

# *The East Asian Economies: From Miracle to Crisis*

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- 1. Introduction**
2. East Asian Miracle
3. Causes of the Asian Financial Crisis
4. Lessons from the Asian Financial Crisis
5. Conclusive Remarks



## ■ Export-Oriented Industrialization = East Asian Miracle

- ❖ Some commentators argue that the **rapid economic growth** of the **HPAEs** has **nothing to do** with the **effectiveness of free trade**.
- ❖ A wide variety of policies (**Singapore:** detailed government direction of the economy; **Hong Kong:** laissez-faire; **South Korea:** the formation of very large industrial firms; & **Taiwan:** domination of small & family-run companies)
- ❖ A mix of (1) **high saving rates**, (2) **high rates of investment** & (3) **high levels of public education** is believed among economists to cause the rapid economic growth of the Asian economies.

# Introduction



## Map of East Asia



**BERGAMO**  
Population: 119,684  
Area: 40.16 km<sup>2</sup>  
Density: 3,022/km<sup>2</sup>



### TOKYO

**Population:** 14.1 mil.  
**Area:** 2,199.9 km<sup>2</sup>  
**Density:** 6,424/km<sup>2</sup>  
**Governor:** Koike, Y.



### SHANGHAI

**Population:** 24.9 mil.  
**Area:** 6,340.5 km<sup>2</sup>  
**Density:** 4,200/km<sup>2</sup>  
**Mayor:** Gong, Z.



### SEOUL

**Population:** 9.39 mil.  
**Area:** 605.2 km<sup>2</sup>  
**Density:** 15,509/km<sup>2</sup>  
**Governor:** Park, W.

**Source:** Tokyo Metropolitan Government, National Bureau of Statistics of China, Seoul official website.



## ■ Major Characteristics of East Asia

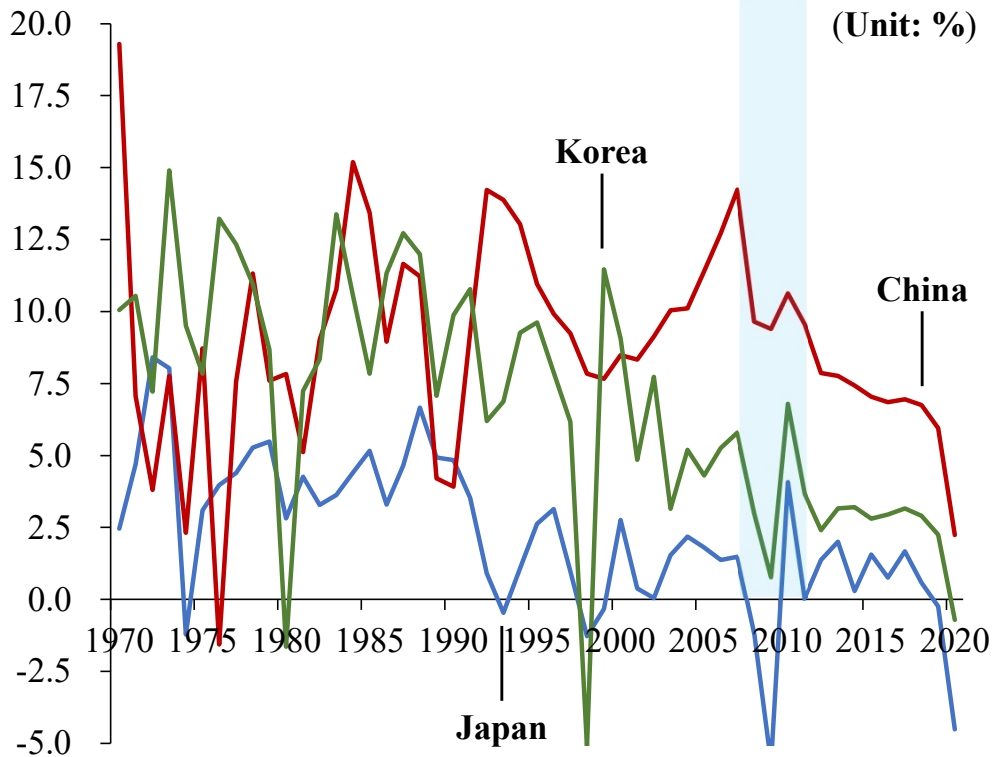
- East Asia is **a sub-region of Asia**;
- It includes **China, Japan**, North Korea, **South Korea**, Taiwan, Hong Kong, Macau, & Mongolia;
- The region covers about **12 million km<sup>2</sup>**, about **15% bigger** than the area of **Europe**;
- More than **1.6 billion** people (↑), about **38%** of **Asia** or **22%** of all the people in the **world**, live in **East Asia**;
- **East Asia's GDP** accounts for **31.1%** of the world;
- **3 major religions** in East Asia are (1) **Buddhism**, (2) **Shintoism**, & (3) **Confucianism**.

