, effective exchange rate management and the wide-ranging deregulation measures, the Indonesian economy from 1987 recovered quickly and started growing at an average annual rate of 6.7 per cent over the period 1987–92. During 1996–97 the economy was growing at 7.8 per cent, and was projected to keep growing at that rate until 2000.

Sustained rapid economic growth during this period transformed Indonesia from the ‘economic laggard’ in Southeast Asia in the early 1960s into a ‘newly industrializing economy’ (NIE) in the early 1990s. From a largely agrarian economy Indonesia was transformed into one in which the industrial sector became the biggest contributor to gross domestic product (GDP) (Table 9.4). Since the late 1980s the manufacturing sector also generated the largest amount of Indonesia’s total exports.

Because of Indonesia’s successful record of economic growth, Indonesia in 1993 was classified as one of the eight ‘high performing Asian economies’ (HPAEs) by the World Bank in its famous but controversial report *The East Asian Miracle*, alongside Japan, the four East Asian Tigers (South Korea, Taiwan, Hong Kong and Singapore) and Malaysia and Thailand. While many other developing countries have also grown rapidly, none of them were able to sustain high growth rates for as long as the HPAEs. Rapid growth of the HPAEs was underpinned by high rates of capital investment, including investment in human capital, and high rates of TFP (total factor productivity) growth (World Bank, 1993: 28–9, 40–48). Remarkably, Indonesia’s rapid economic growth during the ‘New Order’ was accompanied by a steady decline in the incidence of absolute poverty from around 40 per cent in 1976 to 11 per cent 20 years later (Table 9.5).

This was possible as Indonesia had a relatively low income inequality compared with its neighbours such as Malaysia, the Philippines and Thailand, where Gini ratios range between 0.40 and 0.45. Indonesia was also more successful than several other developing countries in avoiding a deterioration in its pattern of income distribution, as indicated by the trend in the Gini ratios over the period 1969–70 to 1996 (Table 9.6).²

Indonesia also experienced rapid improvements in social welfare, as reflected, amongst other things, by a steady growth in private consumption per capita, a steady rise in the net primary enrolment ratio, a steady decline in the infant mortality rates and a steady rise in

Table 9.4 *Indonesia's economic transformation (% sectoral shares in GDP), 1965–97*

Sector	1965	1980	1997
Agriculture	51	22	16
Industry	13	42	42
Manufacturing	8	13	25
Services	36	34	41

Sources: World Bank, *World Development Report, 1992*, World Development Indicators, Table 3, Table 222; *World Development Report 1998/99*, World Development Indicators, Table 12, p. 212.

Table 9.5 *Absolute poverty in Indonesia, 1976–96*

Year	Percentage of People Under the Official Poverty Line		
	Urban	Rural areas	Total
1976	38.8	40.4	40.1
1978	30.8	33.3	33.3
1980	29.0	28.4	28.6
1981	28.1	26.5	26.9
1984	23.1	21.2	21.6
1987	20.1	16.1	17.4
1990	16.8	14.3	15.1
1993	13.5	13.8	13.7
1996	9.7	12.3	11.3

Sources: For the period 1976–96, see: Badan Pusat Statistik (1999), *Statistical Year Book of Indonesia, 1998*, Jakarta, Table 12.1, p. 576.

Table 9.6 *Trend in the Gini ratio, 1969/70–96*

Year	Gini Ratio
1969–70	0.34
1976	0.34
1978	0.38
1980	0.34
1984	0.33
1987	0.32
1990	0.32
1993	0.34
1996	0.37

Sources: For the years 1969/70–93, Hill (1996: Table 10.1, p. 193). For the year 1996: World Bank, *World Development Indicators 1999*, Table 2.8, pp. 70–73.

Table 9.7 Improvements in social welfare in Indonesia compared with its Southeast Asian neighbours, 1970–97

Country	Average Annual Growth Private Consumption Per Capita (%) ^a 1980–97		Net Primary Enrolment Ratio ^c				Infant Mortality Rate Per 1000 Live Births ^d		Safe Water % of Population With Access ^e
	Unadjusted	Distribution adjusted ^b	Male % of relevant age group		Female % of relevant age group		1970	1997	1996
			1980	1996	1980	1996			
Indonesia	4.5	3.0	93	99	83	95	118	47	65
Malaysia	3.1	1.6	–	102	–	102	45	11	89
Philippines	0.7	0.4	95	–	92	–	67	35	83
Thailand	5.5	2.9	–	–	–	–	73	33	89

Notes:

- Growth of private consumption per capita is the average annual rate of change in private consumption divided by the mid-year population.
- Distribution-adjusted growth of private consumption per capita is 1 minus the Gini ratio multiplied by the annual rate of growth in private consumption per capita.
- Net primary enrolment ratio is the number of children of official school age (as defined by the education system) enrolled in school to the number of children of official school age in the population.
- Infant mortality rate is the number of deaths of infants under one year of age during the indicated year per 1000 live births in the same year.
- Access to safe water is the percentage of the population with reasonable access to an adequate amount of safe water (including treated surface water and untreated but uncontaminated water, such as from springs, sanitary wells and protected boreholes).

Source: World Bank, *World Development Indicators*, 1999, Table 1.2, pp. 16–19.

the access to safe water (Table 9.7). However, although infant mortality rate in Indonesia has dropped by more than 50 per cent during the 1970–97 period, it was still much higher than its Southeast Asian neighbours, and the access to safe water in Indonesia in 1996 was much lower than in these three countries. Thus, although Indonesia's human development index (HDI) improved significantly from 0.46 in 1975 to 0.67 in 2001, it still remains much below Malaysia (0.79), Thailand (0.77) and the Philippines (0.75).

As the *National Human Development Report, 2004* notes, much of Indonesia's improvement in HDI was due to increased private expenditure, as households enjoyed rapid income growth. Indonesia's public expenditure on social sectors has been much less than its ASEAN neighbours. For example, Indonesia's public expenditure on health during the latter half of the 1990s was less than 1 per cent of GDP, while in most comparable ASEAN neighbours (Malaysia, Thailand and the Philippines) the figure was close to 2 per cent. Public expenditure on education in Malaysia and Thailand is well over 5 per cent of GDP; but Indonesia spends less than 2 per cent of GDP on public education. This inadequate public expenditure on social sectors resulted in a human development divide between the poor and the richer segment of the society. For example, the infant mortality rate in Indonesia among the poorest quintile in the late 1990s was 78 (per 1000 live births) as opposed to 49 in the Philippines and 43 in Viet Nam. The rates among the richest quintile

in Indonesia, the Philippines and Viet Nam were 23, 21 and 17 respectively. That is, Indonesia's poor are far worse off compared with their counterparts in neighbouring countries as a result of meagre public expenditure on health. A similar divide also exists in other social indicators such as literacy rates and maternal mortality rates.

The failings and subsequent collapse of the 'New Order'

From the early 1990s many knowledgeable observers and academic economists began to express concerns about various economic and social issues, which in their view threatened to undermine not only Indonesia's long-term growth prospects, but also the cherished national goal of establishing a 'just and prosperous society' (*masyarakat adil dan makmur*). Many of these issues were inter-related and included the massive scale of corruption, collusion and nepotism committed by the president, senior government officials, the president's children and their business cronies. Policy-generated barriers to domestic competition and trade proliferated, which distorted economic incentives and only created lucrative but unproductive rent-seeking opportunities (Thee, 2002b). Although these restrictions on domestic competition and trade were often justified on spurious grounds of 'national interest', they conferred huge monopolistic or monopsonistic rents on politically well-connected businesspeople and their political patrons, both in the central and local governments. Estimates by Calessens, Djankov and Lang (1999) show that by 1996 around ten families in Indonesia owned over 60 per cent of all industrial assets, which was the highest among the East Asian countries. This rise in asset concentration is remarkable given the fact that in the early 1960s Indonesia was largely an egalitarian society (where poverty was shared) with practically no landlord class or a rich trading community linked to colonial extortion.

The corrosive effects of these 'KKN' (*korupsi, kolusi, nepotisme*) practices have greatly damaged public morale and confidence in the government. They also eroded fiscal and financial discipline, as reflected in the proliferation of off-budget expenditures beyond the control of the Department of Finance. In part this was also due to the growing influence of Dr Habibie, the powerful Minister of State for Research and Technology, who promoted costly 'hi-tech' projects, such as the aircraft industry. These projects received huge explicit and implicit subsidies even though their economic viability was questionable. In the end, the abuses by the increasingly corrupt and oppressive 'New Order', which had lost its political legitimacy, contributed to its ignominious downfall after the Indonesian economy was hit by the Asian Crisis in mid-1997.

The Asian Crisis

In July 1997, only two months after the release of a fairly upbeat report by the World Bank about the medium-term prospects of the Indonesian economy, market perceptions about the Indonesian economy suddenly changed for the worse. In the wake of the sudden depreciation of the Thai baht, the Malaysian ringgit and the Philippino peso, the Indonesian rupiah started to depreciate. When the rupiah continued its downward slide, even after it was floated in August 1997, the Indonesian government turned to the International Monetary Fund (IMF) for financial assistance. In return for a large standby loan offered by the IMF, the Indonesian government in its Letter of Intent (LoI) to the IMF pledged to implement a comprehensive economic reform programme. This reform programme included sound macroeconomic policies, restructuring of the financial sector and carrying out structural reforms.

The involvement of the IMF, however, failed to stem the continuing depreciation of the rupiah, as the Indonesian government, specifically the president, was reluctant to implement the agreed reforms, particularly the structural reforms. The president viewed the structural reforms as primarily aimed at undermining the business interests of his children. The inability or unwillingness of the government to carry out the IMF-mandated reform agenda further eroded market confidence, leading to a serious economic crisis. The inability to deal with the economic crisis exposed the weakness of the authoritarian regime, which depended solely on the whims of one person – Soeharto. The economic crisis, thus, quickly turned into a political crisis, and with the forced resignation of President Soeharto, Indonesia went into a systemic transition involving its polity, economy and governance structure.

Although the crisis hit Indonesia in mid-1997, the economy was still able to grow, though at a lower rate of 4.6 per cent. The full impact was only felt in 1998 when the economy contracted by an unprecedented –13.6 per cent. The manufacturing sector, which since the late 1980s had emerged as the major engine of growth and the major source of export revenues, contracted by almost –12.0 per cent. The economic crisis was aggravated by the worst drought of the twentieth-century, caused by the El Niño effect since 1997. Because of this drought, rice production in 1997 declined by 4 per cent, causing the agricultural sector to grow by only 0.6 per cent. To make matters worse, the price of oil in the world market also fell sharply during this period, hurting export and government revenues. Thus, within a time span of only one year, Indonesia's 'booming economy', praised by the international aid community as a model for other developing countries, turned into a 'melted down' economy, dependent on large infusions of aid for its survival.

Following the advice of the IMF, the Indonesian government responded by raising the interest rate steeply in order to stem capital flight and to control inflation, which rose to nearly 70 per cent. This succeeded in bringing down inflation to a single-digit level and to stabilize the rupiah, but failed to ignite private sector investment – both domestic and foreign. The economy, however, returned to positive territory as it grew in 1999, though at a miniscule 0.2 per cent. In 2000, the economy made a stronger recovery, growing by 4.8 per cent. However, unlike other crisis-hit economies, such as Thailand and Malaysia, where economic recovery was led by public investment, the Indonesian recovery was mainly private-consumption-led. Indonesia's poor investment climate, rated as the worst in East Asia, continued to have a discouraging effect on private sector investment, particularly foreign direct investment.

Growth in 2004 was 5.1 per cent, higher than growth in the two preceding years (4.3 per cent and 4.5 per cent, respectively). This time, growth was not only driven by consumption, but also by investment, the growth of which for the first time after the crisis grew in double digits, namely 15.7 per cent. However, the rise in investment was concentrated mostly in the property and retail trade sector, accounting for about 80 per cent of total fixed capital formation. Export growth in 2004 at 8.5 per cent, though, was higher than in 2002 and 2003, but was subdued by import growth of around 25 per cent (Table 9.8).

In general, investment, particularly foreign direct investment (FDI), remains sluggish due to the poor investment climate, caused by legal uncertainty, weak law enforcement, business-unfriendly labour law, widespread corruption, particularly at the tax office and customs service, uncertainties caused by the regional autonomy introduced in early 2001 and deteriorating infrastructure.

Table 9.8 GDP growth by expenditure, 2001–2004 (annual percentage change)

	2001	2002	2003	2004
GDP	3.8	4.3	4.5	5.1
Private consumption	7.6	3.8	3.9	4.9
Public consumption	3.5	13.0	10.0	1.9
Fixed investment	6.5	2.2	1.9	15.7
Exports	0.6	–1.0	6.6	8.5
Imports	4.2	–4.0	2.8	24.9

Source: Badan Pusat Statistik (BPS), Jakarta.

Table 9.9 The incidence of absolute poverty, 1996–2003

Year	Percentage of Population Below the Poverty Line		
	Urban	Rural	Urban+Rural
1996	13.6	19.9	17.7
1998	21.9	25.7	24.2
1999	19.5	26.1	23.5
2000	14.6	22.4	19.1
2001	9.8	24.8	18.4
2002	14.5	21.1	18.2
2003	13.6	20.2	17.4
2004	12.1	20.1	16.7

Note: The figure on absolute poverty in 1996 (17.7 per cent) is higher than that presented in Table 9.5, which showed that absolute poverty in 1996 was only 11.3 per cent. The reason for this discrepancy is that in 1998 the Central Agency for Statistics (BPS) used a new poverty line, which is based on an expanded range of goods and services.

Source: BPS, Jakarta.

The economic meltdown reversed the gains in poverty reduction as the poverty rate shot up close to 25 per cent (Table 9.9). Although the poverty rate came down once inflation was brought down, the World Bank estimates show that close to 50 per cent of the population remain vulnerable to poverty. The social safety-net programme put in place quickly with the help of the international aid community helped prevent a serious deterioration in other social indicators, such as infant and maternal mortality rates and school enrolment rates.

The most debilitating impact of the crisis is the rise in government debt. As the government was forced to bail out the banking sector, the domestic public debt, which was non-existent before the crisis, rose to about 92 per cent of GDP in 2000. It stood at 67 per cent of GDP in 2004. As a matter of fact, the costs of the banking sector crisis has been the highest in recent economic history. It was estimated at 70 per cent of GDP as opposed to Argentina's 55.3 per cent of GDP during its 1980–82 banking crisis (see Mishra, 2001). The government's external debt also rose from US\$54 billion in 1997 to US\$80 billion in 2003. As a percentage of GDP, government external debt increased from 26 per cent in

1996 to 55 per cent during 2000–01. However, due to the tight fiscal policies and prudent debt management pursued by Dr Boediono, Minister of Finance in the Megawati administration, fiscal sustainability was further strengthened as the government debt-to-GDP ratio declined from 59 per cent in 2003 to 53 per cent in September 2004. The external debt-to-GDP ratio declined from 56 per cent in 2003 to 51 per cent by September 2004 (World Bank, 2005: 5).

The servicing of debt severely restricted government's ability to spend on social sector and infrastructure investment. For example, in 2002 the state budget allocated approximately 21 per cent of government revenue to meet the domestic debt obligation, and 24 per cent to meet the external debt obligation. The budget allocated only 16 per cent of government revenue to development expenditure.

Some critics have argued that the initial mishandling of the crisis (for example, pushing the interest rate too high and closing down of 16 banks) by the IMF contributed to the worsening of the crisis. They also believe that the large number of conditionalities beyond the implementation capacity of the government in a new democracy and a large government debt on account of the blanket bailing out of banks also adversely affected a speedy economic recovery. As noted earlier, the large government debt not only constrained government's ability to initiate a public-investment-led recovery, but also adversely affected government's social sector spending. Worsening economic conditions and greater flexibility on the part of the IMF led in early April 1998 to a third agreement, which allowed for large food subsidies for low-income groups and a budget deficit of 3.5 per cent of GDP, instead of the 1 per cent under the second agreement.

The effects of the tsunami

On 26 December 2004 Indonesia's northernmost province, Aceh, and the island of Nias off Sumatra's west coast were hit by a tsunami, caused by a heavy earthquake off Sumatra's west coast. Nias was subsequently struck by another earthquake, which added to the misery suffered by the population. The tsunami caused a staggering loss of life of an estimated 200 000 people, and extensive damage, including the losses to income, output and public and private property. The costs of 'replacement' (including loss of income) are estimated at US\$4–5 billion (World Bank, 2005: 1). The psychological costs of the tsunami on the population can, of course, never be estimated.

In the short run, output and income in Aceh and Nias naturally declined steeply, but for the country as a whole, GDP growth in 2005 has been estimated to be reduced by only 0.1–0.4 per cent, with the ultimate effect depending significantly on the rehabilitation and reconstruction activities, which offsets the negative impact (World Bank, 2005: 1). Although the costs of rehabilitation and reconstruction and assistance to the many victims have significant budgetary consequences, part of the total costs are being borne by expanded financial assistance from the Consultative Group on Indonesia (CGI) aid consortium. In response to the tsunami crisis, the Paris Club creditors also offered a moratorium of three months on foreign debt repayments. Thus far, however, rehabilitation and reconstruction activities have proceeded slowly, as the foreign donors have been reluctant to disburse large amounts of aid without adequate guarantees that these funds would not be embezzled by corrupt government officials and their business cronies.

Prospects and challenges

The collapse of Soeharto's 'New Order' regime was followed by a fundamental political transition from a highly authoritarian, centralized state to a democratic and decentralized state. This transition has been rather messy, as Indonesia has actually never known real democracy, except during the first half of the 1950s. Improving governance, which now is seen as imperative to combating widespread corruption, reforming institutions, strengthening legal certainty and undertaking economic reforms, is an uphill struggle. While a lot has been achieved, there is still a long way to go. Reform efforts constantly face oppositions from vested interests, who use the populist argument that reforms would hurt the low-income groups in society. Members of the newly empowered Parliament have not yet come to terms with their power to scrutinize the government policies and programmes; they need to balance their popular appeals to the electorate with the need to take hard decisions.

With a weakened presidency and the ascendancy of populist politicians and intellectuals, the three successive presidents after Soeharto were either unwilling or unable to take the necessary steps to get the economy moving again. However, when on 17 August 2005 Indonesia celebrated its sixtieth anniversary of independence, it had a different political landscape. For the second time after Soeharto's fall Indonesia conducted free, relatively fair and peaceful elections in 2004 to choose a new Parliament, and a newly-established Council of Regional Representatives. It had also a new president, Susilo Bambang Yudhoyono (SBY), elected for the first time in its history directly by popular votes with a clear mandate of 61 per cent of votes. In early 2005, direct regional elections were held, which, although marred by money politics, were also peaceful. Indonesia thus appears firmly set on a democratic path, which compares favourably with the tenacity of the authoritarian regimes in some Southeast Asian countries to cling to power.

Despite significant macroeconomic improvements in 2004, as reflected by lower inflation, a stable rupiah, greater fiscal sustainability in terms of a lower public debt as a share of GDP and higher economic growth of 5.1 per cent, Indonesia still faces serious economic challenges. First of all, economic growth has to accelerate even more to create sufficient employment to absorb the large number of new entrants into the labour market each year. Creating sufficient and remunerative employment is essential to lowering the incidence of absolute poverty. Secondly, to achieve higher and sustained economic growth, private investment, including foreign direct investment (FDI), has to increase substantially, particularly as capacity utilization is now very high. For this investment to materialize, however, Indonesia's poor investment climate needs to be improved substantially.

Improving Indonesia's investment climate requires taking the difficult but important steps to deal firmly with widespread corruption at central and local government levels and in the judiciary. It requires improving legal certainty and ensuring proper enforcement of law to solve investment disputes in a fair and transparent way. Indonesia must also improve the opaque regulatory framework at both central and regional levels by simplifying regulations, improve management-labour regulations by removing overly anti-business regulations and upgrade the dilapidated physical infrastructure.

All these steps require improved governance, a tall order given the neglect of building strong and viable institutions during the Soeharto era and the strong opposition of vested interests, both at the central and regional government levels. Since improving governance also requires changing the mindset of government officials, this process may take years,

even one generation or more. However, building these strong and viable institutions, which are required to establish and enforce the basic rules on the government, business community and society at large, is imperative to achieve rapid, sustained and equitable growth. Without ensuring steadily rising standards of living for the Indonesian people at large, governments, even though democratically elected, may soon forfeit their political legitimacy, and even endanger the hard-won democratic and civil rights, as demagogic and populist leaders attempt to gain power by promising law and order and a better economic deal for the disadvantaged groups in society.

While decentralization in a big and geographically dispersed country as Indonesia was long overdue, the regional autonomy introduced in early 2001 also poses some new challenges to national unity and economic integration. Some regional governments have resorted to local chauvinism by favouring local businesspeople over businesspeople from other regions, in providing contracts, and favouring local people over people from other regions in providing employment opportunities in government offices. This can seriously affect the quality of contracts and employment, as meritocracy and competency are compromised. Equally worrisome is some regional governments' raising of barriers to inter-regional trade, which inhibit national economic integration. Several regional governments have also introduced various levies to raise their revenues as the grants from the central government have turned out to be insufficient to cover their expenditures. These levies have turned out to be merely 'nuisance taxes', which unnecessarily raise the costs of doing business in these regions.

Another challenge related to fiscal decentralization is that much larger amounts of revenues are now accruing to resource-rich regions. Consequently, the central government, with a budget already stretched by the large amount of foreign and domestic debt service payments and the large burden of fuel subsidies, has less funds to redistribute to the resource-poor regions. This poses another challenge to the central government: how to assist resource-poor regions to develop more rapidly and reduce inter-regional and intra-regional economic disparities in order to preserve national unity.

Despite the serious economic and political challenges facing Indonesia, President Susilo Bambang Yudhoyono has made several significant steps to deal with these challenges. A peace agreement has been reached with the Acehese rebels. If both the army and rebels adhere to this agreement, it will finally put an end to the bloody 20-year conflict, which has caused the loss of lives of thousands of innocent people. The president has also committed himself to reach a similar deal with the indigenous people of the other restive province, Papua, Indonesia's easternmost province, by offering them the same significant regional autonomy as has been promised to Aceh. The peace agreement with the Acehese rebels can also be seen as a significant step in reining in the propensity of the Indonesian military to resort to violence to what essentially are political or economic grievances, and thus slowly but surely establish civilian control over the military.

The president has also, to a much larger extent than has been the case with previous presidents, made a personal commitment to tackle the corrosive and widespread corruption by empowering the newly-established Commission to Eradicate Corruption (KPK) to interrogate senior officials suspected of it, and, with sufficient evidence, to incarcerate them. While one may be cynical of these actions, it is an incontrovertible fact that never before in Indonesia's history have so many senior government officials, both at the central and local government levels, been hauled to court, convicted and put in jail. While these

actions will certainly not make corrupt officials honest overnight, the humiliating experience of being interrogated and incarcerated must certainly have a deterrent effect on them to engage in blatantly corruptive behaviour.

It is still early days to proclaim that a new dawn has emerged for Indonesia. But the first steps towards genuine democracy, national reconciliation and strong economic recovery have been taken. For the interests of the Indonesian people and that of the whole East Asia region, it is to be hoped that this progress will show a steady upward trend, even though along the way there may be some unexpected setbacks.

Notes

1. The adverse effects of the real appreciation of a currency due to a resource boom experienced by the booming sector on the other sectors producing tradable goods is known as the 'Dutch disease'.
2. There is some controversy as to how accurately the Gini coefficients, calculated from the household expenditure surveys, reflect the true nature of inequality. Some observers, including this author, believe that Indonesia's income inequality rose towards the end of the 'New Order' regime due to its economic policies, which enabled the privileged groups in society, including the president's family and its cronies, to accumulate income-earning assets on a large scale.

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Further reading

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This book contains reprints of the surveys of recent economic developments in Indonesia written by the author since the mid-1960s through the early 1980s.
- Booth, A. (1988), *The Indonesian Economy During the Nineteenth and Twentieth Century – A History of Missed Opportunities*, London: Macmillan.
This book is the first book on Indonesia's modern economic history since the early 1800s through the mid-1990s, using the tools of economic analysis.
- Thee Kian Wie (ed.) (2003), *Recollections – The Indonesian Economy – 1950–1990s*, Singapore: Institute of Southeast Asian Studies.
This book contains 11 interviews with nine of Indonesia's former economic policy-makers and two indigenous Indonesian businesspeople. The interviews are preceded by an introductory chapter by the editor, putting the interviews in their historical context.

10 Brunei Darussalam

Rosnah Opai

A short political history

Brunei was referred to as 'Po-ni' or 'Po-li' in the ancient Chinese records of AD 518, 523 and 616. In the ninth century, it was conquered by the Sumatran Hindu Empire of Srivijaya. When the Srivijaya empire collapsed, Brunei came under the control of the Majapahit empire for a short while but soon regained its independence.

From the fourteenth to the sixteenth centuries Brunei was able to extend its control and influence over Sabah, Sarawak and the lower Philippines. During this period (1605–19) the ninth sultan, Hassan, fully developed an elaborate Royal Court structure, elements of which still remain today. However, this period of golden age entered a period of decline in the early seventeenth century due to internal conflicts as well as the rising influences of European colonial powers.

Brunei's territory gradually reduced. In 1839, the English adventurer James Brooke arrived in Borneo and helped the sultan put down a rebellion. As a reward, he first became governor and then later 'Rajah' of Sarawak in northwest Borneo expanding the territory under his control. In 1846 the island of Labuan was ceded to the British and a year later a treaty of friendship and commerce was signed between Brunei and Britain in which the Sultan agreed not to cede any more territory to any power, except with the consent of the British government. Later on, the British North Borneo Company expanded its control over territory in northeast Borneo.

In 1847, the sultan concluded a treaty with Great Britain and in 1888 Brunei Darussalam officially became a protectorate of the British government, which let it retain internal independence, but with British control over external affairs. By 1906, Brunei accepted a further measure of British control when executive power was transferred to a British resident, who advised the ruler on all matters except those concerning local custom and religion. This system was in place until the Japanese invasion in 1941.

A new constitution was written in 1959 declaring Brunei a self-governing state, while its foreign affairs, security and defence remained the responsibility of the United Kingdom. In 1962 a partially elected legislative body with limited powers was abandoned after the opposition political party, Parti Rakyat Brunei (PRB), launched a rebellion, which the government quickly put down with the help of British forces. Also during the late 1950s and early 1960s, there was pressure to join neighbouring Sabah and Sarawak in the newly formed Malaysia. The sultan eventually decided that Brunei would remain an independent state.

In 1967, the present sultan, Hassanal Bolkiah became the twenty-ninth ruler after the abdication of Sultan Omar Ali Saifuddien. The former sultan remained as defence minister and assumed the royal title Seri Begawan. In 1970, the national capital, Brunei Town, was renamed Bandar Seri Begawan in his honour. The Seri Begawan died in 1986. On 4 January 1979, Brunei and the United Kingdom signed a new treaty of friendship and cooperation. On 1 January 1984, Brunei Darussalam became a fully independent state and the sultan took office as prime minister, finance minister and home affairs minister,

presiding over a cabinet of six.¹ In 1987, the sultan took over the Ministry of Defence. In 2004, the sultan re-introduced Legislative Council consisting of 21 members appointed by the sultan and 15 elected members.

Economic progress and structural change

In this section, emphasis is on the economic progress and structural change of the economy. The main indicators that will be included are the basic macroeconomic data such as population, gross domestic product, per capita income, sectoral growth and contribution to GDP, export–import growth and surplus and deficit expenditure.

Gross domestic product

The last four decades had witnessed a continuous and sustained economic growth. From 1975 to 2004 the GDP at constant prices increased from B\$5307.3 million to B\$7661.1 million (Table 10.1) averaging an annual growth rate of 1.3 per cent per annum.

The most rapid GDP growth occurred during the 1970s, reaching its peak in 1980 with a total of B\$141 09.1 million (Table 10.1). Being an oil-dependent country, this was mainly due to the movement in oil prices. In 1979–80, the oil price hit its highest level and at the same time liquefied natural gas (LNG) exports to Japan came on-stream. With the decline in oil prices, GDP declined from B\$14.1 billion in 1980 to only about B\$8.4 billion in 1985. There was a substantial decline in GDP in 1986 due to the declining prices of oil and gas and the reduction of oil and gas production to comply with the nation's conservation policy. However, the performance of the economy improved in the early 1990s, but deteriorated again from 1994. The GDP from 1990 to 2004 fluctuated between B\$6.5 billion and B\$7.6 billion.

Per capita income

Brunei has a small population of only 0.3 million and the high income earned from the oil industry enabled Brunei to enjoy an increase in living standards. Brunei's GDP per capita is one of the highest in Southeast Asia. But as the oil revenue declined since 1981, the GDP

Table 10.1 Population, CPI, GDP and per capita income, 1975–2004

Year	Population	CPI	GDP (B\$ million) (constant)	PCI (B\$) (constant)
1975	156 180	52.2	5 307.3	33 981.9
1980	185 220	74.8	14 109.1	76 174.8
1985	218 100	92.7	8 362.8	38 343.9
1990	253 400	100.0	6 508.6	25 685.1
1994	280 500	109.9	6 083.9	21 689.5
1995	287 300	116.5	6 346.9	22 091.5
2000	324 800	121.7	6 114.3	18 824.8
2001	332 844	122.4	5 852.9	17 584.5
2002	340 800	119.6	6 397.7	18 772.6
2004	359 700	121.0	7 661.1	22 298.5

Source: Brunei Darussalam Annual Statistical Yearbook, various issues.

per capita income in constant prices decreased from its peak of B\$76 174.8 in 1980 to B\$21 298.5 in 2004 recording a negative annual growth rate of 1.6 per cent per annum.

Sectoral performance

Since the discovery of oil in 1929, oil has become the main engine of growth and economic development for the country. The oil sector's contribution to GDP reached its peak of over 90 per cent in 1980 (Table 10.2). Owing to declines in oil prices and increasing emphasis on diversification programmes in the mid-1980s the contribution of the oil sector declined considerably. For example, the oil sector's share in GDP fell from 71.37 per cent in 1985 to only 53.63 per cent in 1990, and now stands at around 35 per cent. In the years 1975 to 2004 the oil sector experienced a negative growth with an average of about -2.3 per cent per annum.

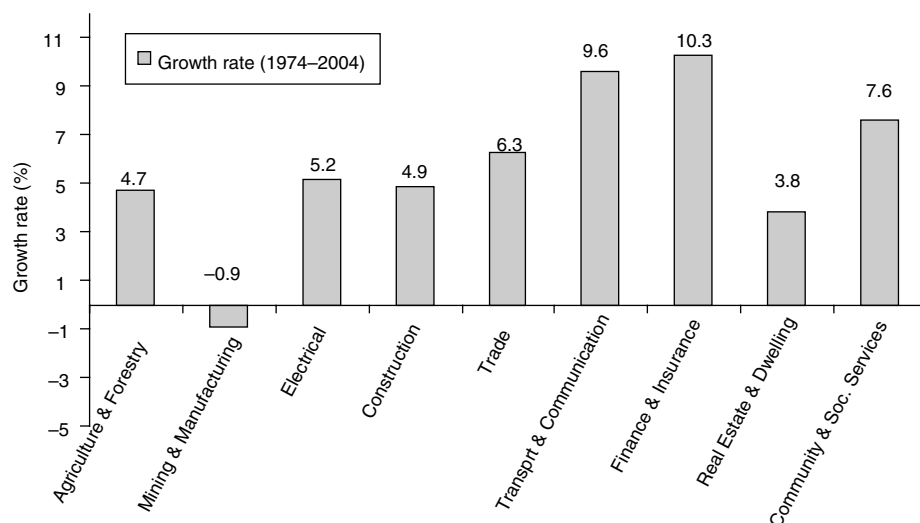
There has been strong growth in the non-oil sector, especially the community and social services, finance and insurance, transport and communication, trade and construction sectors. Among the non-oil sector, the share of community and social services in GDP rose from 4.4 per cent in 1975 to 25.6 per cent in 2004, recording an annual average growth rate of 7.6 per cent (Figure 10.1). The rapid increase in the share of this sector is due to the strong emphasis placed on providing services and facilities to improve the living standards or the welfare of the people. The community and social services sector is one of the highest recipients of the allocated budget or expenditure in every five-year National Development Plan period. The next after the community services is the contribution of trade (around 10 per cent) followed by financial services (around 7 per cent) and transport and communication services (around 5 per cent). The trade sector, which contributed between 1.6 per cent and 13.1 per cent (Table 10.3) to the country's GDP, grew at an average growth rate of 6.3 per cent in the period 1974–2004 (Figure 10.1). Although the trade sector's performance has been uneven, it is likely to play a key role in the future as the economy diversifies.

The sector that has recorded the highest growth rate is finance and insurance. It grew by 10.3 per cent per annum from 1974, increasing its relative GDP contribution from 0.5 per cent to 6.5 per cent in 2004 (see Table 10.3). The sector's growth can be attributed to the objective of the five-year National Development Plans to establish Brunei as a major financial centre in the ASEAN region.² The construction sector grew by 4.9 per cent per annum between 1974 and 2004. However, the performance of this sector has been

Table 10.2 Relative contribution to GDP by oil and non-oil sectors (1975–2004)

Year	Oil Sector (%)	Non-oil Sector (%)
1975	86.01	13.99
1980	90.29	9.71
1985	71.37	28.63
1990	53.63	46.37
1995	35.90	64.10
2000	36.90	63.10
2004	43.78	56.22

Source: Brunei Darussalam, *National Development Plans*, various issues.



Source: *Brunei Darussalam Statistical Yearbook*, various issues.

Figure 10.1 Sectoral growth rate, 1974–2001 (constant prices)

erratic. The early 1980s witnessed acceleration in construction activities, expanding at a remarkable growth of 16.5 per cent per annum. This was due to the construction of the public buildings prior to independence in 1984. The main problem faced by this sector is the lack of labour; most of the workforce is composed of migrant workers from ASEAN countries (for example, Thailand, the Philippines and Indonesia) and other Asian countries like India and Bangladesh.

The transport and communication sector grew by 9.6 per cent per annum. Overall, the growth of this sector reflects the concern of the government as reflected in the National Development Plan to improve the country's infrastructure to meet the demand of vigorous economic activities. There has also been an increase in the investment in telecommunications infrastructure and equipment. The transport sector has become an increasingly vital contributor to Brunei's economy, led in part by the expansion and modernization of the Brunei International Airport and road network. Brunei is developing into a key transport player in ASEAN countries, in particular, the East ASEAN Growth Area (EAGA).³

The agriculture and forestry sector grew at an average annual growth rate of 4.7 per cent. However, its share in GDP is still small. Hence, several efforts were made by government to develop the sector, as is reflected in the allocation of development expenditure in the various five-year National Development Plans. In order to stimulate interest amongst local Bruneian involvement in this sector, the infrastructure and facilities in rural areas were upgraded and agricultural training centres and agricultural stations in all districts were established to provide support services. However, success seems to be limited, output remains low and there is a continued dependence on importation of food from abroad. This clearly shows there is a lack of Bruneian interest in working on the land. The Bruneians find the jobs and salaries offered in the public services more attractive. For forestry, it only contributed less than 0.5 per cent to the national GDP.

Table 10.3 Distribution of sectoral GDP at constant prices (percentage), 1974–2004

Year	Agriculture & Forestry	Mining & Manufacturing	Electrical	Construction	Trade	Transport & Communication	Financial & Insurance	Real Estate & Dwelling	Community & Soc. Services
1974	1.3	88.5	0.2	1.3	2.2	0.5	0.5	0.9	4.4
1975	0.9	91.4	0.1	1.3	1.6	0.5	0.6	0.7	2.9
1980	0.6	82.8	–0.1	1.6	9.0	0.5	0.7	0.8	3.9
1985	1.2	68.7	0.4	2.0	10.5	1.7	2.0	1.7	11.7
1986	2.1	53.3	0.6	3.3	12.2	2.4	3.3	1.8	21.1
1987	2.0	54.3	0.6	3.1	11.8	4.0	3.3	1.7	19.3
1988	2.4	46.2	0.8	3.6	13.0	4.5	4.0	1.9	23.7
1989	2.4	45.6	0.9	4.3	13.1	4.5	4.2	1.9	23.0
1990	2.3	47.8	0.9	4.2	12.5	4.3	4.4	1.8	21.7
1995	2.5	36.5	1.0	5.3	11.2	4.7	5.1	2.1	31.5
2000	2.6	40.2	0.7	5.6	8.8	5.4	6.6	2.3	27.6
2004	3.5	43.8	0.7	3.6	9.1	5.5	6.5	1.8	25.6

Source: Brunei Darussalam Statistical Yearbook, various issues.

Brunei is still covered with 80 per cent forest. The local sawn timber only satisfies about 50 per cent of the domestic demand while the rest are imported from neighbouring countries.

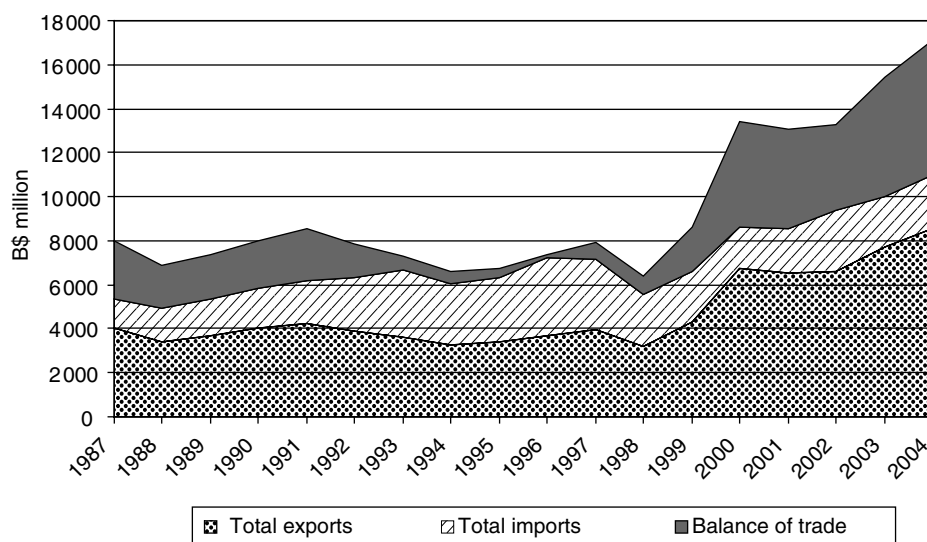
External trade

Before oil production became commercial in the 1930s, Brunei was dependent on coal mining and agricultural products such as rubber and cutch. Today, Brunei's main exports consist of crude oil, petroleum products and liquefied natural gas. These products account for over 90 per cent of the total exports, and Japan and South Korea are the principal destinations. Japan is the country's largest trading partner, which takes half of the oil produced by Brunei, followed by Korea, Singapore, Thailand and Australia. The major imports are machinery and transport equipment, manufactured goods, food and live animals. The major suppliers are Singapore, the United Kingdom, the United States, Malaysia and Japan.

Brunei maintains a favourable balance of trade owing to its oil and gas exports. As the population and domestic market is small, the demand for imports is limited. This has resulted in a large trade surplus (Figure 10.2). In recent years between 1999 and 2003 the trade surplus had increased.

Fiscal position

Table 10.4 demonstrates that Brunei managed to record a very high budget surplus in the early 1980s. A steep rise in budget surplus was recorded in 1980s from B\$1336 million in 1979 to B\$5125 million. The surplus was highest in the year 1981 (B\$7077 million). This was the result of the second oil price rise in the international market (US\$35.92 per barrel). With the decline in oil price, the budget surplus started to dwindle in 1982 when



Source: *Brunei Darussalam Statistical Yearbook*, various issues.

Figure 10.2 Exports, imports and balance of trade, 1987–2004 (B\$ million)

Table 10.4 Government revenue and expenditure, 1975–2004 (B\$ million)

Year	Government Revenue	Government Expenditure	Surplus/Deficit
1975	1564.4	481.0	1083.4
1980	6266.3	1140.9	5125.4
1985	7532.9	4317.9	3215.0
1990	2796.4	2790.5	5.9
1995	2450.5*	3656.4	–1205.9
2000	5084.4	4196.5	887.9
2004** (Apr. 04–March 05)	6402.0	4868.4	1533.6

Notes:

Foreign investment income is not included in the government revenue.

* Excluding transfer from Brunei Investment Agency.

** Fiscal year was adopted since 2003.

Source: *Brunei Darussalam Statistical Yearbook*, various issues.

it fell to B\$6129.6 million. In 1983 there was a further drop to B\$3295.8 million. From then onwards the government financial situation deteriorated continually and the budget became a budget deficit in 1988 (–B\$234.6 million).

The situation improved in 1993 and 1994, but since 1995 the government has been incurring a budget deficit averaging B\$1 billion a year and this is equivalent to an average of 15 per cent of the GDP. The highest budget deficit was recorded in 1998 (–1982.6 million) amounting to about 22 per cent of the GDP of that year. A continual budget deficit has greatly reduced the government's ability to provide direct employment and finance infrastructure development. Drawing from the Brunei Darussalam's foreign reserves has funded this deficit (Brunei Darussalam Economic Council, 1999).

The expenditure was at its highest in the years 1983–1985. The reasons were the increased expenditure on wages and salaries of public employees, construction of a new palace in preparation for Brunei's independence and other needs of the royal family (Arief, 1986). The biggest government expenditure by department is on Royal Brunei Armed Forces, followed by education, then medical and health and public works.

Social progress

In this section an attempt will be made to document the social progress or the general improvement in the condition and quality of living. Improvements of the quality of life of the people have always been one of the major aims mentioned in all five-year National Development Plans of Brunei.

Educational improvement

There are about 247 government and non-government educational institutions throughout the country, ranging from a university to pre-school classes (Department of Economic Planning and Development, 2003). Between 1974 and 2004, the number of enrolments in kindergarten rose from 1 496 to 13 014, primary enrolment from 30 109 to 46 382 and secondary from 13 687 to 39 553. The total enrolment increased from 46 216 in 1994 to 106 484

Table 10.5 Literacy of total population aged nine and over, 1971–2001

Year	Literacy	Illiteracy	% Literacy
1971	68 572	30 218	69.41
1981	115 942	28 453	80.29
1991	180 455	21 885	89.09
2001	249 550	14 402	94.50

Source: Department of Economic Planning and Development, *The Population Census*, Prime Minister's Office, Brunei Darussalam (various issues)

in 2004. To meet the need of the growing population and high level of education, the government has spent and allocated millions of dollars. For example, the education sector received B\$66.5 million, accounting for the highest share (12.5 per cent) of total expenditure in the Third National Development Plan (1975–79) (Economic Planning Unit, 1977). The government is not only active in establishing educational institutions locally but also gives scholarships to qualified Bruneians for courses not available locally to further their studies overseas.