# Introduction

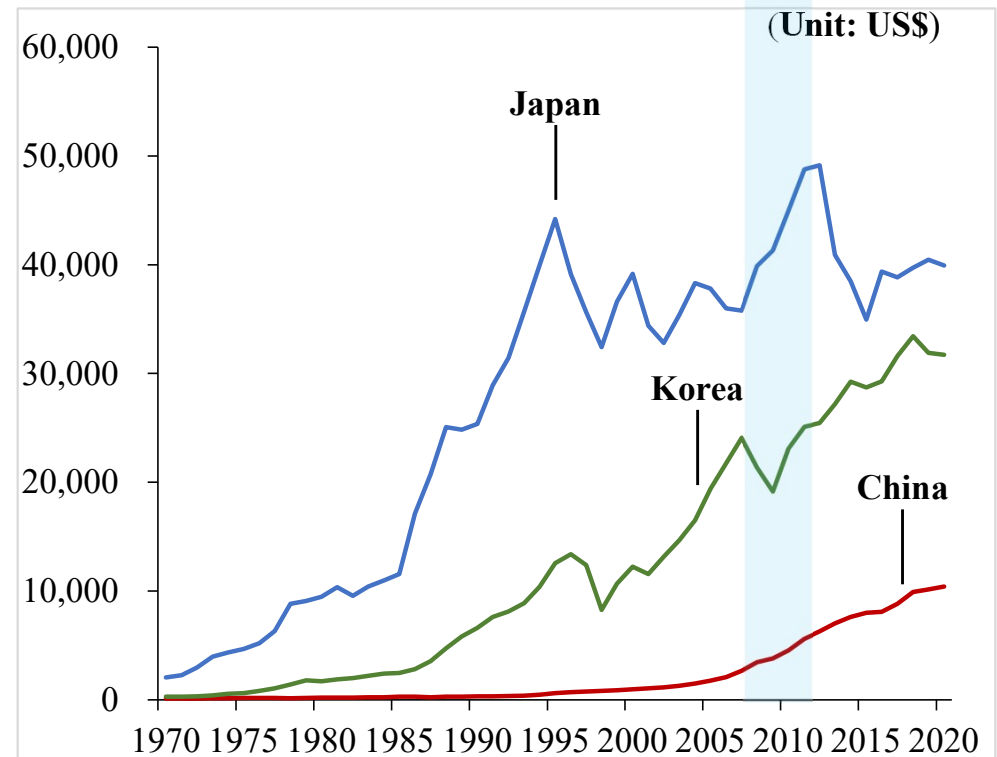


## ■ East Asia's Key Economic Performance

### GDP Growth



### GDP per Capita



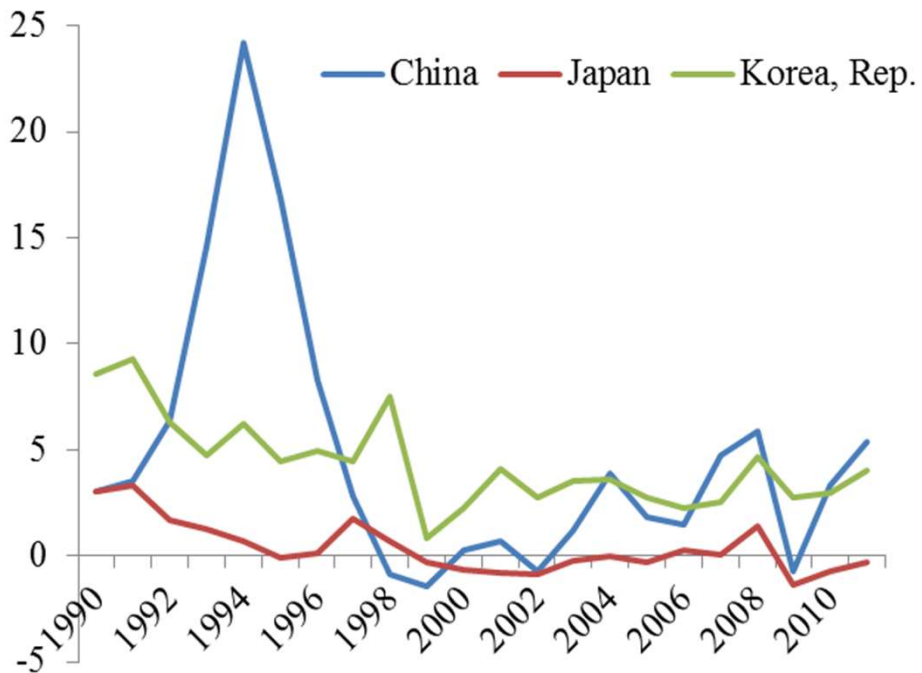
❖ **Japan has been struggling through sluggish growth with a shrinking workforce.**

Source: Own illustration based on data.worldbank.org

# Introduction

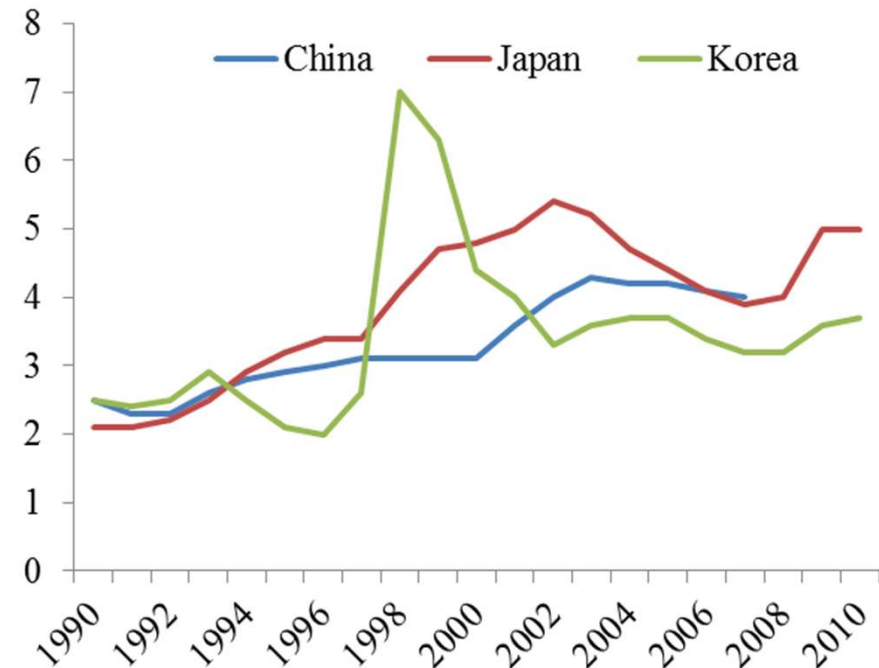


## Inflation (Unit: %)



- > China experienced an inflation rate of **25%** in 1994.
- > Japan has faced a deflationary spiral.

## Unemployment Rate (Unit: %)



- > As the 1997-1998 Asian financial crisis hit the Korean economy, the unemployment rate increased to **7%**

Source: Own illustration based on World Bank.



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## OPENING QUESTIONS

- ◆ What is 'East Asian miracle'?
- ◆ What are the antecedents of this phenomenon?
- ◆ Who is the most important actor in Asia's rapid growth?
- ◆ Do you think that it has happened in all Asian economies at the same time or at different points in time?
- ◆ What do you know about the Asian monetary crisis in 1997?