As a result of the heavy investment by government in education, the literacy rate of the population of the country had improved tremendously. The percentage of literacy increased dramatically in the 1980s and by the 1990s the adult literacy rate increased to more than 90 per cent (Table 10.5). Considerable progress and expanding educational opportunities also meant that the number of girls attending school increased.

Health and medical care

The improvement in the standard of health is clearly shown through the general trends of increasing rates of life expectancy and the falling rate of infant mortality and crude death rate (Table 10.6). The steady improvement in health of the population in recent years was due to better health services and facilities. Not only has the number of public hospitals and private clinics increased but also the number of government and private doctors, nurses, midwives and dentists (Table 10.7).

There is also an easy access to health care and better medication. For medical services, the population only has to pay a minimum fee (B\$1 only for citizens and B\$3 only for non-citizens). Medical services are also provided for rural families in the remote areas by flying medical teams and doctors. Many tropical diseases have been completely eliminated and awareness of basic health through education has greatly improved. Recently, the Ministry of Health has taken a significant initiative to introduce its first strategic health plan, known as 'The National Health Care Plan 2000–2010'. It is a guiding principle for current and future implementation of programmes and projects designed to meet the challenges of the new millennium. These include the changing disease patterns, lifestyles, population demography and the escalating cost of health care and public expectations for better quality health care (*Borneo Bulletin*, 2005).

Poverty and income distribution

Generally, there is no clear evidence of extreme poverty. The overall growth in GDP was high enough to prevent the incidence of poverty, though it is not enough of a factor in

Table 10.6 Life expectancy at birth, infant mortality and death Rate, 1971–2004

Year	Life Expectancy		Infant Mortality Rate (per 1000)	Crude Death Rate (per 1000)
	Male	Female		
1971	–	–	38.4	5.9
1975	–	–	27.2	4.7
1980	69.5	72.7	17.5	4.0
1985	–	–	12.1	3.9
1990	72.0	76.4	7.2	3.0
1995	73.0	77.0	7.9	3.0
2002	74.0	77.2	8.3	3.1
2004	74.5	77.5	8.8	2.8

Source: Brunei Darussalam Statistical Yearbook, various issues.

Table 10.7 Number of hospitals and medical personnel, government and private, 1975–2004

Year	Hospitals	Physicians	Nurses	Dentists	Midwives
1975	6	51	288	18	118
1980	8	84	452	17	155
1985	8	149	663	25	172
1990	8	197	1228	27	254
1995	10	251	1288	38	278
2000	10	336	1359	48	441
2001	10	371	1540	48	462
2004	10	463	1747	68	527

Source: Brunei Darussalam Statistical Yearbook, various issues.

quantifying the incidence of poverty. In Brunei, the growth of GDP is used as a macro-economic instrument through public expenditure and public investment to affect the poverty and the aggregate economic activity. Public expenditure on social services and public utilities has been used as a powerful tool in influencing the distribution of income. For example, the growth in public expenditure on education and health care has appeared to help the poor in the country. Both education and health care are free for the citizen and the permanent resident.

In short, the issue of poverty and income distribution was tackled through the provision of the various services and facilities. The rapid development since the 1970s has made most remote areas accessible by roads. In addition, schools and medical centres were built in rural areas. As a result, the access to health care and education has also become easier. Government has also subsidized basic foodstuffs such as rice and sugar and has also subsidized public utilities such as electricity and water. It has also offered a special housing scheme and welfare scheme of special cash support. Under this welfare scheme, the government provides a monthly pension of about B\$200 to pensioners (60 years old and above).

Housing

Housing is another indicator for social development and social changes. The government has placed a great emphasis on improving the overall quality of housing for its employees and people. For the low-income group and landless citizen, the government introduced schemes such as the 'Housing Development Programme'. The government allocated B\$44.9 million (7.7 per cent of the total expenditure) for housing development under the Third National Development Plan, 1975–79 and B\$167.3 million (9.6 per cent of the total expenditure) in the Fourth National Development Plan, 1980–84 (Economic Planning Unit, 1980). These housing development programmes or schemes consist of three categories, namely the National Housing Development Programme (NHDP), Landless Indigenous Citizen Housing Scheme (LICHs) and Land Entitlement and Fill Scheme (LEIS). Under these schemes, eligible citizens can buy a house at subsidized prices. Housing development is a continuous programme and between 1972 and 1997 about 4667 housing complexes had been completed and about 1209 complexes are still under construction. Another housing scheme is provided by the Sultan Haji Hassanal Bolkiah Foundation mainly to help citizens affected by natural disasters. Government not only provides the various housing schemes but also gives 'government rented accommodation' to its officers and expatriates and gives assistance like interest-free housing loans to its local employees.

The role of the government

In the 1950s, the focus of the economic development plan in Brunei was on infrastructural development and the provision of social services. However, the execution of this plan was not properly monitored. Consequently, it was not a success and some regard it as purely experimental (Cleary and Shuang, 1994). Serious development planning started from the Second Development Plan (1962–66). Eight advisory groups from different ministries were involved in its formulation. The major economic objectives specified were economic diversification, the reduction of disparities in regional growth and a sustained increase in per capita GNP growth of at least 4 per cent per year. More equal income distribution and the creation of a more comprehensive system of education and health services were also important targets.

By the 1970s during the Third National Development Plan the Economic Planning Unit was established specifically to coordinate and to monitor the development plans and this resulted in new administrative structures and much more coordinated planning efforts. In the Third National Development Plan, the main declared objective was economic diversification. The Fourth National Development Plan covering the period of between 1980 and 1984 had an all-encompassing range of objectives, among which were to maintain the high employment levels, to reduce income inequalities, to diversify the economic base and to control inflation. More explicit ones were to secure an increase of per capita income levels of at least 4 per cent per annum and a minimum average annual GDP growth rate of 6 per cent per annum.

The Fifth National Development Plan (1986–90) (Economic Planning Unit, 1986) was the first full plan since independence in 1984 and it coincided with the downward spiral of oil and gas revenues. Economic diversification remained the main objective and to support this, new export-oriented as well as import-substitution industries had to be developed. As a result, there was a big increase in the private sector employment reflecting its expanding role. The major achievement appeared to be the development of human

resources, and the first university known as Universiti Brunei Darussalam was established during this period.

In the 1990s, during the Sixth and Seventh National Development Plans (1991–2000) (Economic Planning Unit, 1993, 1997) greater emphasis was given to diversification and sustainable economic base, maximizing resource utilization and optimizing government expenditure. Strategies to develop the agriculture sector to satisfy the diversification objectives were continued and the expansion of industrial estates was also emphasized. The oil sector declined at an average rate of 1.5 per cent per annum while the non-oil sector comprising both government and the private sectors grew at an average rate of 5.7 per cent per annum. There was an encouraging growth of employment opportunities in the manufacturing and the retail industries due to the increase in capital investments.

The Eighth National Development Plan covers the period 2001–05 (Department of Economic Planning and Development, 2000). The newly introduced sectors under the current Eighth NDP are information and communication technology, human resources and science and technology. The East Asian Financial Crisis in 1997, the collapse of the country's Amedeo Conglomerate in 1998 and the sharp drop in oil prices heavily affected many individuals and businesses in the private sector. In an effort to recover from these economic difficulties, His Majesty the Sultan during the Seventh ASEAN Summit on the 6 November 2001, announced the allocation of B\$1 billion development budget for year 2002 under the Eighth NDP. The objective of the fund injection into the NDP is to ensure that the development projects and programmes can be effectively implemented to accomplish the target of reaching the economic growth of between 5 and 6 per cent per annum. The budget allocation is also aimed at boosting business growth in the country in order to regain the confidence of investors.

Prospects and challenges

Brunei has experienced rapid economic growth as well as socioeconomic development and progress in the last three decades due to the huge revenue earned from hydrocarbons. The oil sector has been the backbone of Brunei economy dating back to the 1930s. The population has enjoyed a high living standard due to the expansion of infrastructure, improvement of public utilities and facilities, increased investment and accessibility to health care and education services and training. The workforce had become better educated and thus has led to an improvement of status of people economically and socially.

Unfortunately, the hydrocarbon industry upon which Brunei is entirely dependent is a non-renewable resource and according to some reports the oil reserves are near depletion. With the current estimate of reserves and the given current rate of extraction, the oil production is expected to last about another 20 years. The estimated proven reserve of oil in Brunei is 1350 million barrels (2004) and the annual production is 69 million barrels (2002).⁴ Other threats faced by the oil industry are the fluctuations in the global oil prices, recessions in the importing countries and new sources of energy. Hence, it is very difficult to predict long-term prospects and sustainability of income earned from oil and hence the sustainability of economic growth and socioeconomic development. In view of the over-dependence on revenue obtained from the oil sector, diversification of the economy has become a policy imperative. For this reason, the government has placed a special emphasis on diversifying the economy as reflected in the objectives in most of the five-year National Development Plans.

In response to this, the relevant agencies that are involved in the economic development planning put forward initiatives to formulate several strategies in their effort to help the economy diversify away from oil and gas industry. The major strategy to diversify the economy is by developing downstream industries, trading, tourism, financial services and small and medium-size enterprises (SMEs).

Brunei Economic Development Board (BEDB), which was formed in 2001, launched its two-pronged strategy in early 2003. The first strategy is the aluminium smelter project and with that it also plans to develop downstream petrochemical and manufacturing industries. The foreign investor in this project is Alcoa. The second strategy is to develop a deep-sea port facility that would be able to offer trans-shipment facilities and handle the next generation super tankers and containers. This is to develop Brunei as a trading and a mega-container port hub. These two projects expected to create 6000 jobs by 2008.

To develop Brunei as one of the financial centres in the region is also one of the top priorities of the government. With that aim, the Brunei International Finance Centre was established in July 2001. There is stiff competition from already established offshore international financial centres in the region. However, Brunei has found a niche where it can focus on providing Islamic financial facilities and services. Recently, the Islamic Bank of Brunei (IBB) and Islamic Development Bank of Brunei (IDBB) merged. The main aims of the merger are to eliminate duplication in order to reduce cost efficiency, to develop more products and services, to accelerate the growth rate of the industry and to expand regionally in line with the aim of the government to develop Brunei as an Islamic banking hub. IBB has already been involved with the establishment of Islamic Bank of Thailand through equity participation and technical assistance (*Borneo Bulletin*, 2005).

It is believed that tourism is one of the promising sectors. There has been a great effort in promoting the tourism industry in Brunei. An effort to turn Brunei into a 'service hub for trade and tourism' (SHuTT) has also been made. The vision of establishing Brunei as a SHuTT in the context of BIMP-EAGA⁵ is giving the nation a focus for future development. The objective of Brunei Darussalam as a SHuTT is to promote activities in the following areas:

- importing and exporting through Brunei Darussalam;
- travelling to and through Brunei Darussalam;
- doing business in and through Brunei Darussalam;
- communicating from and through Brunei Darussalam.

The country also targeted to see one million visitor arrivals by the year 2001. Therefore, in 1999, the Visit Brunei Year 2001 campaign was launched in London. In the same year Brunei hosted the SEA Games and in the 2000 APEC summit was held there. Now, in terms of hotel and other hospitality facilities Brunei already has met the international standard.

In pursuing the diversification policy, the government encouraged the establishment of small and medium-sized enterprises (SMEs) by providing infrastructure and the necessary incentive. Intensive effort was made, which included the construction of infrastructure to facilitate accessibility, technological support and financial assistance programmes. Brunei Economic Development Board (BEDB) is setting up its first SME Innovation Centre, scheduled to be completed in April 2006 (*Borneo Bulletin*, 2005). It is also believed

that the development of downstream industries will give opportunities to many contractors. This will also help create jobs for the growing local workforce.

It is hoped that the research and development, emphasis on labour development through training and education, intensive investment promotion policy, growing cooperation and public-private partnership, strengthening of capabilities of relevant agencies and so forth will help in catalyzing all the strategies mentioned in order to enable the country to achieve and generate rapid and stable growth rates.

Notes

1. Under Brunei's 1959 constitution, the sultan is the head of state with full executive authority, including emergency powers since 1962. The sultan is assisted and advised by five councils, which he appoints. The councils are the Religious Council, the Privy Council, the Council of Ministers (the Cabinet), the Legislative Council and the Council of Succession.
2. The Brunei International Financial Centre (BIFC) is under the Ministry of Finance and has been operational for almost five years since its establishment in July 2000.
3. Economist Intelligent Unit, *Country Profile Malaysia and Brunei*, 1996–97, p. 62.
4. *National Geographic* (2004).
5. BIMP-EAGA: Brunei-Indonesia-Malaysia-Philippines-East Asian Growth Area (or simply EAGA) is Asia's largest economic growth area, and constitutes the entire sultanate of Brunei Darussalam: ten provinces in the Indonesian islands of Kalimantan, Sulawesi, Maluku and Irian Jaya; Sabah, Sarawak and Labuan in Malaysia; and Mindanao and Pahlawan in the Philippines. Its area of roughly 1.54 million square kilometres is home to about 45.6 million people (1996). With the exception of Brunei, these areas have traditionally lagged in economic development when compared with their respective capital regions, despite being rich in natural resources. The ASEAN governments of Brunei, Indonesia, Malaysia and the Philippines united in their desire to enable this area to fully participate in the ASEAN development process, and agreed to form the ASEAN sub-regional economic growth area BIMP-EAGA in March 1994.

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Further reading

Cleary, M. and Wong Shuang Yann (1994), *Oil, Development and Diversification*, London: Macmillan Press.

Provides a comprehensive analysis on the linkages between oil industry and the development of Brunei's economy and society. It also documented the impact of burgeoning oil revenues have had on a range of development strategies.

Anaman, Kwabena A. and Ismail Duraman (eds) (2003), *Applied Economic Analysis in Brunei Darussalam: Evaluation of Economic Growth and Trade, Microeconomic Efficiency and Analysis of Socio-Economic Problems*, Brunei: Department of Economics, Faculty of Business, Economics and Policy Studies, Universiti Brunei Darussalam.

Contains analysis of macroeconomic, microeconomic and socioeconomic problems. The insights presented in the book could perhaps stimulate other perspectives and ideas and may become the springboard for further research.

Obben, J. and Siew Ee (eds) (1998), *Readings on the Economy of Brunei*, Volume 1, Brunei: Department of Economics, Faculty of Arts and Social Sciences, Universiti Brunei Darussalam, Etc, UBD.

Ee, Siew and Ismail Duraman (eds) (2002), *Readings on the Economy of Brunei*, Volume 2, Brunei: Faculty of Business, Economics and Policy Studies, Universiti Brunei Darussalam, ETC, UBD.

These two volumes are a compilation of some recent research papers written by university academics and government policy-makers. There are discussions on various issues such as FDI, government expenditure, public sector housing, private sector employment, inflation and monetary, population and labour, development and planning. These two volumes should give a better understanding of the structure and dynamics of Bruneian economy.

11 China

Huijiong Wang

A short political history

China covers an area of 9 561 000 square kilometres, slightly larger than that of the United States. China shares borders with 14 countries, namely, North Korea, Mongolia, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, Afghanistan, Pakistan, India, Nepal, Bhutan, Myanmar, Laos and Viet Nam. The Han Chinese form nearly 92 per cent of the population, and there are 55 minorities besides the Han. Most of the population inhabit in the eastern coastal side of the country. Nearly 520 million people in China live in cities or towns, but the other 60 per cent live in rural areas.

China has a very rich civilization, dating back thousands of years (to at least 1500 BC). During its long history, various schools of philosophy – Confucian, Daoist, Maoist and Legalist – flourished in China. However, since Confucius' death in 479 BC, China became the centre of conflicts between contending kingdoms (Fitzerald, 1995).

China was unified in 221 BC by the Qin dynasty, which imposed a harsh Legalist code of laws and administration. The Qin law glorified war and despised art and literature. The Qin promoted agriculture as the foundation of military strength. The Qin were replaced in 206 BC by the Han who ruled until AD 221. The Han promoted art and culture, and during the Han rule the use of paper and ink began. The Han also improved the feudal system, filled the civil service with educated people, and accepted Confucianism as the state philosophy.

The Tang dynasty reunified the empire in AD 618 after the confusion and split of the country due to Tartar invasion. The Tang introduced a bureaucracy recruited by public examination open to all literates. It was a highly developed administrative system, and art and literature flourished during the Tang rule.

The Mongols conquered China in AD 1280 in a most destructive war. It was the most oppressive regime and a huge depopulation occurred during the rule, turning great areas of fertile land into wilderness. The Mongol rule ended in AD 1368 with the foundation of the Ming dynasty.

The Ming expanded the limits of the empire, incorporating Manchuria in the south and Yunnan in the north. The Ming rule was much more autocratic and it sent naval expeditions to Southeast Asia, the Indian coast, Persian Gulf, Red Sea and East Africa for merchandise and cultural exchange. The Ming dynasty fell in 1644 to an internal rebellion, which led to the foundation of Manzhou or Qing dynasty. The Qing ruled until 1912. It was during the Qing rule that the infamous Opium War was fought and lost, which led to the Treaty of Nanjing, establishing the Treaty Ports. After that, the Qing rule became weakened by internal feuds. Foreign powers took advantage and Russia, France and Japan seized parts of China. The monarchy was finally abolished in 1911 with a revolt of the army at Wuhan.

People deeply resented the erosion of Chinese sovereignty in the face of the growing influence of foreign powers and the despotic monarchy. Dr Sun Yat-sen, a Western-educated

physician, inspired young intellectuals to revolutionary ideas. He built up a nationalist party (KMT) and maintained an unceasing effort for radical transformation of China. A student riot broke out on 4 May, 1919 in Beijing to protest against the government's secret deal with Japan to hand over the former German port of Qingdao in Shandong. The riot quickly turned anti-Western, in particular against the British. Dr Sun Yat-sen gradually aligned himself with the Soviet Union, which supported him with arms and money. Dr Sun Yat-sen's army and party regained control of Guangzhou in 1923.

The Chinese Communist Party (CCP) was formed in 1921, and marked an important turning point. In 1935 the CCP under the leadership of Mao Zedong organized the 'Long March' to topple the KMT government, but when Japan invaded China in July 1937, both CCP and KMT armies fought together against Japan.

With the fall of Japan in 1945, a civil war broke out between the Communist Party, led by Mao Zedong, and the Nationalists, led by Chiang Kai-shek, who was backed by the United States. Mao's Communist Party defeated the Nationalists, and proclaimed the People's Republic of China (PRC) on 1 October 1949. Chiang Kai-shek fled to the island of Taiwan (Formosa) where he continued to head the government of the Republic of China. The government of the PRC never recognized the government established in Taiwan, considers Taiwan a breakaway province, and wants to reunite it.

The Soviet Union was the role model for China, and provided aid and technical support at the initial stage. However, the two great socialist countries became suspicious of each other over the Korean War. The two communist countries eventually broke relations on ideological grounds after the death of Stalin and the assumption of power by Khrushchev in the late 1950s. The Soviets withdrew their technical aid and experts from China in 1960, forcing China into a very painful adjustment period.

Mao introduced the idea of the 'Great Leap Forward'¹ in 1958 as his favoured approach to economic development, which involved grass-root-level initiatives in contrast to the heavy central bureaucratic-controlled Soviet model. Before that in 1957 Mao had introduced the Hundred Flowers movement, which allowed open criticism of the CCP's methods. However, an anti-right movement was introduced in 1958, which banished the Hundred Flowers movement. The power struggle culminated in the Cultural Revolution (1966–76), which saw the rise and fall of President Liu Shaoqi and purging of Deng Xiaoping and his followers.

After the death of Mao Zedong in 1976, Deng Xiaoping made a dramatic comeback. Under the leadership of Deng, the Communist Party Plenum in December 1978, adopted the policy of economic reform. The reform leaders strongly believed that Mao's bias against foreign technology and trade had severely damaged China's modernization.

The younger generation of the Chinese population who tasted economic freedom following the market-oriented reforms, became thirsty for political freedom as in the West. Premier Zhao Ziyang emerged on the students' side in the Tiananmen Square protest in 1989. The purging of Premier Zhao and his followers after the Tiananmen Square event looked very similar to the one during the height of Cultural Revolution² that purged Deng himself. However, what made the difference was that the leaders of Cultural Revolution (the 'Gang of Four') were ideological demagogues, whereas Deng was a pragmatist who believed that without economic strength and political stability, no lasting socialist state could be built. Deng Xiaoping pointed out that the market mechanism could be a useful tool for China's economic development and was hence consistent with the socialist

ideology. Deng's view was formally endorsed in October 1992 by the Fourteenth National Congress of the Chinese Communist Party. The concept of establishing a socialist market economy was enshrined in China's constitution during the first session of the Eighth National People's Congress in March 1993. Thus, by reconciling the two concepts of 'building the economy' and 'building socialism', the ideological breakthrough for a legitimate role of market was made in the early 1990s.

The role of the party and the administrative structure

China's basic political structure remains that of a one-party government where party and government functions are intertwined. The party delegates much of the running of China's affairs to a government that is organized separately but is subordinate to the party. The party has enforced social and political discipline through the pervasive role of party branches, and claims the absolute command of China's military force. There is also the Chinese People's Political Consultative Conference, composed of CCP and different democratic parties. This conference is led by the CCP, and cooperates with the CCP on political and other affairs.

The new constitution describes China as a socialist state of the dictatorship of the proletariat led by the working class, and is based on an alliance of workers, peasants and intellectuals. According to the constitution, the supreme organ of state power is the National People's Congress. It makes legislation and treaties, nominates the executives and approves the constitution. It has roughly 3000 members, indirectly elected from the lower-level People's Congresses every five years. A plenary session of two to three weeks is normally held each spring in Beijing.

The country's administration is run by the state council (the Cabinet) whose members are elected by the National People's Congress acting on recommendations from the Communist Party. The first layer of administration comprises 22 provinces, five autonomous regions and four municipalities (Beijing, Shanghai, Tianjin and Chongqing). The names of the autonomous regions reflect the concentration of minority ethnic Chinese. The regions with a relatively large minority concentration are set up as autonomous regions instead of provinces. The five autonomous regions are Inner Mongolia, Guang Xi Zhuang, Tibet, Ning Xia Hui and Xingjiang Uygur. The next layer of administration includes 151 rural prefectures and 187 prefecture-level cities, under which there are about 289 county-level cities and 1894 counties.

In addition, four Special Economic Zones (SEZs) were established in 1980 in the southern provinces. Hainan province was later declared the fifth SEZ. The SEZs enjoy considerable financial autonomy, and preferential treatments for foreign investors.

Hong Kong and Macau became Special Administrative Regions after their reversion from the British and Portuguese rule in 1997 and 1999 respectively. The Chinese government has also offered a similar model to Taiwan for reunification.

Economic progress and structural change

With the recent revision of Chinese national accounts data, China has become the sixth largest economy in the world, with a GDP of nearly US\$2 trillion in 2004. At the current rate of economic growth, China is expected to overtake the United Kingdom's position and rank fourth. Thus, China has become a fully-fledged economic superpower.

The economic performance of China should be studied separately for the pre-reform era (1950–80), and the reform era (1980–present). The early phase of the pre-reform era

was characterized by a central planning system, which was a reprint of the former Soviet model. However, in the post-1957 period, there were several cycles of decentralization and recentralization of the economic decision-making power. This made the Chinese economic system different from that of the former Soviet Union. Nonetheless, during the pre-reform era, China continued to use the Material Production System (MPS) of statistics, which regards only the economic activities related to material production as productive. For example, China used GVIAO (gross value of industrial and agricultural output) to represent overall economic activity, rather than GDP. The former indicator includes consumption of intermediary materials, while the latter represents the net value-added. The National Bureau of Statistics recalculated many pre-1980 figures to make them consistent with international practice. But they are only approximations.

Macroeconomic performance in the pre-reform era

Economic growth, structural change and inflation China enjoyed a relatively higher growth rate than many developing countries in this period. The average growth rate of GDP was 6.2 per cent from 1952 to 1978, and per capita GDP grew at 4 per cent in the same period. This period is also marked by a rapid increase in the share of the secondary sector in GDP (Table 11.1), which is normal for developing countries in their process of industrialization. But it is interesting to note that there is a decline in the share of tertiary sector from 1950 to 1980. This is an outcome of the former Soviet model, which discriminates against the tertiary sector, considered non-productive in the MPS system.

Some of the industries that grew significantly during the pre-reform period were: steel (12.5 per cent), crude coal (8.3 per cent), crude oil (21.6 per cent), electricity (14.2 per cent), chemical fertilizers (22.8 per cent), plastics (24.3 per cent), power generating equipment (26.3 per cent), mining equipment (17.4 per cent), internal combustion engines (25.9 per cent), cement (12.6 per cent), sugar (6.4 per cent), wine (10.4 per cent), tobacco (6.4 per cent), cotton cloth (4.6 per cent), woollen piece goods (11.9 per cent).

Due to strict controls of the price system by the central government and the system of rationing commodities of basic needs, such as food, oil, cloth etc., generally, the rate of inflation was low, except in the period of the 'Great Leap Forward'. China used the general retail sales price overall index for the measurement of inflation during this period, which is shown in Table 11.2.

Fiscal position In the initial period of establishment of the PRC, all means and measures were used to establish a highly centralized fiscal system. At the National Financial Conference in February 1950, it was decided to centralize strictly all matters of finance and decisions on their use; all major receipts in various regions of China must be

Table 11.1 Share of GDP of economic sectors (%)

	1950	1957	1970	1980
Primary sector	50.5	40.6	35.8	31.3
Secondary sector	20.8	29.2	39.8	48.2
Tertiary sector	28.7	30.2	24.4	20.5

Source: China Statistical Yearbook 1992, China Statistics Press.

Table 11.2 Retail sales price overall index and rate of inflation

Year	Retail Sales Price Overall Index	Year	Annual Rate of Inflation (%)
1957	121.3	1950–57	2.8
1965	134.6	1957–65	1.3
1975	131.9	1965–75	–0.2
1979	138.6	1975–79	1.2

Note: 1950 = 100.

Source: China Statistical Yearbook 1992, China Statistics Press.

Table 11.3 Fiscal revenue income and expenditure unit: RMB100 million

Year	Total Revenue Income	Total Budget Expenditure	Balance
1952	183.72	175.99	7.73
1957	310.19	304.21	5.98
1965	473.32	466.33	6.99
1975	815.61	820.88	–5.27
1979	1103.27	1273.94	–170.67

Source: Ma (1982: 448).

submitted to the Central Treasury; they could not be used without the order of allocation from the central government. All local outlays also needed to be approved by the central government, which allocated the outlays on a monthly basis. Thus, the national budget was divided into three levels (central, provincial or municipal and county). In allocating the outlays, generally, the local authority had a share of around 20 per cent, while the central government had a share of around 80 per cent. The national budget was in surplus in most years, except from the mid-1970s (Table 11.3).

In the period of the 'Great Leap Forward', there was decentralization of the management of state-owned industries. But this process of decentralization was implemented without detailed planning. Eighty per cent of the enterprises and institutions (*shiye danwei*) managed by various line ministries were delegated to local governments within a very short period. This created confusion as most local governments did not have administrative capacity and adequate fiscal power. Hence, the process was abandoned with recentralization in January 1961. This cycle reappeared in the period of the Cultural Revolution from 1966. There was further recentralization in 1977. This to some extent explains the negative budget balance as shown in Table 11.3.

The central government's revenue was composed of receipts from local governments, profit from state-owned enterprises (SOEs) and taxation. As can be seen from Table 11.4, personal income tax formed a very minuscule source of revenue. The bulk of the revenue came from the SOEs.

External sector China's international trade in the pre-reform era can be roughly divided into four periods. During the economic recovery period (1950–52), there was a trade

Table 11.4 Structure of fiscal income of China in the pre-reform era (selected years)

Year	Enterprise Income		Various Taxation Income				
	Total (%)	Within which: industrial income (%)	Total (%)	Industrial and commercial tax (%)	Agricultural tax (%)	Debt Income* (%)	Other Income* (%)
1950	13.4	6.8	75.1	36.2	29.3	4.6	6.9
1957	46.5	19.1	49.9	36.5	9.6	2.3	1.3
1965	55.8	45.7	43.2	35.0	5.4		1.0
1978	51.0	39.3	46.3	40.3	2.5		2.7

Note: *Debt income: loans from the former Soviet Union.

Source: 1984 *China Statistical Year Book*, China Publishing House.

blockade enforced by Western countries. As a result, trade stagnated and total external trade increased marginally from US\$1.135 billion in 1950 to US\$1.941 billion in 1952. Both imports and exports were mainly raw materials and agricultural products during this period.

The second phase was the First Five-year Plan period (1953–57) when China constructed 156 industrial projects with assistance from the former Soviet Union. Imports in this period were mainly capital goods, with a share of around 92 per cent. Exports from China included cotton yarn and cloth, and equipment for light industries, such as textiles, cement and paper. The total amount of external trade reached US\$3.103 billion in 1958.

Next was the period of adjustment ('Great Leap Forward') and the beginning of trade relations with Western countries (1958–65). There was also a change in the structure of imports in this period. For example, the share of consumption goods (grain, sugar, etc.) increased from 4.3 per cent in 1959 to 44.5 per cent in 1964. Exports from China reached US\$2.228 billion in 1965, the highest level since establishment of the PRC.

The pattern of external trade in the period of the Cultural Revolution (1966–76) was a zigzag one. In 1969, the total external trade was US\$4.029 billion, a decline of 12.7 per cent compared with 1966. There was a recovery of external trade after 1970, with the gaining of China's position in the UN. In 1975, total external trade reached US\$14.75 billion in 1976. External trade declined to US\$13.433 billion due to domestic political disturbance. But the average growth rate of external trade from 1965 to 1976 still reached 11 per cent as China changed from a closed or semi-closed society to a semi-open society in the latter stage of this period. The structure of imports was mainly raw materials for industrial production, China exported petroleum oil from 1973, and it became a dominant export item from 1975.

Macroeconomic performance in the reform era

China achieved significant progress through a gradualist approach to reform. Economic reforms and the opening up of a country like China, with 1.3 billion population and a land area around 9.60 million square kilometres, have by no means been simple tasks. An entire new social infrastructure had to be built and introduced to a people who knew very

Table 11.5 Gross output (in 1990 prices) percentage share by ownership

	1995	1996	1997	1998	1999	2000	2001	2002	2003
State-owned	64	58	57	54	45	40	30	26	24
Collective	13	14	13	11	11	9	7	6	5
Joint stock	8	9	11	13	17	23	27	29	28
Domestic private	0	0	0	0	1	1	2	3	4
Foreign investment (all types)	15	19	19	22	26	27	34	36	39

Source: Deng et al. (2005).

little about them. For example, workers could no longer depend on lifelong employment and the SOEs could not act as social safety nets. Thus, most of the reforms were undertaken initially on an experimental basis. If they went wrong, the government was quick to abandon them. However, in most cases, the pilot reform measures were further fine-tuned and re-introduced in a more sophisticated fashion. In short, reforms were seen as a continuous process rather than one big-bang event.

What China has achieved since it embarked on economic reforms in 1978 can be attributed to careful sequencing of reforms. For instance, at the beginning, rural and foreign sectors were selected for reforms as per capita grain output stagnated and it was believed that Mao's bias against foreign technology and products had hurt the economy most. Later when the reforming SOEs faced difficulties, the financial sector and the welfare system, as well as the infrastructure, were identified for further reforms. Finally, the leadership regarded economic reform as a dynamic programme in which non-profitable activities were squeezed out by more vibrant sectors. For example, instead of a large-scale privatization programme or bankruptcy of SOEs, the reduction in the role of SOEs was achieved by letting the dynamism of the private sector grow while SOEs struggled to survive (see Table 11.5).

Economic growth structural change and inflation China's economy grew at an average annual growth rate of around 9.5 per cent during 1980–2004. The growth rates of GDP in the Sixth Five-year Plan (1980–85), the Seventh Five-year Plan (1985–90), the Eighth Five-year Plan (1990–95), and the Ninth Five-year Plan (1995–2000) periods were 11.1 per cent, 6.4 per cent, 14.9 per cent and 6.0 per cent, respectively. With rapid growth, the Chinese economy has also undergone significant structural change. As can be seen from Table 11.6, while the industrial sector continued to grow, in contrast to the pre-reform period, the tertiary (or service) sector's share grew since the introduction of reforms. Banking and tourism sectors experienced the fastest growth in the service sector. The recent revisions of the national accounts revealed that the service sector has in fact grown at a much faster rate, contributing to 17 per cent growth of its GDP in 2004.

The highest rate of inflation in the reform era was 24.1 per cent, and the lowest was –1.4 per cent. CPI varied between 103.1 and 118.6 during the Seventh Five-year Plan (1985–90). It varied between 103.4 and 124.1, and between 99.2 and 108.3 during the Eighth Five-year Plan (1990–95) and the Ninth Five-year Plan (1995–2000) periods, respectively. In 2004, CPI was 103.9. In general, inflation in China is driven by a high growth rate of investment. The Chinese government had to take measures such as

Table 11.6 Sectoral share GDP (1980–2003, selected years, %)

Year	Primary Sector	Secondary Sector	Industry within Secondary	Tertiary Sector
1980	30.1	48.5	44.2	21.4
1985	28.4	47.1	38.5	28.5
1990	27.1	41.6	37.0	31.3
1995	20.5	48.8	42.3	30.7
2000	16.4	50.2	43.6	33.4
2004	15.2	52.9	45.9	31.9

Source: China Statistical Abstract 2005, China Statistics Press.

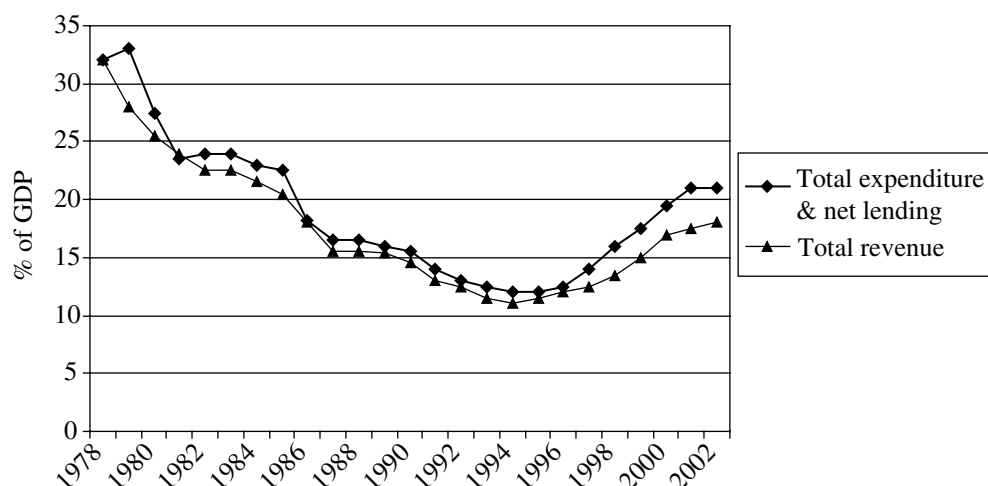
controlling credit growth and slashing of public investment to slow down the economy and control inflationary pressure.

Fiscal position and rationalization of the fiscal system As part of the reform process, the budgetary system in China has undergone major changes. For example, the government changed the profit remittance of the SOEs into a contract responsibility system. The government also implemented the fiscal contract responsibility system to all provinces. As a result, the revenue and expenditure of the central government declined rapidly as shown in Figure 11.1.

The Chinese government rationalized its fiscal system from 1994. Three types of revenues are classified for distribution between the central and local governments: fixed central government revenues, fixed local government revenues and shared revenues. Proper scope of fiscal expenditure between the central and local governments has also been established, based on the responsibility of administration. The reimbursement of tax from the central to local government has been made consistent with expenditure responsibilities. There is also rationalization of the relationship with the SOES through taxation. This process of rationalization resulted in the improvement of revenue income of the central government as shown in Table 11.7.

Savings–investment ratio One unique feature of the rapid economic development of China is its high domestic savings and investment rates. In the pre-reform era, there were almost no personal savings. All savings came from SOEs and all investments were allocated by the government. Since the launch of economic reform and opening up of China, there has been a rapid increase of personal savings in the banks and it has become a dominant source of investment over the fiscal expenditure of the government. Savings from urban and rural households in the banks increased from RMB21.06 billion in 1978 to RMB11 955.4 billion in 2004. This growth of savings in the banks has not been steady due to the establishment of two stock markets in Shanghai and Shenzhen in 1990 and a newly emerged property market, which have diversified channels of savings and investment. The savings rate increased from around 32 per cent in 1980–96, to 42 per cent in 2004.

Commensurate with high savings, the investment ratio also rose. The total social investment in 2003 was RMB5556.6 billion, representing an investment ratio of 48 per cent. The structure of investment sources in 2003 was 4.3 per cent from the state budget, 20.5 per



Source: Ministry of Finance.

Figure 11.1 Government revenue and expenditure (% of GDP), 1978–2002

Table 11.7 Budget revenue income and expenditure since 1990 (RMB100 million)

Item	1990	1995	2000	2002	2004
Total fiscal revenue income	2 937.1	6 242.2	13 395.2	18 913.9	26 355.9
Central	992.4	3 256.6	6 989.2	10 390.0	14 476.1
Local	1 944.7	2 985.6	6 406.1	8 523.9	11 879.8
Extra budgetary income	2 708.6	2 406.5	3 826.4	4 566.8*	
Extra budgetary income local	60.6	171.7	3 578.8	4 187.4*	
Debt income	375.5	1 549.8	4 180.1		6 871.4
Domestic debt	197.3	1 510.9	4 153.6		6 726.3
Loan from abroad	178.2	38.9	23.1		145.1
Total budget expenditure	3 083.6	6 823.7	15 886.5	22 011.7	28 360.8
Central	1 004.5	1 995.4	5 519.9	6 755.8	7 895.6
Local	2 079.1	4 828.3	10 366.7	15 255.9	20 465.2
Total budget surplus	−146.5	−581.5	−2 391.3	−3 097.1	−2 004.91
Share of GDP	−7.9 %	−1.4 %	−2.7 %	−3 %	−1.5 %

Note: * 2003 figure.

Sources: China Statistics Abstract 2003, 2004, China Statistics Press.

cent from domestic loans, 4.4 per cent from foreign investment and 70.5 per cent from fundraising of enterprises and others. In contrast, the relative contribution to investment from these sources in 1981 was 28 per cent, 12.7 per cent, 3.8 per cent and 55.4 per cent, respectively. This shows that the government has shifted its responsibility for investment to other sources of funding.

Table 11.8 Growth of exports and imports of China (billion US\$)

Time Period	Import+Export	Export	Import	Trade Balance
Sixth Five-year Plan period (1981–85)	252.4	120.0	132.3	–12.3
Seventh Five-year Plan period (1986–90)	486.4	232.5	253.8	–21.4
Eighth Five-year Plan period (1991–95)	1014.3	518.3	496.0	22.2
Ninth Five-year Plan period (1996–2000)	1773.9	961.6	812.2	149.4
2004	1154.8	593.4	561.4	32.0

Source: *China Statistics Abstract 2003*, China Statistics Press.

External economic relations and external trade Another feature of the rapid economic development of China in the era of reform and opening up, in terms of its external sector, has been the rapid growth of external trade, utilization of FDI and opening of Special Economic Zones. China became a member of WTO on 11 December 2001.

China's total external trade grew annually by about 15 per cent on an average from US\$38.14 billion in 1980 to US\$1154.79 billion in 2004. China now ranks second in terms of imports and fourth in terms of exports in the world. The growth of exports and imports can be seen in Table 11.8.

Not only has there been growth of exports and imports, there have also been structural changes in these two. The share of Chinese exports of primary products reduced from 50.4 per cent in 1980 to 7.9 per cent in 2003, and that of manufactured goods export increases in this period. The share of imports of primary products also declined from 34.7 per cent in 1980 to 17.6 per cent in 2003. Correspondingly, the imports of manufactured goods or intermediaries increased during the reform era.

China enjoyed a trade surplus from 1990 to 2004 except in 1993. This has caused increased trade friction with the United States and European Union. China had nearly US\$225 billion trade surplus with the United States in this period.

Since the opening up of the economy, the United States and Japan became two major trading partners of China, accounting for over 30 per cent of both its exports and imports. China's trade with other Asian countries has increased substantially over the last decade, and China is now regarded as the economic power house for Asia, as the Japanese economy still struggles for sustained recovery. China's relations with the fast-growing Southeast Asian countries have been improving very rapidly within the framework of ASEAN Plus Three (Japan, China and South Korea). China participated in the East Asian leaders' summit at Kuala Lumpur (held in December 2005), which shows its growing influence in the region.

China has been successful in diversifying its economic relations with other nations as well. For example, its trade and investment links with the Latin American countries, such as Venezuela and Brazil, have strengthened since early 2000. China agreed to invest in Venezuela's oil industry to double its production to 5.1 million barrels a day by 2012. China's imports of soya beans and iron ore from Brazil have also increased substantially in recent times.

Third-generation leader Jiang Zemin and the current leader Hu Jintao have both travelled around the world to promote dialogue among world leaders and to encourage economic, technological and cultural relationships among the people. China participates

Table 11.9 Foreign direct investment in China (1979–2004)

Source	US\$ billion 1979–93	% Share 1979–93	US\$ 1994–2004	% Share 1994–2004
Hong Kong and Macau	150.9	68.0	212.1	42.5
Taiwan	28.4	8.3	35.2	7.1
USA	14.4	6.5	43.3	8.7
Japan	8.9	4.0	41.9	8.4
Singapore	3.0	2.2	24.7	4.9
UK	3.0	1.4	11.6	2.3
Thailand	2.1	0.9	2.3	0.5

Sources: Ministry of Foreign Trade and Economic Cooperation, reported in *China Economic News*; *China Statistics Yearbook 1995–2005*.

actively in the APEC Forum and the Shanghai Cooperation Organization (of mainly countries of Central Asia and Russia).

Utilization of foreign funds The total amount of foreign funds used by China from 1979–2004 (Table 11.9) was US\$743.6 billion. Of this amount US\$147.2 billion was foreign loans, US\$560.4 billion was FDI and US\$36.1 billion were other types. China changed its policy to utilize more FDI than foreign loans since the Eighth Five-year Plan period, when foreign loans was US\$45.6 billion and FDI was US\$114.2 billion. The corresponding figures in the previous period of Seventh Five-year Plan, were US\$30.1 and US\$14.3 billion, respectively.

Gradual approach of opening up to the outside world China had set up four Special Economic Zones (SEZs) – Shenzhen, Zhuhai, Shantou and Xiamen – in August 1980, with preferential policies for foreign investment in those SEZs. In 1984, 14 industrial port cities were further opened up to the outside world. In February 1985, the State Council further decided to open 51 municipalities and counties of the delta area of Pearl River, Yangtze River and Southern Fujian province – Xiamen, Zhangzhou and Quanzhou. In the late 1980s, this opening up was extended further to Eastern Liaoning Peninsula, Shandong Peninsula, Hainan province and others. The Shanghai Pudong New Zone was opened in 1990. There was further opening up of capitals of all provinces and autonomous regions and some border cities in the early 1990s.

External debt By the year 2002, the total external debt of China was US\$168.5 billion. This included borrowings from foreign governments worth US\$24.4 billion, borrowings of US\$27.7 billion from international financial organizations, commercial loans of US\$90.0 billion and others amounting to US\$26.3 billion. China has a high share of long- and medium-term loans compared with short-term loans. In 2002 the ratio between long-term and short-term loans was roughly 69:31. The debt:service ratio of China in 2002 was 13.6 per cent. The foreign debt is not threatening, as China's foreign reserve by mid-2005 stood at US\$711 billion. About US\$500 billion of its reserves is kept in US treasury bonds and other US securities.

Table 11.10 Contribution to output growth (in % of GDP)

Model	1971–78	1979–89	1990–98
Translog production function			
Potential output	5.7	9.2	9.3
Capital accumulation	4.8	5.2	4.7
Labour force growth	0.7	1.2	0.7
TFP growth	0.2	2.8	4.0
Output gap	–0.3	–0.2	0.2

Sources of growth

One major source of growth in China during both pre-reform and reform eras has been high savings and high investment rates. However, unlike the government-investment-led growth in the pre-reform era, private and foreign investment has been driving the growth since reforms began in 1979. Naturally since opening up, the other main source of growth has been external trade. Table 11.10 shows the sources of growth since 1978 as estimated by the IMF. The rise in the contribution of total factor productivity (TFP) has been the result of technological upgrading helped by FDI, and shifting from the low value-added agricultural sector to the high value-added industrial and service sector through the establishment of Town and Village Enterprises (TVEs).

Social progress in China

China made huge social progress in its pre-reform era due to its socialist system and egalitarian policy of development. Since the launch of reform and opening up, new social issues emerged that have focused the attention of the party and the government. Five coordinated development strategies were adopted in the third Plenary Session of the party's Sixteenth Congress in October 2003. These included (1) coordinating development between urban and rural areas, (2) coordinating development of regions, (3) coordinating between economic and social development, (4) coordinating economic development and environmental sustainability and (5) coordinating domestic development with opening up to the outside world. Thus, social progress is once more put on the priority list of the development agenda.

Social progress in the pre-reform era

China's achievements in social sectors and the reasons behind there that can be seen from the following observation of the World Bank (Hasan and Lim, 1981: iii) in the early 1980s:

Nonetheless, and despite slow growth of the average level of consumption, China's most remarkable achievement during the past three decades has been to make low income groups far better off in terms of basic needs than their counterparts in most other countries. They all have work; their food supply is guaranteed through a mixture of state rationing and collective self-insurance; most of their children are not only at school, but being comparatively well taught; and the great majority have access to basic health care and family planning services. Life expectancy – whose dependence on many other economic and social variables make it probably the best single indicator of the extent of real poverty in a country is (at 64 years) outstandingly high for a country at China's per capita income level.

Table 11.11 Progress in social indicators

	Life Expectancy		Adult Literacy		Under Five Mortality	Maternal Mortality
	1980	2002	1977	2002	Rate per 1000 2002	per 100 000 1990–98
China	64	71	66	91	38	65
Low income countries	57	58	50	61	126	
Middle income countries	60	70	65	90	38	

Sources: World Development Report 1982, 2000/2001, 2005.

Table 11.12 Progress in education

	No. Enrolled in Primary School in Percentage of Age Groups									No. Enrolled in Secondary School in Percentage of Age Groups		
	Total			Male			Female			1960	1979	1997
	1960	1979	1997	1960	1979	1996	1960	1979	1996			
China	102	118	100		111	93		114	94		63	70
Low income countries	76	94	76	68	88		34	64		38	49	51
Middle income countries	76	97	97	84	104		68	93		63	39	71

Sources: World Development Report 1982, 2000/2001.

Tables 11.11–11.13 show social progress in China. All data are derived from the *World Development Report* of the World Bank of various years.

The basic instruments of China's social development in the pre-reform era are elaborated below.

Rural areas China was mainly an agricultural economy before the establishment of the PRC. The agricultural sector had a share of 70 per cent of the national economy. But the landlords and rich peasants, comprising less than 10 per cent of the rural population, owned around 70 per cent of the cultivated land. There was serious poverty and inequality in the rural areas. Land reform was already being carried out in the various liberated areas during the People's Liberation War. Radical land reform was completed among a population of 140 million on the eve of the founding of the PRC. Under the Agrarian Reform Law of the PRC, promulgated in June 1950, a nationwide egalitarian land reform programme was completed by the end of 1952. Cooperative movement was pushed from 1952 and completed in 1956, and in 1958, people's communes were set up throughout

Table 11.13 Progress in poverty reduction and income distribution

Survey Year	National Poverty Line (population below poverty line %)		
	Rural	Urban	National
1998	4.6	<2.0	4.6
	International Poverty Line		
	Population (%) below US\$1 a day	Population (%) below US\$2 a day	
2001	16.6	46.7	
	Gini Coefficient	Share of Income & Consumption (%)	
		Lowest	Highest
2001	44.7	4.7	50.0

Source: *World Development Report 2005*.

China. The commune system before the economic reform was an experiment to combine the function of public administration and production in rural areas; it owned and rented out large machinery and was responsible for providing skills or management not available in the production team (the basic level of organization in rural areas). It was also responsible for organizing small, but technology-intensive industrial enterprises. Commune and brigade (the level of organization above the production team) enterprises became important sources of income for the rural sector from 1970. In the period of economic reform, they came to be known as 'Town and Village Enterprises'. The commune was also responsible for secondary schools, health clinics, marketing services and civil administration.

Urban areas There was virtually no urban poverty in China in the pre-reform era. The Chinese government limited urban poverty to an extremely low level through its full employment policy in the SOEs. The average wage rate of an employee in SOEs was RMB446 in 1950; it increased to RMB644 in 1978. In addition, the workers in SOEs received free health care, free housing and a pension after retirement.

There were price controls on basic needs such as foodstuffs, cloth and nearly universal access to education and health care. China also implemented an urban food and cloth ration system, which gave the urban population a preferential access to staple foods and cloth below market prices.

Social issues in the era of opening up and reform (1980–present)

China's achievement in poverty reduction was remarkable in the initial period of rural reform. World Bank estimates the number of people living in poverty to have declined from roughly 270 million in 1978 to 97 million in 1985. However, no further reduction was achieved during the second half of the 1980s. The proportion of total population living in absolute poverty remained roughly constant at about 9 per cent (Piazza, 1992). To address the problem the Chinese government launched the 8–7 Poverty Eradication

Programme in 1994, that is, to solve the issue of 80 million people in poverty within seven years. By the end of 2000, the target was mostly accomplished, but there are still 27 million people living in poverty, located mostly in very poor geographical and climate conditions.

Increasing income inequality and regional disparity The Eastern coastal regions benefited due to early opening up, and they also have more than an 80 per cent share of FDI. On the other hand, nine provinces and autonomous regions and one Central Administered Municipality in the northwest and southwest regions have only a share of 4.4 per cent of FDI. The progress in China varies greatly among different provinces or regions of China. For example, the human development index in China ranges from a high of 0.89793 in Shanghai to a low of 0.5924 for Tibet. As can be seen from Table 11.13, China has a higher Gini coefficient in spite of its success in poverty alleviation.

Urban poverty in the transitional period As noted earlier before the mid-1990s, the urban poverty of China was not a serious issue. However, in the transition process from a centrally planned economy to the socialist market economy, urban poverty rose. Due to restructuring of SOEs, unemployment increased. In addition, there was an increased number of retired, elderly and disabled staff and workers, who could not get their normal pensions or wages due to the inefficient operation of SOEs while a new social security system was in the process of being established. Urban poverty swelled also due to a large inflow of rural migrants who did not qualify for social welfare services such as the low-cost housing and medical care that are available to urban workers.

Some measures have been taken to address the issue of urban unemployment. They include a nation wide re-employment project, unemployment insurance and the system of guaranteed minimum living standard. However, the responsibility for the action plan rests partly on local and municipal governments, and hence the achievement of these action plans depends upon their fiscal condition.

Prospects and challenges ahead

The Sixteenth Congress of the Communist Party, held on November 2002, has set out an ambitious target for China's future with a view to establishing an all-round *xiaokang* (literally, 'well-off') society. *Xiaokang* was an ancient concept, a pre-stage of *datong* (great unity) society, based on the Confucian philosophy of harmonizing global visions with family values. It emphasizes discipline and education to maintain social order. Economically, it is a society of the middle class. In order to achieve this vision, the plan aims to quadruple GDP by 2020, implying an average annual growth rate of around 7.2 per cent.

This growth target is consistent with what the World Bank projected in its *China 2020* (Nehru, 1997) document. However, it is not going to be an easy task. The policy-makers need to be aware of problems, constraints and trade-offs, some of which are highlighted below.

Rapid urbanization and disparities

With industrialization, the size of the urban population will increase dramatically. China already has two megacities – Beijing and Shanghai. The rapid urbanization will not only

create pressure on infrastructure, such as housing, sanitation and transport, it also has the potential to produce ghettos of the underclass as the experience of other megacities shows. With the exposure to the outside world and higher expectations, this can be a source of political instability.

As noted earlier, the reform era has been witnessing a trend of increasing income inequality and disparity between urban and rural and among the regions. There has also been an increase in urban poverty. Regional disparity can not only be destabilizing, but also hampers the development of an integrated domestic market. The fragmentation of domestic market and its underdevelopment will make China vulnerable to the vagaries of the world economy. Thus, ensuring that the future growth is equitable and balanced will be a critical task for the policy-makers.

Environmental sustainability

It is well known that rapid industrialization can cause enormous environmental damage. The cost of rapid growth in China has become very obvious after a series of chemical spillages. China already ranks number two in the world in terms of discharge of greenhouse gas. The crucial air pollutant discharge, SO₂, increased from 18.58 million tons in 1999 to 22.2 million tons in 2003.

There is a U-shaped relationship between environmental quality and economic growth. That is, environment quality deteriorates initially with growth before it improves. In the search for higher growth, China's appetite for foreign investment may rise, which has the potential to lower environmental standards – a phenomenon known as 'a race for the bottom'.

Resource shortage

The rapid growth of China and further industrialization will face serious challenges from insufficient supply of domestic resources. Table 11.14 shows China's dependence ratio of demand for ores and raw materials from the international market.

Arable land per capita fell from 0.19 hectares in 1953 to 0.095 hectares in 2003. China is becoming a country with the largest consumption of water resources, representing a share of 15.4 per cent of global consumption; but China is also one of the countries with a shortage of water resources.

Table 11.14 Dependence ratio of demand for ores on international market

Ore	Import Dependence Ratio (%)		
	2000	2010 (estimate)	2020 (estimate)
Petroleum	31	41	58
Iron	33	34	52
Manganese	16	31	38
Copper	48	72	82
Lead	0	45	52
Zinc	0	53	69

Source: Wangmengkui, *Key Issues in China's Development*, Beijing: Development Press.

Technology and innovation

The problems of sustainability and resource shortages are partly due to the fact that China's growth is mainly factor- or investment-driven. According to the World Bank's estimate (Nehru, 1997), to achieve an annual growth target of over 7 per cent, TFP (total factor productivity) must grow at 2 per cent on the assumption that the savings rate will remain high at between 30–40 per cent. This estimate is roughly consistent with other studies. For example, one study at the Development Research Centre (of the State Council) finds that to achieve an annual growth target of 7.5 per cent during 2005–20, TFP must grow at 2.2 per cent on the assumption that the growth of capital will decline from 6.4 per cent during 2000–05 to 5 per cent between 2005 and 2020.

TFP growth certainly depends on technological advances. China has focused very much on the development of science and technology since the establishment of the PRC in 1949. The number of science and technological personnel increased significantly during the pre-reform era. For example, the number of people with a science background working at various institutions including SOEs increased from 425 000 people in 1952 to 5.276 million in 1980. China made its first successful atomic bomb test in October 1964, synthesis of insulin in September 1965, earth satellite in April 1970 and optical fibre communication system in Shanghai, Beijing and Wuhan by 1979.

The above shows that during the pre-reform era, China achieved considerable strength in science and technology at the national or macro-level. However, China was very weak at the micro-level or the enterprise level. There was no incentive for innovation or change, as evidenced by the model of truck produced at the Changchun automobile plant that did not change for more than 20 years. There was also no horizontal channelling of information between the Chinese Academy of Science, the defence industry, manufacturing enterprises and universities.

Therefore, in the reform era, the Chinese government has adopted a two-prong policy to promote science and technology. On the macro-side, the central government follows past practice in preparation for the 'National Long- and Medium-term Science and Technology Development Programme'. This programme was approved by the State Council in 2005. There are also special important projects, such as 'Exploration of the Moon' and the national innovation system project of the Chinese Academy of Science. High Technology Development Zones are set up in every province and autonomous region.

On the micro-side, the government is restructuring its science and technology system, liberalizing the research institutions attached to different line ministries under the former regime, and encouraging the research institutions to be independent or self-financing by linking with enterprises. Research and development centres are set up in large enterprises. Cooperation among productive units, academic units and research units is encouraged. The Chinese government also encourages companies to set up their own brand of product.

While the shift from centralized research to enterprise-level research and development is a move in the right direction, one needs to bear in mind that innovation crucially depends on free exchange of ideas and free flow of personnel. China still lacks in that area.

Institutional weakness

The deep-rooted mandatory planning culture may further constrain the reform in both depth and breadth. For example, the investment approval system is inefficient. There are

no clear rights and responsibility on investment approval. There are also weaknesses in the fiscal system. The public finance system is not well established enough to play its proper role in consumption of public goods. The extra budgetary system needs further rectification, and there is an urgent need to clarify the role and responsibility of various levels of government matched with appropriate revenue income and a fair and transparent transfer payment system.

China still grapples with loss-making SOEs and the banking sector is saddled with the non-performing loans of the SOEs. The arms-length relationship of the banking sector with the SOEs needs further correction if the banking sector is to perform its financial intermediation role efficiently.

Political stability

China has so far been successful in balancing economic reforms and political stability. It has successfully managed the transition of leadership. And the ideological breakthrough for a legitimate market role was made when the two concepts of 'building the economy' and 'building socialism' were officially accepted in the early 1990s. The Chinese leadership has shown great capacity in the gradual opening up of the economy. On the political front, the CCP has begun this by introducing limited local-level elections, and hopefully this trend will continue. The party is taking action to refresh and advance the members of CCP and it has the awareness to increase its capacity on administration and governance. The gradual opening up will not only ensure political stability, but, as noted earlier, also will help China to move to the next phase of innovation-driven growth.

Concluding remarks

The objective of China's reform is to establish a socialist market economy. Although the target is clear, the real challenge is to establish a market economy with sound social institutions. The legal institutions of a market economy take a long time to establish. It also has to balance the need for economic development, especially in deeply impoverished rural areas, with concerns for protecting the environment and demands for reform from its trading partners.

What we are witnessing in China now is a systemic transition, and not a simple economic transition. Although it began with a transition from a former centrally planned economy to a market-based socialist economy, it is also redefining the concept of socialism itself. A more open political structure will also evolve in China as the economy moves more towards a rule-based, transparent system.

Those who ask when and how long it will take need to bear in mind that there are no blueprints or textbook models for a systemic transition that can guide China, so the process of transition is basically a trial and error experiment. China's gradual approach has so far succeeded in preventing a catastrophe like Eastern Europe or the former Soviet Union, and one can be reasonably hopeful of China's successful transition into a globalized economy with a more tolerant and participatory political system.

Notes

1. The economic policy of PRC introduced by Mao Zedong under the Second Five-year Plan of 1958–62. High unrealistic growth targets for agriculture and industry were set. People's communes were also set up. This strategy failed by the early 1960s due to many complex factors.

2. Chinese mass movement initiated in 1966, and lasted around ten years. It was led by Chairman Mao Zedong directed against party leaders, officials at various levels, artists and academics. It was also an attempt by Chairman Mao to renew his political and ideological pre-eminence inside China.

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(English language edition is an up-to-date revision and translation of the German edition by W. Kraus). This book provides a very detailed political background and various policies of China in the pre-reform era.
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12 Viet Nam

*John Thoburn**

A short political history

Colonial rule, and attempts to escape from it, have characterized large parts of Viet Nam's history. A colony of China for a millennium, Viet Nam rebelled successfully in the tenth century against the declining Tang dynasty (AD 618–907), and defeated an attempt by armies of the new Song dynasty (AD 960–1279) later in the century to re-impose Chinese control. Limited at that time to the region of the Red River Delta – the area centred on Hanoi – the Vietnamese expanded southwards following the defeat of another attempt by the Chinese to subjugate the country in the fifteenth century. By the seventeenth century the Vietnamese had expanded further south into the Mekong Delta, to roughly the area of present-day Viet Nam and parts of Cambodia.¹

The gradual expansion of the French colonial empire into Viet Nam in the mid-and late nineteenth century, first into southern Viet Nam and 20 years later into the north, followed earlier involvement in the country by French missionaries and traders. French Indochina comprised Laos, Cambodia and Viet Nam, with Viet Nam split into three separate territories: Cochin China, Annam and Tonkin. Cochin China in the south of Viet Nam was administered directly as a colony and centred on the port of Saigon. Annam in central Viet Nam, centred on the city of Hue, and Tonkin in the north around Hanoi and the Red River Delta, were administered as protectorates, with a Vietnamese emperor resident in Hue. In Cochin China before World War II, the French colonial government encouraged the development of commercial rice production and plantation crops such as rubber, while mining and some limited industrial development characterized the northern region, Tonkin. Annam was developed less than the other regions; politically it would form part of South Viet Nam during the post-war conflicts.

Frances Fitzgerald (1972) has identified differences in both economic and social and, by implication, political development between southern and northern Viet Nam. These differences antedated French colonial rule but were reinforced by it. In the Red River Delta in the north, with its high ratio of population to cultivable land, there was a relatively even distribution of income and of land, and a structure of village organization along patriarchal, Confucian lines. Compared with the north, with its tradition of economic equality, southern Viet Nam, particularly the Mekong Delta, was characterized by a more uneven distribution of land: the bulk of the population under the French were either tenants on land owned by French and Vietnamese landlords, or landless labourers. Southern elites tended to be heavily influenced by French culture and had often converted to Catholicism. Anti-colonial sentiment against the French in the south before World War II had little power base in rural areas. Ho Chi Minh, the leader of Viet Nam's revolution against the French, came from a province in Annam where, Fitzgerald argues, the Confucian mandarin tradition remained strong.

Struggles against French colonial rule had gathered strength in the 1930s during and following the world Depression, and an Indochinese communist party was in existence.

World War II saw the peaceful transfer of power from the French colonial authorities to a French Vichy governor following the fall of France in 1940. Viet Nam was administered by Vichy on behalf of the Japanese until a few months before the end of the war, when the Japanese openly took control. The Vietnamese national independence league, the Viet Minh, comprising communist and other parties, was founded by Ho Chi Minh in 1941, with its main power base in the Red River Delta. In August 1945 the Viet Minh seized power in Hanoi, establishing the Democratic Republic of Viet Nam (North Viet Nam) in the north of the country, while the French proceeded to reoccupy the south. Negotiations with the French for Vietnamese independence failed, leading to the French capture of Hanoi in 1947; a war of resistance had started. May 1954 saw the spectacular defeat of a French force by a Viet Minh army led by General Vo Nguyen Giap at Dien Bien Phu, near the Laotian border.

In April 1954, as the French military position in Viet Nam was worsening, an international conference was opened in Geneva, with the involvement of the British, Americans, Soviets and Chinese, in an attempt to settle the future of Viet Nam. An armistice was signed after Dien Bien Phu, with regrouping by the Viet Minh and French on either side of the 17th parallel (a little north of the city of Hue). Free elections throughout the country were agreed to be held in 1956, with the French administering the south in the meantime, but the idea of elections was quickly overtaken by events. Far from being the basis of a peace, the Geneva Accords proved to mark the start of the Viet Nam war – the ‘American war’ as the Vietnamese call it – as the Americans increasingly came to be involved, regarding Viet Nam as a ‘domino’ that should not be allowed to fall to a communist government. Even in 1954 the Americans were financing 80 per cent of French military expenditure in Viet Nam (Fitzgerald, 1972: 67).

The French had notionally given Viet Nam independence under Emperor Bao Dai in 1950, while maintaining control in practice, and they formally handed over to Bao Dai before Geneva in 1954. However, Bao Dai left for France during the Geneva Conference, virtually abdicating in favour of his prime minister, Ngo Dinh Diem. By 1955 Diem had repudiated the Geneva Accords and closed the border with the north at the 17th parallel. By then over 800 000 people, mostly Catholics, had been evacuated from the north to the south with the help of the US fleet during the Geneva armistice.

In 1955 the Diem regime started to try to round up former members of the Viet Minh. By 1960 the communist-led National Liberation Front had been formed, known to the Americans as the Viet Cong, quickly becoming a formidable military force. In the early 1960s, active US military aid to the regime of South Viet Nam – under Diem until his assassination in 1963 and then under a succession of generals – involved the provision of military advisers. Direct US military involvement started in 1965, with the arrival of US troops and the bombing of North Viet Nam. By the end of 1966, 400 000 US troops were in Viet Nam.

The course of the war with the United States is well known and can be outlined here briefly. Major Vietnamese offensives such as Khe San and Tet in early 1968 caused serious political problems for the administration back in the United States. In 1969 there was secret US bombing of Cambodia to deny the Viet Cong their bases and supply routes. In January 1973 a ceasefire with the United States was agreed, and the Americans subsequently left in disarray. By April 1975 South Viet Nam had surrendered to the North, and the country was reunified under a Communist government in 1976. For the Vietnamese,

however, the 1970s remained a period punctuated by war. In 1978–79 Vietnamese troops invaded Cambodia to drive the (Chinese-backed) Khmer Rouge government from power; the Vietnamese army stayed in Cambodia until 1989. In 1979 China, Viet Nam's ancient enemy, invaded Viet Nam from the north, and was repulsed.

The 1970s after reunification saw attempts by the Communist government to impose land collectivization in the south and to nationalize private enterprises, often owned by ethnic Chinese. This mirrored similar attempts at collectivization in the north in the late 1950s, and the nationalization of private enterprises in the north after the 1954 defeat of the French. One result of these activities in South Viet Nam after reunification was a mass outflow of refugees, the 'boat people', to neighbouring Asian countries in the late 1970s.

As will be elaborated later in this chapter, the 1970s and the early and mid-1980s were a time of great economic difficulty as Viet Nam moved from a war economy and attempted to incorporate the south, with its different economic structure and traditions. *Doi moi*, Viet Nam's famous 'economic renovation' set of reforms, was initiated in 1986 to deal with these difficulties, although to some extent the reforms validated changes that were already occurring as a free market economy arose spontaneously in response to the country's economic problems.² The economic reforms antedated the return of the major donors in the 1990s and thus have had strong national ownership. In the 1990s Viet Nam rapidly started to re-join the international scene. A US trade (and investment) embargo on Viet Nam was lifted in 1994. In 1995 Viet Nam joined the ASEAN, the Association of Southeast Asian Nations.

As in China, and unlike Eastern Europe and the Soviet Union, the Communist government has remained in control in Viet Nam into the 1990s and 2000s, with few signs of any slackening of its authority (Gainsborough, 2002). And Viet Nam has had no equivalent of the 1989 Tiananmen Square demonstrations against the government in China.

Economic progress and structural change

Under its *doi moi* programme of economic reforms, Viet Nam has been making the transition from a centrally planned economy to a market economy. Albeit starting from a low base in terms of income per head, its overall economic performance has been impressive. Over the period 1990 to 2003 its 7.5 per cent average annual rate of real GDP growth was exceeded in the world economy only by China and (marginally) by Ireland.³ Nevertheless, as Table 12.1 shows, Viet Nam remains a poor country. In 2003 its GNI per head in terms of real purchasing power⁴ was similar to Pakistan's and half that of China. Viet Nam's GNI per head of US\$480 (at market exchange rates) in 2003 was below the average for Sub-Saharan Africa (US\$500). Viet Nam's share of manufacturing in GDP remained lower than any of the five Asian comparator countries shown, except Pakistan. The comparator countries are necessarily chosen arbitrarily, but all are exporters of manufactures and have populations of substantial size; city states such as Hong Kong or Singapore are excluded.

As Table 12.2 shows, Viet Nam's rapid economic growth has been accompanied, as would be expected, by substantial structural change, with a large fall in the share of agriculture since 1990 and a large rise in the share of industry. However, as of 2004, 'agriculture, forestry and fishing' was still generating 59 per cent⁵ of total employment in Viet Nam, and industry only 13 per cent. The fall in the share of agriculture in GDP has been lessened by the growth in importance of marine products (4 per cent of GDP in 2004) and by the success of reform in the rice sector, discussed below. The large difference between

Table 12.1 Viet Nam – a comparative economic overview, 2003

	Viet Nam	Indonesia	Thailand	Philippines	China	Pakistan
Population (millions)	81	215	62	82	1288	148
Population density (people per sq km)	250	119	121	273	138	193
Gross national income per head (US\$)	480	810	2190	1080	1100	520
Purchasing power parity GNI per head (US\$)	2490	3210	7450	4640	4980	2040
Average annual growth rate of GDP 1990–2003 (%)	7.5	3.5	3.7	3.5	9.6	4.3
Growth rate of GDP 2002–2003 (%)	7.2	4.1	6.9	4.5	9.3	5.1
Exports of goods and services/GDP (%)	60	31	66	48	34	20
Gross capital formation/GDP (%)	35	16	25	19	44	15
Agriculture/GDP (%)	22	17	10	14	15	23
Industry/GDP (%)	40	44	44	32	52	23
Manufactures/GDP (%)	21	25	35	23	39	16
Services/GDP (%)	38	40	46	53	33	53
Consumer price index average annual growth 1990–2003 (%)	2.8	13.9	4.1	7.3	6	8.1

Source: WDI (2005).

Table 12.2 Sectoral shares of GDP at current prices, Viet Nam, 1990–2004(%)

	1990	1995	2000	2003	2004 (preliminary)
Agriculture, forestry and fishing	38.7	27.2	24.5	22.5	21.8
Industry and construction	22.7	28.8	36.7	39.5	40.1
Services	38.6	44.1	38.7	38.0	38.2

Source: VNSY (2004).

the share of industry and the share of manufacturing (refer back to Table 12.1), is accounted for by the importance of mining and quarrying, mainly petroleum extraction, accounting for 10 per cent of GDP in 2004.⁶

One important aspect of structural change in the 2000s has been the expansion of the private sector, both in the economy as a whole and especially in industry (Table 12.3). The foreign-invested sector has also served as a form of substitute private sector since the early 1990s. Although a Company Law was enacted in 1990, and there were many private enterprises operating unofficially in the 1980s, the private sector faced many uncertainties and much discrimination in the early years of *doi moi*. The 2000 Enterprise Law was designed to address such difficulties, including making it easier and less costly for new businesses to register (Van Arkadie and Mallon, 2003: Ch. 11). State enterprises remain important, though, and state enterprise reform continues too. As Table 12.3 shows, the state sector

Table 12.3 Shares of GDP and industrial output by ownership, Viet Nam, 1997–2003 (%)

	1997	1999	2000	2003
Shares of GDP				
State sector	40.5	38.7	38.5	39.1
Domestic non-state sector	50.4	49.0	48.2	46.5
Collective	8.9	8.8	8.6	7.5
Private	3.4	3.4	7.3	8.2
Household	34.3	32.9	32.3	30.7
Mixed	3.8	3.9	n/a	n/a
Foreign invested sector	9.1	12.2	13.2	14.5
Shares of industrial output				
State sector	49.6	39.9	34.2	29.4
Central	33.1	26.8	23.4	20.9
Local	16.5	13.1	10.8	8.5
Domestic non-state sector	23.9	22	24.5	27.5
Collective	0.6	0.5	0.6	0.4
Private	2.4	2.2	14.2	18.4
Household	15.5	12.3	9.7	8.7
Mixed	5.5	7	n/a	n/a
Foreign invested sector	26.5	38.1	41.3	43.1

Source: VNSY (various years).

in 2003 was still generating almost 40 per cent of GDP and almost 30 per cent of industrial output.

As part of *doi moi*, Viet Nam has been integrating rapidly into the global economy. In the 1990s Viet Nam had the highest annual export growth rate in the world, nearly 28 per cent (Thoburn, 2004: 129). The share of merchandise exports in Viet Nam's GDP rose from 25 per cent in 1994 to 47 per cent in 2002 (VDR, 2004: 55). By 2003 the share had risen to 52 per cent; and to almost 60 per cent if exports of services are included. This rise in openness is not unusual among the comparator countries of Table 12.1, but in 2003 only Thailand had a higher share of exports in GDP, having, like Viet Nam, virtually doubled the ratio since 1990.

Table 12.4 shows the structure of Viet Nam's merchandise exports, indicating a diversified pattern between primary commodities (petroleum, marine products and various agricultural commodities) and manufactures. The pattern of manufacturing exports is heavily concentrated on textiles and garments (now overwhelmingly garments) and footwear, although electronics is increasing in importance. In addition, Viet Nam had exports of commercial services of US\$3.45 billion in 2004, almost as much as exports of textiles and garments. Of these service exports, the most important category is tourism, generating US\$1.4 billion, and other major items were telecommunications exports, shipping and financial, banking and insurance services (CIEM, 2005: 21).

As Table 12.4 shows, earnings from most major export products have increased two- to threefold over the six years from 1998, while petroleum export sales have quadrupled.⁷ One less successful export has been coffee. The relatively minor fall in total dollar coffee

Table 12.4 Viet Nam: major merchandise exports, 1998, 2003, 2004

	1998		2003		2004 (prelim)	
	Value (US\$mil)	% of total	Value (US\$mil)	% of total	Value (US\$mil)	% of total
Petroleum	1 232	13.2	3 821	19.0	5 671	21.4
Textiles and garments	1 450	15.5	3 609	17.9	4 386	16.5
Footwear	1 032	11.0	2 261	11.2	2 691	10.2
Marine products	858	9.2	2 200	10.9	2 401	9.1
Electronic products	n/a		855	4.2	1 075	4.1
Rice	1 024	10.9	720	3.6	950	3.6
Coffee	594	6.3	505	2.5	641	2.4
Rubber	127	1.4	378	1.9	597	2.3
Handicrafts	111	1.2	397	2.0	426	1.6
Cashew nuts	117	1.2	277	1.4	436	1.6
Coal	102	1.1	188	0.9	355	1.3
Fruit and vegetables	53	0.6	151	0.7	179	0.7
Black pepper	64	0.7	105	0.5	152	0.6
Other merchandise exports	2 601	27.8	4 682	23.2	6 544	24.7
Total all merchandise exports	9 365	100	20 149	100.0	26 504	100.0

Sources: 1998 figures are from VDR (2004: Table 3.2). 2003 and preliminary 2004 figures are from IMTVN (2003).

export earnings between 1998 and 2003 masks the fact that, compared with 1998, Viet Nam in 2003 was exporting almost double the volume of coffee for a little more than 40 per cent of the price (export unit value). Of the major exports, only rice exports have fallen over the 1998–2004 period although, as we shall see, rice exporting had earlier been one of the successes of *doi moi*.

Trade agreements have been an important part of Viet Nam's export success story, especially as (in mid-2005) it has not yet succeeded in joining the World Trade Organization. Cut off from the US market by the US trade embargo until 1994, Viet Nam secured market access to the European Union under a bilateral agreement giving it GSP (generalized system of preferences) access in 1992. From 1994 until 2000 Viet Nam faced punitive tariffs in the US market, which were designed for non-WTO members. Under the United States Bilateral Trade Agreement (USBTA), signed in 2000, the average US tariff facing all Vietnamese exports fell from about 35 per cent to 5 per cent, giving Viet Nam de facto WTO-member status (VDR, 2002: 27).

As a result of the USBTA, Viet Nam's exports to the United States have risen rapidly. The United States has become Viet Nam's largest export market (Table 12.5), overtaking Japan.^{8,9} In the case of textile and garment sales to the United States the rise has been astonishing: from a mere US\$49 million in 2001 to US\$952 million in 2002 (Nadvi and Thoburn et al., 2004b: 255). By 2004 they had risen to US\$2.7 billion¹⁰ and, given the large increase in *total* textile and garment exports, this cannot be dismissed as diversion from other destinations. Textile and garment exports initially benefited from the fact that the United States did not impose MFA (Multi-fibre Arrangement) quotas on Vietnamese exports; MFA-style quotas were imposed in May 2003. These quotas into the United

Table 12.5 Viet Nam: merchandise export destinations, 2004

	US\$ Billion	% Total Exports	Growth 2003–2004 (%)
United States	5	18.9	26.9
Japan	3.51	13.2	19.8
China	2.75	10.4	57
Australia	1.68	6.3	18.3
Singapore	1.31	4.9	27.9
Germany	1.03	3.9	21.4
United Kingdom	0.95	3.6	26
Taiwan	0.88	3.3	17.7
South Korea	0.59	2.2	19.9
France	0.58	2.2	16.9
Total top ten destinations	18.28	69.0	

Source: CIEM (2005: 20).

States have been maintained even since the MFA was phased out on 1 January 2005 under the Agreement on Textiles and Clothing of the Uruguay Round, on the justification that Viet Nam is not a WTO member. In contrast, the EU included Viet Nam in its MFA quota abolition at the end of 2004. As of mid-2005, Vietnamese textile and garment exporters to the United States were facing problems of quota availability¹¹ and Vietnamese exports of garments were showing signs of decline in the EU market (ILO, 2005: 28).

A second strand in Viet Nam's export success has been foreign investment. In 2004 foreign-invested enterprises (FIEs) accounted for 55 per cent of the country's export earnings (including oil exports) (CIEM, 2005: 19). Along with state-owned enterprises (SOEs), which account for 30 per cent of Viet Nam's (non-oil) exports (VDR, 2005: v), FIEs have spearheaded the export drive, leaving little role for the domestic private sector.¹² Underlying the importance of FIEs in Viet Nam's exports, particularly of its labour-intensive manufactures, is the role of global buyers. It is the decisions of buyers – such as Clarks and Timberland in footwear – to make Viet Nam into a significant country of sourcing for garments and footwear that has caused the quantum leap in exports. Typically, buyers will prefer to source in a new country from existing vendors, and will persuade their first tier suppliers – often garment companies in Hong Kong or Taiwan, or footwear companies in Taiwan or Korea – to invest in setting up production facilities in the new country of sourcing (Nadvi and Thoburn et al., 2004a). SOEs also have established good relations with buyers, at least in garments and textiles, and their important role in developing exports has been conceded even by donor agencies, which normally strongly press for privatization (VDR, 2003: 27).

Foreign direct investment (FDI) inflows into Viet Nam date from the late 1980s. Of the cumulative total of implemented FDI from 1988 to 2004, 44 per cent has gone into manufacturing, 21 per cent into mining and quarrying (including oil), and 6–7 per cent each into hotels and restaurants and into real estate; less than 6 per cent has gone into agriculture (VNSY, 2004).¹³ In the early years up to 1994, when the US trade (and investment) embargo was in force, European and Australian firms took advantage of the chance to set up in a market where their US competitors were excluded, and were followed by firms from

Table 12.6 Foreign direct investment projects in Viet Nam, 1988–2004 (US\$ billion)

	Total Registered Capital	(Foreign Side)	(Vietnamese Side)	Total Implemented Capital
1988	0.32	0.26	0.01	n/a
1991	1.29	1.00	0.29	0.33
1994	4.53	3.46	1.08	2.04
1997	6.06	4.64	1.42	3.11
2000	2.70	2.28	0.42	2.41
2003	3.15	2.95	0.19	2.65
2004	4.22	3.79	0.43	2.85

Source: VNSY (2004).

East Asia.¹⁴ Although implemented FDI peaked in 1997 (Table 12.6), FDI approvals peaked in 1996 and started to fall quite sharply thereafter. The fall reflected the effects both of the 1997–98 Asian Crisis and adverse investor sentiment about the investment climate and the Vietnamese government's commitment to using FDI (Gainsborough, 2004: 40). In other respects, though, Viet Nam – with its capital controls and lack of exposure to short-term overseas borrowing (Dapice, 2003: 11) – weathered the Asian Crisis well.

Both approvals and disbursed direct foreign investment reached a trough in 1999. By 2003, implemented FDI was up to US\$2.65 billion, and to US\$2.85 billion in 2004, but still below the peak of 1997. However, FDI inflows into Viet Nam as a proportion of GDP (3.7 per cent) were almost the same as China's (3.8 per cent) (2003 figures from WDI, 2005). Of the cumulative foreign direct investment into Viet Nam over the period 2001–03/04,¹⁵ the largest investors were Taiwan (with 18 per cent of the total), followed by South Korea, Norway, Japan, Russia, Singapore and Hong Kong (RSE, 2005). In the early 2000s, almost 40 per cent of the inward FDI flow was for labour-intensive exportable products – garments, footwear and electronics – and 23 per cent was for garments alone.¹⁶

The size of the FDI inflows, estimated by the World Bank at US\$1.45 billion in 2003,¹⁷ can be compared with its inflows of official development assistance of US\$1.77 (WDI, 2005). Viet Nam in 2003 was the third biggest recipient of official development assistance (ODA) in the world,¹⁸ with Japan by far the largest bilateral donor, followed by France. However, in per capita terms, Viet Nam's ODA receipts (US\$22 per head) are not so large. Although they are more than those of low income countries on average (US\$14), they are substantially less than for Sub-Saharan Africa (US\$34). ODA inflows were equivalent to only 12.9 per cent of Viet Nam's gross capital formation, a figure below that of the average for low income countries (13.1 per cent), and less than half that for Sub-Saharan Africa (29.5 per cent). Nevertheless, the major aid donors in Viet Nam are very active in attempting to influence policy.

Social progress

Viet Nam scores well on social indicators of development, despite its low level of per capita income. Its human development index – a composite measure of income, education and health – stood at 0.704 in 2003, putting Viet Nam in the 'medium human development' group of countries, and well above the average for low income countries of 0.593 (HDR, 2005). Progress in health over the period 1990–2002 is illustrated by the rise in life

Table 12.7 *Viet Nam: Net school enrolment rates, 1993 and 2002 (%)*

	Primary		Lower Secondary		Upper Secondary	
	1993	2002	1993	2002	1993	2002
All Viet Nam	87	90	30	72	7	42
Poorest quintile	72	85	12	54	1	17
Ethnic minorities	64	80	7	48	2	19

Source: VDR (2004: 62).

expectancy at birth from 65 to 70 years, higher than Thailand, almost as high as China, and vastly higher than Sub-Saharan Africa (which fell from an average of 50 to 46 over the same period). Primary school net enrolment in Viet Nam, already high in 1993 rose to 90 per cent in 2002 (Table 12.7); while lower secondary enrolment rose to almost three-quarters of the age group, and upper secondary enrolment from 7 to 42 per cent. Even among the poorest fifth of the population, primary enrolment had reached almost 85 per cent by 2002, though the corresponding figures for lower secondary and upper secondary enrolments were lower. In 1990, adult literacy rates in Viet Nam were 94 per cent for males and 87 per cent for females; the corresponding figures for Pakistan, for example, were 49 and 20 per cent. By 2002 in Viet Nam the literacy rate had risen to 95 per cent for men and 89 per cent for women, and for the age group 10–14 it was claimed to be over 97 per cent for both genders (VHLSS, 2002: 43). The adult literacy rate for Pakistan was 49 per cent.¹⁹

One of Viet Nam's strongest achievements under *doi moi* has been its reduction in poverty. Between 1992–93 and 1997–98, the dates of the first two *Vietnam Living Standards Surveys*, the proportion of the poor in the population fell from 58 per cent to 37 per cent. The definition of headcount poverty used for these figures is that of the General Statistics Office of Viet Nam, based on the cost of a basic daily calorific intake of 2100 plus various basic non-food items, but Litchfield and Justino (2004) have shown that poverty fell convincingly in the 1990s irrespective of which of a number of alternative poverty lines is used.²⁰ By the time of the 2002 *Vietnam Household Living Standards Survey*, the proportion of the population in poverty had fallen to 29 per cent (VDR, 2004: 9). The poverty gap – the difference between the poverty line and the average household expenditure of the poor, expressed as a percentage of the poverty line – was reduced from 18 per cent in 1993 to 7 per cent in 2002.

Even more strikingly, using the international poverty line of a dollar a day (in purchasing power parity), the proportion of the poor fell from 50.8 per cent in 1990 to only 10.6 per cent in 2002. On this criterion, the headcount poverty rate in Viet Nam is about a third that of India. However, if a US\$2 a day criterion is used, the fall is from the very high figure of 87 per cent in 1990 to 53.4 per cent in 2004, the remaining high percentage reflecting Viet Nam's still low per capita incomes (VDR, 2004: 15–16).

The reductions in poverty in Viet Nam have not been uniform across regions, though, or among ethnic groups. Between 1993 and 1998 the largest reduction in poverty was in the Red River Delta, the region around Hanoi, and the smallest was in the Mekong Delta in the south. For the period 1998–2002 the Mekong Delta improved its position, with the second largest fall in poverty (Weeks et al., 2004: 45 and 56). The poorest region is the

Central Highlands, where over half of the population remains poor. This compares with a figure of less than a quarter in the Red River and Mekong Deltas, whose combined populations constitute 43 per cent of the population of Viet Nam (VNSY, 2004). The regions contributing most to poverty are the Northern Mountains and Central Highlands, whose populations together contain a third of the country's poor. Ethnic minority groups, comprising 14 per cent of Viet Nam's population,²¹ are over-represented among the poorest: among these minorities, poverty only decreased from 86 per cent in 1993 to 69 per cent in 2002 (VDR, 2004: 9).

At the same time as poverty has been reduced, inequality has been increasing, however. From 1993 to 1998 the shares of consumption of the eight lowest deciles of households classified by their level of consumption fell, and those of the top two deciles rose. Almost systematically,²² the fall in share for each decile was greater the lower its consumption level (Litchfield and Justino, 2004: 155). Over the longer period from 1993 to 2002, the share of total expenditure of the lowest fifth of the population has fallen (from 8.4 to 7.8 per cent), while that of the richest quintile has risen (from 41.8 to 45.9 per cent). The shares of the three intermediate quintiles have also fallen. The (expenditure-based) Gini coefficient – which runs on a scale from 0 (perfect equality) to 1 (perfect inequality) – rose in Viet Nam from 0.34 in 1993 to 0.37 in 2002. This reflects a growing disparity between urban and rural incomes, as both the urban Gini and the rural Gini have remained stable (at 0.35 and 0.28, respectively). Inequality within urban areas, however, is likely to have increased in ways that are not captured by the measures of inequality based on the VLSS and VHLSS data, which do not cover unregistered migrants resident in cities. In the southeast region in 2002, where Ho Chi Minh City is located, inequality is marginally higher, with a Gini of 0.38 (VDR, 2004: 14–15), although the southeast contains only 5 per cent of the nation's poor, compared with the adjacent Mekong's 17 per cent.