# East Asian Miracle

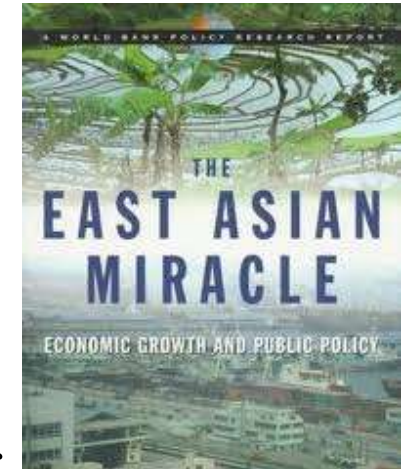


## ■ Key Countries

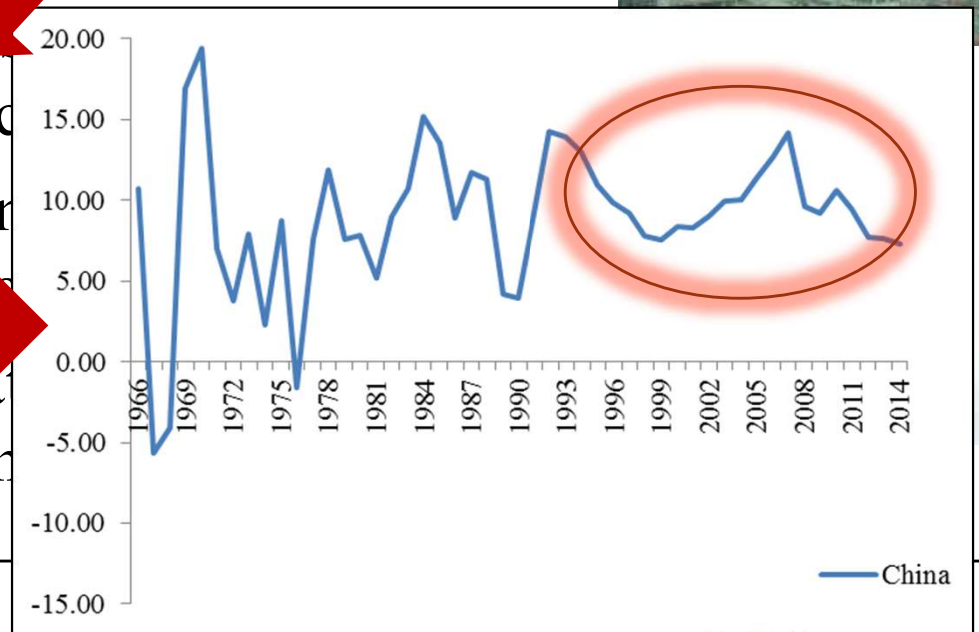
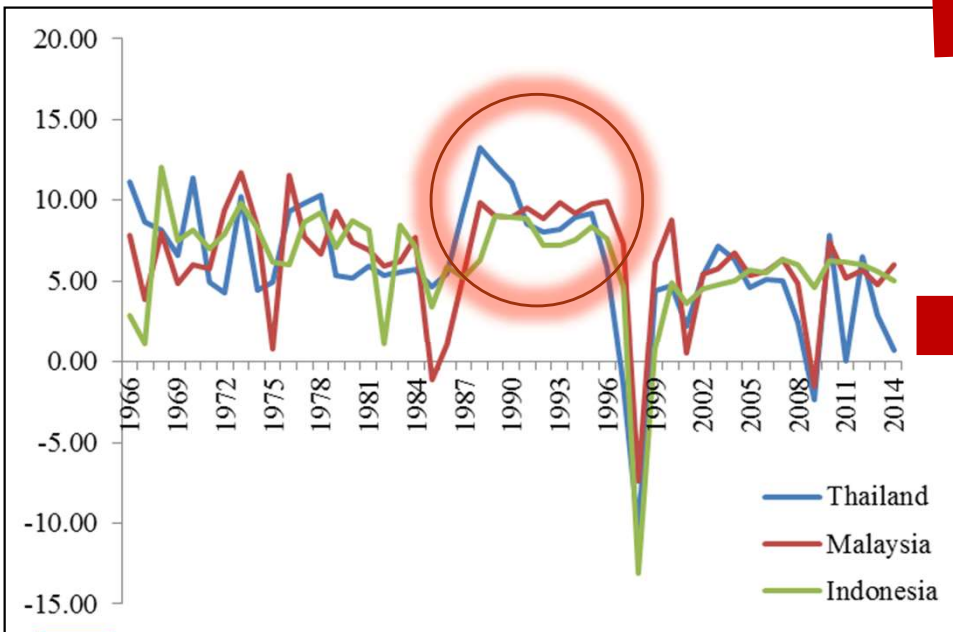
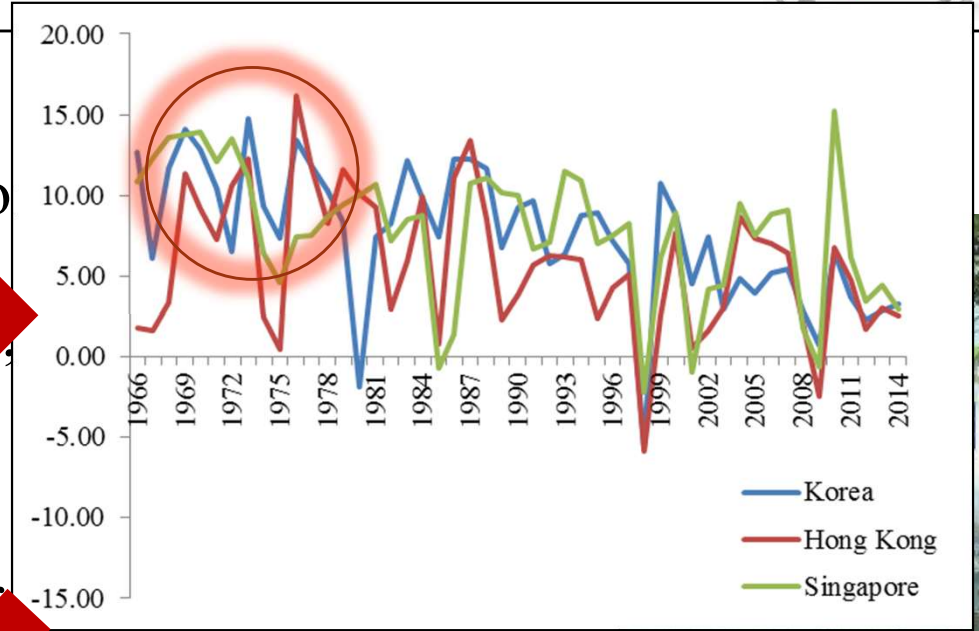
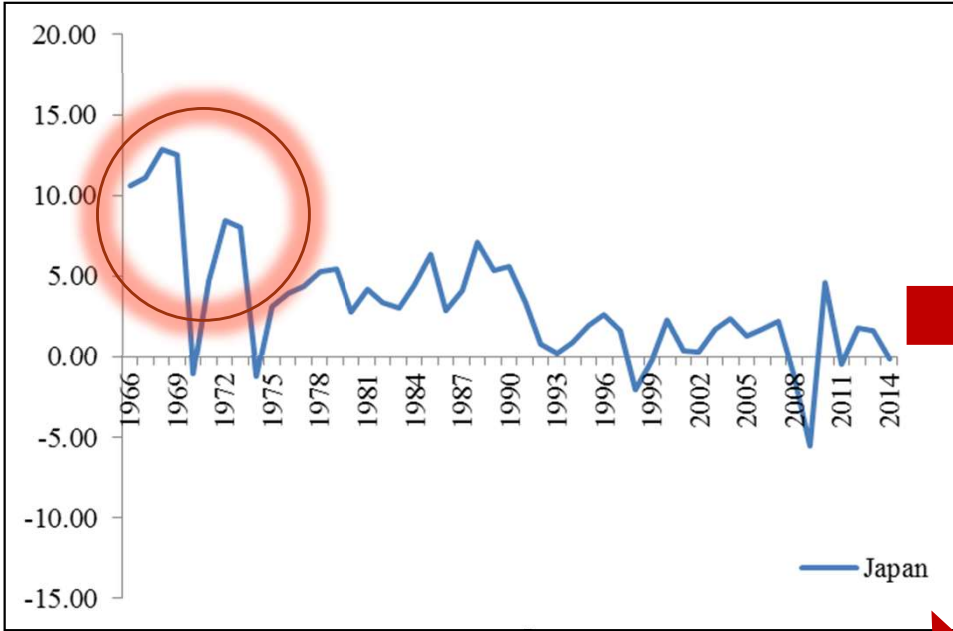
- ❖ In the **1960s**: The 4 tigers (Hong Kong, Korea, Taiwan, & Singapore)
- ❖ In the **late 1970s & the 1980s**, Malaysia, Thailand, Indonesia, & China

## ■ Key Questions

- ❖ What are policies & other factors that involve **government interventions** acting together contributed to East Asia's success?
- ❖ Can other developing countries **replicate** those policies to stimulate equally rapid growth?
- ❖ **How** did East Asia ensure that **the benefits of rapid growth** were spread widely among the population?