Generally, landlessness in Viet Nam is primarily a characteristic of the rich, who are either urbanites who have no land or rural dwellers who have sold land. Indeed, the proportion of households that are landless in the population as a whole rises systematically from the poorest quintile to the richest. But in the Mekong, the country's major rice-growing area, the situation is the reverse, with the poorest quintile being the most landless in 2002, while the incidence of landlessness in the Mekong is over 50 per cent higher than in the whole country (VDR, 2004: 39). This is happening in the context of Viet Nam's very high population density (see Table 12.1), with holding of agricultural land per farming family exceptionally low by international standards (McCarty and Steley, 2004: 20).

Although there has been considerable structural change in the Vietnamese economy, with the share of industry in GDP rising and that of agriculture falling (see Table 12.2), Bales, Tung and Cuc (2001: 56) calculate that 92 per cent of the decline in headcount poverty²³ between 1993 and 1998 was due to rising incomes within sectors rather than shifts of labour from lower to higher income sectors. Agricultural reform and the land decollectivization of the late 1980s lay behind the subsequent increases in productivity and commercialization in agriculture, where 72 per cent of the economically active population worked in 1990.²⁴ Between 1993 and 2002 the proportion of farm output marketed rose from 48 to 78 per cent (VDR, 2004: 41).

The rice sector is a key influence on poverty in Viet Nam,²⁵ where three-quarters of the population is still rural (VNSY, 2004). In 1992–93 72 per cent of Vietnamese households,

and 83 per cent of the poor, were both producers and consumers of rice. Rice generates about three-quarters of the total calorific intake of an average Vietnamese household, and constitutes over four-fifths of the country's cropped area and nearly 90 per cent of food output. Agricultural reform under *doi moi* saw rice production increased by over 50 per cent in volume during the 1990s. Viet Nam moved from being a net importer of rice in the early years of *doi moi* to becoming the world's second largest exporter in terms of volume by 1996,²⁶ although rice export performance subsequently flagged (see Table 12.4).

It has been shown by Niimi et al. (2004) that there are strong regional variations in the poverty-reducing effects of rice production: the chances of escaping poverty are lower for rice-growing households in the Mekong and Red River Deltas than for rice-growing households in the rest of the country, though for both these regions the effects of rice production are still positive. An explanation for the (relatively) negative regional effects in rice is that increased rice production in the Mekong Delta could be associated with increased concentration of holdings, and with the landlessness already mentioned, working against the poverty-reducing effects of higher rice production. Litchfield and Justino (2004) in their study of poverty dynamics in Viet Nam find that in the Mekong, almost 10 per cent of their panel of rural households fell from being non-poor to being poor between 1992–93 and 1997–98, a proportion roughly double the national average.

Besides the fact that increases in agricultural productivity, especially in rice, reduced rural poverty in situ, another reason why inter-sectoral shifts in the labour force did not act as the prime force for poverty reduction (as noted by Bales et al., 2001), is the disappointing rate of job creation in industry, including the labour-intensive manufacturing export industries. Jenkins (2004) has estimated that for Vietnamese industry between 1990 and 1999 as a whole, nearly 3 million jobs would have been created if the labour:output ratio had remained unchanged; but against this, 2.4 million jobs were lost as a result of productivity increases. In the late 1990s for every one percentage increase in GDP, there was only a 0.22 percentage increase in employment. In manufacturing, the elasticity of employment with respect to output is very low in relation to that of other Asian countries (Jenkins, 2004: 195). In the case of the largest manufacturing export industry, garments, output growth resulting from export expansion was large enough to increase total employment despite productivity increases. In textiles, in contrast, during the 1990s, output (in constant prices) rose by a total of 74 per cent, but textile employment fell by 31 per cent. An important factor in these productivity increases has been SOE reform: over the period 1995–99, for which more detailed statistics are available by ownership, textile SOEs' labour productivity rose 48 per cent, although foreign-invested enterprises' productivity, already high, did not rise (Thoburn et al., 2005; Nadvi and Thoburn et al., 2004a: 119–20).

Despite the disappointing record of job creation in the urban industrial sector in the 1990s, internal migration has been an important feature of Vietnamese development. Some four million people may have migrated to urban areas since the 1999 population census – equivalent to about 5 per cent of the country's population (VDR, 2004: 123). Such migration is a means by which people from poorer areas can move to richer ones – sometimes to new agricultural areas such as the Central Highlands during the mid-1990s' coffee boom – although migrants are not usually the poorest people from poor areas, since the poorest may not have the resources necessary to move (Winkels, 2004).

Major policies

The major policy watershed in Viet Nam is, of course, the *doi moi* economic reform programme introduced at the Sixth Party Congress in December 1986.²⁷ Viet Nam came to *doi moi* at a time of crisis, with inflation at 700 per cent annually and a severe current account deficit. Exports were equal to only half the value of imports, and external sources of assistance were lacking. Western and Chinese aid had been cut off by the end of the 1970s, and the multilateral agencies did not enter Viet Nam until 1993 (Van Arkadie and Mallon, 2003: 95), although some bilateral donors such as Sweden were there earlier. The crisis followed a decade of attempts to introduce Soviet-style central planning following the reunification of the country in 1976. Problems with the centrally planned system were apparent by the end of the 1970s and, before *doi moi*, various partial reforms were introduced. These included the relaxation of some constraints on private sector activity, the giving of permission to farmers to sell above-quota output on the private market, giving SOEs the right to engage in some operations outside the plan, and moving planned prices towards market prices.

Anyone familiar with the Chinese economic reform programme started in 1978 will recognize many aspects of *doi moi*. Van Arkadie and Mallon (2003: 76) note that ‘the relevance of Chinese reforms would have been clear to informed Vietnamese leaders, many of whom had received training in China’.²⁸ A major difference between Viet Nam and China, however, is that Viet Nam did not have the equivalent of China’s famous Town and Village Enterprises that were so important in China’s rural industrialization and its export drive – and in providing competition to traditional SOEs.

As in China, agricultural decollectivization was a central plank of the reforms under *doi moi*. Land had been collectivized in North Viet Nam during the late 1950s under a land reform programme later acknowledged by the Communist Party of Viet Nam to have been conducted with many excesses. Collectivization of land into cooperatives had also been attempted in the 1970s in the south of Viet Nam after reunification, and in the early 1980s, but collective farming – in the face of the resistance of farmers in the south – never became so important as in the north.

Under decollectivization in the late 1980s, land was leased to households by local co-operatives or communes, and property rights in the land were gradually extended. As in China, farmers were able to sell their surplus produce on free markets, facilitated by the reduction of restrictions on private trading. In 1989 the state stopped its practice of procuring agricultural produce from farmers at below-market prices. Decollectivization was completed quickly in the agricultural lowlands of Viet Nam in the late 1980s, although the process was reported still to be underway in the 2000s in some upland areas (VDR, 2004: 38). In the all-important rice sector, though, it is important to note that the decollectivization that preceded the 50 per cent rise in physical output over the 1990s was not accompanied by simple deregulation. The state intervened in many ways, including export quotas and export taxes to drive a wedge between the international price and the domestic price, and the development of rice exports was mainly handled by state trading corporations (Niimi et al., 2004: 173–9).

Price reform – the replacement of plan prices by market prices – was also conducted quite quickly, and as early as 1987 most non-essential consumer good prices moved towards market prices. Price reform and trade reform are closely linked in the sense that exposure to opportunities to export and import produces pressure on domestic prices to

move towards world prices. The continuing existence of quantitative controls such as import and export licensing, and import quotas, will obstruct such movement. The use of import tariffs will allow domestic prices to move with world prices, albeit with a 'wedge' between them. Once domestic prices start to move with world prices, the level of the exchange rate becomes important as an incentive to firms and consumers as the domestic prices of importables and exportables will move with it.²⁹

In Viet Nam in the early days of *doi moi* much trade reform took the form of 'involuntary liberalization', with unofficial trade possibly as large as official trade (Van Arkadie and Mallon, 2003: 84). Unofficial supplies of imports helped damp domestic inflationary pressure. The trade shock at the end of the 1980s from the rapid political and economic collapse of the Soviet bloc countries, to which much of Viet Nam's export trade had been directed, made the development of new export markets an important priority. Fortunately for Viet Nam's export earnings, this also was a time when its oil exports were coming on-stream. In terms of more formal trade reform, Viet Nam abolished the central government monopoly on foreign trade, and introduced tariffs in 1988 to substitute for direct controls on imports. The exchange rate of the Vietnamese dong, devalued in 1987, was quickly moved towards a free market level. A Foreign Investment Law was enacted in 1988 and by the early 1990s flows of inward direct investment were substantial, with implemented investment reaching over US\$1 billion in 1993.

The severe build up of inflationary pressure before *doi moi* was eased by the strong domestic supply responses from agricultural and other reforms, as well as the inflow of unofficial imports. In 1988–89 Viet Nam introduced an IMF-style stabilization programme of monetary restriction, which initially reduced inflation to single-digit figures, although strong inflationary pressure re-emerged in 1991 as the government was unable to control monetary growth in the face of a substantial fiscal deficit (Van Arkadie and Mallon, 2003: Ch. 8).

In transitional economies such as Viet Nam and China, state enterprise reform and the government's budgetary position are strongly linked. SOE operating surpluses can be an important source of revenue, particularly if plan prices can be manipulated to generate them. SOEs' losses in a partially reformed system can also become a major drain on the government's budget, and can contribute to inflationary pressure if they are financed by bank borrowing. Major restructuring of state enterprises – to be discussed later – was delayed until the 1990s, and was given urgency by the loss of export markets in the Soviet Union and Eastern Europe. Van Arkadie and Mallon (2003: 93–6) record that the share of revenue from state enterprises fell from around 60 to around 37 per cent over the period 1990 to 1996, and that the government attempted to generate new sources of revenue through the development of sales and profit taxes and an income tax system, while also reforming and expanding the state-controlled banking system. However, the *Vietnam Development Report 2005* reports that five large state-owned commercial banks were still responsible for four-fifths of total bank credit and that their corporate governance was still weak (VDR, 2005: v).

Economic reform in Viet Nam has continued into the mid-2000s. The country continues to follow an export-led growth strategy. The *Comprehensive Poverty Reduction and Growth Strategy* for Vietnam – the document incorporating policies agreed by the Vietnamese government in consultation with the major donors – states: 'Continue the open-door policy and actively integrate into the international economy for development'

(CPRGS, 2002: 60). It is important to remember that trade reform, though, does not necessarily take the form of import liberalization (Jenkins and Thoburn, 2003). Most East Asian countries have reformed their trade in the sense of developing exports while protecting their domestic economies from import competition, and this is also true of Viet Nam (Gainsborough, 2004: 43). According to an International Monetary Fund report in 1999, Viet Nam still had one of the most restrictive trade regimes in the world in the late 1990s (IMF, 1999: 59).

Table 12.8 shows that on average, nominal tariffs fell only slightly between 1997 and 2002, though there was a somewhat greater fall in the effective rate of protection (that is, protection on value-added) for the manufacturing sector.³⁰ Viet Nam, like other Asian countries, has introduced export processing zones and duty drawback schemes to minimize for exporters the impacts of the existence of tariffs on imported inputs (such as fabrics for garments).

There is much room for debate as to whether the quite high levels of effective protection against imports have generated the strong bias against exports that is often used by donors to argue for import liberalization. Athukorala's (2002) World Bank study estimated that the anti-export bias against wearing apparel, for example, was between about 100 and 300 per cent, depending on realistic assumptions about the drawback on import duty on imported inputs and the effects of domestic taxes. This means that an apparel manufacturer selling to the domestic market could survive with costs (in terms of value-added) of between 100 and 300 per cent higher than the level associated with selling in the export market. Yet Viet Nam in the 1990s had the highest export growth rate in the world, including very rapid growth in apparel exports. Explaining how apparently strong anti-export bias can coexist with such high export growth rates can be done in several ways. As noted by STAR (2003: 96–8) – the first piece of 'donor literature' in Vietnam to consider this contradiction – sectors like garments are highly heterogeneous: export garments may well have little potential sale in the domestic market, where consumer incomes are low. Also, though not noted by the STAR report, even if there were some local demand, it could easily be saturated if large domestic sales were attempted.³¹

Further trade reform has been occurring. Import liberalization has been pushed by Viet Nam's commitments under the ASEAN Free Trade Area agreement (AFTA) and by Viet Nam's USBTA commitments to reduce its trade barriers. Another major push towards import liberalization is likely to result when Viet Nam joins the World Trade Organization, which would commit Viet Nam to tariff reductions, as happened in the case of China after it joined the WTO in 2001. These agreements, particularly the USBTA and

Table 12.8 Nominal tariffs and effective rates of protection, Viet Nam, 1997 and 2002 (%)

	1997		2002	
	Nominal Tariff	ERP	Nominal Tariff	ERP
Overall average	17.4	59.7	15.9	54.2
Manufacturing average	26.9	111.1	21.1	77.8

Source: Athukorala (2002).

prospective WTO membership, also involve Vietnamese commitments in a range of trade-related areas, including TRIPs (trade-related intellectual property rights) and TRIMs (trade-related investment measures).

State-owned enterprise reform in Viet Nam,³² as in China, has proceeded more slowly than other major reforms, such as those in agriculture. The internal organization of SOEs was changed in 1987 with profit targets replacing output targets, the greater use of contracts, limitations on subsidized lending from commercial banks and the purchase of inputs through the market rather than their being supplied by the state. Direct subsidies by the government to SOEs have been phased out, and SOEs' budget constraints have hardened. Divestiture of state assets has not played a large role in Vietnamese development. Although a programme of equitization of SOEs was set out in 1991 – an intermediate sort of privatization where the state retains shares in the enterprise – only a handful of SOEs were actually equitized up to the mid-1990s. In 1996 a compulsory process of equitization was enacted, and the numbers of SOEs equitized started to rise significantly. In 2001 it was decided that all SOEs that were to remain under the complete control of the state would nevertheless become 'corporatized' (transformed into limited liability companies) and those where 100 per cent state control was no longer required would be equitized. By the end of 2005 all state companies were to have become limited liability companies (Van Arkadie and Mallon, 2003: 139). Whether equitization makes a significant difference to behaviour is not yet clear: a large state garment company interviewed by the author near Hanoi in mid-2005, 51 per cent owned by the government and 49 per cent owned by its workers, felt it was operating much as it had when it was a traditional SOE.

As Van Arkadie and Mallon (2003:145–7) sensibly observe, although the aid donors have been highly critical of Viet Nam's commitment to state enterprise, mass privatizations might well have been inappropriate and prone to capture by privileged groups, as happened in the former Soviet Union. And, as noted earlier, there have been substantial improvements in SOE productivity. The donor-produced *Vietnam Development Report 2004* commented: '[the] gradual decline in the State share of economic activity, combined with the remarkably high rate of economic growth, implies that the performance of the State sector has not been dismal. . . . Vietnam could not have grown the way it did if the State sector had not increased its efficiency' (VDR, 2004: 54).

Prospects and challenges

An obvious question to ask – but a difficult one to answer – is whether Viet Nam's remarkable performance since the late 1980s in terms of economic growth and poverty reduction can be continued into the future. As is widely recognized, an important part of the initial increase in growth and poverty reduction resulted from the highly egalitarian land reform (decollectivization) of the late 1980s onwards, the commercialization of agriculture and the freeing of internal trade. This was essentially a once and for all increase in income and cannot simply be projected forward. Similarly, the explosive growth of foreign direct investment in the early to mid-1990s was buoyed by pre-Asian Crisis optimism and possibly unrealistic views on what it was possible to achieve in Viet Nam. Foreign direct investment has since stabilized at more 'normal' rates of inflow, though still similar as a proportion of GDP to FDI inflows into China. The rapid growth of exports too, particularly of garments and footwear, is thanks most of all to decisions taken by global buyers to make Viet Nam into a country of major sourcing. Once a

country assumes a certain importance in buyers' worldwide sourcing patterns, the rapid growth will tend to level off.

On the other hand, Viet Nam still has far to go before it achieves the income per head of comparable countries such as Thailand. This reflects the fact that Viet Nam started its rapid growth process only after 30 years of war, during which time many other countries in the region were already experiencing sustained economic expansion. Viet Nam's impressive increases in garment exports in the early 2000s following the signing of the bilateral trade agreement with the United States indicates its potential to continue its high performance. And Viet Nam's maintaining of its FDI inflows in the early 2000s should be seen against the background of world FDI inflows falling (STAR/MPI, 2005, Chap. III: 2). Some quite pessimistic views have been expressed, however. Dapice (2003) argues that much of Viet Nam's manufacturing growth has been in protected heavy industry, which is vulnerable to competition from ASEAN countries as import barriers are reduced under AFTA, and that much investment has gone to the state sector, which creates few jobs. Yet even the main aid donors in Viet Nam have conceded that the state sector has grown substantially in efficiency and has played a significant role in spearheading export development.

Weeks and his associates have argued – despite the fact that China has already experienced rapid sustained growth for almost a decade longer than Viet Nam – that Viet Nam is out of 'its youthful, exuberant stage of the transition', and is now maturing as a market economy (Weeks et al., 2004: 14). They believe that exports, at over half of GDP, are constrained in their further expansion by the difficulty of raising further their share of GDP (because of a consequent shortage of complementary non-traded goods).³³ A more realistic constraint on export expansion is whether global buyers of labour-intensive consumer goods will wish to increase their dependence on Viet Nam as a country of sourcing and whether new such buyers can be attracted.

More a cause for concern is whether the inequality that has started to appear will intensify as growth proceeds, as it has done in China. Although the increasing inequality between rural and urban areas and between regions to some extent can be bridged by rural-to-urban migration, unregistered migrants in urban areas are among the new poor. Weeks et al. (2004: 9) note that economic growth, rather than any redistribution, has accounted for the bulk of poverty reduction so far – an example of 'a high tide raising all boats'. They stress the importance of pro-poor growth policies to prevent the rise of market-created inequality in the form of increased unemployment and landlessness. Such policies are a major concern of both the Vietnamese government and of the aid donors. One hopeful sign is that the currently low elasticity of employment with respect to output in Vietnamese manufacturing is likely to increase to more like those of its Asian neighbours once productivity has caught up to their levels.

Notes

* I am grateful to Chris Edwards, Rhys Jenkins and Tom Powrie for comments on drafts of this chapter, although the usual disclaimer applies. I also should like to thank Richard Jones in Hanoi for drawing my attention to various items of new research material during my visit to Viet Nam in July 2005, and my doctoral student Pham Vu Thang for arranging a number of useful interviews during the visit.

1. See Fitzgerald (1972: 35–9). Fitzgerald is also useful on the war against the French and subsequently against the United States. This section draws heavily on her work, especially her Chapters 2 and 3. However, to modern readers, her accounts of Vietnamese people, especially rural Vietnamese, may seem stereotyped, and indeed have been criticized as 'orientalist' by Templer (1999: 16–21)
2. This point is nicely argued by McCarty and Steley (2004).

3. Data from WDI (2005). To avoid repetitious citations, note that all comparative data are from this source unless otherwise stated.
4. That is, measured at purchasing power parity exchange rates. See WDI (2005: 25).
5. Of this total, 3.4 percentage points were generated by fishing (VNSY, 2004).
6. All figures cited in this paragraph are from VNSY (2004).
7. In terms of current US dollars.
8. In 2000, the year before the USBTA, Japan was Viet Nam's most important export destination, followed by China and Australia (VNSY, 2001: 372–3).
9. Also, sales to China are now large and growing much faster than to other destinations. However, note that 46 per cent of total exports to China in 2003 were of crude oil, and were almost matched by imports from China of refined petroleum products (IMTVN, 2003).
10. See <http://otexa.ita.doc.gov>.
11. This comment is based on interviews with such companies in the Hanoi region in July 2005.
12. However, and leaving aside the problem that the CIEM figure includes oil exports and the VDR figure does not, there may also be some overlap between the FIE and SOE shares as a result of some joint ventures between SOEs and FIEs possibly being included in both categories.
13. The cumulative total of implemented FDI will include some contributions from the Vietnamese side. See Table 12.6 in the text.
14. This discussion is taken from Freeman and Nestor (2004), who give a good introduction to FDI in Viet Nam, and include a very useful account of the considerable discrepancies between Vietnamese FDI data from different sources.
15. The exact period of the cumulated inflow is not made clear, but the survey in RSE (2005) draws its data from enterprises surveyed in end-December 2001, 2002 and 2003. The cumulative figure for the total inflow is US\$13.4 billion, which is broadly comparable (given the usual discrepancies!) with the VNSY figure for 2001–04 for contributions by foreign investors of registered capital of US\$12.6 billion.
16. These are 2000 and 2001 figures from Mirza and Giroud (2004: 228). Of the other ASEAN countries, only Cambodia had a higher percentage for garments in its total FDI inflow, and the average for ASEAN countries for garments was 2.1 per cent. Some of the garment investment is likely to have been in anticipation of improved market access to the United States under the USBTA.
17. The difference between the figure of US\$2.65 billion for 2003 from the VNSY (2004) and the World Bank WDI (2005) figure for FDI inflows of US\$1.45 billion illustrates the problem of knowing how large are the inflows. Even allowing for the 7 per cent of the VNSY figure in 2003 accounted for by the Vietnamese contribution to the registered capital, the large discrepancy between the two figures is striking.
18. Following the Democratic Republic of the Congo, and Iraq. See WDI (2005: 350–52), which is also the source of the other data on aid in this paragraph.
19. 2003 figure from HDR (2005).
20. This point is also made in VDR (2004: 17) about the decline in poverty from 1998 to 2002.
21. This figure excludes the 2 per cent of the Vietnamese population who are ethnic Chinese (Van Arkadie and Mallon, 2003: 227). The majority Vietnamese population is sometimes referred to as Kinh.
22. The exception is that the share of the lowest decile but one fell more than that of the very lowest decile (falls of 5.9 and 5.1 per cent, respectively).
23. Bales et al. (2001) appear to use a slightly different headcount measure from that of the General Statistics Office (GSO), and their measured decline in poverty is from 53 per cent in 1992–93 to 35 per cent in 1997–98.
24. Figure includes forestry (VNSY, 2001).
25. This account of rice production and poverty is taken largely from the summary and discussion in Thoburn (2004: 130–32) of Niimi, Vasudeva-Dutta and Winters (2004) and Litchfield and Justino (2004).
26. Its ranking in terms of world export value is lower because Vietnamese rice trades at a discount as a result of quality and delivery problems.
27. The material here on *doi moi* and the economic events preceding it draws heavily on Van Arkadie and Mallon (2003: chs 4–8).
28. Van Arkadie and Mallon (2003) do not make any sustained comparison between Viet Nam's reforms and China's. A comparative discussion of the two countries' reforms is given by Thien Pham (2003).
29. For some further discussion of these trade reform principles – though in relation to China – see Thoburn and Howell (1999).
30. The estimates are import-weighted but do not take account of the price-raising impacts of Vietnam's remaining quantitative restrictions, which also were reduced between the two dates and which affect both the nominal rate of protection and ERP (effective rate of protection) estimates. Athukorala's re-estimated ERP for manufacturing to take account of these impacts was 96 per cent in 2002 (Athukorala, 2002).
31. In such a case the domestic price would fall to below the world price + tariff; that is, there would be *tariff redundancy*, which would rapidly erode the anti-export bias.

32. See Van Arkadie and Mallon (2003, ch.12) for a full account of SOE reform in Viet Nam over the past 20 years, on which we draw heavily. See also Thoburn et al. (2005) on textile SOEs.
33. Against this, one might note the high import content of Vietnamese manufactures exports (Jenkins, 2004: 204–5). This implies that further expansion would be less constrained by the availability of goods in the domestic economy than would first appear. In any case, Malaysia, for example, had a ratio of exports to GDP of 114 per cent in 2003 and Hong Kong 170 per cent! This apparent contradiction arises, of course, because exports are measured gross of imported inputs, whereas GDP is a value-added concept.

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Further reading

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- A convenient collection of readings on the Vietnamese economy.
- McCargo, D. (ed.) (2004), *Rethinking Vietnam*, London: RoutledgeCurzon.
- A good collection of papers on the Vietnamese economy.
- Templer, R. (1999), *Shadows and Wind: A View of Modern Vietnam*, London: Penguin.
- A good place to start for a readable account of Vietnamese society in the 1990s.
- Van Arkadie, B. and R. Mallon (2003), *Viet Nam: a Transition Tiger?*, Canberra: Asia Pacific Press at the Australian National University.
- Probably the most useful single source on the Vietnamese economy.
- Weeks, J., Nguyen Thang, R. Roy and J. Lim (2004), *Viet Nam: Seeking Equity with Growth, Macroeconomics of Poverty Reduction Case Study*, United Nations Development Programme.
- Provides a thoughtful discussion of Viet Nam's economic and social progress during the transition era.
- A collection of papers on globalization and poverty alleviation in Viet Nam can be found in a special issue of the *Journal of the Asia Pacific Economy*, 9 (2), 2004.
- Viet Nam now has a large literature generated by the aid donors. The annual *Vietnam Development Report* (VDR), though it has its biases, is an excellent source of information on recent events and includes basic statistics. Each year's report has its own theme, such as *Poverty* in 2004 and *Governance* in 2005. The current VDR can be accessed on www.worldbank.org.vn. The Development Information Center in Hanoi has a useful website, www.vdic.org.vn, which also contains many reports and links to other relevant sites such as those of the various United Nations agencies active in Viet Nam.

13 Cambodia

Melanie Beresford

Political history

Cambodia's political history in the past half-century is intimately bound up with the wars and political instability resulting from decolonization. The country was under French rule from 1863 as part of the larger French colony of Indochina, including Viet Nam and Laos. While in 1946, following the end of Japanese occupation, the Vietnamese nationalists waged an independence war against the returning French nationalists were more ambivalent.

In pre-colonial days, the very existence of the Cambodian state had been under pressure from territorial encroachments by both the Thai and Vietnamese monarchies. French colonization created secure boundaries for the country, but these were once again disrupted during World War II, as Thailand, a Japanese ally, claimed a large slice of the western part of Cambodia, including the most productive rice-growing region around Battambang. The defeat of Japan enabled the restoration of this territory to the Cambodian monarchy under French protection. Nationalists in Cambodia were therefore less hostile to the French than their Vietnamese counterparts who had suffered no such territorial dismemberment during the war. Although communism had gained many Khmer (indigenous Cambodian) adherents, it was much weaker in Cambodia during the 1940s and early 1950s than in neighbouring Viet Nam.

By 1953, the French faced defeat in Viet Nam. In order to preserve their influence in Cambodia, they granted independence to the young, French-educated, Cambodian monarch Norodom Sihanouk.¹ Already Indochina was becoming embroiled in the Cold War – the United States would soon take charge of the project of defeating communism in Viet Nam – and Sihanouk's strategy was to distance Cambodia from this conflict as much as possible. In order to achieve this goal, he declared Cambodia neutral – joining the Non-aligned Movement in 1956 – and named his regime a 'People's Socialist Community' in order not to alienate the left wing of Cambodian politics.

It was a difficult balancing act to maintain. The Americans were not at all sympathetic to Sihanouk's neutrality, particularly when the latter turned a blind eye to Vietnamese communist forces using Cambodian territory to smuggle arms and troops to the battlefields of South Viet Nam. Some of the more nationalistic communist elements within Cambodia also became disaffected with Sihanouk's highly personalized rule. In addition, factional infighting between communist groups, respectively sympathetic and hostile to the Vietnamese, led one group, dubbed by Sihanouk the 'Khmer Rouge', to take up guerrilla warfare against his regime in 1963.

In 1969, the United States commenced bombing Cambodian territory as a means of preventing its use by the Vietnamese communists. The effect was to push the Vietnamese further inside Cambodia where, despite deep ideological differences, they began supplying arms to the Khmer Rouge. The United States responded by extending its bombing campaign further inside the country. Sihanouk's neutral position was now untenable and,

amid anti-Vietnamese riots in Phnom Penh, he was overthrown by a military coup in March 1970. The new Republic of Cambodia, led by General Lon Nol, entered the war firmly on the US side.

These events initiated the bloodiest decade of Cambodia's history. The entire nation became embroiled in war. US bombing continued to escalate until 1973, a year in which it is estimated that half a million Cambodians died. Meanwhile, the Americans, like the French before them, were being driven from Viet Nam. Communist forces continued to gain in strength and to advance upon the Cambodian capital. Finally, on 17 April 1975, two weeks before the Vietnamese communists captured Saigon (the capital of the US-backed regime in South Viet Nam) the Khmer Rouge entered Phnom Penh.

If war had brutalized the Cambodian population during the previous five years, Democratic Kampuchea (DK),² as the new state was called, brutalized it even further. Under the leadership of Pol Pot, the Khmer Rouge instituted a xenophobic policy, aimed at destroying foreign and non-communist influences in social and economic life as well as 'reclaiming' territory in the Mekong River Delta that had been lost centuries earlier to southward migrating Vietnamese. Hundreds of thousands of Cambodians fled or died as schools and universities, Buddhist monasteries, cultural organizations, medical centres, factories, government offices – the entire modern infrastructure of the country – were closed and their personnel killed or forced to hide their real identities among the rural and refugee populations. As early as May 1975, the regime began attacking Vietnamese territory, ultimately forcing about three-quarters of a million people to flee from the border regions. Within Cambodia, forced migration of the urban population to the countryside and from the eastern region (where people might be too friendly to the Vietnamese) to the west was undertaken on a vast scale. The Khmer Rouge itself was subjected to a series of purges resulting in the deaths of about 20 000 people, including children of suspect cadres, at the infamous Tuol Sleng prison in Phnom Penh. Whole communities, families and social networks were uprooted and destroyed.

In the economic realm, the vision of a communist agrarian society was implemented. Agricultural communes were established in which, in order to prevent the development of alternative ties of loyalty, families were broken up and lived separately. Since there was no foreign trade, apart from the export of a diminishing rice surplus to China in exchange for armaments, everything had to be done by hand. Chemical fertilizers, pesticides, water pumps and other machinery were absent. There were no medicines available either. Agricultural output plummeted and many more people died from starvation or curable diseases. In all, the best estimate of the number of deaths caused directly and indirectly by the Khmer Rouge during their four years of power is about 1.5 million (Vickery, 1984). By the end of the 1970s, therefore, the combined effects of war and the DK regime had caused the loss of some two million Cambodian lives – or about a quarter of the estimated total population.

In the last days of 1978, Viet Nam retaliated against the frequent Khmer Rouge attacks on its territory by launching a full-scale invasion of Cambodia. Under the circumstances of a destroyed society it is hardly surprising that, notwithstanding Khmer anti-Vietnamese sentiment, there was very little resistance and an almost complete occupation was achieved in the space of two months. The fourth post-colonial state was established, the People's Republic of Kampuchea, initially under the leadership of Heng Samrin and

later of Hun Sen – both former Khmer Rouge regional leaders who had fled to Viet Nam to escape the purges.

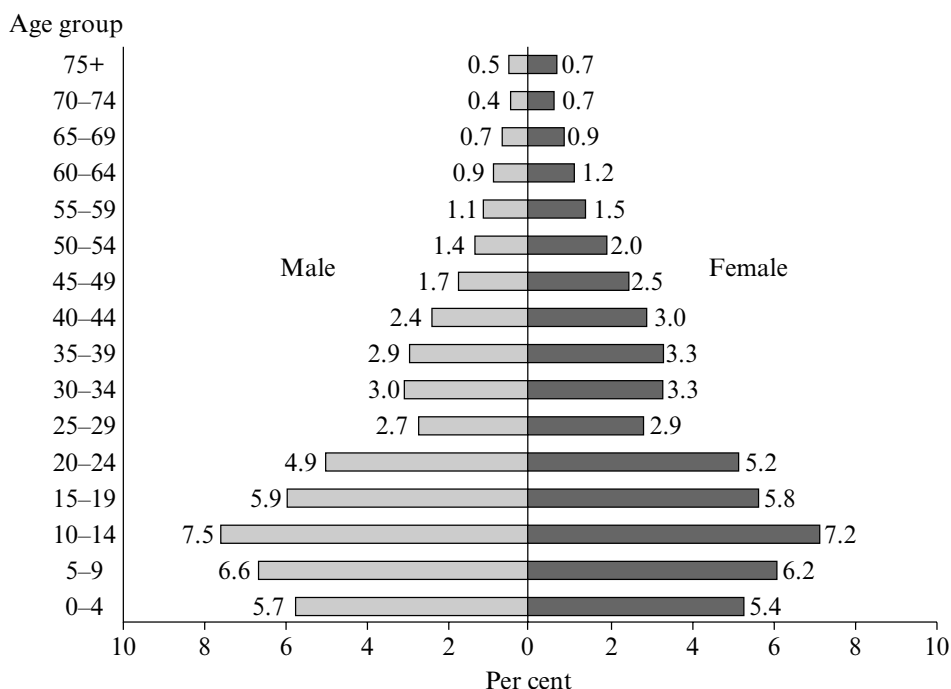
Given that Viet Nam was also a very poor country, the amount of aid it could supply to promote Cambodia's recovery was extremely limited. Nevertheless, a start was made and further aid came from the Soviet Union and Eastern Europe. Somewhat surprisingly, in view of the West's earlier anti-Khmer Rouge clamour, there was no assistance forthcoming from that direction. On the contrary, the boycott of Viet Nam initiated by the United States at the end of the war in 1975, was now extended to all major Western powers and their aid went, instead, to the Khmer Rouge-controlled refugee camps in Thailand. During the 1980s the Cold War still dominated Western policy towards Southeast Asia, which meant that the Khmer Rouge was able to survive in the jungles of western Cambodia for more than another decade.

In 1989, suffering from economic fatigue induced by its Cambodian occupation, Viet Nam withdrew its troops. Then, in 1991 the Soviet Union collapsed and the West moved towards reconciliation with its former enemies in Southeast Asia. The result for Cambodia was the rapid development of a UN-sponsored peace agreement between the Hun Sen government and the warring factions. Sihanouk finally returned to the country as Head of State of the fifth post-independence state, the State of Cambodia, a state that was overseen by the United Nations Temporary Administration of Cambodia (UNTAC). Elections were held in 1993 and, although a plurality of votes was achieved by Sihanouk's son, Norodom Ranariddh at the head of the FUNCINPEC (Front Uni: National pour un Cambodge Indépendant, Neutre, Pacifique, et Coopérantif) Party government was subsequently shared by two prime ministers, Ranariddh and Hun Sen (Cambodian People's Party), in a tense coalition. A new constitution was promulgated after these elections in which Cambodia became a constitutional monarchy under its sixth post-independence name, the Kingdom of Cambodia.

More than a decade has passed since the formation of the Kingdom of Cambodia. During that time, Hun Sen has succeeded in re-consolidating his and his party's power – largely due to the inability of opposition parties, who spent so many years in exile, to form a coherent programme, rise above personality politics or make an impact among the rural majority of the voting population. Election campaigns have been characterized by corrupt practices and frequent violence. The so-called 'peace dividend', which ended the Khmer Rouge's war has also brought many former Khmer Rouge into positions of influence, to the dismay of more liberal political leaders and Western aid donors, but probably improving political stability in the country. Finally, Sihanouk, who had adopted so many ideological guises over the past half-century, all in the name of preserving the Cambodian monarchy, retired in 2004 and passed the throne to another of his sons, Sihamoni.

Economic progress and structural change

The terrible events of the 1970s continue to influence the Cambodian economy and society today. Most notable among these effects is the population structure. The high death rate of working age men during the war of the early 1970s is reflected in a disproportionately large share of women in the population aged 40 and over; the DK years (1975–78) resulted in low birth rates, due to family disruption, and extremely high infant mortality, due to starvation and disease; the 1980s saw a baby boom as families re-connected and tried to



Source: National Institute of Statistics, Phnom Penh.

Figure 13.1 *Population pyramid, Cambodia, 2004*

recover. Cambodia's population pyramid (Figure 13.1) therefore shows a highly abnormal structure.

In the rural areas of the country, where 80 per cent of the population live, 54 per cent of the working age population (15–64) are female, rising to 59 per cent among the over-40s. The high proportion of working-age females contributes to low productivity and very high levels of poverty in the agricultural sector. In addition, those who survived the Khmer Rouge years have little education, so the country suffers from a higher than usual scarcity of high-quality human resources compared with other countries in the region. According to the most recent Cambodia Socio-economic Survey (2003–04), 80 per cent of women and 55 per cent of men aged 25 and over have not completed primary school, while the proportions having completed more than nine years of schooling were 3 and 8 per cent respectively (NIS, 2004). At the top echelons of government, there is a very thin layer of highly qualified personnel who have either returned from exile or who were educated during the 1980s in the Soviet Union and Eastern Europe. Skilled workers tend to be immigrants, often ethnic Vietnamese who have returned or newly migrated since 1979. Finally, the post-DK baby boomers, now aged 10–25, have begun entering the workforce, often without employment prospects. Today over half the population is under 25.

As in Viet Nam, the Cambodian economy underwent market-oriented reforms of its previous socialist system during the 1980s. Notably, an egalitarian land distribution was carried out in 1989 and previously existing cooperatives were dismantled. However, the

most dramatic structural changes have taken place since the establishment of UNTAC in 1991. Since then, the economy has operated as a market economy, albeit with features that are characteristic of other transition economies – including a government and bureaucracy exhibiting high levels of corruption and a general absence of the rule of law. All but a handful of state-owned enterprises were privatized, private commercial banks were encouraged (only two of 17 remain in state hands), foreign trade was liberalized and foreign investment promoted.

The growth performance of Cambodia over the period 1993–2004 was mixed. Measured in riel (the Cambodian currency) at constant 2000 prices, the average annual growth rate of GDP was 7.1 per cent and the per capita figure rose from 897 000 riel to 1 319 000 riel. Measured in US dollars at 2000 prices, however, the growth rate was far less impressive, averaging only 3.9 per cent per annum and in per capita terms it only rose from US\$326 to US\$328 (NIS, 2004). The importance of the dollar figures lies in the fact that the Cambodian economy is highly dollarized – about 80 per cent of currency in circulation is US dollars and only a tiny proportion of bank deposits are held in riel.³ The rural population (about 80 per cent of the total), however, is quite insulated from the dollar economy, conducting most of its transactions in riel.

The relatively poor performance of the dollar economy is related to both the political crisis of the mid-1990s and the wider regional crisis of 1997–98. In dollar terms the economy suffered a decline in per capita GDP of 30 per cent between 1996 and 1998, and 16.8 per cent in 1998 alone. In the same year the riel devalued by a 27 per cent and there was a temporary increase in inflation to 15 per cent. In the riel sector of the economy, on the other hand, real per capita GDP remained stable during these years – reflecting not only the lack of connection of the rural population to the dollarized economy, but its lack of integration into the market economy generally.

Since 1999 both economic and political conditions have stabilized and growth has resumed. The average real growth rate 1999–2004 was 7.7 per cent in riel and 6.6 per cent in dollars. The riel/dollar exchange rate remained relatively stable and the period was characterized by negative or very low (less than 1 per cent) rates of inflation (NIS, 2004). Given the high dollarization of the economy, monetary policy is basically unavailable as an instrument of macroeconomic policy. Fiscal policy has remained tight in recent years under an agreement with the IMF, which prevents both central bank financing and borrowing from the private sector⁴ as means of supporting a large budget deficit and caps public sector wages. These measures have been introduced due to a fear of resurgent hyperinflation that characterized the period 1989–90 and low confidence in government accountability. Budget deficits have been restricted to 5–6 per cent of GDP as a result and these are entirely financed by the foreign sector, principally via project aid (IMF, 2004: 25). Government revenues rose from 10 to 12 per cent of GDP during 1999–2003. Within this figure, value-added tax, excise and taxes on international trade accounted for 7 per cent and non-tax revenues 4 per cent in 2003. Direct taxes, chiefly paid by foreign-invested enterprises, were only 1 per cent of the total (IMF, 2004: 13). Low capacity to increase government revenues is thus an additional constraint on development spending.

Structural change

Real sectoral rates of growth for 1999–2004 (measured in riel) are depicted in Table 13.1. Industrial expansion accounted for 56 per cent of all growth during the period. In fact, about

Table 13.1 Annual growth rates and shares of real GDP by sector, 1999–2004

	Growth (% p.a.)	Shares	
		1998 (%)	2004 (%)
Agriculture, fisheries and forestry	1.8	42.8	30.9
<i>of which:</i> crops	3.7	17.4	15.0
fisheries	2.0	12.8	8.8
forestry and logging	–7.1	5.4	2.0
Industry	17.5	16.8	28.9
<i>of which:</i> textiles, wearing apparel and footwear	31.9	4.7	16.3
construction	17.3	3.6	6.4
Services	5.3	36.3	34.4
<i>of which:</i> hotels and restaurants	14.7	3.1	4.7
transport and communications	6.3	5.9	6.6

Note: These sectoral contributions do not add to 100 per cent because growth in net taxes and imputed bank charges are not included.

Source: NIS (2004).

two-thirds of industrial growth was due to the extremely rapid expansion of the export-oriented apparel industry, which has increased its share of GDP from just 1.1 per cent in 1993. Other sectors that showed strong growth rates include construction, transport and communications, and the tourism-related sector of hotels and restaurants. Taken together, these four industries doubled their share of GDP from 17.3 to 34 per cent. The service sector's contribution to overall GDP growth was about 30 per cent, while agriculture contributed only 1.8 per cent. Cambodian agriculture is heavily concentrated on rice production and its yields, at about 1.8 tonnes per hectare, are among the lowest in Asia. High yielding varieties are not yet widespread and many areas remain in food deficit. There is, therefore, considerable potential for rural growth via agricultural intensification and crop diversification.

Such a pattern of structural change is, of course, consistent with historical development patterns in all developing countries, including today's developed countries. The rapid growth of garments, in particular, has been a plus for export income and non-farm employment generation – both direct and indirect. However, the growth has had a remarkably narrow base with rising dependence on expansion of garment production over time. This industry is currently in a rather fragile state. At the time of writing, no evidence is available as to the impact of the ending of the Multi-fibre Agreements and China's accession to the WTO, but the fear in Cambodia has for many years been that China's untrammelled access to EU and US markets would devastate the local industry. Moreover, the industry is heavily concentrated in and around three urban centres of Phnom Penh, Siem Reap and Kompong Som (Sihanoukville) and thereby increases the urban bias that Cambodia's pattern of growth has exhibited so far. The other major growth sectors of tourism, construction and transport and communications are similarly heavily concentrated in a handful of urban centres.

Further, the sector of agriculture, forestry and fisheries continues to provide a large share of GDP at 33 per cent and to employ over 70 per cent of the population. Poverty is

Table 13.2 Investment share of GDP, 1993–2004 (%)

	1993	1997	1998	1999	2000	2001	2002	2003
Gross investment	13.9	15.1	11.9	17.0	17.3	21.2	22.2	21.0
<i>of which:</i>								
Public	3.9	4.4	5.1	5.4	6.3	6.6	7.8	7.4
Grant financed		—	—	5.4	6.1	5.5	4.9	5.3
Private	10.0	10.7	6.7	6.2	4.9	9.1	9.5	8.3

Sources: RGC (2002: 13); IMF (2004).

overwhelmingly concentrated in these rural sectors, particularly agriculture (crops and livestock) where growth has been highly unstable. This sector is severely affected by natural conditions due to low levels of water control. In 2000, for example, there were severe floods. Other years, including 2002, were affected by drought conditions or late arrival of the monsoon. Increased investment in agriculture – in raising productivity, rendering output less vulnerable to natural conditions, encouraging expansion of market-oriented production (especially through infrastructure improvements) and increasing value-added in rural production by developing processing and related services – would both widen the base on which growth occurs and have maximum impact on the poor. Forestry's poor performance, on the other hand, has been the result of policy directed at ending the mostly illegal trade in raw logs.

Investment

Economic growth comes chiefly from investment that leads to more employment and from changes in the capital–output ratio. The latter can be achieved by the introduction of more productive technologies *or* through better utilization of existing labour resources – for example, by better organization or higher skill levels – without the addition of more capital equipment.

Total investment (both public and private) grew fairly steadily from 1993 to 1996, then tapered off during the crisis years and has stabilized at about 21–22 per cent of GDP in the early 2000s (Table 13.2). Foreign investment grew rapidly in the earlier period – foreign savings provided the majority of investment until 1996, shared roughly 50:50 between public (foreign aid) and private investment. However, foreign private investment recovered very slowly after the Asian Crisis. Lack of dynamism in FDI has been offset in recent years by growth in non-budgetary spending financed from grant aid and domestic private investment. Capital–output ratios are rather high for an economy with surplus labour: US\$460 of investment were required to produce a US\$100 increase in output during 1994–2001.⁵

The investment data show that dollarization has been successful in stemming capital flight. Table 13.3, showing financial aspects of the balance of payments, illustrates this – net private transfers and investment have been positive every year since 1994. However, the table also shows the fragility of confidence in the Cambodian economy as net private financial inflows have reduced substantially since the mid-1990s. The current account deficit grew rapidly in 1994–96 and has remained high after the 1997 crisis, at 9–13 per cent of GDP each year. While the deficit has been financed by medium- and long-term

Table 13.3 *Balance of payments, 1994–2003*

	1994	1998	1999	2000	2001	2002	2003
Current account ^a	–368	–382	–456	–421	–348	–359	–429
Trade balance	–254	–365	–462	–538	–523	–564	–537
Net services and income	–134	–106	–99	–26	37	56	–54
Receipts	2	225	345	496	582	655	568
Payments	–49	–331	–444	–522	–545	–599	–622
Of which: interest	–15	–13	–14	–15	–15	–16	–18
Net private transfers	20	89	105	144	137	149	163
Net official transfers	283	199	276	317	303	312	328
Capital account	16	73	81	42	91	107	133
Medium and long-term loans	13	–62	–61	–24	64	133	120
FDI net	69	223	331	142	142	139	77
Short-term flows and error	–66	–88	–79	–75	–115	–165	–65
Overall balance	36	–110	–99	–62	45	60	33

Note: a. Includes estimates for unrecorded exports.

Sources: NIS (2002: 252); IMF (2004: 25).

capital, Cambodia has maintained a manageable debt service requirement. In 2003 debt service amounted to only 0.9 per cent of export income (World Bank, 2005), although increased levels of external borrowing should see this figure rise in future. With this in mind, the International Monetary Fund in December 2005 included Cambodia in its Multilateral Debt Relief Initiative, granting 100 per cent debt relief on all debt incurred with the institution before January 2005. We should note here also that net private sector transfers shown in the table include only those recorded by the National Bank of Cambodia. An unknown amount is transferred in and out of the country by illegal means.

Trade

Exports have expanded rapidly, mainly due to the growth of the apparel industry mentioned above. Whereas in 1994, total export income amounted to only \$US490 million, it had risen to over US\$2 billion by 2003, of which garments accounted for 79 per cent. The only other major foreign exchange earner is tourism, which expanded in value from US\$107 million in 1998 to an annual average of US\$407 million in 2001–03. The tourism industry is highly concentrated around the Angkor Wat complex of ruins in the north-west. Other important exports include re-exports (goods that enter Cambodia only in transit to another destination), fish, rubber and rice. Of all Cambodia's exports, only the last three include a significant component of domestic value-added: together they accounted for only 10.6 per cent of total exports in 2003 (IMF, 2004: Table 22).

Many fears have been expressed that the ending of the Multi-fibre Agreement's export quota system in 2005, together with China's accession to WTO, would have a major negative influence on future development of the Cambodian garment industry. China has been one of the more important investors in the industry, along with Taiwan, Malaysia and Thailand. In order to offset any negative effects, Cambodia also joined the WTO – among the first least developed countries to do so. The country has also developed a

unique approach to sustaining the industry, by implementing high labour standards and permitting the development of independent trade unions.⁶ As one commentator noted (Becker, 2005):

Cambodia, while still a very cheap place to produce apparel, has chosen to rely on outside inspectors and to foster unusually strong garment unions that have become an independent political force in a country otherwise awash in corruption and cronyism. The efforts at improvement here may point the way for other nations seeking to avoid a race to the bottom as they struggle to establish or sustain footholds in the global economy.

According to Cambodia's Garment Manufacturers' Association, higher labour standards have increased the quality of work and have been a positive attraction for Western clothing retailers like Gap, Levi Strauss, Abercrombie & Fitch and Marks & Spencer. Thus, while China's massive growth in garment exports has caused some factories to close, the impact was offset by the opening of new plants.

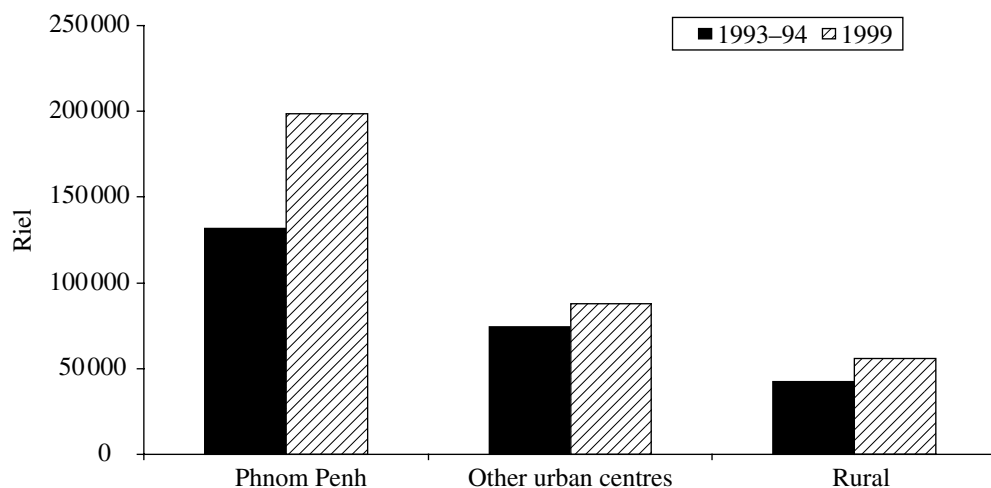
Social progress

Income poverty and inequality

As noted above, economic growth since 1993 has been heavily biased towards urban areas. There are no available statistics on the breakdown of GDP by region, but using per capita household expenditure data from the socioeconomic surveys as a proxy, it can be seen that not only are incomes in Phnom Penh much higher than rural incomes, but the gap has widened over time. Whereas average monthly expenditure per head was 3.1 times higher in Phnom Penh than in the rural areas in 1993–94, by 1999 it was 3.6 times higher (Figure 13.2). The gap between Phnom Penh and the other urban centres has also increased over time.

According to the 1999 Cambodia Socio-economic Survey (CSES), 36 per cent of the population remained below the national poverty line, compared with 39 per cent during the 1993–94 survey. The figure is, however, shrouded in controversy since there were changes in methodology between surveys and many Cambodian experts estimate a figure closer to 45 per cent for 1999 (Beresford et al., 2004: 28). There are some indications that poverty reduction has not taken place at all since the early 1990s; for example, according to the same two CSES surveys, average daily per capita consumption actually fell, from 2260 riel to 1800 riel.⁷ Moreover, while output and yields of rice, the staple food crop, have risen a little since 1995, per capita availability has shown no comparable trend (Beresford et al., 2004: 51).

Poverty in Cambodia is overwhelmingly a rural phenomenon. About 85 per cent of the population live in rural areas and, according to the 1999 CSES, about 85 per cent of these were employed in agriculture, forestry and fisheries (74 per cent of the total population). While the proportion of the urban population living below the poverty line had been reduced to 10 per cent, the figure for the rural areas was 40 per cent. Thus, about 95 per cent of Cambodia's income poverty was in the rural areas according to the official statistics. Another factor, however, is that apart from some especially vulnerable groups, such as those disabled by the civil wars, poverty is quite shallow. Most Cambodians are clustered just above or just below the poverty line and this means that broad-based measures targeted at the rural areas could have significant benefits in reducing poverty quite rapidly. Conversely, it also means that, in adverse circumstances, large numbers of people are vulnerable to falling below the poverty line.



Source: Beresford et al. (2004).

Figure 13.2 *Per capita monthly household expenditure 1993-94 and 1999*

Rural poverty in Cambodia is compounded by lack of access to basic infrastructure and unequal distribution of productive assets. Within the rural areas the system of roads is in an extremely poor state of repair. A recent report described 65 per cent of provincial roads as 'untrafficable', presumably meaning inaccessible to vehicular traffic. Fifty nine per cent of rural tertiary roads were similarly classified (Kingdom of Cambodia, 2004: 98). The lack of access by the poorest section of the rural population to productive assets, such as land, livestock, transport equipment and machinery is illustrated in Table 13.4 The financial system is extremely underdeveloped, with only an estimated 10 per cent of the population able to obtain access to formal credit (Beresford et al., 2004: 48).

Health

Data on the health status of the Cambodian population, particularly in the rural areas, provide another indication that poverty reduction has not happened since the early 1990s. Infant and under-five mortality rates (the proportion of children born alive who die before reaching the ages of one and five years respectively) are two of the strongest indicators of how healthy a population is. For Cambodia, the infant mortality rate increased from 80 per 1000 live-born children in 1990 to 197 in 2003. The under-five mortality rate also rose, from 115 to 140, over the same period (World Bank, 2005). Further, 45 per cent of children under five were underweight and 45 per cent were protein malnourished in 2000 (Kingdom of Cambodia, 2003: 9).

These terrible statistics are partly explained by the collapse of the public health system in the post-communist period. The number of public medical establishments had declined to two-thirds of its 1989 level by 2000. Private clinics have grown in number, but these are largely concentrated in urban areas. Thus, while 70 per cent of Phnom

Table 13.4 Rural distribution of assets

	Share of Bottom 20 %	Share of Top 10 %	Gini Ratio
Land (cultivated)	3.7	33.0	0.47
Animals	0.4	30.4	0.50
Transportation	2.3	46.0	0.61
Durables	6.9	36.3	0.49
Machinery	1.6	47.1	0.65

Source: Murshid (1998).

Penh residents had a qualified physician nearby, only 4 per cent of rural residents did (Beresford et al., 2004: 30).

Sanitation levels are also low. Eighty per cent of the rural population and 40 per cent in urban areas had no toilet at all in 2000 (Beresford et al., 2004: 32). Only 34 per cent of the population had access to clean water in 2002 – a figure basically unchanged since 1996 (Beresford et al., 2004: 31; World Bank, 2005).

Education

The Cambodian government, in tandem with aid donors, has placed much emphasis on rebuilding an education system that was completely devastated during the Khmer Rouge years. In 2002–03 education took over from defence as the largest single item of budget expenditure (following post-war reductions in military expenditure) (IMF, 2004: 16).⁸ However, the task is a protracted one and, given the long lag times involved in the process of creating high-quality human resources, Cambodia is likely to suffer from low education levels for at least another generation.

Even while school enrolment rates have risen rapidly since the early 1990s, 35 per cent of children in the 6–14 age group were not actually attending school in 1999 (Kingdom of Cambodia, 2003: 26). Moreover, the enrolment data show that the gender gap in education remained significant. While 87 per cent of boys were enrolled in primary school in 1999, only 81 per cent of girls were: for lower secondary school the figures were 21 and 16 per cent respectively. Given past trends, the government estimated that the gender gap was not likely to close in primary education by 2010 or in lower secondary education by 2015 (Kingdom of Cambodia, 2003: 28). Data available from the 2003–04 CSES (NIS, 2005a) show that among those over 25 years old, women were more than twice as likely as men never to have attended school and men were twice as likely as women to have completed either primary or lower secondary education.

A similar education gap can be found between the urban and rural populations. At the primary level this gap is only a small one, but children living in Phnom Penh were about four times more likely to be enrolled in lower secondary school than rural children and six times more likely to be in upper secondary school. In some remote areas, the education gap is even more pronounced. Ethnic minorities in these areas reportedly had literacy rates as low as 5.3 per cent for males and zero for females (Kingdom of Cambodia, 2004: 43). As noted above, about 85 per cent of the population live in rural areas, while rural families also tend to have more children.

Employment

The sectoral structure of the labour market changed comparatively little over the 1990s (Table 13.5). In fact the proportion of workers in agriculture actually increased during the decade. Reasons for this increase, which is contrary to the normal pattern of development, may include gradual settlement of land ownership rights after privatization in 1989, the return of refugees and demobilization of the armed forces, rather than a shift of people to agriculture because of rising labour demand. Since 1999, a shift out of agriculture has begun to take place. The other sectors to show increases in their share were manufacturing, construction and fisheries. The increase in the proportion of women working in manufacturing, reflecting the rise of the garment industry where they constitute 95 per cent of employees, is remarkable. A more diverse range of occupations was clearly available to men compared with women. But under the labour standards that Cambodia agreed to implement in 1999, work in the garment industry tends to be highly paid compared with work in most other sectors.

Underemployment is a more serious problem in Cambodia than unemployment. Table 13.6, based on the 2000 Labour Force Survey, gives some indication of the extent to which labour resources are under-utilized. It shows that 5.3 million persons aged ten and over were employed. Of these, 1.66 million (31 per cent) indicated that they were available for extra work and over half a million were employed for less than 30 hours during the survey week. Formal unemployment, on the other hand, is negligible.

Child labour is a particularly prominent issue in Cambodia where it was estimated that in 2001 some 2.5 million children 5–17 years old were working, two-thirds of them in the 5–14 age group. While 87 per cent were unpaid household workers, 4 per cent were full-time employees. Although boys formed a majority of child workers of all ages, except in the urban areas, girls worked harder, averaging 50 per cent more time at work than boys. Only 45 per cent were, according to the survey, attending at least some school or training

Table 13.5 Employment by sector of primary employment and sex, 1993–94 to 2001 (%)

	Male		Female		Total		
	1993–94	1999	1993–94	1999	1993–94	1999	2001
Agriculture and forestry	65.6	70.3	75.3	77.1	70.6	73.9	66.0
Fishing	2.0	3.3	1.0	1.0	1.5	2.1	4.2
Manufacturing	4.2	3.9	3.2	6.5	3.7	5.3	8.8
Construction	1.6	2.6	0.1	0.3	0.9	1.4	1.3
Wholesale, retail trade	6.2	3.9	15.6	10.6	11.1	7.4	10.3
Hotels and restaurants	0.2	0.4	0.3	0.4	0.2	0.4	0.2
Transport, storage and communications	6.1	4.3	0.9	0.4	3.4	2.3	2.7
Public admin, defence, etc.	8.2	6.1	0.8	0.6	4.3	3.3	2.4
Education	2.4	2.2	1.0	1.9	1.7	1.5	1.4
Others	3.5	3.0	1.8	1.2	2.6	2.4	2.7
	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Godfrey et al. (2001); IMF (2004).

Table 13.6 Employed persons ten years and over, 2000

	Employed		Working <30 hours		Available For Extra Work		'Unemployed' Housekeepers	
	Total (000s)	Female (%)	Total (000s)	Female (%)	Total (000s)	Female (%)	Total (000s)	Female (%)
Urban	614.7	48.6	58.7	59.9	94.2	39.3	101.2	92.8
Rural	4660.5	52.3	491.2	51.0	1567.2	44.8	315.4	89.7
Total	5275.2	51.9	549.9	51.9	1661.4	44.5	416.5	90.5

Source: NIS (2002: 44–5).

institution. Indeed 30 per cent of all Cambodian 5–14-year-olds had not completed any class (NIS, 2005b).

Challenges and prospects

Since the establishment of the Kingdom of Cambodia in 1993, government policy has aimed at establishing an open market economy with fiscal and monetary stability. These goals have certainly been achieved. The value of trade reached 108 per cent of GDP in 2004 (IMF, 2004: 25; NIS, 2005a); inflation has not only been curtailed, but has possibly been too low in recent years; the fiscal deficit has been reduced to manageable levels, despite increasing levels of debt service requirements. While private foreign investors have shown reduced confidence since the political turmoil of 1996–97, slow growth of FDI has been compensated by official aid inflows and domestic private investment. Growth rates have been maintained at relatively high levels of around 5–7 per cent per annum.

The major policy issues during the first decade of the twenty-first century relate to the dramatic inequality between the urban and rural sectors of the economy, particularly the apparent inability of high growth rates to produce any significant reduction in rural poverty. Part of the responsibility for this situation must be borne by the international donor community, which, in focusing on the achievement of macroeconomic stability, has tended to ignore the serious plight of the majority of rural Cambodians. In terms of sectoral assistance, donor funds have been very heavily concentrated in two sectors – education and health – while the government's other priority sectors, agriculture and rural development, have received relatively little support. Another major focus of donor-driven aid programmes is governance – especially public administration reform, financial sector prudential regulation and judicial reform.

The reasoning behind these donor priorities stems from a belief that macroeconomic stability will encourage economic growth and investment by the private sector, while the role of aid is to concentrate on improvements in the country's human resources, in health and education, and creating a level playing field (eliminating corruption) so that everyone can take advantage of new economic opportunities.

A problem with this view is that for the foreseeable future, only the urban sector is likely to benefit. Cambodia's large rural population is only marginally connected to the market economy and this is at least partly due to the bad state of rural infrastructure, including roads, water, power and communications. The restrictions placed by the IMF on public

expenditure, while certainly justified by rampant corruption and mis-spending, also make it impossible to increase the rate of investment in rural areas. Private investors are unwilling to undertake such investments since the risk is perceived to be too high. Meanwhile, rapid growth in the urban economy creates extra demands for urban infrastructure that soak up the available capital expenditure from the budget.

In theory, expenditure on education and health should have large benefits for the rural population. Poor health is a major cause of poverty as health care is expensive and high levels of indebtedness required to purchase it push many farmers into a vicious circle of poverty. Distress sales are the main cause of land loss, for example, with about 12 per cent of land changing hands over a five-year period (Beresford et al., 2004: 47). Expenditure on education is more controversial as it is clear that many poor rural families are not taking advantage of improved availability of schools. Demand for education is generally associated with better employment opportunities that are not yet available in the rural areas, while poor families often cannot afford to send children to school when they are needed at home to help out with daily subsistence activities. Thus, as noted above, a majority of the 2.5 million working children in 2001 were not attending any kind of education or training institution. Given the relative neglect of agricultural and rural development in donor priorities, the cycle of urban growth with rural stagnation seems set to continue.

There are some positive developments, however. In the garment sector, the application of labour standards and emergence of an independent union movement have not only enabled the industry to survive the abolition of Western import quotas, but have reportedly led to the emergence of an independent political force that is untainted by the corruption of the current political elites (Becker, 2005; Hughes, 2003). It has also provided relatively well-paid jobs for some 270 000 young women and indirect employment for another quarter million or more. Together with tourism and its associated employments, the industry accounts for a good deal of the employment diversification that has taken place in recent years – notably the increased shares of employment in manufacturing and trade shown in Table 13.5.

Non-governmental organizations (NGOs) have also made an impact in the rural areas. Illegal logging, formerly one of the chief sources of finances for the civil wars, has diminished in recent years too. The government has encouraged the activities of Global Witness, an international NGO that has assisted the government to track and fine illegal loggers. NGOs and the United Nations Development Programme have also played a prominent role in community development projects that establish Village Development Committees, especially with participation of women, and decentralization of expenditures to the local level.⁹ Local elections were held for the first time in 2003 and, while the corruption of central-level political party politics was not absent, these elections gave the rural population their first chance ever to participate in the political life of the country.

Cambodia's history since the 1960s has been marked by tragedy. War and the Khmer Rouge regime in the 1970s shattered its economy and society in unimaginable ways. The 1980s were characterized by only partial recovery amidst an economic and political blockade by the West that both deprived it of much needed resources and permitted the civil war to continue. The peace settlement of 1991 has likewise had mixed blessings. No doubt the end of the wars has been a major benefit, as have the achievement of economic progress in the major urban centres, the rise of new employment opportunities in garment

manufacturing and achievement of macroeconomic stability. The country still has a long road to hoe, however: the 1990s saw the pronounced emergence of corruption in every sphere of life, continued political turmoil among the political elite, increases in some indicators of poverty and failure to spread the benefits of growth to the rural areas. It is only since 1999 that political stability has emerged more strongly and, although Cambodian democracy has so far been more artificial than real, the foundations are now being laid for increased popular participation in decision-making. In the near term, Cambodia's prospects will depend a great deal on how well the government and donors manage to shift their policy priorities towards agricultural and rural development.

Notes

1. Born in 1922, Sihanouk was educated at Francophone schools in Phnom Penh and Saigon (Viet Nam) and at a military academy in Saumur, France. For more details see his fascinating website: <http://www.norodomsihanouk.info>.
2. Sihanouk, although nominally restored as Head of State, remained in exile in Beijing where he had gone in 1970. He resigned again in 1976, but resumed the post, as Head of State in exile (but creating a separate, royalist, guerrilla force) in 1982 after the Vietnamese invasion of Cambodia.
3. Only the state-owned Foreign Trade Bank accepts any riel deposits at all.
4. Despite excess liquidity in the commercial banking sector amounting to approximately 3 per cent of GDP (Beresford et al., 2004).
5. Calculated from RGC (2002: 13).
6. The system was originally initiated in 1999 as part of the Clinton administration's push to include labour standards within the WTO rules.
7. Over the same period, the riel devalued by 48 per cent against the US dollar. A new CSES was conducted in 2003–04, but at the time of writing the data on poverty were not yet available.
8. The figures were 15 per cent of budget expenditure in 2002 and 14 per cent in 2003, compared with 10 per cent in 1997 and 18.4 per cent in 1989, the last year of the Vietnamese-backed regime (Chan Sophal et al., 1999).
9. Hughes (2003) provides a suitably cautious analysis of these developments.

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- Provides a detailed overview of the Cambodian economy, especially macroeconomic policies of the period since 1993 and analysis of its impact on poverty.
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- Vickery, Michael (1984), *Cambodia 1975–1982*, Boston and Bangkok: South End Press and Silkworm Press.
- Vickery is one of the world's foremost scholars of Cambodia. This volume explains better than any other I have read, the complex situation prevailing in Cambodia during the Khmer Rouge period. It also provides carefully reasoned estimates of deaths.

14 Laos

*Andrea K. Chareunsy*¹

A modern political history

In the twentieth century, the Lao have gone along with a series of major ‘flows’: the flow of European domination, the flow of communist-led national liberation, the opposing flows of the cold war, and, finally, the global flow of market liberalization. (Ivarsson et al. 1995: 12)

Appreciating how the unified Lao territory was ‘created’ permits an understanding of why a people who were once powerful and cultured have deflated into a ‘superficial’ nationhood. The Lao People’s Democratic Republic (Laos) has frequently been consigned labels denoting its lack of distinct national character: Laos is sometimes called a ‘colonial backwater’, a ‘buffer state’ or a ‘region rather than a nation’. This reflects the recognition that Laos, due in part to its historical dependence on the ‘flows’ of neighbours and of global powers, continues to bear an ephemeral identity.

The feature characterizing the early period of modern Lao history and that permeates present-day Lao consciousness is that the Lao were never perceived as having any claim to their own country. Decisions were made by the French and Siamese and later by the Vietnamese and Americans. The Lao political system was fashioned along Vietnamese lines, their cultural persona is closely bound to the Thai and their want for patronage looks to the French. What happened during the French colonial era marks the internal struggle that besets Laos to the present day: as Jerndal and Rigg stated, ‘[the Lao were] manipulated by and defined within the terms of foreign economic and political needs’ (2000: 37). The present-day territorial demarcation of the country, put together by opposing currents in the region during the nineteenth century, suggests part of the rationale behind the country’s heavy dependence on ‘outsiders’ and why the Lao are still searching for something called *Sat Lao* (Lao Nationality).

The era of French Indochina

By the end of the nineteenth century, the Khorat plateau – including Isan (part of today’s northeast Thailand) and most of what is now northern Thailand – was part of the greater Lao kingdom of Lan Xang, with Luang Prabang as the royal capital (Stuart-Fox, 1995: 112). While Viet Nam maintained suzerainty over the mountainous regions of the northeast, the kingdom of Luang Prabang (northern Laos), Vientiane (southern Laos) and most of Lan Xang were under the control of Siam² until the end of the nineteenth century (Pradumna and Hamid, 1996: 4).

In 1893, under the terms of a Franco-Siamese treaty, Laos became a protectorate of France. Further treaties, in 1904 and 1907, established the boundaries of present-day Laos – ceding to Siam the thriving agricultural and trading area west of the Mekong (Ivarsson, Svensson and Tonnesson, 1995: 12). The division of the Lao territories into a French-controlled east bank of the Mekong and a Siamese-controlled west bank

dissolved the centuries-old trade and migration routes of the Lao (Jerndal and Rigg, 2000: 36–38; Stuart-Fox, 1995: 111–21).

Under French suzerainty, only modest social and economic development took place.³ Commercial tin mining, extraction of forest products, and tea and coffee production were established but not fully promoted. Infrastructural improvements (for example, the rail link from Laos to Viet Nam) were instigated but abandoned because of escalating cost. An influx of Chinese and, in particular, Vietnamese immigrants, arrived to work in the tin mines and as traders, administrators and teachers. Many Lao felt that not only were they subject to the French, but managed by the Vietnamese.⁴ To quell dissent, the administration hand-picked members of the Lao elite to be educated and, in the early 1940s, encouraged a rejuvenation of Lao culture and identity in an attempt to lessen the growing political influences of Viet Nam and Siam (Jumasi, 1971: 243; Pradumna and Hamid, 1996: 4–5; Stuart-Fox, 1995: 127–39).

In 1945, Lao independence was urged by the Japanese as their brief occupation was coming to an end. This encouragement, however, split the Lao royalists between pro- and anti-French factions (SarDesai, 1997: 202).

The Thirty Years' Struggle

The split in the royal house endured from the declaration of independence in 1949 until the end of the 1970s, a period commonly referred to as the 'Thirty Years' Struggle'. Sibling rivalry within the royal family was prolonged by the wars in neighbouring Viet Nam and Cambodia (see Gunn, 1998: 57–86) as, in the context of the Cold War, Viet Nam, China and the Soviet Union aided the communist forces, while the United States and Thailand led the opposing campaign in support of the Royal Lao Government (RLG) (Freeman, 2001: 123).

The first generation of French-educated Lao became anti-colonialists and organized themselves into the Lao Issara (Free Lao) movement. They were led by the charismatic 'Red Prince' Souphanouvong, who had entered an alliance with the communist Viet Minh in the 1940s. The group eventually became unhinged with in-fighting: one group, led by Prince Souvanna Phouma, accepted an independent Laos 'watched over' by the French and, later, the United States (Gunn, 1998: 97–107; Ivarsson et al., 1995: 13).

In 1950 Souphanouvong inaugurated a guerrilla organization – the Pathet Lao (Lao Nation). After an attempt at reconciliation between the princes during the 1950s, the Pathet Lao and Lao People's Revolutionary Party (LPRP), which it had formed in 1952, withdrew to two northeastern provinces bordering Viet Nam, which became their headquarters for the next two decades. The hardships endured by the LPRP and its leader, Kaysone Phomvihane, during the intense US bombing campaign of the 1960s gave credibility to the Pathet Lao movement among the growing urban educated class (Freeman, 2001: 123; Gunn, 1998: 66–8; SarDesai, 1997: 203).

US military defeat in Viet Nam by 1973 gave rise to political upheaval among this urban elite. Particularly demoralizing for the pro-Western faction were the protests and walk-outs in Vientiane and Luang Prabang – the historical nesting place of the royalists. The civil conflict between factions in Laos mirrored the greater struggles for ideological territory in Viet Nam and Cambodia. Hence, it was not coincidental that, soon after the communist victories in these neighbouring countries in 1975, the Pathet Lao declared a People's Revolutionary Administration. The second half of 1975 saw the rapid departure

of various key anti-communist ministers and generals, followed by thousands of middle and upper class Lao as well as the Vietnamese and Chinese commercial class. At the beginning of 1976, Lao People's Democratic Republic (LPDR) came into being (Brown and Zasloff, 1976).

The LPRP's success in seizing power was in part due to popular support throughout the country, especially among ethnic minorities – the Lao Theung (Upland Lao) and Lao Soung (Midland Lao). By contrast, backing for the RLG was concentrated among the majority ethnic group, the Lao Loum (Lowland Lao) in the major towns and in the Mekong River valley (Freeman, 2001: 124).

The Thirty Years' Struggle drastically eroded Laos's economic situation, and radically disfigured its human resource base. While external aid from the United States and the communist bloc had been phenomenal, social and economic developments were virtually non-existent. Hence, when the Republic was formed, almost 30 years after independence, it was among the poorest countries in the world, very few skilled people remained in the country and the economic situation had deteriorated dramatically since the period of French hegemony.

The communist era

The LPRP came to power in 1976 with a programme of carrying out three revolutions: 'a production-relations revolution, a technical revolution and a cultural and ideological revolution' (the formulation was Vietnamese) (Brown and Zasloff, 1977: 109). What dominated the Lao political arena in the first decade was the last of the three – the effort to stamp out remaining right-wing activists.

The new regime refused further US influence and neutralized the Royal Army, leaving the Pathet Lao in unchallenged military control. Re-education of non-communists was most characteristic of this period of transformation. Re-education 'seminars', were dispensed to a large section of the population in order to instil the ideology of the 'new socialist' person. Senior army officers, government officials, police and other royalists, were required to attend 'special seminars', which included political re-education and hard manual labour. Fear of these special seminars prompted another exodus of the middle and upper classes (Brown and Zasloff, 1976: 195–6).

At the same time, eradication of illiteracy and the advancement of education and national culture came to the forefront of LPRP reforms, partly as an appeal to the outlying population and to distance themselves from the previous regime, and partly to eradicate the deficiency of skilled personnel who were required to rebuild the nation (Chagnon and Rumpf, 1982: 163).⁵ The desire to 're-educate' the masses was perhaps the driving force behind this earnest effort rather than any real concern for the literacy and educational levels, particularly those of ethnic minorities. By and large, the comparatively extensive achievements in education in the early years of LPRP rule can be seen as a by-product of the government's re-education and transition policy.

Along with mandatory seminars, the LPRP undertook the other two 'revolutions': to restructure production relations through collectivization of ownership; and to acquire new industrial technology and scientific knowledge in order to stimulate industrialization. All three 'revolutions' were, in effect, put in place through political and financial support given by Viet Nam, the Soviet Union and China, in a concerted effort to replace the influence of Thailand and the West (Brown and Zasloff, 1976: 198–9).

Gradual transformation of the principal sector – through agricultural collectivization, initially by forming labour exchange units and then state-run cooperatives – was intended to improve production in agriculture, forestry and livestock breeding. Some 300 000 people were encouraged to return to their native areas in the former ‘liberated zone’. The government also promised development of processing industries and enhancement of physical infrastructure. At the same time, however, the leaders recognized the plans were unrealistically ambitious, accepting that there was a serious scarcity of competent administrative cadres and skilled technicians. This void was created by the flight of an estimated 10 per cent of the population (Thayer, 1983: 84–7), many of whom were civil servants and professionals, and ‘participation in seminars’ of (at least) 20 000 officials (Brown and Zasloff, 1977: 109–11).

The LPRP’s plans were further thwarted by consecutive years of natural disasters, which brought about severe grain shortages. Strained relations with Thailand resulted in closure of the mutual border and were exacerbated by tensions over Viet Nam’s war with Cambodia, worsening Laos’s economic situation during 1977–80. Notwithstanding the strain on farmers as a result of the government’s increased taxes on agricultural products and rising prices in urban centres (partly due to devaluation of the kip), the leaders reiterated their dedication to transforming two-thirds of farms into cooperatives by the end of 1980 (Bedlington, 1981: 102–10; Brown and Zasloff, 1978: 167–71). By December 1979, agricultural collectivization was abandoned mid-stream, with only a quarter of all peasant families assembled in approximately 2800 cooperatives (Stuart-Fox, 1996: 109). Without actually abandoning its collectivization policy (Bedlington, 1981: 111), the LPRP assured the public of a more diluted approach to enacting socialist transformation and central planning techniques. Religious worship was permitted and the private sector was officially recognized (Freeman, 2001: 125–6).

This reversal marked the start of the road towards liberalization. The LPRP (still under the leadership of Kaysone Phomvihane) placed greater emphasis on the role of the private sector in an effort to quell the increasing stream of people exiting Laos. In the following years the LPRP attempted, with mixed results, to re-establish relations with Thailand, while simultaneously solidifying its allegiance with Viet Nam and the former Soviet Union.

Economic conditions nevertheless deteriorated as a consequence of the shortage of skilled personnel and insufficient capital, continued devaluation of the kip, poor transport and communications infrastructure, and rural unrest (an outcome of the deserted collectivization campaign, which left cooperatives members disdainful of private traders) (Thayer, 1984: 50–52). In 1986, following a visit to Moscow, Kaysone Phomvihane released the ‘New Economic Mechanism’ (NEM), or ‘*chin thanakaan mai*’ (new thinking), in the party’s 1986–90 plan. This new approach allowed for greater autonomy to enterprises and increased decentralization and liberalization for private and public investment, while maintaining a socialist political system (Joiner, 1987: 108).

Economic progress and structural change since 1986

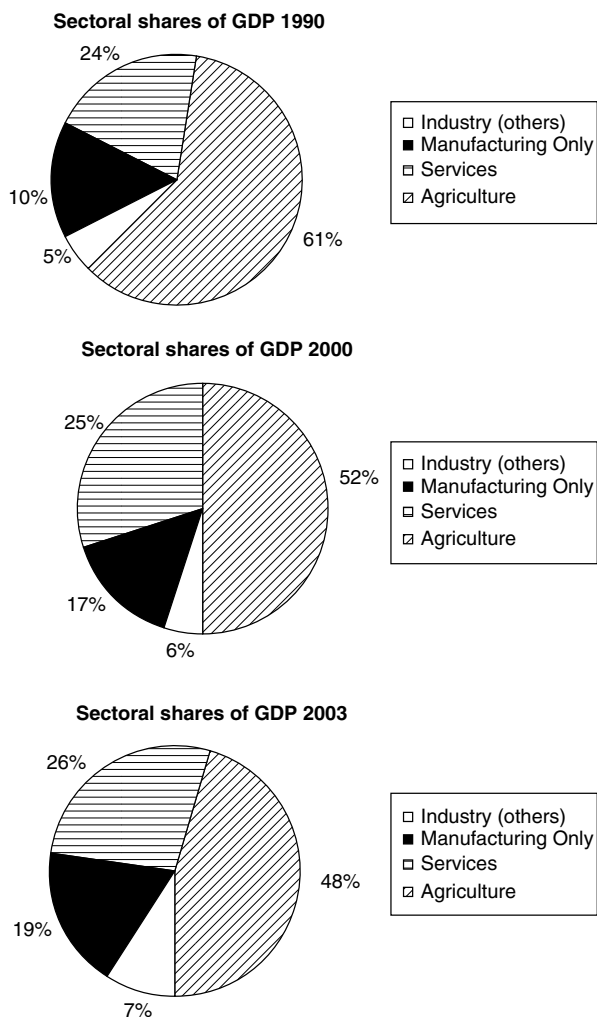
The NEM instated economic reforms that promised to decentralize decision-making with relaxed central planning techniques and marketization of prices of rice and staples and other essential goods. Further, there were steps towards divesting unprofitable state-owned enterprises, reducing international trade barriers (including the state monopoly over trade) and increasing private sector participation and general economic freedom in

commerce and finance. This had been pilot-tested in the previous year in the Vientiane area, proving that transition from plan to market was a successful move. As a result, the NEM swept the country within a few months, and according to Lao officials, with positive results. However, according to many observers, these reforms took hold easily because 'socialist Laos' had existed more in name than in practice. The economic reforms were accompanied by resettlement schemes relocating many highland people to lowland areas (Bourdet, 2000: 29–30; Freeman, 2001: 131).⁶

Laos started the reform era in 1987 with a staggering negative 1.1 per cent output growth rate. The economy was one of the poorest in the world, with a per capita income of US\$180. The new reform programme was welcomed for the reason that inflationary pressures and successive hefty budget deficits were plaguing Laos during that time (Bourdet, 2000: 9). However, by 1990, the reforms had pushed the output growth rate up to 6.7 per cent and an impressive average of 7 per cent growth was maintained throughout the 1990s (ADB, 2004a: 187).⁷ The beginning of the new millennium saw a slight economic slowdown: from 2000 to 2003, growth averaged 5.8 per cent (ADB, 2005: 275, 304–5). In 2004 the growth rate improved to 6.5 per cent and is expected to remain around this level for the rest of the decade (ADB, 2005: 303). With a current population of 5.84 million (growing at 2.8 per cent annually since 2000), per capita growth is estimated at 3.8 per cent. At current market prices, Laos's GDP in 2003 was only US\$2132.3 million, with output per capita at a meagre US\$375.44 (ADB, 2005: 275, 278).⁸

Agriculture's contribution to GDP has gradually declined from 61 per cent in 1990 to 48 per cent in 2003 (Figure 14.1). With a high concentration of production in rice crops, the Lao agricultural sector is semi-subsistence in nature and low in productivity, implying that improvements in this arena will free up labour from rural areas (Bourdet, 2000: 155). However, there has been a slow downward trend in the relative importance of rice, which once contributed to half of agricultural GDP. Livestock has become as important as rice, with cash crops starting to gain some position. The low productivity of food production in Laos (particularly compared with higher growth in food production in more densely populated Asian countries) can be attributed to low usage of chemical fertilizers and irrigation. More than 80 per cent of the country is mountainous, making irrigation systems difficult and costly to install. The virtual non-existence of modern farming technologies (such as high-yielding cereal varieties) in Laos's countryside also contribute to the perpetually low productivity and lack of competitiveness of Lao exports vis-à-vis those of its neighbours in basic foods, especially rice (Anderson, 1999: 25).

As a proportion of total output, industry has grown rapidly, from a low base (15 per cent) in 1990 to 26 per cent of GDP in 2003, an upturn of 11 percentage points. Manufacturing, in particular, has almost doubled its share of total output from 1990 (10 per cent) to 2003 (19 per cent). The primary concentration of the manufacturing sector is on light industry, such as textiles, garments and motorcycle assembly, handicrafts, and agricultural and forestry product processing, as well as power generation and construction and mining. While growth in the mining sector has been sluggish to date, it could prove to be a significant player in the Lao economy in future, in light of the mineral wealth the country is reported to have (Freeman, 2001: 130–31). Nonetheless, the increasing industrial share of GDP, and its relatively higher growth rate, suggests a growing disparity in income between urban and rural dwellers.



Source: ADB (2004a: 187).

Figure 14.1 Shares of GDP by sector

The sector that benefited most from the government's liberal policy stance was industry, rising from a negative 1987 base of -16 per cent to 11.5 per cent output growth in 2003 (Tables 14.1 and 14.2). While the average annual growth rate for the 1980–1990 period was 6.1 per cent (ADB, 2001: 80), the average rate for 1990–99 was 12.4 per cent. An industrial downturn occurred towards the end of the 1990s and in early 2000, mainly resulting from deferment of several large hydropower investment projects due to the Thai financial crisis of 1997 (the sole market being electricity export to Thailand) and the EU's removal of preferential access for Lao garment exports in 1995 (resumed in late 1997). If not for these external interruptions, the industrial sector would have grown even more rapidly. Industrial growth appears to be upwardly mobile thereafter, due to the better

Table 14.1 GDP and sectoral growth

Growth of Output (annual change, %)	1987	1990–99*	2000	2001	2002	2003
GDP	–1.1	7.0	5.8	5.8	5.8	5.8
Agriculture	–1.2	6.7	4.9	3.8	4.0	2.2
Industry	–16.0	12.4	8.5	10.1	10.1	11.5
Services	8.0	5.5	4.9	5.7	5.6	7.5

Note: * Average rate for the period (ADB, 2004a: 187).

Source: ADB (2005: 275–6).

Table 14.2 Comparison of actual GDP in agriculture and manufacturing

At Constant 1990 Factor Cost (million US\$*)	1987	1990	2003	% Growth 1987–2003
Agriculture	459	525	909	98
Manufacturing	57	85	359	530

Note: * Conversion from kip to US\$ is based on 1990 average exchange rate of 708 kip/US\$1.

Source: ADB (2005: 275, 278).

economic performances of neighbouring countries, expansion of garment exports to the EU, the start of the gold and copper mining operations in Savannakhet and increased electricity exports from the Nam Theun II hydropower plant (ADB, 2001: 80). In 2002, there was a 23 per cent rise in exports, 80 per cent of which is accounted for by increased exports of hydropower, timber and garments.

By contrast, agriculture experienced oscillations in production throughout the 1990s: its growth rate, while averaging 6.7 per cent, fluctuated between 8.7 per cent in 1990, 3.1 per cent in 1995 and 8.2 per cent in 1999 (Table 14.1). However, improvement in the primary sector is evident when compared with the average annual growth for the previous decade of only 3.5 per cent (World Bank, 2004a: 182). Since 2000 the sector has maintained an average growth rate of 3.7 per cent. Actual output has almost doubled from 1987 to 2003 (Table 14.2): at constant 1990 factor cost, agricultural production totalled US\$459 million in 1986, but by 2003 it had expanded to US\$909 million.