# East Asian Miracle





## ■ **Complementing Markets Rather Than Replacing Them**

- ❖ There were ‘2’ **dominant paradigms** for development:
  - **Markets:** Its intellectual roots in Adam Smith’s “**invisible hand**”; markets lead to efficient outcomes.
  - **Governments:** Government exists to ensure through the planning process that resources were deployed in a way that promotes economic growth.
- ❖ **Arrow & Debreu’s (1954) framework:** Markets are to yield efficient outcomes when the following **3 conditions** are met:
  - (1) The absence of externalities;
  - (2) The presence of perfect competition; &
  - (3) A complete set of markets.
- ❖ **Market failures** often occur where these conditions are not met.
  - The government intervenes to correct each market failure (*e.g.*, **pollution taxes to correct for environmental damage**).



## ■ Complementing Markets Rather Than Replacing Them

- ❖ How does the **government intervention** matter?
- ❖ The governments of East Asia recognized **the limitations of markets** but confined the **government's role** to:
  - (1) Policies that actively sought to ensure '**macroeconomic stability**';
  - (2) Making markets work more effectively by '**regulating financial markets**';
  - (3) '**Creating markets**' where they did not exist;
  - (4) Helping to direct investment to ensure that resources were deployed in ways that enhance '**economic growth & stability**'; &
  - (5) Creating an atmosphere conducive to private investment & ensured '**political stability**'.
- ❖ **Rather than replacing markets, various interventions had to be carefully balanced.**



## ■ What were the Major Interventions Taken by the Governments of East Asia?

### 1 Industrial Policies

- > Developing technological strength
- > Promoting exports
- > Building the capacity to manufacture a range of intermediate goods.



### Cooperation & Competition 2



- > **Ties:** Government & business, Workers & employers, small & large businesses.
- > Rewarding well-performing companies

- > Rapid growth, No inequality!
- > Redistribution of income
- > High saving rate



- > Success in exporting provides policy makers with an objective way to award credit & foreign exchange.

### 3 Equality

### Export-led Growth 4



## ■ 5 Reasons: Why were Industrial Policies Adopted?

**1** **Weak & non-existent markets**

- > In East Asia, capital markets were weak, leading government to **create institutions** to promote **savings** (postal savings banks) & to extend **long-term credit** (development banks).
- > Governments tried to develop the financial system by helping establish **bond & equity markets**.

**2** **Technological spill-overs**

- > Developing countries typically operate at a level of technology **far below** that of **industrial countries**.

**3** **Marketing spill-overs**

- > **Governments** adopt programs aimed at **promoting the country's products** (e.g., Japan's reputation for high quality benefits all Japanese products).
- > **Brand recognition**.

**Adopting Industrial policies**



## ■ 5 Reasons: Why were Industrial Policies Adopted?

4

### Coordination failures

>The traditional examples relate to **the development of downstream & upstream industries**: Developing **a steel-manufacturing industry** does not pay unless there is **a steel-using industry**; & developing a steel-using industry does not pay if there is no steel-manufacturing industry.

5

### Strategic negotiations

>The governments **reduce competition among buyers of technology** & try to **increase competition among sellers** in order to appropriate more of the surplus associated with the transfer of technology.  
>In Japan, a single firm was sometimes given the right to negotiate a licensing agreement; it might then be compelled to **share the technology with other firms** in the industry.

Adopting  
Industrial  
Policies





## ■ Cooperation & Competition

### ❖ Cooperation:

- The government of East Asia recognized that the business community had **superior information** about investment decisions (*e.g.*, **formal & informal councils**).
- In Japan, the government tried to **encourage mergers** (*e.g.*, banks).
- In some circumstances, the government approved the formation of so-called **recession cartels** (which is a way to **restrict competition** to enable the industry in question to avoid the low prices that would damage all the firms).
- A guarantee of **lifetime employment**; cooperative ties between **banks & firms**.