The increase of 98 per cent in actual output since the introduction of the 1986 reforms could be attributed to improved macroeconomic management and stability, and continuing structural reform programmes. More importantly, however, it is largely a result of widespread public irrigation investments from 1997 to 1999, which were a mandatory condition of ASEAN membership (ADB, 2001: 82). Natural aid further strengthened agriculture's position with increases in rainfall in the upland areas during the period, leading to increased rice production (ADB, 2004b: 80). Evidently, agriculture has grown through structural improvements, which act as a buffer in periods of cyclical downturn to which the service and industrial sectors are more susceptible (such as during the Asian Crisis of the late 1990s).

The service sector has marginally gained ground, increasing its share of GDP by only 2 percentage points in one and a half decades, mainly owing to established trading activities.

However, recent trends in the tourism industry as the government relaxes its conservative stance on manageable levels of foreign visitors, could prove to be the main push forward for this sector.

The service sector experienced belated benefits from the reforms, dropping its output growth rate from 8 per cent in 1987 to almost zero in the early 1990s and averaging only 5.5 per cent for the decade (Table 14.1). Most of this growth was a result of trade expansion, particularly across the Mekong to Thailand and with Viet Nam. The latter part of the 1990s, however, saw a soaring growth rate in the service sector, as the government took a more pro-tourism policy stance. After 2000, growth in services slowed due to the global security scare following the destruction of the World Trade Center in the United States in 2001 and global health scares caused by the two SARS outbreaks during 2002 and 2003 as well as ongoing endemic avian flu in Asia.

At the beginning of the NEM reform era, 85.5 per cent of the total population lived by agriculture, though only about 6.5 per cent of the country's land area is under cultivation. Urbanization proceeded slowly up to 2003 when 79.3 per cent of the population still resided in rural areas (ADB, 2005: 275). Agriculture, specifically a semi-subsistence form, remains the main lifeline for the bulk of the population. The country is characterized by great disparities in income and development. The central region and less remote provinces of the southern and northern regions are more economically dynamic and affluent than the peripheral areas, in particular the northern highlands. This is due in part to improved infrastructure, communications and superior education levels in these central areas (Freeman, 2001: 130). A narrowing of inequality has been reported, however, by the Lao government in its first full poverty reduction strategy report, under the new National Growth and Poverty Eradication Strategy (NGPES, 2004: 22–4), and backed by the joint report on NGPES by the International Monetary Fund (IMF) and International Development Association (IDA) (IMF and IDA, 2004: 3–4).

One of two possibilities could occur in the remainder of this decade: improvements in agricultural development to promote increased output and rural living standards, or greater rural-to-urban migration to facilitate rapid industrialization. A slow rate of urbanization could be a negative factor because the scattering of population throughout densely forested mountain ranges makes the provision of basic facilities (like water supply, schools, hospitals and roads) expensive. Furthermore, the demographic pattern may also dissuade foreign investment, which is sorely needed as domestic savings are extremely low. However, a more subdued rural-to-urban migration also means that towns and cities are not overcrowded, allowing government planners to accommodate future flows of people into urban areas. Ultimately, there must be a drift of labour out of rural into urban sectors if industrialization is to take place in Laos.

A study of employment by sector during 1980–90 (Table 14.3)⁹ indicates that a bias against agriculture has persisted since the formation of the LPDR. While the agricultural sector had a 61.2 per cent share of total output in 1990, it employed 78.3 per cent of the working age population. Between 1980 and 1990, only 1.5 per cent of labour shifted out of agriculture, but the recorded growth rates of employment in industry and services were nevertheless insufficient to absorb these numbers. This bias is likely to have continued after 1990.

Urbanization has been similarly slow since 1990: whereas at that time the urban population was 15.4 per cent of the total, by 2003 it was still only 20.7. The decline in rural population has been accompanied by a much more rapid decline in agriculture's share of

Table 14.3 *Changing structure of employment, 1980–90*

	Average Economically Active Population (as % of working age population) 1980	Average Economically Active Population (as % of working age population) 1990	% Change 1980–90	Sectoral GDP Growth 1980–90	Sector Share of GDP in 1990
Agriculture	79.8	78.3	–1.5	3.5	61.2
Industry	5.4	6.2	0.8	6.1	14.5
Services	14.8	15.5	0.7	3.3	24.3

Sources: ADB (2003: 96, 104); World Bank (2004: 183).

output (as can clearly be seen in Figure 14.1). While non-agricultural sectors have been growing rapidly, they are not attracting enough labour away from agriculture.

Part of the explanation of this slow trend in urban migration in Laos could be that the higher educational requirements of urban sectors and their higher cost of living discourage young, less educated, rural labour. By comparison with Thailand, Viet Nam, Malaysia and China at similar stages of development, education levels in Laos are relatively low. If this situation continues, a majority of the population (still residing in rural areas) will be left behind as growth takes off in industrial and service sectors, and the accompanying infrastructure develops further.

International trade

The system of multiple exchange rates, trade taxes and various market restrictions and subsidies of the pre-reform period was eased. Exports, which were discouraged through overvalued exchange rates and low procurement prices, are now encouraged and relied upon for foreign exchange earnings. The lessening of subsidies, however, has subjected Lao exporters to increased competition from other ASEAN countries and decreased preferential trade with members of the Council for Mutual Economic Assistance (CMEA). Imports were complicated by quantitative restrictions via quotas and licences, all of which were either ‘relaxed’ or abolished. The reform of the import regime which commenced in the late 1980s was completed by 1995 (Anderson, 1999: 18; Bourdet, 2000: 76–7). The government’s loosening of the preference for capital over consumption goods meant, on the other hand, that the demand for consumer imports increased rapidly.

While the lessening of trade barriers meant increasing openness and volume traded of goods and services, imports have grown more rapidly than exports – in 2004, the estimated current account deficit as a percentage of GDP was 13.2 per cent (World Bank, 2005). While the current account balance has improved slowly since 1987 from the key export performers (electricity and garments exports), devaluation of the Lao kip due to the 1989 shift to a flexible exchange rate system resulted in inflationary pressures. In the same year, consumer prices rose by 60 per cent due to the volatility of the kip. Since the early 1990s, the inflation rate has hovered around 10 to 15 per cent excepting the period of the Asian Crisis when, as elsewhere in Asia, inflation reached unprecedented levels (NERI, 2002: 5–6).

As Laos entered the phase of economic liberalization, its relationship with Thailand became easier as Thai companies piloted a welcome flow of foreign investment into a capital-hungry Laos. The opening of the Australian-funded Friendship Bridge in 1994 validated the promise of future trade relations between the neighbours, despite occasional flaring up of decades-old border disputes. Viet Nam, however, continues to have good relations with and influence over Laos, albeit to a lesser extent since 1986 as the certain LPRP economic policies deviate from those of the Vietnamese (Freeman, 2001: 128–9). In addition, a significant black market in non-traded goods and services, predominantly livestock and farm perishables, emerged after 1975 and flourishes to date. The softening of border rules (particularly, between Thailand and Laos) has also increased these activities across the Mekong, especially in the trading of farm animals (Anderson, 1999: 25; Pradumna and Hamid, 1996: 3). In essence, an old trade route that existed before the current border demarcation has been revived through better bilateral relations and ASEAN influences. However, a consequence of lower border walls between Laos and Thailand (and all surrounding countries) is an adverse effect on inland Lao farmers. The inter-province trade in rice and food stuffs is no longer mandatory, allowing consumers to purchase cheaper goods across the border.

The direction of trade between Laos and its major trading partners shows an emerging pattern dampening the international community's euphoria surrounding trade liberalization in Laos. There is a positive net flow of imports from the Asia-Pacific region, namely Thailand, China, Singapore and Viet Nam (Table 14.4). Thailand (76 per cent), China (12 per cent) and Viet Nam (11 per cent) together supplied almost all of Laos's imports in

Table 14.4 Direction of trade

Trading Partners	Exports (million US\$)		Imports (million US\$)		Net Flow (million US\$)	
	1999	2004	1999	2004	1999	2003
Singapore	–	0	37	42.3	–37	–42.3
Thailand	51.6	104.3	452	639.4	–400.4	–535.1
Viet Nam	179.4	90.2	181.8	91.7	–2.4	–1.5
China	8.7	12.4	24.4	97.2	–15.7	–84.8
Hong Kong	–	–	11	8	–11	–8
Japan	12.3	7.3	24.9	15.4	–12.6	–8.1
South Korea	–	–	11.9	9.2	–11.9	–9.2
Australia	–	–	2.5	18.3	–2.5	–18.3
Belgium	13.5	13.4	–	–	13.5	13.4
France	18.2	43.2	7.6	10.5	10.6	32.7
Germany	27	30.6	9.5	26.7	17.5	3.9
Italy	5.9	11.2	–	–	5.9	11.2
Netherlands	8.9	10	–	–	8.9	10
United Kingdom	12.5	26.8	–	–	12.5	26.8
Total	462.5	441.6	808.6	844.9	–346.1	–403.3

Sources: ADB (2004a: 189); ADB (2005: 277).

2004. The growth spurts in these countries should have 'filtered through' to greater demand for Lao goods and services but the reverse is emerging.

The principal exports are electricity, garments, wood products and coffee. Electricity plays an important role in export income, particularly since Laos's inception into the ASEAN. Export of garments has an equal share of export earnings to electricity, after surging from zero to 37 per cent after the introduction of NEM, but the hydropower industry has since overtaken garments as the fastest-growing exporter (ADB, 2005: 277). While exports of light and heavy industrial goods have benefited from both the reform and trade liberalization during the ASEAN and WTO accessions, export of primary goods has decreased gradually since 1987. There several reasons for this: first, the international community's clamp-down on deforestation and the lack of modern technology in Lao farming has led to a lack of competitiveness vis-à-vis countries like Viet Nam. Second, the international donor community – including the major export destination of electricity, Thailand – contributes substantially to building hydropower stations in Laos.

Machinery and raw material (particularly from Thailand) make up a sizeable 76 per cent of total imports. The main components are electrical and mechanical machines, transport equipment and oil and mineral products, which collectively account for 60 per cent of total expenditure on imports. The remainder tells of a new phenomenon in post-reform Laos – a rapidly expanding consumer society. Consumer goods, in particular, processed food, beverages and tobacco, and textiles and apparel, are fast gaining ground in both quantity and variety (NSC, 2002: 66–9). Since the slackening of import restrictions, items such as cars and motorbikes have also found their way into Laos.

Foreign aid

During the years leading up to the collapse of East European communism, following in the footsteps of Viet Nam, Laos turned from the Soviet Union and associated countries to Western official development assistance (ODA) (Ivarsson et al., 1995: 9). By 1990 when Soviet aid was withdrawn, Laos's negligible savings and domestic revenue accounted for only 44 per cent of planned expenditure for the promotion of agriculture and agro-forestry, transport and communications, and health and education. The flexibility of the party to adapt to the changing political climate was tested as it turned to wealthier European and Asian countries to fill the void (Gunn, 1991: 88). Consequently in the 1990s, Japan and Sweden jointly supplanted CMEA funds, providing annual assistance of 60 and 22 per cent of total aid to Laos, respectively. The Asian Development Bank (ADB) and World Bank also became important donors, surpassing the United Nations group (Lam, 1997: 281).

To date Japan continues substantial aid to Laos – contributing 46 per cent of the total bilateral aid in 2002 (Table 14.5). The ADB and World Bank remain the most important multilateral agencies in Laos. The sectors to receive the greatest share of aid are education (17 per cent), agriculture (12 per cent) and energy (10 per cent) of total bilateral ODA commitments.

The Public Investment Programme, part of the Poverty Eradication Strategy proposed in 2003, indicated that ODA contributed 66 per cent in FY 2002–03. According to the NGPES report, the government aims to 'gradually lessen the Lao PDR's high dependency on official development assistance . . . However, until these resources eventuate, we will still need to address the issue of the existing resource gap in order to keep the momentum of growth and poverty eradication' (NGPES, 2004: preface).

Table 14.5 Foreign aid (highest contributions in million US\$)

Bilateral Agencies	2002	% of total
Japan	90.1	46
United Kingdom	31	16
Total	194.9	
Multilateral Agencies	2002	% of total
ADB	43.7	44
IDA (World Bank Group)	27.2	28
Total	98.7	
Bilateral ODA Commitments by Purpose		% of total
Education	30.4	17
Agriculture	21.5	12
Energy	17.9	10
Total	180.50	

Source: OECD (2004): 165.

Investment

Investment in Laos comes almost entirely from foreign direct investment (FDI). To this effect, Laos has inadvertently developed a dependency on aid as well as foreign investment. The largest increase in FDI activity occurred after the liberal foreign investment law, passed in 1994 and the government's commitment to promoting foreign capital inflows at the 1996 Sixth Party Congress (Freeman, 2001: 131). Openness and promotion of foreign ventures by the government led to an FDI inflow of US\$88.4 million in 1995 (ADB, 2005: 278). The main recipients were the energy sector, telecommunications, tourism, the textile and garment industry and handicrafts. Nonetheless, not all licences for foreign undertakings planned for by the government were exhausted.

The Asian Crisis resulted in a dramatic drop in FDI expenditure, of which more than half was from Thailand, South Korea, Taiwan and Singapore. However, China's FDI outflow to Laos increased steadily throughout the crisis and filled the cavity left by other Asian countries. By 2001 China had overtaken Thailand as the largest source of FDI in the LPDR, providing 80 per cent of total FDI inflow. However, in the following year, the unstable climate in Asia delivered a pre-reform level of FDI (US\$4.5 million). In 2004 foreign investment renewed its upward momentum, achieving US\$16.9 million (ADB, 2005: 278; Freeman, 2002: 31; UNCTAD, 2002).

A new law on Promotion of Foreign Investment was passed in 2004 under which the government planned to create three economic zones with special considerations (such as lower foreign employee income tax schedule and lower rates of import duties and taxes). Most attractive to foreign investors would be the two to seven years of profit tax exemption (LPDR, 2004: 6), which, however, might also deprive the government of much needed revenue from the FDI-dominated secondary and tertiary sectors.

Social development and progress

Laos is a country rich in cultural diversity, with a population that is spread thinly throughout mountainous terrain (some in very isolated locations) and inhabitants who speak

various ethnic languages. To date, there are 230 ethnic groups found, which are generally categorized under four ethno-linguistic clusters (Arshad and Phomtavong, 2003: 5). Of the total population, the Lao Loum make up the majority at about 60–68 per cent, and can generally be found in urban and more fertile areas of the lowlands. The next largest group comprises of the upland inhabitants, the Lao Theung at about 22–30 per cent, who live on mountainous slopes and plateaus. The Lao Soung, the highlanders, are about 9–10 per cent. Ethnic Vietnamese and Chinese (about 1 per cent) are scattered throughout Laos.

Of these groups, the Lao Theung and Lao Soung are the poorest and are generally cut off from health, education and other infrastructure. They occupy the mountainous regions of the country, where the lack of roads and telecommunications makes the provision of basic facilities and linkages to the market difficult and extremely costly. The Lao Theung and Lao Soung are ethnic minorities who practise shifting cultivation and whose livelihoods depend as much on forest resources as they do on crop farming. The stated intention of the government towards these minorities has been to ‘assemble’ the population around public amenities (roads, electricity and schools), in a bid to overcome the infrastructural obstacles to improving welfare of remote rural communities. However, ongoing relocation of highlanders has caused social friction, a product of increasing strain on the limited fertile lowland farmland.¹⁰ So far, relocated ethnic groups remain amongst the poorest in the country with limited access to roads, schools, irrigation, electricity or safe water and sanitation (Alabastro, Brooks and Thant, 1998: 383; Hamilton-Merritt, 1992).

There is no doubt that the lives of many Lao have improved since the reform period of the late 1980s – a direct result of greater openness, accountability and transparency in political and economic activities, consistent growth in all economic sectors and improvements in roads, health and education access. It is also evident that disparities between different regions, sectors, ethnicity and gender have increased.

The trend in the human development index shows an improvement from 0.423 before reform to 0.545 in 2003 and a gradually improving world ranking from 135 (2002) to 133 (2003).¹¹ While 26.3 per cent of the population lived in poverty in 2002, the purchasing power parity gross national income (GNI) per capita had increased by 36 per cent compared with 1990 and the infant mortality rate had decreased substantially (Table 14.6). Furthermore, life expectancy increased by nine years between 1990 and 2003 and many more people in both urban and rural areas had access to safe water and improved sanitation.

Evidently, the disparities in access to resources favour the urban sector. Infrastructure investments in health services have been concentrated in the urban areas, especially in larger and prosperous centres with direct access to the Thai market, such as the Vientiane Municipality, Champasak and Savannakhet. The success of extensive health campaigns has been limited (especially in rural Laos) due to a severe shortage of local medical personnel and difficult access to medical training facilities. The remote upland areas where a majority of ethnic minorities reside suffer most acutely from this shortage. The lack of basic education amongst Lao Theung and Lao Soung communities, coupled with geographical and social isolation (that make some areas inaccessible as well as unattractive to medical and education workers), make any attempt at poverty eradication problematic.

The Lao National Statistics Centre (NSC) identified the poorest regions as those along the western border, in the north and some inland areas. Inflow of tourists and foreign investment provides a good incentive and income for improvements in health services in

Table 14.6 *Social development trends*

	1990	1995	2003
Poverty (% of population below US\$1 a day)	–	–	26.3*
GNI per capita (PPP, US\$)	–	1180	1610*
Infant mortality rate (per 1000 live births)	120	–	82
Life expectancy at birth (years) – female	51	–	60
Life expectancy at birth (years) – male	49	–	58
Access to safe water (% of population) – urban	47	–	66*
Access to safe water (% of population) – rural	25	–	38*
Access to sanitation (% of population) – urban	30	–	61*
Access to sanitation (% of population) – rural	8	–	14*

Note: * Refers to 2002.

Sources: ADB (2005: 140–53); UNDP (2005); World Bank (2003).

these areas. Not accidentally, the areas bordering Thailand and those earmarked for Special Economic Zones have higher than the national average income per capita.

Notwithstanding the lack of recent employment data by gender, 1990 figures show a comparatively even distribution (for developing countries) between men and women involved in various economic activities (Table 14.7). A noticeable difference is the greater participation of women in agriculture and the substantial gap between males and females employed in services. This, however, is in keeping with the relative feminization of agriculture in other developing countries, whereby men are more likely to take up employment in industry and services.

While overall literacy improved by 5.8 per cent from 1995 to 2003 (Table 14.7), the increase does not reflect the enormous aid and government expenditure directed into education for the past decade. Education was the only sector to receive consistently high levels of ODA funding over the past decade, particularly primary education. An achievement of education aid programmes (whose targets are women, girls and ethnic minorities) was the faster increase in female literacy, by 18 percentage points, indicating a narrowing of gender inequality in access to education. The female primary completion rate also rose, from 58.7 per cent in 1997 to 64.2 per cent in 2000 (World Bank, 2003).

Secondary enrolment remains disappointingly low at 37 per cent for females and 50 per cent for males. The long-term consequence of this will be lower quality of labour compared with neighbouring countries where secondary education has almost achieved universality. The quality of education and repetition rate remain problems at both primary and secondary levels, even though improvements have been reported (ADB, 2005: 142–4).

The two largest aid contributors to education in Laos are Japan and the ADB. The building grounds and access roads of the National University of Laos (NUOL) were funded by the Japan International Cooperation Agency, while the curriculum and technical training received ADB aid. NUOL is the first and only university of Laos and accepted its first enrolment in 1996.¹² The total number of students has increased rapidly, from 11 152 in 1999 (3219 females), to almost 23 000 currently (over 7000 are females). There are 922 male and 670 female staff – a ratio of 1.4 to 1. The qualification stratification of staff is 21 per cent postgraduate and 56 per cent bachelor, with the remainder

Table 14.7 Gender inequality

Gender Disparities	1990	1995	2003
Literacy rate (% ages 15 and above) – total	–	60.6	66.4 ^a
Literacy rate (% ages 15 and above) – female	43	–	61 ^a
Literacy rate (% ages 15 and above) – male	70	–	77
Economically active population (as % of working age population) – female	76.9	–	77.9
Economically active population (as % of working age population) – male	91.2	–	90
% employed in agriculture – female	81	–	–
% employed in agriculture – male	76	–	–
% employed in industry – female	5	–	–
% employed in industry – male	7	–	–
% employed in services – female	14	–	–
% employed in services – male	17	–	–
Ratio of estimated female to male earned income	–	–	0.65

Notes:

a. Refers to 2002.

b. Refers to 2004.

Sources: ADB (2005: 140–53); UNDP (2005); World Bank (2003).

holding diplomas and other qualifications. For a less-developed country and a young university, the collection of qualified staff and student numbers is commendable.¹³

The dearth of skilled local labour is increasingly felt as Laos opens its doors to the global market. These needed personnel are currently ‘borrowed’ from Northeast Asia, the ASEAN countries and the West. Governmental staff and administrators are adding to their qualifications through liaisons with and training by donor advisers, while a better-educated younger age group provides the potential to fill the skilled labour gap.

Prospects for an aid-dependent economy

Laos is one of the most underdeveloped countries in the world and the poorest and least known economy in Southeast Asia. The country is small, poor and landlocked – weighed down by structural deficiencies (both human and physical) and a long-term dependence on aid and foreign capital. Nevertheless, Laos is resource-rich with the capacity to grow exponentially within the Asian region. The extensive reserve of minerals is a case in point.

For this reason the conception has emerged that Laos could be the ‘Kuwait of Southeast Asia’, where natural resources are abundant, but the populace is excluded from their exploitation. As Rigg explains:

The Laotian government, in trying to identify a regional role for their country, appears to have chanced upon the notion that they should promote Laos as an internode or ‘keystone’ in mainland South East Asia. Strategically sandwiched . . . between Thailand, Myanmar, southwest China’s Yunnan province, Vietnam and Cambodia, Laos should be able to create a role for itself as an intermediary, channelling goods and services and providing, perhaps, a store house of natural wealth for countries which have in the most part, exhausted their own. (Rigg, 1997: 149)

It has become apparent, however, that this design is not simply a task of building roads and promoting the Lao energy industry – a problem that the Lao and donors fully appreciate. There are other formidable obstacles, such as the lack of physical infrastructure, the inadequately skilled labour force and the insufficiency of domestic savings and foreign investment (UNDP, 1991: 67).

The continuation of growth and development is highly dependent on aid. The irrigation and hydropower projects, mining and garment export, and social development have been heavily supported by multilateral and bilateral aid, either in terms of financial support or technical expertise. All these are vulnerable to disturbance in the donor's own country causing suspension of such projects, as happened during the Asian Crisis. Laos's chief problem, quality human resources has, after a long period of attention, improved only slowly.

Apart from the major bilateral and multilateral aid agencies, there are currently 47 non-government organizations (NGOs) registered in Laos, with a total of approximately 900 projects. The three main areas of focus for NGO activities are human resource development, including health care and education (23 per cent), social and community development (11 per cent), and agriculture, forestry and fisheries (6 per cent), with the remainder in other sub-sectors such as data collection and analysis and income generation and economic development.¹⁴

The activities of major donors and NGOs overlap considerably, leading the government to initiate a registry of NGOs and respective projects (commenced in 2003 with World Bank funding), in a bid to consolidate aid activity in Laos. It remains to be seen whether the consolidation of NGOs with multilateral and bilateral agencies will lead to greater coordination and reduce the ad hoc nature of aid distribution in Laos and increase the transparency of donor activities, or whether it will effectively be a form of government censorship of NGO activities. The fact that many NGOs have voluntarily registered and supported the initiative is a sign of a better working relationship than in the past.

While Japan remains the largest bilateral aid donor in Laos, China is increasing its strategic presence, steadily increasing investment in cement, textiles and agribusiness in northern Laos. The Sino–Lao relationship is renewed as Laos seeks to replace the former allegiance to Viet Nam, with China counterbalancing its strengthening relations with Thailand. The LPRP is torn between the pro-Vietnamese faction and a new generation of the politburo who are inclined towards China. Political survival, however, unites the factions to maintain relations with their socialist neighbours in consideration of their large reliance on the international aid community (Bourdet, 2002; Stuart-Fox, 2005). As China increases its aid and investment, the pressure for radical reforms and marketization (a strong condition of Western loans and grants) is considerably lessened, as is pressure on the one-party state. It will be interesting to see the outcome of the next party congress, to take place in 2006, where a struggle for dominance in policy direction is expected between the old and new faction of the LPRP.

Notes

1. The author wishes to thank Melanie Beresford for her valuable comments.
2. Siam was the official name of Thailand before 1949.
3. The French perceived the Lao as, although insouciant, lazy and ineffectual. Their design was that Laos would eventually be dissolved into greater Viet Nam. As such, Laos was seen to be no more than an administrative unit, albeit an expensive one (Ivarsson et al., 1995: 13).

4. In Luang Prabang the Lao sovereign continued to rule under the French protectorate (Jumsai, 1971: 243).
5. In fact, the promise of equality and universal education is still the government's best-remembered and popular policy to villagers who endured the 'Thirty Years' Struggle'. Chagnon and Rumpf found, in interviews conducted throughout the countryside on the changes to village life since 1975, that one of the key focuses was the expansion of educational opportunities (Chagnon and Rumpf, 1982: 163).
6. The effects on the livelihoods of the highlanders will be discussed below (see the section on Social Progress).
7. This figure is obtained by averaging annual growth rates for 1990, 1995 and 1999.
8. This is based on the average exchange rate for 2003.
9. The most recent employment statistics available for Laos are for 1990 at the time of writing.
10. Approximately 15 per cent of land in Laos is cultivable.
11. Human development index is a measure of development employed by UNDP that includes not only GDP per capita, but also indicators of health, education and longevity.
12. The university is in fact an amalgamation of three former tertiary institutions.
13. Recent information and data was taken from the NUOL website. Data for 1999 was obtained from the university's information booklet.
14. Information about NGO activities can be obtained from the website of the Internet Directory of NGOs in the Lao PDR (www.directoryofngos.org/index.cfm).

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Further reading

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- This is one of the few books written on the Lao economy that gives a detailed overview of macroeconomic and microeconomic policies and outcomes of the post-reform period.
- Gunn, Geoffrey C. (1998), *Theravads, Colonialists and Commissars in Laos*, Bangkok: White Lotus.
- Gunn provides a comprehensive political and social review of events that have shaped Laos from the colonial period to the present.
- Stuart-Fox, Martin (1996), *Buddhist Kingdom, Marxist State: The Making of Modern Laos*, Bangkok: White Lotus.
- By far the most authoritative scholar on Laos, Stuart-Fox gives an in-depth view of Lao historical and cultural development, and a rare insight into the underpinnings of the Lao identity and consciousness.

15 Myanmar (Burma)

Tin Maung Maung Than

A short political history

Myanmar (Burma until 18 June 1989 when the junta changed the name) became a distinctive political entity with the establishment of a dynastic rule in Bagan (Pagan) in central Myanmar in the first millennium (AD). The monarchic rule continued for many centuries under several dynasties until 1885 when Britain colonized the country by force of arms and administered it as part of British India.

Most members of the Myanmar elite remained unexposed to the philosophical and conceptual foundations of Western political thought (democratic or otherwise) until well into the twentieth century, when many anti-colonialists became influenced by socialist ideas. When World War II engulfed Asia, a group of young Myanmar nationalists (mainly ethnic Bamar or Burman), led by General Aung San, sought the help of the Japanese to undergo military training and subsequently raised an army that joined the invading Japanese in driving the British out into India. This brought Japanese militarism and fascist practices into Myanmar. However, in 1945, the Myanmar army under General Aung San revolted against the Japanese occupiers and facilitated the Allied campaign to retake Myanmar from the Japanese. Back under British rule, the new politico-military elite led by Aung San launched a successful political campaign and mass mobilization to demand independence from Britain. However, in July 1947, Myanmar's independence movement suffered a huge traumatic blow when political assassins gunned down Aung San together with members of his legislative assembly. The harsh experience under the fascist rule and the assassination of Aung San, together with the influence of 'leftist' ideology over the nationalist elite, created a historical legacy that introduced considerable tensions into the post-independence political process.

After gaining independence on 4 January 1948, the sovereign state adopted parliamentary democracy as the political regime in accordance with the 1947 Constitution. It was a union comprising the central government and state (provincial) governments in a bicameral legislature in which states inhabited by non-Bamar (Burman) ethnic groups were given some local autonomy. The Anti-Fascist People's Freedom League (AFPFL: the national front that was formed as a clandestine resistance movement against Japanese occupation) dominated the Myanmar political arena for a decade and formed successive governments after winning the elections in 1947, 1951 and 1956. On the other hand, the AFPFL government and its outnumbered armed forces had to overcome overwhelming odds to survive the onslaught of communist and ethnic rebellions that erupted soon after independence. Once the danger of a civil war had subsided, differences amongst the leaders of the AFPFL became more accentuated and an internecine power struggle within the AFPFL led to its break up into two factions in 1958. The ensuing confrontation led to political instability and attempts to draw the military into the fray. As the danger of violent conflict between the contenders for state power loomed large, the prime minister invited (albeit under pressure) the armed forces Commander-in-Chief, in

September 1958, to form a non-partisan caretaker government mandated with the task of holding a free and fair election within six months (which turned out to be more than 16 months).

The overwhelming election victory of the so-called 'clean faction' over the rival 'stable faction' of the AFPFL in the elections of February 1960 did not bring about political stability, as the winner was beset by an intra-party feud within a year. Meanwhile, the ethnic-based politicians' demands for more autonomy for their states escalated and some threatened to secede (allowed by the Constitution after a period of ten years following independence) from the Union if they could not secure substantial concessions from the central government. On 2 March 1962, the armed forces chief, General Ne Win, staged a coup and established the ruling Revolutionary Council (RC), justifying the takeover of state power as a pre-emptive measure to avoid national disintegration.

The RC formed a cadre party called the Burma Socialist Programme Party (BSPP) and restructured the state and the society into a socialist mould guided by an eclectic approach known as the Burmese Way to Socialism (BWS), a blend of Buddhism, nationalism and Marxist philosophy. The populace was deprived of political initiatives except for those generated by the government. The depoliticization of the citizens and the reassertion of the state were deemed necessary to start afresh with an ideology true to the goals and aspirations of the pre-independence progenitors of national socialist ideals.

In 1974, the junta handed over power to an elected government in accordance with a new Constitution that established a one-party socialist unitary state. The state was led by the BSPP, which had been transformed into a mass party in 1971. Electoral representation was based on a four-tier hierarchy, held on a quadrennial basis, for the People's Councils (ward/village, township and state/division) and the unicameral Pyithu Hluttaw (People's Congress). However, given the BSPP's prerogative of nominating 'official' candidates, elections implied confirmation rather than competition. There were regional and local administrative and judicial bodies under the central organs of state power (Council of State, Council of People's Judges, Council of People's Attorneys and Council of People's Inspectors). All central organs of state power operated under the leadership and guidance of the BSPP. Similarly, the territorial hierarchy of People's Councils were led and guided by the party organizations at the corresponding level. This system lasted for 14 years and became atrophied before it was toppled by a popular upheaval that swept through urban Myanmar during August and September 1988.

Myanmar is currently under direct military rule by the junta called the State Peace and Development Council (SPDC), which, in November 1997, replaced the original junta (SLORC – State Law and Order Restoration Council) that took power in a military coup on 18 September 1988 (after breaking up the demonstrations with deadly force). The military has been ruling by decree after abrogating the 1974 Constitution. In the beginning, the junta imposed Martial Law in the capital Yangon and some regions of Myanmar but it progressively rescinded the Martial Law Orders over the first two years as the security situation improved. The junta held an election in 1990 but the National League for Democracy (NLD, led by Aung San's daughter Aung San Suu Kyi) that won the election was not allowed to form a government, with the junta insisting that a new Constitution be formulated first. Thereafter the junta and the NLD had been at odds, with the latter

claiming its right to rule based on the election mandate. The confrontation between the junta and the NLD had resulted in the preventive detention of its leader Aung San Suu Kyi (the Nobel Peace Prize winner in 1991) on several occasions since 1989 and she was still under custody by the end of 2005 following the latest detention in May 2003. The junta announced in August 2003 that it would introduce a multi-party democratic political system through a seven-step road map and is sponsoring the formulation of the basic principles for a new Constitution through a national convention that was first convened in 1993. Meanwhile, the United States, the European Union and some Western states had imposed punitive sanctions against Myanmar, ostensibly for widespread political repression and human rights violations.

Economic transformation of British Burma

Under colonial rule, Myanmar's economy was transformed to suit the commercial interests of the British mercantile class. However, the majority of the indigenous population were not the main beneficiaries of the monetized economy.

Foreign trade was the engine of growth and Myanmar's natural resources (timber, oil, minerals) and agriculture products were exploited by British and Indian companies who repatriated their profits to the metropolis. Huge surpluses of rice were exported, leading to investments in processing industries and infrastructure developments, which, in turn, supported the rice industry as well as mining and timber industries. Cheap imports of consumer goods displaced traditional handicrafts and cottage industries.

When the delta rice frontier was opened in the second half of the nineteenth century, an open immigration policy for Indians was instituted to supply labour for commercialized agriculture in southern Myanmar. As trade and commerce grew, businesspeople, bankers and moneylenders, professionals and others also followed, and by the turn of the century Indians became well-integrated into the economic and administrative structures of Burma. Thus, there emerged a racial stratification in the occupational structure. This not only retarded the spread of economic benefits to the natives but also created communal tension and depressed indigenous entrepreneurship.

The economic transformation under the British rule resulted in a doubling of the nominal GDP in the first two decades of the twentieth century while export trade nearly quadrupled. However, the expansion of the economy was also accompanied by the dominance of aliens with the circle of beneficiaries confined to European and Indian business interests in general and a handful of monopolistic and oligopolistic firms in particular (Aye Hlaing, 1964). It was as if the British had 'made Burma a colony of India as well as Britain' (Fenichel and Huff, 1971: 28).

World War II destroyed the majority of what little industry Myanmar had developed. The retreating British implemented a 'scorched-earth' policy for 'strategic industries', virtually demolishing the petroleum industry and dockyards. Similarly, vital plant equipment of the two largest mines (Bawdwin in the Shan States, and Mawchi in the Kayah State) was rendered inoperative. The fighting destroyed many factories while others were either dismantled by their owners or looted in the ensuing chaos. During the Japanese occupation, oil wells and mines attained only a small fraction of their former production levels. Meanwhile, handicraft industries continued to function at a subsistence level. Major alien business concerns returned after the Japanese retreat and restored vital industries such as petroleum production, mines and electric power.

Extraction of natural resources

Blessed with fertile soil and a rich variety of flora and fauna, Myanmar's inhabitants have imbibed the notion of an inexhaustible natural resource base. On the other hand, though 'Burma is the most favourably endowed of the nations of Southeast Asia . . . [and] also has extensive natural resources . . . (t)his potential has never been fully realized' (Steinberg, 1982: 14–15).

Exploitation of Myanmar's natural resources considerably increased after colonization. The Myanmar nationalist elite strongly resented this economic exploitation but often cited the impressive volume and variety of exports to underscore the potential wealth of the country and seemed to be counting on major contributions from Myanmar's natural resources once independence was attained. Indeed, their pre-World War II output was very impressive, as illustrated in Tables 15.1 and 15.2. 'Burma . . . must be ranked among the more richly endowed small nations' and 'stood first in the Eastern Hemisphere part of the British Empire in . . . petroleum, sixth in the world in lead, second . . . in tungsten, and probably fifth among world producers of tin' (Andrus, 1948: 115). Moreover, '75 % of the world's teak in recent years [circa 1940] has come from Burma' (ibid.: 102). In the late 1930s, Myanmar 'occupies a predominant position as an exporting country for rice' accounting for '37 % of the net world exports' (Binns, 1948: 50–51).

The economy under parliamentary rule (1948–62)

Myanmar's first-generation political leaders, who embraced socialism as a guiding ideology, seemed to believe that the only way to develop Myanmar's backward economy and achieve economic independence was to replace private capital with state-controlled investment. The idea of the state dictating the pace and direction of economic activities had

Table 15.1 Production of major commodities, 1939

Product	Annual Production (in thousands)
Crude petroleum (barrels)	6494.0
Lead ore and concentrates (tons)	77.2
Zinc concentrates (tons)	59.3
Mixed tin and wolfram concentrates (tons)	5.6
Tin concentrates (tons)	5.4
Wolfram concentrates (tons)	4.3
Nickel speiss (tons)	2.9
Teak (cubic tons)	437.0 ^a
Other timber (cubic tons)	476.0 ^b
Paddy (tons)	7800.0 ^c

Notes:

- a. For fiscal year 1938–39.
- b. For fiscal year 1938–39; the average figure for the period 1936–40 was 502 (*Economic Survey, 1959*: Table 11, p. 21).
- c. For fiscal year 1938–39; the quinquennial average for the fiscal year ending 1940–41 was 7.4 million tons (ibid.: Table 9, p. 17).

Sources: Mineral data are from *Economic Survey, 1952*: Table VII, p. 8; and Andrus (1948: Table 16, p. 115). Others are from *Economic Survey, 1951*: Table V, p. 4 and Table VII, p. 6.

Table 15.2 Exports of primary products, 1938–39

Product	Export Volume (in thousands)
Rice and rice products (tons)	3329
Teak (cubic tons)	204
Other timber (cubic tons)	47
Metals and ores (tons)	168
Petroleum products (barrels)	5505

Note: The total value of the exports listed in Table 15.2 was some 87 per cent of the total for all exports and was 2.7 times the amount of the annual expenditure incurred by the government.

Sources: *Economic Survey, 1952*: Table VIII, p. 9; and petroleum products from Andrus (1948: Table 23, p. 164).

tremendous appeal in the light of negative experiences of the laissez-faire colonial economy. In particular, they were impressed by the Soviet economic performance, ostensibly achieved through rapid accumulation of physical capital stock. Thus, capital investment was seen as the most significant factor for economic growth. As such, standard prescriptions recommended by the economic orthodoxy for a 'mixed economy' were found to be equally applicable to Myanmar's socialist economic strategy. They comprised rapid accumulation of capital through increased savings and investment; exploitation of agriculture surplus for industrial investment; import substitution and import protection; and the state's direction of the development process.

The Myanmar government announced, on 1 April 1948, a two-year economic plan. The outbreak of insurrections prevented its implementation. In the first two years, nationalization and indigenization measures, together with the state's rice export monopoly and foreign exchange restrictions, constituted the state's attempt to control the strategic sectors of the economy.

In 1951, Prime Minister U Nu engaged foreign consultants to conduct a national economic and engineering survey leading to a comprehensive economic development programme.¹ It formed the basis of the so-called Pyidawtha (Eight-year) Plan announced with much fanfare at the Pyidawtha Conference held in Yangon from 4–17 August 1952. Retrospectively, it appears to be an overly ambitious attempt at establishing a democratic welfare state, through a state-led strategy of the 'big push'. On the other hand, it may be seen as a necessary (but not sufficient) attempt to improve the people's standard of living that had deteriorated since 1940.

The economic targets were based on the Harrods-Domar growth model, employing a fixed incremental capital–output ratio (ICOR).² A doubling of the GDP by the end of the plan period, to 7 billion Myanmar Kyat (MMK) in 1950–51 prices, was envisaged. The aim was to raise the 'gross national income' substantially so that the average annual per capita income reached the 'pre-war [level] at the earliest possible date' (Government of Burma, 1952: 37). About one-third of the total investment was to be in foreign currency, realized mainly through rice exports as well as foreign loans and assistance. No serious constraint on domestic capital formation was foreseen as there would be increased economic activity and private capital investment would be forthcoming. On the other hand, the onus was on the state 'itself to start a large development programme' to generate 'sufficient momentum'

for the whole effort (*ibid.*: 39).³ Four (parastatal) development corporations were envisaged to lead the industrial, minerals, agricultural and transport sectors.

This grand scheme to propel Myanmar to 'take off' via a 'big push' in state-led industrial development lost momentum within a few years after its initiation, as financial shortfalls (especially scarce foreign exchange) rapidly manifested and other factors such as insecurity, political infighting within the ruling party and human resources problems severely constrained the implementation. Although the targeted doubling of real GDP was not achieved, the 52 per cent rise between 1951–52 and 1959–60 was not dismal by regional standards.⁴ However, that was from a very low base and it is illuminating to compare the structure of Myanmar's economy in 1959–60 with that for 1938–39.

The share of overall goods production in GDP (in constant 1961–62 prices) between fiscal years 1938–39 and 1959–60 declined from 81 per cent to around 49 per cent. Moreover, the total value of goods produced in 1959–60 achieved only 71 per cent of that in 1938–39. Hence, its contribution to GDP, in absolute as well as relative terms, had decreased while the contributions of both trade and services increased. This failure to attain even the pre-war production level meant that the Pyidawtha programme had not been able to establish a broad economic base to support the envisaged welfare state.

Unfulfilled expectations seem to be the manifest failure of the Pyidawtha Plan. Consequently, Myanmar in 1962 remained a primary product exporter dependent upon low-productivity agriculture. The leaders' socialist vision was not realized by their capital-intensive development strategy predicated upon state intervention and indigenization.

The economy under the Revolutionary Council (1962–74)

The main thrust of the economic policy of the military junta known as the Revolutionary Council (RC), which assumed power in a coup on 2 March 1962, was oriented towards establishing state control over the 'commanding heights' of the national economy through nationalization and regulation of the private sector, while attempting to considerably expand state-owned enterprises in commerce and industry.

The nationalization of the joint venture Burma Oil Company (BOC) (1954) Ltd, in January 1963, and the ousting of the junta vice-chair Brigadier-General Aung Gyi, in February 1963, signalled a move towards a more rapid assertion of state control over the economy. Subsequently, there were waves of nationalization affecting banking, industry, trade, commerce, and services over the next five years. These, together with the demonetization of large currency notes dispossessed the 'capitalists', mopped up liquid assets, and transferred substantial amounts of capital stock from the private sector to the state.⁵

In agriculture, it was acknowledged that the existing private production system could not be changed quickly into a collective system and the main objective was to rid it of exploitative practices. 1963, the RC decreed that peasants be protected from foreclosure and in 1965 promulgated a law to abolish the tenancy rent system. Farmers were allowed the right to work on their respective plots that belonged to the state. A compulsory delivery system for paddy was instituted in October 1964, ensuring the delivery of the stipulated amount at a fixed price to the government. Land committees to supervise land utilization were formed curtailing the economic freedom of the peasants.

The RC's perception of trade as the arena for struggle between anti-socialist elements and the state led to its preoccupation with the problem of commodity procurement and distribution. In 1964, the state assumed responsibility for countrywide distribution of

most commodities. In the following years, while grappling with the problem of ensuring equitable distribution, the state introduced a variety of institutional arrangements and administrative controls that failed to deliver and the entire distribution system floundered.

The economy was characterized by near isolation from the international system and stagnant growth. It was particularly affected by the depressed state of agriculture, which was not only the leading sector (in both employment and production) but also provided vital foreign exchange and surplus for industrial capital formation. The First Four-year Plan for 1971/72–74/75, truncated in March 1974 to conform with the new financial year (starting 1 April instead of 1 October) and the term of the first Parliament under the civilianized one-party socialist state, failed to achieve its annual GDP targets by a wide margin.