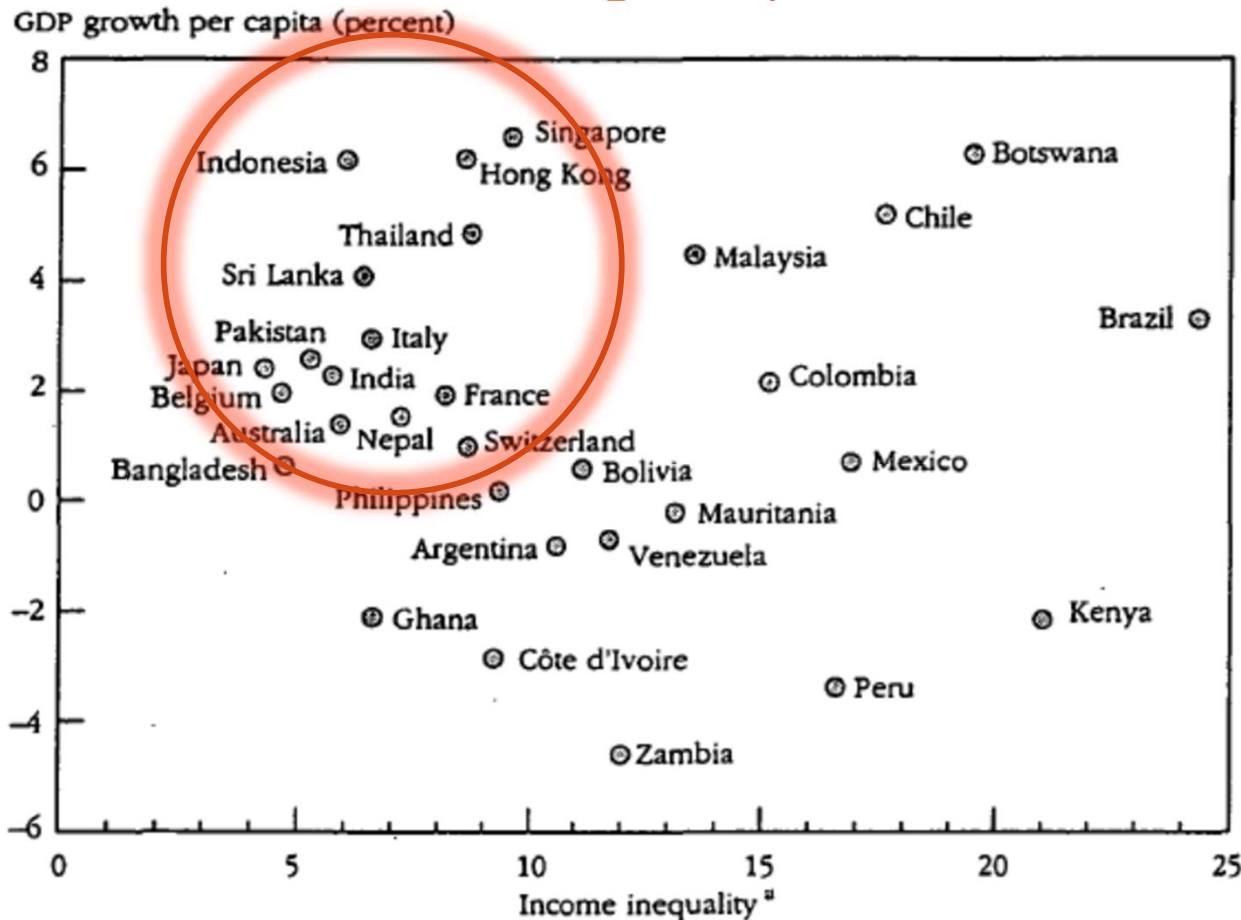
### ❖ Competition:

- Governments **rewarded** firms that performed well relative to others by providing them with **access to capital & foreign exchange**.

# East Asian Miracle



## ■ Growth with Equality



## COMMENTS

Land reforms had **3** major effects on equality:

- (1) The level of **rural productivity & income** (↑) → **savings** (↑);
- (2) Higher incomes provided the **domestic demand** that was important before export markets expanded;
- (3) The redistribution of income contributed to **political stability**, an important factor in creating a **good environment for domestic & foreign investment**.

Notes: Income inequality is measured by the ratio of the income shares of the richest 20% and the poorest of the population. **Original source:** World Bank; **Source:** Stiglitz (1996: 168).



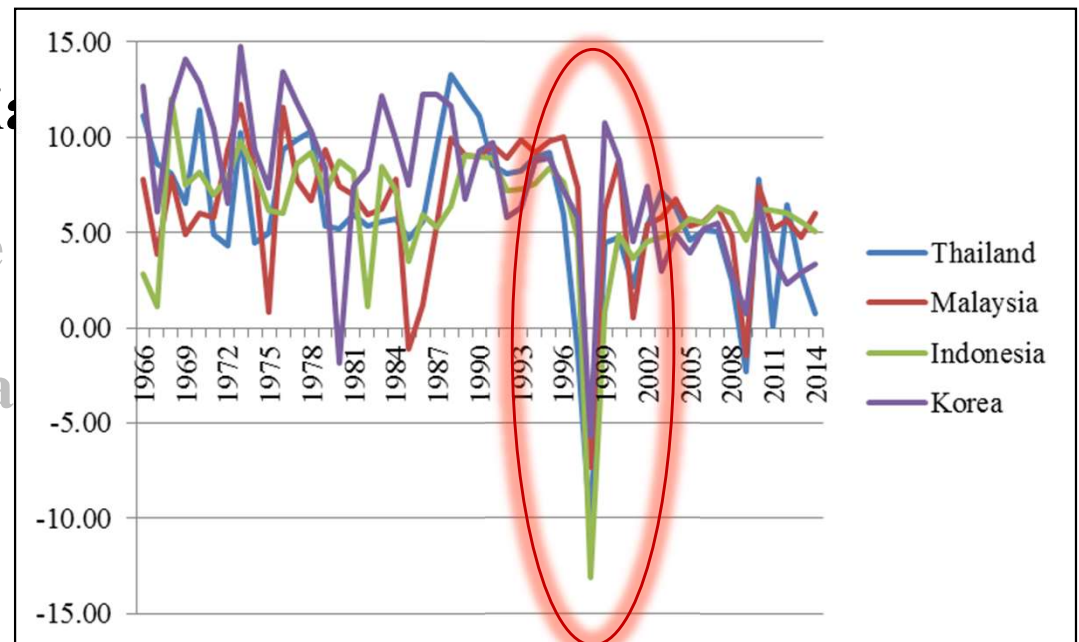
## ■ Export-Led Growth: What Promoted Export Growth?

❖ ‘4’ major export promotion activities:

- **The provision of infrastructure:** Promoting good port facilities & improving transportation systems.
- **Preferential access to capital & foreign exchange.**
- **Developing new export markets:** Singapore’s Economic Development Board has actively worked on **developing foreign markets** & takes an active interest in what goods might be produced for export (*e.g.*, JETRO, KOTRA).
- **Enhancing the reputation of the country’s export:** Because establishing a reputation is expensive for any firm seeking to export, individual firms had little incentive to improve the quality of their products. The government conducted a **concerted effort** to improve **the quality of the products** & to establish **brand reputations** (*e.g.*, Japanese firms) & provided **subsidies**.



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# The East Asian Currency Crisis (Kawai, 1998)



## ■ History

**July 2, 1997:** The de facto devaluation of the Thai baht

**Mid-July, 1997:** In response to a series of speculative attacks, the Philippines, Indonesia & Malaysia allowed currency depreciation either by widening their exchange rate bands or by not intervening heavily in the currency market.

**Mid-August, 1997:** Indonesia decided to abolish exchange rate bands & moved to independent floating to allow further depreciation of the rupiah.

**Late October, 1997:** There was a delayed speculative attack on the Korean won which began to depreciate drastically over the next two months.

**Mid-December, 1997:** Korea also moved to independent floating after widening exchange rate bands a month earlier.



# The East Asian Currency Crisis (Kawai, 1998)



## ■ 5 Causes

- 1** **Worsening of Macro-Economic Conditions**
- > Exports stagnated substantially in 1996 due to **weak demand abroad**.
  - > The real effective appreciation of the baht.
  - > Increased competition from China & Vietnam.
  - > The real effective exchange rates appreciated in Thailand & other ASEAN countries & Korea because of sustained high domestic inflation, the devaluation of China's Renminbi in 1994, & Yen depreciation since mid-1995.

- 2** **Rapid Inflows & Outflows of Short-Term Capital**
- > Relaxing foreign exchange restrictions on capital-account related transactions caused excessive inflows in Thailand & Korea.
  - > Establishment of the Bangkok International Banking Facility (BIBF), an offshore banking center, in 1993.

**Asian monetary crisis in 1997 led to severe credit crunch & economic contraction.**

# The East Asian Currency Crisis (Kawai, 1998)



## ■ 5 Causes

**3** **Inappropriate Exchange Rate Regimes**

> ... adopted exchange rate regimes that did not reflect fundamental patterns of their international transactions by tying their exchange rates to the U.S. dollar. (U.S. dollar's appreciation since mid-1995).

**4** **Financial System Fragility**

> Weak supervision system & disclosure standards.  
> The collapse of the bubble economy in Thailand & the investment boom in Korea resulted in the weakening of their domestic financial institutions.

**5** **Wide-Spread Regional Contagion**

> The ASEAN countries, were perceived to be closely linked with each other in real economic activity & similar in their financial & economic structures, so that the Thai baht depreciation was accompanied by the neighboring countries' currencies.