The number of state-owned enterprises (SOEs) in the processing and manufacturing sector increased substantially under the military rule with the state dominating resource-based production and large-scale enterprises. However, these were hampered by the lack of financial and managerial autonomy that degraded their efficiency and deprived them of the ability to generate surplus. Moreover, the emphasis on new projects and capacity expansion resulted in an endemic capacity underutilization and technological obsolescence. The private sector was emasculated both by regulations on private ownership and exclusion of the private sector from institutionalized credit and other resources.

The economy under Burma Socialist Programme Party rule (1974–88)

The overall economic strategy, adopted by the BSPP's First Congress of 1971 and elaborated in the party's 'Long-term and Short-term Economic Policies' (LTSTEPs), was to substantially increase commodity production. The aim was to achieve proportional growth under planned production. The Second Party Congress, in October 1973, endorsed the Twenty-year Plan (TYP) from 1974–75 to 1993–94, constituting five Four-year Plans (FYPs), as well as the Second FYP that replaced the truncated First FYP (1971/72–1973/74). Thus, the TYP became the guiding manifesto for all economic policies of the BSPP era.

There were some institutional restructuring and limited reforms during the mid-1970s. These reforms occurred within the socialist framework and neither introduced market-based solutions nor reduced the state's hold of the economy's 'commanding heights'. Some selected private enterprises were also allowed to operate under a new law promulgated in 1976. The agriculture sector was identified as an engine of growth and the government devoted substantial resources to promote intensive cultivation of rice and cash crops. However, the retention of the compulsory delivery system, government price controls and state monopoly of major export items restricted the full realization of economic benefits from increased agriculture production.

The BSPP government welcomed multilateral assistance from the International Monetary Fund (IMF), the World Bank (WB) and the Asian Development Bank (ADB) as well as official development assistance (ODA) from Western countries and Japan (which became the largest donor). Gross foreign loans and grants increased dramatically after the fiscal year 1976–77 and within two years annual gross receipts quadrupled to US\$359 million. Thereafter, it averaged some US\$390 million for the next nine years. The government relied on the agriculture surplus and ODA to service its investments in SOEs.

Driven by ODA and the introduction of high-yield varieties of rice, there was an economic recovery in the late 1970s followed by almost a decade of agriculture-led growth. The investment-driven growth became unsustainable as agriculture production

stagnated after 1983 and the mounting debt servicing became increasingly burdensome. Subsequently, Myanmar's economy regressed and tottered on the edge of financial bankruptcy as resource constraints (especially energy, foreign exchange and government revenues) reappeared and effective policy responses to adverse economic circumstances (unfavourable foreign trade balances and balance of payments, persistent fiscal deficits aggravated by inefficient SOEs) were not forthcoming.

Furthermore, vested interests of the *nomenklatura* (a small, elite group of party members) operating under a rent-seeking economic regime predicated upon a quasi-shortage economy, blocked potential avenues for effective reforms. The top leadership, isolated from the grass-roots and devoid of alternative opinions, became divorced from reality and revelled in the sanguine projections spawned by distorted statistics. As distorted markets undercut the plans, stasis set in and the economy became hostage to the ideological inertia and political sclerosis of the ruling party. The impending economic crisis, in turn, fuelled the latent fires of popular discontent. Finally, an eleventh-hour attempt by the BSPP and the state executive to institute wide-ranging economic reforms was overtaken by events as the BSPP rule was terminated by a military coup in the wake of an upheaval of unprecedented fury and scope.

The economy under direct military rule (1988–)

The State Law and Order Restoration Council (SLORC), later superseded by a reorganized junta, renamed the State Peace and Development Council (SPDC) in November 1997, inherited a rather grim economic situation in 1988. It then decided to abandon socialism as the organizing principle. Consequently, it opened up the economy to private initiatives, invited foreign direct investment (FDI), revamped the bureaucracy and divested some loss-making SOEs. Meanwhile, massive labour-intensive infrastructure development in irrigation, electric power, roads, bridges and public buildings, together with relatively large state investments in developing business parks and industrial zones, were initiated in the early 1990s. In doing so, the military leadership apparently believed that the economy could achieve a strong and sustained growth in no time.⁶ Given the nature of the crisis that led to the collapse of the socialist order and the subsequent unsettling political conditions, the state managers have been rather weary of relinquishing control over economic functions perceived as essential for maintaining order and stability. The fact that the reduction in the state's share of GDP (in constant 1985–86 prices) between fiscal years 1986–87 and 1997–98 was only 2.1 per cent (from 24.6 to 22.5 per cent) indicates that a decade after formally abandoning the socialist command economy, Myanmar state's involvement in value-added output had not significantly diminished.

Moreover, despite acceding to the ASEAN common effective preferential trade (CEPT) scheme, the state retains control over foreign trade through a complex licensing system for normal trade while restricting border trade through exclusion lists and administrative measures. The local currency is not convertible and a grossly overvalued (by some 200 times in November 2005 in relation to the US dollar) official exchange rate, pegged to the IMF's special drawing rights by the BSPP regime, is maintained.

In the mid-1990s the military leadership endorsed the following economic objectives as a policy guideline for its economic development efforts:

- development of agriculture as a base and all-round development of other sectors as well;

- proper evolution of the market-orientated economic system;
- development of the economy inviting participation in terms of technical know-how and investments from sources inside the country and abroad;
- the initiative to shape the economy to be kept in the hands of the state and the national peoples;

The last objective implies an overriding imperative that indicates that the state would still carry on playing a dominant role in managing the national economy.⁷

Among policy-makers, there appears to be a somewhat inchoate notion of the market as a solution to the economic malaise but at the same time there seems to be some trepidation towards the ramifications of allowing the market to run its course. The absence of a comprehensive and consistent set of economic reforms, in which the role of the state in the new economic setting is clearly delineated in both operational and legal terms, exemplified the expediency and opportunistic nature of the transition process in Myanmar. Crucial issues, whose resolution should have been an integral part of a well-laid transition programme, have not yet been tackled as a whole in a manner befitting their importance in determining the outcome of the ongoing economic transformation. Instead, some have been considered piecemeal by different state agencies with varying levels of influence in the policy-making process while others have been deferred or neglected, resulting in conflicting measures or uncoordinated actions.

At the centre, the same bureaucracy responsible for the BSPP's plans had formulated the Annual and Five-year Plans whose objectives and quantitative targets would be fulfilled by '[m]ass participation and co-operation of the organizations concerned' (Government of Myanmar, 1992: 23). Meanwhile, civil servants and citizens are constantly exhorted to strive towards plan fulfilment while being vigilant against 'subversion' and 'the malevolence of neo-colonialists'. Farmers, traders and industrialists have been continuously reminded of their obligation to the state and are warned to refrain from excessive greed and profiteering.

The following sections illustrate the current trends in selected indicators of Myanmar's national economy, thereby highlighting its macroeconomic structure and sectoral features.

Demographic and economic trends

Population

According to the 1931 Census of India, the population of Myanmar under the British rule was nearly 14.7 million. Estimates based on a two-stage census carried out in 1953–54 in selected areas put the total population in 1955 at less than 20.4 million. By 1961 the population reached 22.2 million. Between the 1973 and 1983 censuses, the population grew from 28.1 to 35.3 million (Government of Myanmar, *Statistical Yearbook (SYB) 1967*: 28; Saito and Lee, 1999: 7). However, the population growth rate slowed down in the late 1980s and early 1990s but picked up again in the late 1990s, as can be seen from Table 15.3.

Economic structure

When Myanmar's economic structure is examined over four decades, punctuated by the 1962 and 1988 coups, one finds very little structural change in terms of relative contribution by major sectors to the gross domestic product (GDP) in constant prices.⁸ The significant role of agriculture in the national economy, which, in fact, increased after the introduction of market reforms is evident in Table 15.4.

Table 15.3 Population of Myanmar (as of October)

Year	Millions	Annual Growth Rate (%)
1987	38.54	1.96
1990	40.79	1.88
1995	44.74	1.87
2000	50.13	2.02
2002	52.17	2.02

Sources: SYB 1997: Table 2.01, p. 14; and SYB 2003: Table 2.01, p. 14.

Table 15.4 Sectoral shares of GDP in Myanmar (constant prices)

Sector	1952–53	1961–62	1985–86	1997–98
Construction	3.4	1.9	1.7	4.9
Transport	3.7	5.8	3.6	4.3
Industries	7.5	12.3	11.4	11.6
Other primary	11.2	8.5	8.5	8.3
Admin and services	18.6	16.2	11.2	14.4
Trade	26.4	29.3	23.9	20.9
Agriculture	29.1	26.0	39.7	35.6

Notes:

Industries include manufacturing, mining and energy sectors.

Other primary includes forestry and livestock and fisheries sectors.

Due to rounding errors the total may not add up to 100.

For fiscal year 1952–53 constant 1948 prices, for fiscal year 1961–62 constant 1969–70 prices, and for fiscal years 1985–86 and 1997–98 constant 1985–86 prices are used. Fiscal year was October to September until 1974 and April to March thereafter.

Sources: Ministry of Planning and Finance (up to 1985–86); Ministry of National Planning and Economic Development (1997–98).

Similarly, as evident from Table 15.5, the employment distribution among major economic sectors hardly changed over more than six decades from that ascertained in the 1931 census. Most significantly, the employment share of the agriculture sector remained virtually unchanged. The employment share of the processing and manufacturing sector, which reached only 9.1 per cent in 1997–98, was much less than those of Taiwan (22 per cent) and South Korea (13 per cent) in 1971.⁹ The average annual growth rate of manufacturing employment achieved during the 1964/65–85/86 period was around 2.8 percent and was considerably lower than that achieved by Taiwan (5.2 per cent; 1952–60) during the latter's ISI (import substituting industrialization) phase.¹⁰ On the other hand, the 4.9 per cent compound growth rate achieved during the eight years after liberalizing the economy in 1989 was mainly due to the expansion of private sector manufacturing employment spearheaded by the creation of a few hundred thousand jobs in the export-oriented textile and garment industries.

GDP growth

In fact, Myanmar's average GDP growth rate during the 1950s, albeit starting from a different base, was quite respectable when compared with the corresponding figures for

Table 15.5 *Share of employment in major economic sectors*

	1931 (%)	1987–88 (%)	1997–98 (%)
Agriculture	66.4	62.5	62.7
Livestock and fishery	2.3	1.4	2.2
Forestry	0.9	1.2	1.0
Mining	0.6	0.6	0.7
Processing and manufacturing	9.1	8.7	9.1
Construction	1.6	1.7	2.2
Transport and communications	3.5	3.3	2.7
Social services	3.9	2.9	3.3
Administration	0.8	3.8	4.8
Trade	9.0	9.8	9.7
Others	1.9	4.3	1.6

Note: The values may not add up to 100 due to rounding errors.

Sources: Taylor (1987: Table 5.7, p. 344); and Ministry of Planning and Finance.

Table 15.6 *Real GDP growth rates: period averages*

	1951–61 (%)	1953–61 (%)
Myanmar	5.3	—
South Korea	—	4.0
Thailand	5.8	—

Sources: Kyaw Myint (1978: 15), for Burma; *IFS 1980* for South Korea; Ingram (1971: Table XVII, p. 222) for Thailand.

Taiwan and South Korea.¹¹ This is evident in Table 15.6. However, during the 1961/62–87/88 period, Myanmar's growth lagged considerably behind those countries. In fact, it was more in tune with that of India and Pakistan, which had inward-looking mixed economies. This is evident in Table 15.7.

Growth trajectories between Myanmar and the newly industrializing economies of Asia diverged significantly from the early 1960s when Myanmar closed its economy for nearly a decade. Myanmar reverted to accepting official development assistance (ODA) in the early 1970s but the average growth rate of 5.7 per cent achieved during 1975–85 turned out to be unsustainable. The real GDP shrank by 15.8 per cent between fiscal years 1985–86 and 1988–89 and though it registered positive growth thereafter it only managed to surpass the 1985–86 level in 1993–94. However, Figure 15.1 shows that, according to government figures, there has been an unprecedented double-digit growth in Myanmar's GDP since 1999.¹²

Foreign trade

During the socialist era, Myanmar's annual foreign trade value was less than US\$500 million coupled with persistent deficits in the trade balance. As is evident from Figure 15.2, market-oriented reforms introduced by the government in the early 1990s gave rise

Table 15.7 *Real growth rates: period averages (%)*

	GDP	Manufacturing Value-added	
	1962–88	1970–80	1980–88
Myanmar	3.5	3.6	3.2
Taiwan	–	12.0	9.5
South Korea	9.1	17.0	11.2
Thailand	7.4	10.5	6.3
Malaysia	6.2 ^a	12.0	6.7
Indonesia	5.7 ^b	14.5	7.9
India	4.0	4.6	8.3
Pakistan	4.9	5.4	8.2

Notes:

a. For 1970–88.

b. For 1964–88.

Sources: Ministry of Planning and Finance (Myanmar; GDP); *IFS 1991* (others; GDP); ESCAP (1992: Table II.8, p. 165) (manufacturing value-added).

to an upward trend that peaked in fiscal year 2002–03.¹³ The substantial rise in exports after 2000–01 had been due to increased natural gas exports to Thailand whose share of total exports jumped from around 11 per cent in 2000–01 to over 34 per cent within a year.

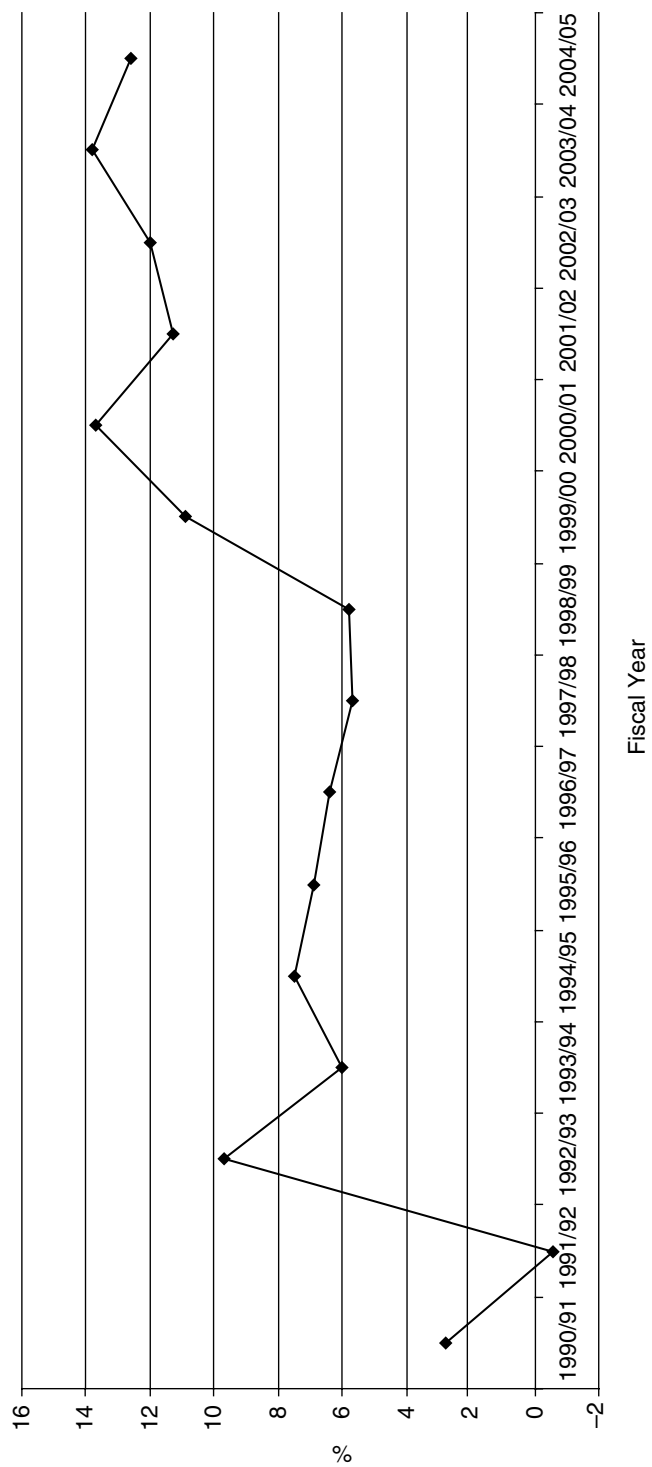
Foreign investment

The value of annual approvals for FDI proposals sputtered in the early 1990s after an initial surge of some US\$450 million in the fiscal year 1989–90, following the promulgation of a liberal Foreign Investment Law in November 1988. It recovered and surpassed US\$500 million in the mid-1990s (see Table 15.8). However, the FDI inflows were drastically reduced in the late 1990s as the Asian Financial Crisis set in and the investment climate was soured by Western sanctions and dissident pressures on corporate investors. Notwithstanding cheap labour, a widespread comprehension of English and a fairly large domestic market (a population of 53 million in 2004), there have also been several factors deterring potential foreign investors, such as lack of regular and consistent supply of electricity, delays and inefficiencies in ports, and inadequate modern communication facilities, as well as complex rules and regulations compounded by a diverging dual exchange rate and lack of a clear dispute settlement mechanism (Nystrand and Rupar, 1997; Zaw, 1999).

As for the sectoral distribution, as indicated in Table 15.9, the majority of the cumulative approved FDI (US\$7.76 billion up to 31 January 2005) was in the (mainly offshore) oil and gas sector that began to generate an income stream, after the turn of the century, bringing in substantial amounts of scarce hard currency through natural gas sales to Thailand (Tin, 2005). However, the tourism sector, among the earliest beneficiary of FDI, had yet to fulfil expectations (EIU, *Country Profile*, various issues; Tin, 2001).

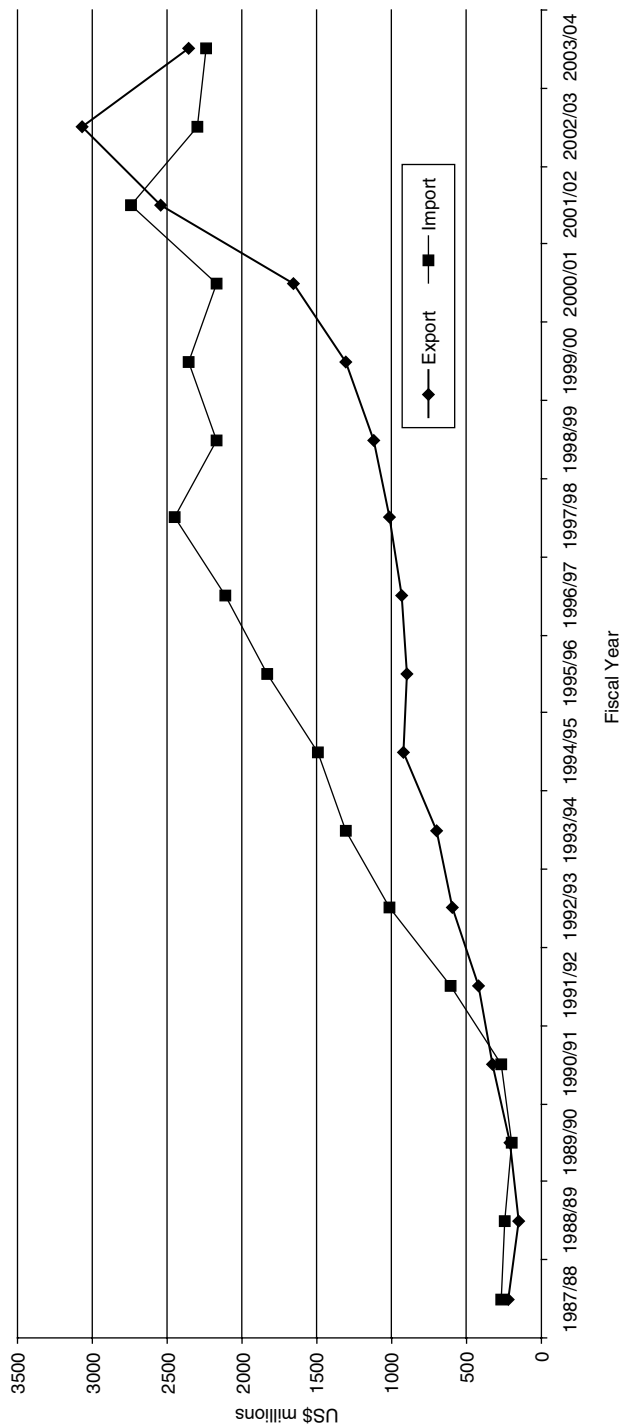
Inflation

Price inflation as indicated by the year-on-year change in the consumer price index (CPI) estimated for the capital city (Yangon) had been consistently high since the late 1980s



Source: Ministry of National Planning and Economic Development.

Figure 15.1 Real GDP growth in Myanmar



Note: The entries for 2000–01 are for calendar year 2000; values for 2003–04 are provisional.

Sources: Myat (2004); *IFS* (2005) and Ministry of National Planning and Economic Development.

Figure 15.2 Myanmar's foreign trade (value)

Table 15.8 Foreign investment approvals (US\$ millions)

Fiscal Year	Amount	Fiscal Year	Amount
1990–91	280.57	1997–98	777.39
1991–92	5.89	1998–99	54.4
1992–93	103.79	1999–2000	58.15
1993–94	377.18	2000–2001	217.69
1994–95	1352.30	2001–2002	19.00
1995–96	668.17	2002–2003	86.95
1996–97	2814.25	2003–2004	91.17

Note: The actual amounts invested are unknown and may be less than the approved amounts.

Sources: *Selected Monthly Economic Indicators* (hereafter *SMEI*) (Yangon: Central Statistical Organization), various issues.

Table 15.9 Sectoral shares of approved FDI (%), as of 31 January 2005

Sector	Share
Oil and gas	33.6
Manufacturing	20.7
Real estate	13.6
Hotels/Tourism	13.3
Mining	6.9
Others	11.9

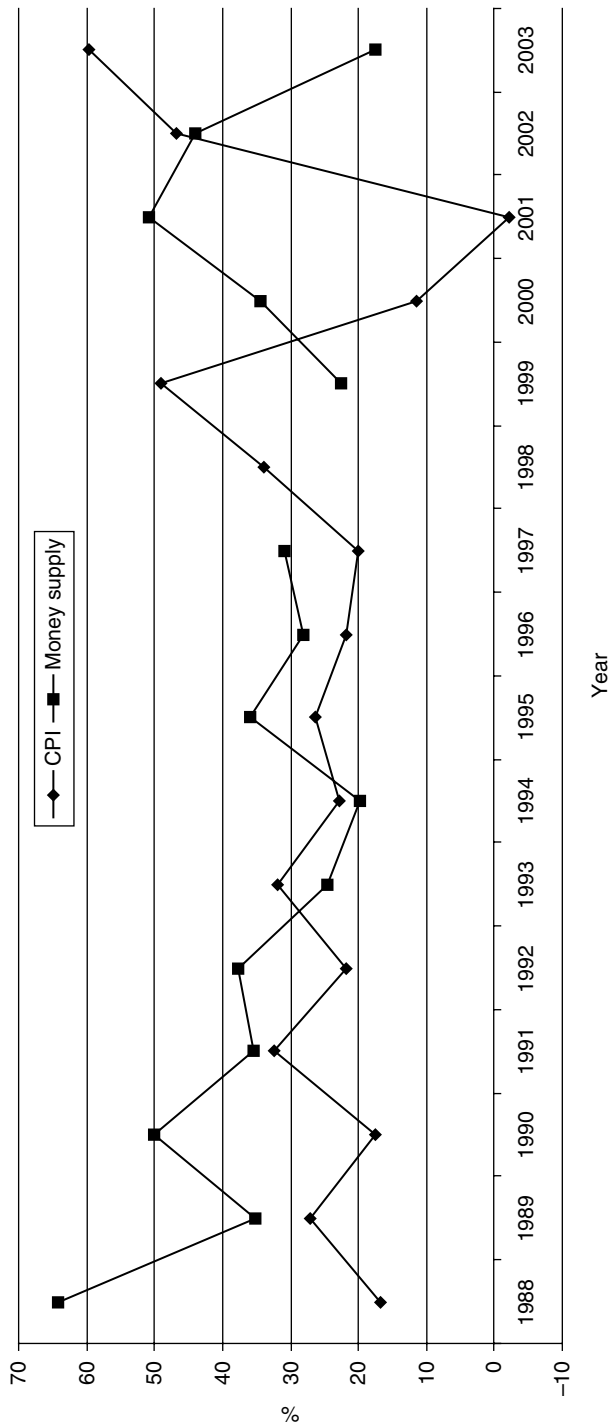
Sources: Ministry of National Planning and Economic Development.

together with the expanding money in circulation, as can be seen in Figure 15.3. Another proxy, the free market exchange rate of the local currency whose official value (pegged to the IMF Special Drawing Rights) had fluctuated around MMK6 per US dollar since the late 1980s showed a similar inflationary trend (Figure 15.4).¹⁴

Conclusion

Myanmar's economy may be stylistically characterized as a double dual economy. The formalized economy is split into two transaction circuits: one a MMK-based exchange regime and the other a US\$-denominated regime with the latter influencing the former's supply decisions as well. The informal or parallel component comprises the extensive rural-based quasi-subsistence exchange circuit and the illegal black market sector based mainly on transactions involving gold, precious stones, opium, timber and other restricted items. They are, of course, interconnected by the cross-flows of money and commodities but each is driven by a different economic logic and operated with different parameters that sometimes overlap. The state is concerned mainly with the formal part and despite occasional forays by the state to control it the informal part generally lies beyond the influence of the state authority, undermining the latter's attempts to manage the transition process.

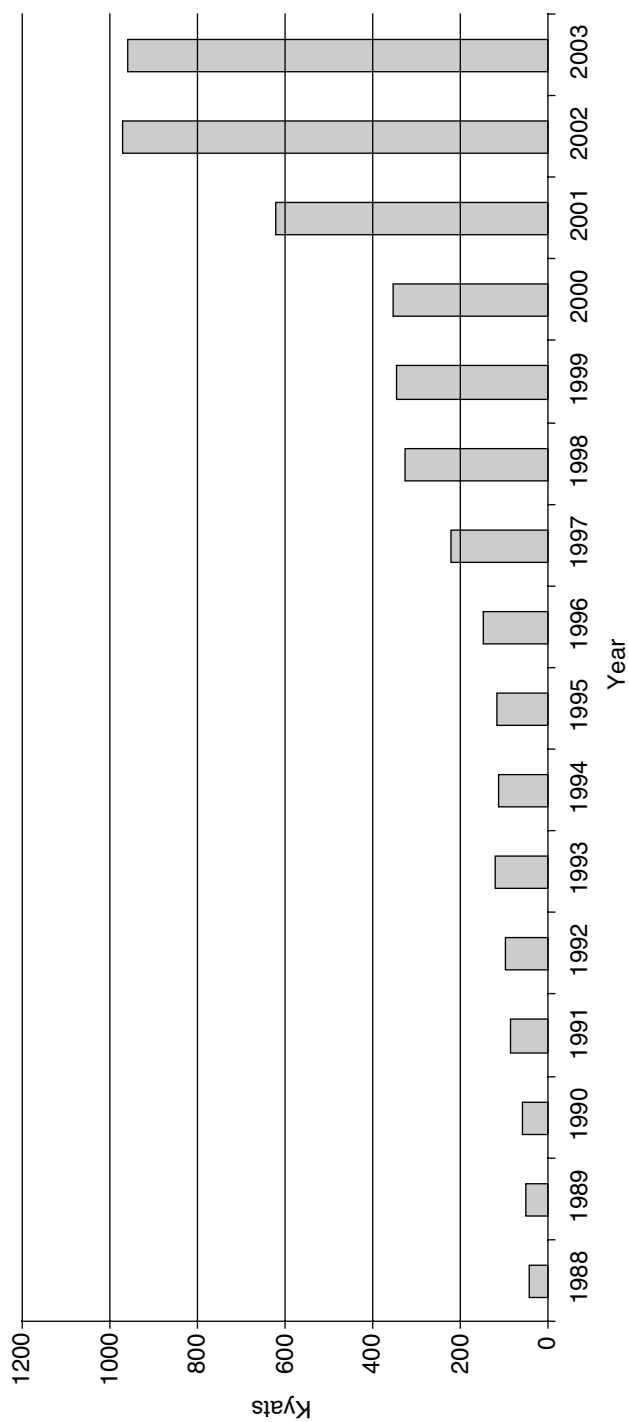
Opportunity cost of capital for productive investments, especially in export-oriented



Note: CPI data from 2001 onwards are for Yangon Division and the rest are for Yangon City.

Sources: Saito and Lee (1999); SYB (2003); and SMEI various issues.

Figure 15.3 Change in CPI (consumer price index) and money supply in Myanmar



Note: The values are average for relatively stable periods, whereas wild swings are not uncommon.

Sources: Myat (2004) and EIU (2004).

Figure 15.4 Free market exchange rate of kyats to US\$

manufacturing, has been high and most, if not all, potential investors are tempted to pursue short-term gains and to invest in areas beyond the reaches of the tax net. They are not risk-averse but have little confidence in the domestic currency and are anxious about the uncertainty of the private sector's future relations with the state.¹⁵ Where political legitimacy is contested, corruption is near endemic, differential privileges are accorded through 'connections', rent-seeking is widespread, rent-avoiding is profitable, and ersatz capitalism looms on the horizon, long-term investment in depreciating assets – subject to controls and regulations by the state – seems simply not worthwhile for many potential investors.

The problems of an unfavourable financial environment were further aggravated by the denial, since 1989, of ODA by Japan and Western donors (Germany, United Kingdom and United States, among others) as well as the World Bank and the Asian Development Bank due to concerns over political repression and human rights. China and India were the only major donors that together had contributed to the tune of several hundred million dollars over the last ten years. Myanmar continued to receive small amounts of humanitarian assistance from the United Nations and some developed countries and some debt relief from Japan that averaged around US\$100 million annually over the ten-year period since 1992. Moreover, since the late 1990s, Myanmar had to contend with putative economic sanctions imposed by the United States and anti-regime groups lobbying for withdrawals of foreign companies from Myanmar and for tourism and investment boycotts. Infrastructure constraints, especially in the form of fuel and electricity shortages, hampered economic growth in general and the realization of growth potential in the hospitality industry, transport, communications, and manufacturing in particular.

Myanmar's economy has, all along, been an agriculture-based economy (both in output and employment) with trade comprising a very small portion of the GDP in nominal terms. The trade–GDP ratio had been falling steadily from around 10 per cent in 1990 to less than 2 per cent in 2004.¹⁶ The export base has also been rather narrow with overwhelming dependence upon products derived from extraction of natural resources. For example, in fiscal year 2004–05 the top five export items constituted some 69 per cent of total export value.

Since the turn of the century, the government has been banking on the agriculture and energy sectors for exports and GDP growth. This entails substantially expanding the area of cultivated land through extensive reclamation of fallowland and wetlands as well as exploiting the several large natural gas deposits offshore (discovered in recent years by joint ventures with Indian, Korean, Malaysian and French oil companies) and implementing major hydroelectric projects with the help of Thai and Chinese governments. These endeavours, if successful, are expected to provide the impetus for a spurt of growth for the rest of the first decade of the twenty-first century.

However, for sustained growth in the long run, significant market-oriented reforms leading to structural changes are unavoidable and there is a serious need to replace opaque discretionary/arbitrary/exclusionary controls, regulations and procedures with transparent legally-constituted/rule-ordered/inclusionary business-oriented rules. Such reforms must be worked out by taking into consideration their social and economic costs as well as their implications on the administrative and decision-making structures of the state. Given the current political impasse between the government and the opposition and the resulting unfavourable international image it remains to be seen whether the state-led

development strategy in Myanmar could overcome the aforementioned economic and financial constraints and make a successful transition to a viable and flourishing market economy.

Notes

1. The study was funded by the US Technical Cooperation Administration Program. The New York engineering firm Knappen Tippetts Abbett (KTA) was the principal consultant. Pierce Management, Inc. served as mining consultants, while the Washington firm of Robert R. Nathan Associates became economic consultants.
2. The assumed ICOR for the Pyidawtha Plan was 2.2, which in practice (ex-post estimate) was nearer to 2.6 (Government of Burma, 1961: 5).
3. One of the major premises of the plan was that there would be peace and order in the country within a year.
4. The average annual rate of GNP growth in the ECAFE (Economic Commission for Asia and the Far East) region for the period between 1953–54 and 1961–62 was estimated as 4.2 per cent, whereas Myanmar achieved 4.8 per cent (Kyaw Myint, 1978: 23).
5. Nationalization was directed against all business concerns irrespective of ownership. It extended even to the retail sector where 13 469 merchandise shops were nationalized (see *Forward*, 22 March 1964, p. 3). The demonetization of MMK100 and MMK50, currency notes, in May 1964, not only affected 'black' money but also undermined small-scale businesses that usually operated outside the banking system. It was rationalized as a counterattack against the capitalists who opposed the BWS (Burmese Way to Socialism) by hoarding commodities, moving liquid assets beyond the state's reach, and initiating capital flight.
6. In fact, Brigadier David O. Abel, then Minister of Planning, Finance and Trade, remarked that 'the changes affected in the economic policy have now reached the right path . . . the country, which is rich in natural resources, could become an economically developed nation within 5–10 years' (*Working People's Daily*, 27 July 1989; quoted in Vokes, 1990: 219).
7. The military also controls two holding companies with extensive business ventures (often with foreign partners) in trading, services, mining, manufacturing and banking.
8. There was a reclassification of GDP sectors in the early 1970s and a change of the base year for constant prices. Hence, it is not possible to compare directly the sectoral GDP structure for the pre- and post-1962 periods. The fiscal year 1952–53 was taken as the initial year for comparison because it was the base year for the Pyidawtha Plan. Similarly, fiscal year 1961–62 had been the benchmark year for all official statistics up to 1988, while, under BSPP rule, 1985–86 was the last year before the economic recession set in.
9. Values for Taiwan and South Korea are from Chowdhury and Islam (1993: Table 6.3, p. 90).
10. Myanmar's growth rate could not be determined accurately because there was a change in public-sector employment data after fiscal year 1975–76, whereby administrative personnel were excluded. Other data are from Haggard (1990: Table 9.7, p. 242).
11. Myanmar's per capita income in 1952 was about US\$40, while South Korea's figure was around US\$30. Thailand's 1957 figure was about US\$70. By 1960 Myanmar attained US\$60 while South Korea's nominal figure went down to less than US\$12 due to the massive devaluation (by over 1000 per cent) of its currency. The corresponding figure for Thailand was about US\$86 (all derived from data given in IMF'S *IFS 1965–66*).
12. Outside observers believed otherwise. For example, the Economist Intelligence Unit (EIU), estimated that the growth rates (in per cent) for fiscal years beginning 1999, 2000, 2001 and 2002 as only 5.7, 6.2, 5.4 and 5.3 respectively (EIU, *Country Profile*, various years).
13. All exports and imports by private traders required licenses from the Ministry of Commerce and private exports of rice and teak had, for all practical purposes, been prohibited. Until late 2005, importers were required to devote a high percentage of their licensed value to essential commodities stipulated by the state. All private importers must show proof of adequate foreign exchange holdings acquired through exports. Kyat, the local currency, is not convertible to any foreign currency.
14. Many outside observers believed that the government was printing money to compensate for deficit spending.
15. Confidence in Myanmar's nascent finance and banking sector suffered a serious blow when several finance companies engaged in illegal pyramid schemes defaulted in 2003, triggering a bank run on several private banks. Money laundering allegations by the US Treasury compounded the problem and the government in 2005 closed down three banks.
16. This decline was more apparent than real because the foreign trade values were converted to local currency using the official conversion rate, which remained almost constant throughout the period, whereas the 'free market rate' had fallen by a considerable margin so that the local currency in 2003 was worth only one-sixteenth of its value in 1990 in US dollar terms (see Figure 15.4).

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Further reading

- Mya Than and Joseph L.H. Tan (eds) (1990), *Myanmar Dilemmas and Options: The Challenge of Economic Transition in the 1990s*, Singapore: Institute of Southeast Asian Studies.
- This edited volume provides a comprehensive stocktaking of Myanmar at the cusp of transition from command to market-oriented economy and a forward-looking exposition of opportunities and challenges in the reform process. It identified and discussed major issues in trade, finance, investment, agriculture, industry and foreign aid.
- Myat Thein, (2004) *Economic Development of Myanmar*, Singapore: Institute of Southeast Asian Studies.
- This volume, intended as a textbook, provides a clear and concise account of Myanmar's economic development from the time of its independence in 1948 up to the year 2000. The emphasis is on the post-socialist era (after 1988) under direct military rule. In tracing the trajectory of Myanmar's economic performance over more than five decades, the author has assembled, tabulated and collated data and analyses from a wide range of primary and secondary sources into a single study with ample illustrations.
- Saito, Teruko and Lee Kin Kiong (1999), *Statistics on the Burmese Economy: The 19th and 20th Centuries*, Singapore: Institute of Southeast Asian Studies.

This volume contains the most comprehensive compilation of economic statistics on Myanmar, covering more than a century for many items. Divided into ten chapters reflecting socioeconomic sectors, illustrated with 55 figures, it includes invaluable time series data of economic indicators in many different sectors of the pre- and post-World War II economy. The two appendices contain a selected bibliography classified under a general heading and along sectoral lines as well as a listing of sources on socioeconomic conditions in British Burma.

Walinsky, Louis J. (1962), *Economic Development in Burma 1951–1960*, New York: Twentieth Century Fund.

Produced by a member of the team of consultants entrusted with the planning of Myanmar's most ambitious development programme, its 35 chapters are divided into six parts and provide detailed accounts of the implementation phase as well as the whys and wherefores of its apparent failure. Its 89 tables and eight appendices include not only informative statistics but also relevant policy statements and national economic objectives. Written from the perspective of a somewhat frustrated foreign advisor, the book reflects the conventional wisdom of the day in development planning and clearly brings out the tensions between economic and political imperatives as well as the relationship between the economic bureaucracy and its political masters.

Tin Maung Maung Than (2007), *State Dominance in Myanmar: The Political Economy of Industrialization*, Singapore: Institute of Southeast Asian Studies.

The central focus of this volume is the state's attempt to industrialize Myanmar without much success since independence in 1948. It situates Myanmar's industrial development from 1948 to 1988 within the developmental state paradigm. The main argument is that the mimicking of a developmental state failed due to low state capacity. Continuities in the form of state dominance in the post-1988 era are also delineated.

16 North Korea

Frank Ruediger

Short political history

Politics, in particular the nationalist ideology, has been a dominant factor in North Korea's economic transformation. Thus, a brief review of the most formative historical experiences of the Democratic People's Republic of Korea (DPRK, or North Korea) is in order before addressing various aspects of the North Korean economy.

In 1876, the Japanese forced the Korean Kingdom of Chosŏn (Joseon; founded in 1392) to open itself to the West with the treaty of Kanghwa. The leadership, paralysed by factional strife and a tradition of self-isolation and close cooperation with China, could not agree on a common reform policy. Lacking economic and military strength, Korea lost its independence and became a colony of Japan in 1910, which until the present time remains a defining experience for all Koreans. The country was liberated when the Japanese surrendered on 15 August 1945, but only to be divided roughly along the 38th parallel according to an agreement between the Great Powers who wanted to establish a trusteeship over the peninsula. The Cold War made such a joint effort impossible. The Soviet Union and the United States each supported their own political followers on both sides of the demarcation line, and tensions were aggravated.

The Democratic People's Republic of Korea was founded on 9 September 1948, three weeks after the Republic of Korea (South Korea) was created. In the same year, the Soviet Union and the United States both withdrew their troops from the peninsula. The Korean War (1950–53) put an end to hopes for an early unification and solidified the division of Korea. Kim Il-sung (1912–94) used the war to further decimate the internal opposition against himself and his supporting group of former guerrilla fighters, and, after surviving a failed coup in 1956, finally reached the status of almost absolute power in North Korea. In the second half of the 1960s he increasingly pursued North Korea's independence from other members of the socialist camp, in particular, the Soviet Union and China. A growing emphasis on the *chuch'e* (*juche*: self-reliance) ideology supported his claims for independence. After at first manoeuvring between Moscow and Beijing, Kim finally decided that only an autarkic course in economy, defence, ideology and foreign policy could ensure the independence of the Korean nation and the survival of his own regime.

The Nixon shock of 1971 had a strong impact on both sides of the 38th parallel. The North and South Korean leaders felt insecure about the readiness of their respective allies to support them in the event of a security crisis. The reactions were twofold: (1) to increase the efforts at the build up of an independent national defence, including a defence industry, and (2) for the first time to open cautious exchanges between the two Koreas. The secret visit of the head of South Korea's intelligence agency to North Korea and his meeting with Kim Il-sung in 1972 started a dialogue that has been going on ever since, with strong variations in results and intensity.

The prime political force in North Korea used to be the Korean Worker's Party. However, the so far last (Sixth) Party Congress was held in 1980, and since the 1990s, the

role of the military has been significantly elevated under the rule of Kim Jong-Il, the son of Kim Il-sung. When Kim Il-sung died in July 1994, Kim Jong-Il remained publicly passive for three years, but then quickly assumed power officially by getting elected to the post of Secretary General of the party in 1997. In 1998, a Constitutional amendment elevated the Chairman of the National Defence Commission, a position Kim Jong-Il held since April 1993, to the highest authority in North Korea. The deceased Kim Il-sung is the Eternal President according to the preamble of the 1998 Constitution. Other influential official figures are the Prime Minister and the Chairman of the Supreme People's Assembly (the Parliament), who functions as the representative head of state.

In October 1994, the first international crisis around the North Korean nuclear programme was temporarily resolved with the Agreed Framework. The Korean Peninsula Energy Development Organization (KEDO) was founded to supervise the construction of light-water nuclear power plants, which were to replace the Soviet-type reactors that could produce weapons-grade uranium. The construction did not proceed as planned. In 2002, it was revealed that North Korea had resumed its nuclear programme, leading to the second nuclear crisis, which is still ongoing. A number of multilateral attempts at resolving the situation, most prominently the Six Party Talks between the two Koreas, China, Japan, Russia and the United States, so far have not yielded the desired results. In February 2005, North Korea officially declared itself a nuclear power. In January 2006, KEDO was officially dissolved.

In sum, the historical experience of present day North Korea heavily influenced its economic policy. This helps to explain North Korea's preference for heavy industries, the propensity for state-led industrial and economic development, and the readiness to spend scarce resources on an unproductive military. They can also account for North Korea's strong emphasis on nationalism, autarky and personal leadership, and the early but reluctant experiments with Joint Ventures and Special Economic Zones.

Economic progress and structural change

Overview

The economic foundation of North Korea was mainly laid under the Japanese during the colonial period (1910–45), when the northern part was quickly industrialized (see McNamara, 1990). Table 16.1 illustrates the imbalances in regional economic development and suggests what the comparative advantages of North Korea were after 1945.

The northern half of Korea started to build a Soviet-type centrally planned economy after 1945. Industry was nationalized and land estates were expropriated and distributed among peasants. Collectivization of agriculture followed in the 1950s. Thus, the state effectively took over the property rights and owned the means of production. Resource allocation took place mainly through central planning; the role of free market forces declined. With the introduction of a coupon system for most goods and state-organized procurement, a de-monetization of the economy took place for consumers and producers. Categories such as prices or profits lost a great part of their meaning in the North Korean economy.

Ironically, the Korean War elevated both parts of the country on the priority list of their respective sponsors. Consequentially, the 1950s marked a period of rapid growth in North Korea. Economic support by the Soviet Union and its Eastern European satellite states started as humanitarian aid during the Korean War, and then concentrated on

Table 16.1 Regional concentration of industries in Korea around 1945

Industry	Percentage Regional Share	
	North	South
Food production	35	65
Coal	80	20
Iron and steel	95	5
Hydroelectric power	90	10
Chemicals	85	15
Machinery	35	65
Consumer goods	20	80

Source: Woo (1991).

rebuilding infrastructure and industrial facilities. One example is the reconstruction of Hamhŭng/Hŭngnam on the eastern coast, which had one of the world's most advanced chemical production facilities, built in the 1930s with the help of German company BASF.¹

With the emergence of the Sino-Soviet rivalry starting in the late 1950s, North Korea first was able to keep an ambivalent position between the two contenders and thereby extracted significant amounts of development assistance from both sides. Eventually, however, Moscow's post-Stalinist criticism of personality cult and the policy of peaceful coexistence, as well as the disappointment over Khrushchev's retreat in the Cuban missile crisis, prompted a serious break in the political relationship between P'yŏngyang and Moscow in the early 1960s. This resulted in a sudden halt to major development projects and the withdrawal of Soviet and Eastern European economic and technical advisors, as well as in a significant reduction of transfers of capital and know-how. Simultaneously, the Cultural Revolution in China, along with the much lower Chinese economic and technological potential compared with that of the Soviet Union, dashed North Korea's hope of balancing the loss on one side by increased inputs from the other.

The situation was even worsened by the Nixon shock of 1971. The unexpected rapprochement between the United States and China made P'yŏngyang feel uneasy and forced the DPRK to invest even more scarce resources into an autonomous military industry. Similar considerations led to the build up of heavy and chemical industries in South Korea. The South was able to properly utilize such external inputs as cash flowed from the 1965 normalization treaty with Japan, the Viet Nam War several years later, and the petrodollars of the first oil crisis in 1973. But North Korea could neither mobilize enough funds nor create a strong export industry to repay the debt. Combined with the growing inefficiencies of the economic system and political restraints, this led to a stagnation of economic development and the rejection of additional loan requests by international donors.

Economic exchange with 'allies' was not overly extensive, either. North Korea under its self-reliant ideology carefully avoided full membership in the socialist countries' military alliance (the Warsaw Treaty) as well as in the economic alliance (Council of Mutual Economic Aid, COMECON). The economic relationship with East Germany is in many respects a telling example for the DPRK's cooperation with other socialist countries. In

1971, trade with North Korea accounted for a meagre 0.37 per cent of East Germany's overall trade. In parallel with the increasing economic difficulties of the socialist partners, their propensity to agree on politically motivated, but economically unprofitable, exchanges decreased. Accordingly, the portion of East Germany's trade with North Korea declined to an even more minuscule 0.032 per cent by 1988.²

Faced with long-term economic difficulties and in reaction to the developments observed in China after the Third Plenum of the Eleventh CPC Congress (in late 1978), North Korea in 1984 passed its first Joint Venture Law. In 1991, the Rajin-Sŏnbong Special Economic Zone was founded in the country's northeast with the support of the UNDP.³ However, both measures produced less revenue than expected.

In sum, building on the industrial structure inherited from the Japanese and with strong support from the Soviet Union, China and other socialist countries, North Korea was able to proceed on the path of industrialization started during the colonial period. The abundance of natural resources, technology import from the Soviet Union, as well as a disciplined and well-educated workforce, motivated by an omnipresent national ideology, have been contributing factors to the country's successful structural change towards an industrial society. The collapse of established trading partnerships and the rising international isolation after 1990 have led to serious difficulties in sustaining stability in North Korea's national economy. A food shortage, catalysed by natural disasters, in 1995–97 led to a famine that provided the final rationale for serious economic reforms.

Macroeconomic data on North Korea

The development as described above would of course be reflected in basic macroeconomic indicators. Although such data are indeed available, a very cautious approach is advisable concerning their accuracy. In fact, in many cases it must be doubted whether these numbers have any utility at all.⁴ However, it can be assumed that the data given below provide a rough estimate of reality and trends.

Population, GNI and GDP The national economy of North Korea witnessed a continuous decline since 1990, but according to the data provided by the Bank of Korea (South Korea) bottomed out in 1998 and has been growing, albeit slowly, ever since.

These statistics do not reflect the fact that the official exchange rate of the North Korean won (KPW) against the US\$ has been reduced from 2.1:1 to 150:1 in July 2002. The current (as of June 2005) official exchange rate of the euro against the KPW is 170:1. The rate on the black market, however, has reportedly gone beyond the 3000:1 mark. The time series as provided by the Bank of (South) Korea is one of the few attempts to allow a continuous observation of economic trends in the DPRK, but neither accounts for the new exchange rate nor for the hyperinflation after the price adjustments of 1 July 2002. Also note that the GDP numbers are below the official North Korean data on the state budget (see Table 16.3 below). The latter, although of significant relevance, reflects only a part of the country's overall output. Private economic activities are not considered, nor is it clear whether the so-called 'second economy' run by the military⁵ is included in the official numbers on the state budget. This means that actual GDP numbers will almost certainly deviate strongly from the data above. There are no data available on the savings–investment ratio.

Table 16.2 *North Korean population, GNI and GDP*

	Population Millions	GDP (bill. won)	Nominal GNI (bill. won)	Nominal GNI (bill. US\$)	Per Capita GNI (10 000 won)	Per Capita GNI (bill. US\$)	GDP Growth Rates (%)
1990	20 221	24 117.9	16 407.3	23.2	81.1	1146	-3.7
1991	20 495	23 282.4	16 766.7	22.9	81.8	1115	-3.5
1992	20 798	21 873.9	16 446.6	21.1	79.1	1013	-6.0
1993	21 123	20 966.1	16 430.5	20.5	77.8	969	-4.2
1994	21 353	20 526.4	17 025.5	21.2	79.7	992	-2.1
1995	21 543	19 693.8	17 169.5	22.3	79.7	1034	-4.1
1996	21 684	18 976.1	17 255.5	21.4	79.6	989	-3.6
1997	21 810	17 774.0	16 814.2	17.7	77.1	811	-6.3
1998	21 942	17 587.1	17 597.2	12.6	80.2	573	-1.1
1999	22 082	18 684.3	18 741.0	15.8	84.9	714	6.2
2000	22 175	18 927.5	18 977.9	16.8	85.6	757	1.3
2001	22 253	19 619.6	20 287.0	15.7	91.2	706	3.7
2002	22 369	19 857.7	21 330.7	17.0	95.4	762	1.2
2003	22 522	20 210.9	21 946.6	18.4	97.4	818	1.8
2004	22 709	20 663.8	23 767.1	20.8	104.7	914	2.2

Source: Bank of Korea Economic Statistics System (ECOS).

Inflation

A calculation of a CPI or a PPI would require sufficient empirical data to create a basket of goods and services. These data are not available. Furthermore, there are no official North Korean reports on inflation. In fact, the issue of inflation and hyperinflation has so far not been dealt with in official publications – although, according to personal communication of the author with North Korean officials, there is a strong interest in learning how to control or reduce inflation.

A possible way to get an estimate of the inflation rate would be to compare annual absolute numbers of the state budget. However, such numbers have not been provided by the Ministry of Finance since 2002. Furthermore, since that same year, when the government attempted to bring artificially set prices to a more realistic level, there have been no further official price adjustments that could give us an idea of the official estimates of inflation. The only sufficiently reliable information on price developments in North Korea comes from the free markets. Sources of information are reports by defectors and visitors of the country, the latter often limited to the T'ongil Market in P'yongyang. Before July 2002, 1 kilogram of rice cost about KPW60–70 on the markets; by mid-2003, this price had increased to KPW220–250, and as of June 2005 was around KPW750. This would correspond with an annual inflation rate of about 175 per cent over a period of three years. On producer prices, the only information available is the exchange rate – of relevance for those enterprises that import components from the world market. The market exchange rate has increased from about 900 KPW/US\$ in mid-2003 to about 3000 KPW/US\$ in June 2005, an annual increase of about 185 per cent.

A third method of estimating an inflation rate is to observe the development of wages. It can be assumed that the state attempts to keep these wages high enough to cover the subsistence level, in order to prevent the workforce from abandoning production and engaging in sideline activities. The monthly wages were set to about KPW3000 in July 2002 and reached KPW30 000 in one instance (based on an interview the author had with a North Korean worker in P'yongyang in October 2005). This tenfold increase in three years is equivalent to an annual inflation rate of 215 per cent.

The three examples provided above lead to an estimation of the North Korean annual inflation rate since 2002 of about 200 per cent. The decision by the state to ban the trading of staple food on the markets and to reintroduce the Public Distribution System for basic food in October 2005 can be interpreted as an attempt at curbing the high inflation and removing the related political risk.

Budget

Concerning the budget, the main sources of information are the annual reports by the North Korean news agency KCNA. The Minister of Finance, usually in March or April, reports at the annual sessions of the Parliament (Supreme People's Assembly, or SPA) on the execution of last year's budget and the budget plans for the next (that is, current) fiscal year. There are no detailed statistics provided on the budget. Rather, the numbers that are summarized in Table 16.3 have to be extracted from a transcript of the Minister's speech. The kind of information provided varies over the years; in some cases, increase rates are given, in others the percentage of the single position in relation to the overall budget is provided.

The selection criteria for information disclosure are not transparent and remain subject to speculation. Furthermore, the single positions in the budget are relatively rough summaries. For example, the rather ambivalent position, 'social programmes', consists of education, culture and arts, health care and sports, but no details are provided on how much of the budget is spent on each of these subcategories. Sporadically, more detailed information on selected areas or projects is provided. However, this does not take place on a regular basis, making the observation of developments very difficult.

As indicated above, all official numbers from North Korea have to be taken with a good grain of salt. But with all caution, there are some interesting developments after the July 2002 economic reforms. In 2002 (reported in March 2003), the state's revenue for the first time since 1998 was higher than the expenditure. Furthermore, for two years since March 2002, the planned budget allowed for a slight deficit, indicated by a higher growth rate of expenditure vis-à-vis revenue.

Since 2003, no absolute numbers for the budget (revenue and expenditure) have been provided. A simple calculation based on the numbers for 2002 and on the given percentage increases is highly problematic, since the reform of 2002 generated a heavy inflationary push, as discussed above.

Foreign trade and external debt

Since detailed balance of payments data are not available for North Korea, we have to focus on trade only. North Korea's international trade partners are the main indirect source of information on the DPRK's exports and imports. The South Korean trade promotion agency (KOTRA) has been very active in collecting and publishing such data.

Table 16.3 State budgets of the DPRK 1998–2005

	1998	1999	2000	2001	2002	2003	2004	2005
Actual increase/decrease								
Revenue (%)	98.0 (19 790.8)	97.2 (19 801.0)	102.4 (20 903.4)	100.3 (21 639.9)	100.5	100.9	–	–
Expenditure (%)	99.0 (20 015.2)	98.2 (20 018.2)	102.7 (20 955.0)	100.5 (21 678.7)	99.8	98.2	99.3	–
Defence (%)	14.6	14.6	14.3	14.4	14.9	15.7	15.6	–
Economy (%)	–	–	40.1	42.3	22.7	23.3	41.3	–
Social programmes (%)	–	–	38.2	38.1	–	40.5	40.8	–
Planned increase/decrease								
Revenue (%)	–	3.0 (20 381.7)	3.1 (20 405.3)	3.2 (21 570.800)	2.5 (22 173.790)	13.6	5.7	15.1
Expenditure (%)	–	1.8 (20 381.7)	1.9 (20 405.3)	2.9 (21 570.8)	2.3 (22 173.79)	14.4	8.6	11.4
Defence (%)	–	14.5	14.5	14.5	–	15.4	15.5	15.9
Agriculture (%)	–	11.0	5.0	–	–	–	21.3	29.1
Science and technology (%)	–	10.0	5.4	–	–	15.7	60.0	14.7
Social programmes (%)	–	–	–	2.5	2.5	49.4	–	10.3
Economy (%)	–	2.0	–	2.7	41.6 (9 230.684)	–	–	–
Power (%)	–	15.0	15.4	–	–	12.8	–	–
Coal and mining (%)	–	10.0	12.3	–	–	30.0	–	–

Note: Figures in parentheses are absolute numbers in million won.

Source: KCNA.

Besides the technical question where to measure trade flows, it has to be noted that the numbers provided below do not necessarily reflect the whole picture. If the accusations of illegal trade activities (narcotics) are correct, it cannot be expected that these are included in the statistics. The same is partially true for the export of military goods. Furthermore, there are significant doubts whether China, North Korea's major economic exchange partner, discloses all of the relevant information to the outside world due to strategic considerations.

A glance at Table 16.4 shows a very positive development since the beginning of the economic reforms in 2002. In particular, the growth rate of exports, 31.3 per cent in 2004, is remarkable. Still, North Korea has a relatively large trade deficit, although the relative size of this deficit (80 per cent of exports in 2004 vis-à-vis 149 per cent of exports in 2001) has been decreasing. We also note that the year 1998 marked a particularly strong decline in trade, probably in connection with the Asian Financial Crisis as well as the North Korean famine.

Japan has significantly reduced its economic exchange with the DPRK since 2002, due to the strong domestic pressure to resolve the issue of abducted Japanese nationals and

Table 16.4 North Korea's foreign trade

	Export		Import		Total	
	Value (million US\$)	Change (%)	Value (million US\$)	Change (%)	Value (million US\$)	Change (%)
1994	858	-13.3	1242	-25.0	2100	-20.6
1995	736	-14.2	1316	6.0	2052	-2.3
1996	727	1.2	1250	-5.0	1977	-3.6
1997	905	24.5	1272	1.8	2177	10.1
1998	559	-38.2	883	-30.6	1442	-33.8
1999	515	7.9	965	9.3	1480	2.6
2000	556	8.0	1413	46.4	1969	33.0
2001	650	14.9	1620	15.2	2270	2.6
2002	736	13.1	1524	-5.9	2260	-0.4
2003	777	5.5	1614	5.9	2391	5.8
2004	1020	31.3	1837	13.8	2857	19.5

Sources: Reports from KOTRA's overseas trade offices; *KDI Pukhan Kyongje Ribyu (North Korean Economic Review)*, 4, 2005; excluding inter-Korean trade.

Table 16.5 North Korea's major trade partners in 2002-03

	NK's Export (thousand US\$)		NK's Import (thousand US\$)		Total Trade (thousand US\$)		Share (%)	
	2002	2003	2002	2003	2002	2003	2002	2003
China	270 685	395 344	467 309	627 583	737 927	1 022 927	32.6	42.8
Japan	234 404	173 818	135 137	91 500	369 541	265 318	16.3	11.1
Thailand	44 616	50 706	171 966	203 611	216 582	254 317	9.6	10.6
India	4768	1613	186 573	157 878	191 341	159 491	8.5	6.7
Russia	3642	2792	77 048	115 575	80 690	118 367	3.6	4.9
Combined volume of five nations	558 115	624 273	1 038 033	1 196 147	1 596 081	1 820 420	70.6	76.1
Total	736 245	776 992	1 524 136	1 614 382	2 260 381	2 391 375	100.0	100.0

Source: Reports from KOTRA's overseas trade offices.

with the US policy towards North Korea. On the other hand, China has strongly increased its activities. North Korea's exports to China grew by 46 per cent in 2003, and imports from China grew by 34 per cent (Table 16.5). The same development was repeated in 2004, when exports grew by 48.2 per cent and imports by 27.4 per cent. The growth rates for 2004 are even more remarkable for trade with Russia (157.1 per cent and 78.45 per cent, respectively), but the starting basis has been much lower compared with China (Table 16.6).

The rapidly developing economic contacts between North Korea and South Korea provide an increasingly significant source of foreign trade. Building upon a common nationality and the goal of a peaceful unification, there is a strong political interest on the

Table 16.6 North Korea's major trade partners in 2004

	NK Exports (million US\$) 2004	NK Imports (million US\$) 2004	Total (million US\$) 2004
China	585.7	799.5	1385.2
change	48.2	27.4	35.4
Japan	88.7	164.3	253.0
change	-3.0	-5.8	-4.8
Russia	7.2	206.2	213.4
change	157.1	78.45	80.3

Source: KDI (2005) op. cit.

Table 16.7 South Korean trade with North Korea

	SK Imports (in 1000 US\$)	SK Exports (in 1000 US\$)	Total (in 1000 US\$)	Balance (in 1000 US\$)
1990	12 278	1188	13 466	-11 090
1991	105 719	5547	111 266	-100 172
1992	162 863	10 563	173 426	-152 300
1993	178 167	8425	186 592	-169 742
1994	176 298	18 249	194 547	-158 049
1995	222 855	64 436	287 291	-158 419
1996	182 400	69 639	252 039	-112 761
1997	193 069	115 270	308 339	-77 799
1998	92 264	129 679	221 943	37 415
1999	121 604	211 832	333 436	90 228
2000	152 373	272 775	425 148	120 402
2001	176 170	226 787	402 957	50 617
2002	271 575	370 155	641 730	98 580
2003	289 252	434 965	724 217	145 713
2004	-	-	697 000	-

Source: Ministry of Unification (South Korea), KOTRA.

side of South Korea to keep the North engaged in peaceful exchanges and dialogue. Although the estimates of the costs of a Korean unification could certainly be challenged, there is an agreement that these costs will be enormously high. South Korea's willingness to engage in economic exchanges with North Korea is therefore in part also motivated by the desire to reduce the costs of an eventual unification before the latter actually occurs.

Table 16.7 shows the trade between both countries since 1990. As can be seen, North Korea had a significant trade surplus with the South until 1997. This has reversed, with massive amounts of economic aid from the South. Currently, trade with South Korea accounts for about one-third of North Korea's overall foreign trade.

In addition to very strong political or tactical motives, trade and investment with North Korea can indeed be economically feasible for South Korean companies. After long

Table 16.8 *South Korea's non-trade engagement with North Korea, 1995–2004*
(million US\$)

	Total	KEDO	Food aid	Fertilizer	Road and Rail links	Mt. Kùmgang tours
1995	241.8	1.8	240.0	–	–	–
1996	11.9	8.9	2.9	–	–	–
1997	31.4	3.0	23.1	–	–	–
1998	21.1	6.5	11.0	–	–	–
1999	35.3	6.4	–	28.5	–	–
2000	706.5	308.9	93.4	83.4	12.9	–
2001	453.2	271.1	17.3	49.5	69.6	34.8
2002	584.9	288.7	120.4	66.6	53.5	43.9
2003	650.4	333.0	122.2	70.1	94.1	5.1
2004	543.3	137.1	164.6	89.8	92.6	6.8
Total	3492.9	1365.2	794.9	387.9	322.7	90.6

Source: Manyin (2005: 38).

negotiations, it was agreed that wages in the Kaesòng (Gaeseong) Special Economic Zone, which is only 70 kilometers away from Seoul, will be set at about US\$37 per month. This makes Kaesòng a real alternative to production in China or Viet Nam.⁶ The first South Korean investors have already moved into the Kaesòng SEZ, and more can be expected. North Korea's external debt is estimated to stand at US\$12 billion, a constant level over the last few years. However, the economic relationship with China is not reflected in this number.

Foreign aid

North Korea is a large receiver of other, non-trade income from international sources. They are composed of food aid and deliveries of other goods such as fertilizer and medicine, disaster relief, but also of development assistance such as support in infrastructure projects. As of early 2005, there were 24 humanitarian organizations present in North Korea. The total value of KEDO- (Korea Energy Development Organization-) related contributions by South Korea, Japan, the United States and the EU was over US\$1.3 billion in the years 1995–2004.

According to data compiled by Manyin (2005), South Korea's non-trade expenditures on engaging North Korea amounted to over US\$540 million in 2004 alone, with significant growth observable since 2000, the year of the first ever North–South summit meeting. As of 2004, the total amount of South Korean non-trade contributions to North Korea stood at about US\$3.5 billion. The United States provided non-trade support to North Korea of over US\$1.1 billion in the period between 1995 and 2004, reaching a peak in 1999. In the context of KEDO, the United States even delivered fuel oil to North Korea.

However, as in the case of trade, these statistics provide only an incomplete picture. As the example of food aid shows, a significant amount was not delivered through international organizations such as the World Food Programme (WFP), but came through bilateral agreements that are not always transparent to the public. Accordingly, Manyin (2005: 22) comes to the conclusion that China's total food shipments to North Korea are

Table 16.9 US non-trade engagement with North Korea 1995–2004 (million US\$)

	Total	Food aid	KEDO
1995	9.7	0.0	9.5
1996	30.3	8.3	22.0
1997	82.4	52.4	25.0
1998	122.9	72.9	50.0
1999	287.2	222.1	65.1
2000	138.7	74.3	64.4
2001	177.6	102.8	74.9
2002	172.9	82.4	90.5
2003	29.2	25.5	3.7
2004	55.3	55.1	0.0
Total	1106.2	695.8	405.1

Source: Adapted from Manyin (2005: 2).

nearly double the entire WFP shipments, and cites reports that China's actual food assistance might even be considerably higher than officially reported.

Economic development by sectors

In view of the very difficult situation concerning economic statistics from or on North Korea, it is surprising to see the detailed numbers provided in the tables below. They do, however, reflect what is widely believed to be more or less a correct picture of the structure of the DPRK's economy. Agriculture is not the dominant sector; but its relative relevance has increased vis-à-vis manufacturing because of a significant downturn of the latter due to shortages of energy and supplies.⁷ The increasing weight of the services sector is remarkable.

The growth rates per sector as provided below are subject to the same caution as indicated above. They illustrate the economic difficulties North Korea was going through in the 1990s after the collapse of the Eastern Block. This is particularly evidenced in the case of mining and manufacturing.

Based on the natural conditions, developed under the Japanese colonial rule and later supported by the Soviet Union and the socialist camp, North Korea is indeed an industrial society. This is an important fact that needs to be kept in mind when looking into the future of economic policy: the country does not need industrialization, it needs modernization.

Social progress

North Korea is not to be found among the 177 countries covered by the UNDP's human development index. Social indicators are, however, provided by a number of international organizations. In general, North Korea is doing comparatively well in terms of education, health care and sanitation standards. The reason for a sharp decline in life expectancy during the 1990s is to be found in the very difficult food situation.

Sponsored by the United Nations Population Fund (UNFPA), the North Korean Population Research Institute issued a number of data on population statistics.⁸ The life

Table 16.10 Sectoral contributions to GDP in North Korea

	Agriculture, Forestry, Fishery (%)	Mining and Manufacturing (%)	Mining (%)	Manufacturing (%)	Light Industry (%)	Heavy Industry (%)	Electricity, Gas and Water (%)	Constr. (%)	Services (%)	Govt. (%)	Others (%)
1990	27.4	40.8	9.0	31.8	6.2	25.6	5.1	8.6	18.0	11.0	7.0
1991	28.0	38.0	9.0	29.0	6.2	22.7	5.0	8.2	20.9	13.0	7.9
1992	28.5	33.8	9.2	24.6	6.3	18.3	5.1	9.1	23.5	15.0	8.6
1993	27.9	32.9	8.2	24.7	6.8	17.9	4.8	8.5	25.9	16.8	9.0
1994	29.5	31.4	7.8	23.6	7.0	16.6	4.8	6.3	27.9	18.6	9.3
1995	27.6	30.5	8.0	22.5	6.8	15.7	4.8	6.7	30.3	20.7	9.6
1996	29.0	28.0	7.1	20.9	6.9	14.0	4.3	6.4	32.3	22.5	9.7
1997	28.9	25.5	6.7	18.8	6.5	12.3	4.3	6.3	35.0	25.1	9.9
1998	29.6	25.6	6.6	19.0	6.4	12.6	4.2	5.1	35.6	25.3	10.3
1999	31.4	25.6	7.3	18.3	6.1	12.2	4.5	6.1	32.4	22.8	9.6
2000	30.4	25.4	7.7	17.7	6.5	11.2	4.8	6.9	32.5	22.6	9.8
2001	30.4	26.0	8.0	18.1	6.7	11.3	4.8	7.0	31.8	22.2	9.7
2002	30.2	25.7	7.8	18.0	6.9	11.0	4.4	8.0	31.6	22.0	9.7
2003	27.2	26.8	8.3	18.5	7.0	11.5	4.5	8.7	32.8	22.9	9.8
2004	26.7	27.2	8.7	18.5	6.7	11.8	4.4	9.3	32.3	22.6	9.7

Source: Bank of Korea Economic Statistics System (ECOS).

Table 16.11 North Korean GDP growth rates by sector

	Agriculture, Forestry, Fishery		Mining & Manufacturing		Mining		Manufacturing		Light Industry		Heavy Industry		Electricity, Gas and Water		Construction		Services		Govt.		Others	
	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	
1990	-9.8	-4.1	-5.5	-3.6	-0.6	-4.5	-3.3	5.9	0.9	1.1	0.4											
1991	2.7	-11.6	-7.0	-13.2	-4.6	-15.9	-4.6	-3.6	2.8	4.0	0.3											
1992	-2.9	-14.9	-5.9	-18.2	-7.0	-22.3	-5.6	-2.4	1.1	2.0	-0.9											
1993	-7.4	-3.4	-7.2	-1.9	3.7	-4.3	-8.6	-9.7	1.4	2.1	0.0											
1994	2.6	-4.2	-5.4	-3.8	-0.6	-5.2	4.2	-26.9	2.4	3.2	0.5											
1995	-10.5	-4.2	-1.3	-5.4	-4.7	-5.6	0.0	-3.3	1.6	2.5	-0.6											
1996	0.5	-9.8	-11.8	-8.9	-6.4	-10.2	-7.7	-11.8	1.1	1.6	-0.2											
1997	-3.9	-16.1	-14.0	-16.9	-12.8	-19.0	-9.6	-10.0	1.2	1.9	-0.6											
1998	4.2	-3.9	-6.1	-3.1	0.1	-4.8	-9.1	-11.3	-0.5	-0.3	-0.8											
1999	9.3	10.2	14.2	8.6	3.3	11.6	6.8	24.4	-1.9	-4.0	3.6											
2000	-2.0	2.3	5.8	0.9	5.9	-1.9	3.0	13.5	1.1	0.6	2.2											
2001	6.8	3.9	4.9	3.5	2.6	4.1	3.6	7.1	-0.3	-0.4	0.0											
2002	4.3	-2.5	-3.8	-1.9	2.5	-4.4	-3.8	10.5	-0.2	-1.3	2.4											
2003	1.7	2.8	3.2	2.6	2.6	2.6	4.2	2.1	0.6	0.2	1.7											
2004	4.1	1.0	2.5	0.4	-0.2	0.7	4.5	0.4	1.4	0.0	4.6											

Source: Bank of Korea Economic Statistics System (ECOS).

Table 16.12 *Life expectancy in North Korea, 1955–2050*

Year	1955	1960	1970	1980	1990	2000	2005*	2015*	2050*
Life expectancy at birth	49.0	54.1	59.1	66.9	70.7	63.1	63.1	66.5	74.7

Note: * Projected figures for 2005, 2015 and 2050.

Source: UN Common Database, http://globalis.gvu.unu.edu/indicator_detail.cfm?IndicatorID=18&Country=KP.

Table 16.13 *Population growth rate in North Korea, 1955–2000*

Year	1955	1960	1970	1980	1990	2000
Annual population growth rate (%)	−0.90	2.00	2.53	1.42	1.48	0.82

Source: UN Common Database, http://globalis.gvu.unu.edu/indicator_detail.cfm?Country=KP&IndicatorID=29.

expectancy for males fell from 68.5 years to 63.1 years during 1993–2002, while that for females declined from 76.1 years to 71 years. The North Korean overall life expectancy dropped by 5.5 years to 67.2 years. The total fertility ratio was 2.03 in 2001. The maternal death ratio was 87 per 100 000 live births during 1993–2002. The mortality rate for newborn babies was 1.39 per cent and 3.22 per cent for children under five years.

The 2004 UNDP *Human Development Report* gives somewhat different data, usually referring to the year 2002. According to this source, the overall life expectancy is 63.1 years, fertility is 2.0, mortality under five years is 5.5 per cent.⁹ The adult literacy for North Korea is given as between 95–99 per cent, reflecting the high achievement of centralized education.

Immunization coverage among young children was high, with 98 per cent of children under the age of two years being vaccinated against poliomyelitis, measles and BCG. Malnutrition rates among children in the DPRK declined between 2002 and 2004, according to a large-scale, random sample survey conducted by DPRK government agencies, the United Nations Children's Fund and the World Food Programme. The advances were largely attributable to the provision of humanitarian assistance by the international community and increased domestic food production (DPRK 2004 Nutrition Assessment).

The North Korean population grows at a moderate rate, which has slowed down recently.

As in most socialist systems, the state cares relatively well for health and education. The high literacy rate would guarantee good access to means of information; however, this access is strictly limited by the state. Most households in North Korea are equipped with radios and/or TV sets, which are, however, usually only able to receive the state's broadcasting. The telephone density (fixed network) is extremely low. Experiments with mobile communication have reportedly been suspended due to security concerns.

Major policies

There are three top North Korean political priorities: the relationship with South Korea and an eventual unification, the survival of the regime against external threats, and the stability of the political system. The economy plays a significant role in attaining each of these goals. Recently, the state reacted by initiating a reform policy.

South–North relationship

With regard to the North–South relationship, it is fair to state that North Korea has lost the race for economic supremacy. The focus of economic policy vis-à-vis South Korea is now to generate as much income as possible, either through aid deliveries and humanitarian assistance, or through development cooperation in the context of the Special Economic Zones. There are four such zones, two of which (Sinŭiju in the northwest and Rajin-Sŏnbong in the northeast) are currently less successful. However, the Mt. Kùmgang tourism project has attracted over one million paying visitors (as of June 2005) from South Korea since its creation in 1998, and the industrial zone near Kaesŏng is doing well in attracting South Korean direct investment. A key North Korean economic policy is to attract as much foreign economic support as possible, skilfully utilizing the slightest discrepancies between its various counterparts. This approach was very successful from the 1950s¹⁰ and has been practised repeatedly until the present time, as has been shown above.

External security

The external threat to regime security has a significant impact on North Korea's economic policy. It influences the allocation of the country's scarce resources in various ways. The old formula 'steel is national power' (learned under the Japanese, reconfirmed by Stalin) led to a structural imbalance emphasizing heavy and chemical industries at the expense of light industries; funds are unproductively channelled into maintaining a strong military industry; and many production facilities are reportedly allocated in costly bunker-type locations inside of mountains to protect them against possible air raids. In addition to the self-imposed isolation, the active opposition by the United States has so far contributed to preventing an integration of North Korea into the global economic and financial networks and effectively cut off the country from any standard source of capital and technology transfer. This is a heavy burden that increased the dependency of the DPRK's national economy on China. The nuclear programme can be seen as a response to both the external threat by the United States and its allies, but also as an attempt to ensure independence from the big Asian neighbour despite the ever-growing reliance on the Chinese lifeline. Another key North Korean economic policy is therefore to ensure and to constantly look for alternative sources of convertible currency income. Such alternatives could include trade with arms.

Domestic political stability

To ensure domestic political stability, a stable supply of food and energy is the top economic priority. Although it would theoretically be possible to convince the population to live without mobile phones, malnutrition and the absence of heating are unsustainable in the long run. It is no coincidence that in the 2005 new year's joint editorial of the country's major newspaper, agriculture was given the top priority in economic construction. However, the natural conditions for agriculture in North Korea are not ideal. The territory is very mountainous, the mean temperature is significantly lower than in the South, and precipitation levels vary strongly even within a single province. Moreover, there are high natural risks of droughts or floods. The latter has been aggravated by the cultivation of hillsides and deforestation.

The situation with energy is different, but not less complicated. Favourable natural conditions for the construction of hydroelectric power plants and the availability of anthracite had led the Japanese to concentrate Korea's energy generation capacity in the North.

However, the collapse of the Soviet Union created considerable structural imbalances by cutting North Korea off cheap deliveries of heavy fuel oil, which was needed to operate Soviet-built thermal power plants. The lack of foreign currency prevents not only the import of fuel, but also of spare parts for the power plants and for the transmission systems.

Accordingly, a third key North Korean policy is to enhance the output of its agriculture and to increase energy production. The major approaches have been irrigation, the intensive use of fertilizers, and land reclamation. Irrigation in the past depended on inputs of energy and hence was somewhat unstable; the construction of a large number of new reservoirs and, in particular, the Paekma-Ch'olsan waterway is expected to alleviate this burden since the water flow is ensured through natural gravitation. Concerning energy, there is a mixed strategy of small hydroelectric power plants, the utilization of alternative forms of energy, and the construction of nuclear power stations.

Economic reforms and transformation

The famine years of 1995–97 have demonstrated to the leadership the necessity of a change of the economic paradigm. The dramatic success of the Chinese reforms has further shown that economic change does not automatically mean regime change, and hence somewhat balanced the negative lessons learnt from the collapse of the Eastern Block.

While the Chinese, following the devastating experience of the Great Leap Forward and the Cultural Revolution, in 1978 had enough domestic political momentum to start the implementation of economic reforms right away, potential reformers in North Korea face a much different environment. Despite difficulties, until the famine of 1995–97 there were no major rifts in the country's economic development. Furthermore, any challenge, direct or indirect, to the legacy of Kim Il-sung would mean an immediate and serious threat to systemic stability. The North Koreans therefore had to lay the ideological foundation before actual economic changes could start. They did so by conveying the following messages to the people: (1) the changes are not changes, they are adaptations of the creative principle as part of the *chuch'e* (self-reliance) ideology; (2) changes might occur, but these are signs of developing the right form of socialist economy, not abandoning socialism in favour of a capitalist model of development; (3) markets themselves are not something related by definition to capitalism, since they have existed long before and are a naturally occurring phenomenon. As such, emphasizing markets does not mean emphasizing capitalism; (4) markets exist only temporarily, and when they are no longer necessary, their functions will be gradually taken over by the state; and (5) markets play a supplementary role in increasing the efficiency of state-directed production and distribution, and are not intended to replace state-direction of the economy.¹¹

Furthermore, the Constitution was revised in 1998 to reorganize the executive branch and to give more responsibility to the Cabinet, which used to be heavily dominated and actually sidestepped by the Korean Worker's Party. The new Constitution gave the citizens the right to cultivate private 'kitchen gardens', and demanded an economic management based on 'cost, prices and profits'.¹² Very importantly, political changes happened with an increased emphasis on the military instead of the working class as the top group in society, and on nationalism instead of socialism as the dominant ideology. This, at least in theory, provides the ideological foundation for the creation of a new class of successful entrepreneurs, who own means of production – a group for which there is no place under orthodox socialism.

The most visible sign of the economic reform was an adjustment of the state price system on 1 July 2002.¹³ The heavily subsidised price for rice was raised to a much more realistic level; the subsidization of rice through high procurement and low retail prices was ended; the nominal wages were not only increased by 1800–5400 per cent, but also reclassified according to types of labour; and the domestic currency KPW was devalued vis-à-vis the US\$ by about 7500 per cent. Production teams in agriculture were reduced to the size of two to three families, a new accounting system was introduced to increase the responsibility of individual industrial production units. The currency exchange certificates, still in place in China in the early 1990s, were abolished.¹⁴ Rental fees on land and agricultural equipment were introduced. Cooperative farms were allowed to freely sell up to 40 per cent (previously 20 per cent) of their products. The working units in agriculture were significantly downsized, from 100 persons to only ten persons, and the family farming system was gradually re-introduced to boost the feeling of responsibility. The individual farming lands were expanded from 100–170 m² to about 1300 m². The ‘peasants’ markets’, although not illegal before, received a boost in official recognition, and eventually the range of goods allowed to be traded on these markets was expanded to include industrial goods, as was reflected in the new official term ‘market’. Their number grew substantially from March 2003 due to governmental efforts, raising the number of large-scale general markets to 300 nationwide, including 40 in P’yongyang.¹⁵

The markets reacted to the state’s price adjustments and, in particular, the inflationary push provided by the growing nominal wages with rapidly increasing prices. The result was a social stratification according to one’s position at the markets: producers and sellers are doing well, while consumers have to find additional or new sources of income. The latter appears to be particularly difficult in the cities. However, as the growth rates in Tables 16.2 and 16.11 suggest, the price reforms have at least been partially successful.

The North Korean state is increasingly eager to let its bureaucrats learn the mechanisms of a market economy. Since the late 1990s, an almost hectic activity concerning various training measures can be observed. The major topics requested by the North Korean side are international trade, international financial institutions, free market economy principles, international accounting standards, international debt management, corporate management training, insurance and re-insurance, regulatory policy, international law, FDI promotion, marketing, principles of taxation, corporate governance, stock market operations etc.¹⁶

Prospects and likely developments

The top issues for the future are the success of the economic reforms, the question of external security, and the transformation of the domestic political system into a form that is sustainable in the long term.

North Korea’s economic situation is doubtlessly very serious. However, it is certainly not hopeless. The country has an abundance of natural resources, a well-educated and disciplined workforce. The country is favourably located between three global economic powerhouses: Japan, South Korea and China. Political support for economic development can be expected from South Korea and probably also in connection with the nuclear issue. Moreover, a reform of the institutional structure has been initiated, which has irreversibly changed North Korea. Further reforms are likely to take place, although it remains unclear at which pace and with which success. In the coming years, we should

expect another price adjustment, a further adaptation of the organizational and institutional structure, and an increase of individual responsibility within the economic system. The emergence of huge military-controlled industrial conglomerates as the state's agents of economic development cannot be excluded.

There are, however, analysts who are less optimistic about the North Korean reforms. For example, Gey (2004) insists that no socialist option is known that could cope with the economic challenges North Korea is facing. Panin and Altov (2004)¹⁷ conclude that Kim Jong-Il has lost the control of the economy. Park (2002), on the other hand, argues that North Korea, unlike the Soviet Union, has always sought some kind of balanced economic development and hence has better preconditions for a gradual reform.

External security is a key issue not only for the survival of the regime, but also for the progress of the country's economic development. The reasons are manifold. A North Korea that is preoccupied with self-defence and mounting external pressure will be less risk-taking on the domestic scene. Valuable funds that would be needed to modernize the infrastructure and other parts of the economy are currently channelled to the military. Potential foreign investors will not be encouraged by high-risk premiums. Finally, the international economic integration of North Korea, in particular, access to international finance and export/import markets is so far seriously underdeveloped and could turn out to be a stumbling block for a further progress of the reforms. It is therefore reasonable to expect that increasing external security will correspond with a propensity for domestic reforms.

A possible adjustment of the political system is closely connected to the progress of the economic reforms. As the Chinese and the Vietnamese examples have shown, an improvement can be achieved even if the political system remains formally intact.

Among the most important questions for the future is the leadership succession after Kim Jong-Il. The options are a continuation of the dynastic rule or the introduction of a system of collective leadership. The latter seems to be the most likely option given the difficulties for the legitimization of a new single leader as well as the benefits of a collective leadership under the new conditions, among them economic development based on private initiative.

Overall, the economic situation in North Korea is as complicated as the international security issues around the country. However, under certain conditions both economic success and a peaceful development are possible; this chance is calling for an adequate response by the international community, which so far could not agree on a coherent approach.

Notes

1. For a detailed account of reconstruction and aid around Hamhŭng, see Frank (1996). As a side note, there were rumours about a secret Japanese nuclear programme in Hŭngnam.
2. See *GDR Statistical Yearbook*.
3. For more information on the Tumen River Area Development Programme, see <http://www.tumenprogramme.org>.
4. For a very intriguing discussion of the various attempts at estimating North Korean macroeconomic data such as GDP, see Noland (2000: 80ff.).
5. Usually, the term 'second economy' is used for the non-state sector. Here, it refers to a whole, in itself almost autarkic, economy including its own agriculture, mining and production facilities, all owned by the military.
6. On the Special Economic Zones, see Cho (2003: 186 ff.).
7. Park (2002) provides an excellent analysis of North Korea's agriculture sector.
8. See *Hankook Ilbo*, 1 May 2005.
9. See *Human Development Report* (2004: 250).
10. See Frank (1996).
11. See Frank (2005).

12. The 1998 DPRK Constitution.
13. For a comprehensive analysis, see Cho (2003).
14. It has to be noted that this process had already taken place in late 1997 in the Rajin-Sŏnbong SEZ (see Noland, 2000: 69); this coincides with the estimated start of the reform policy around 1997–1998 and the function of SEZs as testing grounds for new policies.
15. See MOU (2005).
16. See Frank (2002: 87–119).
17. These names are pseudonyms.

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Further reading

- Eckert, Carter J. and Lee Ki-baik (1990): *Korea Old and New. A History*, Seoul: Ilchogak Publishers.
- This book by two of the most authoritative voices provides a general history of Korea in a readable form, covering the whole timespan from the Palaeolithic age to economic and political development until 1990. A good knowledge of Korea's past, including the neo-Confucian legacy, the opening up in the late nineteenth century and the colonial period 1910–45 is indispensable for a proper understanding of North Korea and the institutional substructure that shapes its behaviour.
- Harrison, Selig (2002), *Korean Endgame. A Strategy for Reunification and US Disengagement*, Princeton and Oxford: Princeton University Press.
- This book is a detailed, balanced, easily readable account of more recent (1990–2002) developments in North Korea by a leading expert with decades of experience. It includes a US perspective on North Korea and covers the economy, the nuclear issue, reunification and international relations.
- Ruediger, Frank (2005), 'Economic reforms in North Korea (1998–2003): systemic restrictions, quantitative analysis, ideological background', *Journal of the Asia Pacific Economy*, **10** (3), 278–311.
- This article provides an account and an analysis of the most recent developments regarding economic and ideological reform in North Korea, arguing that there is a well-prepared and long-term reform process with good chances of success.
- Suh, Dae-sook (1988), *Kim Il-sung. The North Korean Leader*, New York: Columbia University Press.
- This is the standard book by the most authoritative author on the origins of Kim Il-sung and the North Korean political system, including *chuch'e*. It covers North Korea's most influential figure's personal background, the search for independence from major allies and the core of the North Korean ideology.

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