**Asian monetary crisis in 1997 led to severe credit crunch & economic contraction.**



## ■ Measure of Exchange Rate Pressure

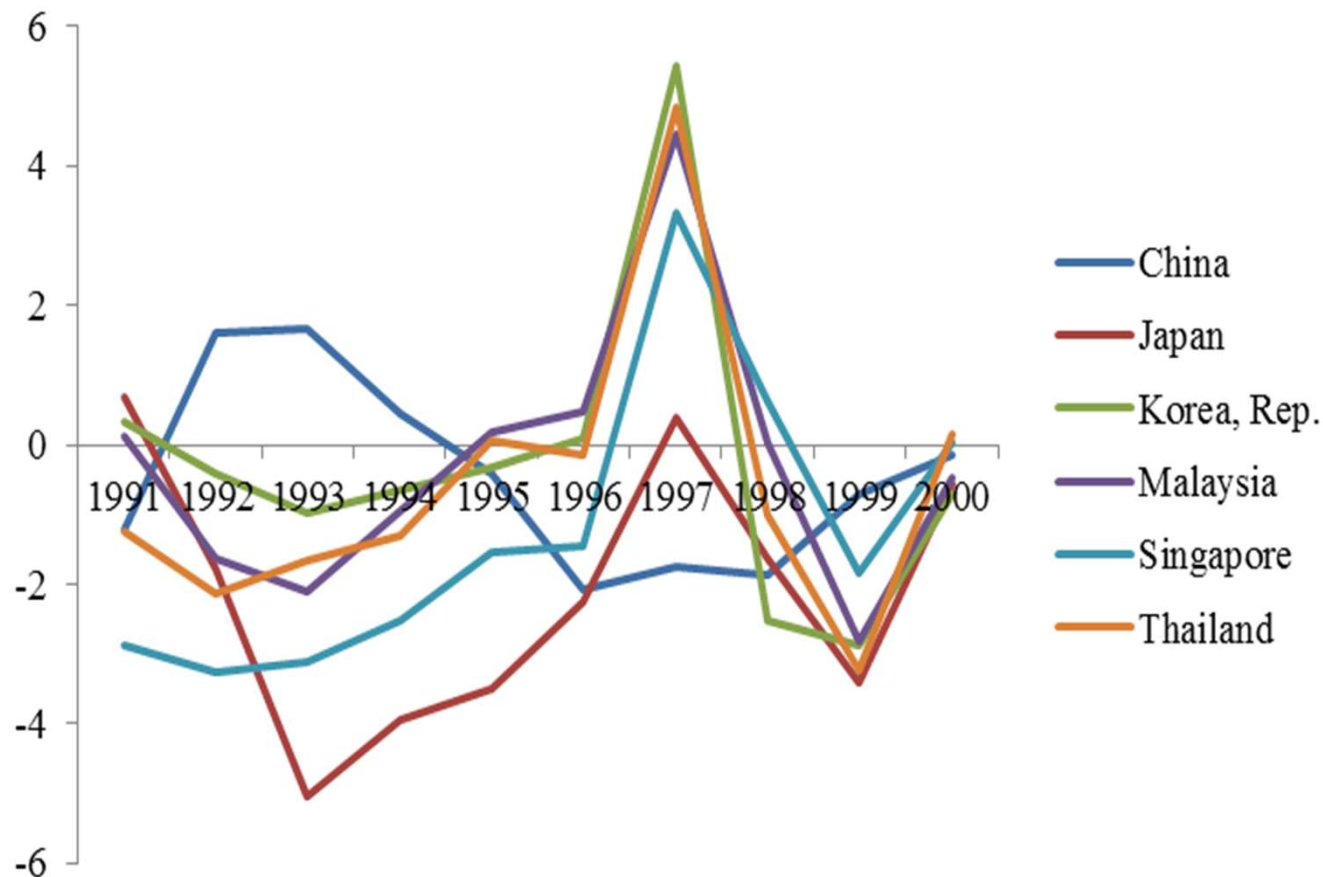
- ❖ The term “**crisis**” indicates the extent to which **speculative pressure** intensively increases on the country’s currency.
- ❖ Major economists (*e.g.*, Eichengreen, Rose & Wyplosz, 1996; Sachs, Tornell & Velasco, 1996; Frankel & Rose, 1996; Cerra & Saxena) developed measures for exchange rate pressure.
- ❖ **Market Pressure Index**  $i,t = \frac{(\% \Delta e_{i,t})}{\sigma_{\Delta e_{i,t}}} + \frac{(\% \Delta i_{i,t})}{\sigma_{\Delta i_{i,t}}} - \frac{(\% \Delta r_{i,t})}{\sigma_{\Delta r_{i,t}}}$
- ❖ ... where  $e$  is the US dollar **exchange rate** (domestic currency/US\$) & the changes in the exchange rate, **interest rate** ( $i$ ) & **foreign reserves** ( $r$ ) are weighted by their respective standard deviations.



# Asian Monetary Crisis: Market Pressure Index



## ■ Measure of Exchange Rate Pressure



### COMMENTS

- > **Korea** shows the highest MPI (**5.43**), followed by **Thailand** (**4.85**) & **Malaysia** (**4.46**).
- > **Singapore** experienced moderate exchange rate pressure on its domestic currency.
- > In sharp contrast, speculative attacks did **not hit China & Japan** so hard.

Source: Own calculation based on data from the Asian Development Bank & the World Bank



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## ■ Lessons from the 1997 Asian Financial Turmoil?

- ❖ Use macroeconomic policy to avoid excessive capital inflows & currency overvaluation;
- ❖ Strengthen the financial system, with proper disclosure & accounting requirements, stringent loan classification & provisioning rules, & capital adequacy requirements, prior to capital-account liberalization;
- ❖ Stabilize exchange rates based on currency baskets that reflect trade & investment linkages.
- ❖ Develop regional financial cooperation with regional surveillance & peer pressure to maintain policy discipline.



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# Conclusive Remarks



## ■ East Asia, East Asia, East Asia !!!



- > East Asia provides a lot of **opportunities** to potential investors due to market size, economic growth, & resource availability.
- > Understanding **cultural variations** in East Asia is helpful to seize more opportunities.



- > A combination of (1) very **high saving rates**, (2) very **high rates of investment**, & (3) **high levels of public education** is believed among economists to cause the rapid economic growth of the Asian economies.



- > **Appropriate** financial deregulation & capital-account liberalization
- > **Transparent practices**, in the form of strong disclosure of institutions' true balance sheets & insider relations
- > **Stable exchange rate policy & regional financial cooperation**

**Li, J. (2003). “Relation-based versus Rule-based Governance: An Explanation of the East Asian Miracle & Asian Crisis”, *Review of International Economics*.**

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## ■ Questions

**Q1: WHAT** is the **main argument** of this paper?

**Q2: WHAT** is the **distinction** between rule-based governance & relation-based governance in terms of definition, nature, & dynamics?

**Q3: WHICH type of governance** is more effective in overcoming transaction & agency costs?

**Q4:** Discuss the **causes** of the “*Asian Economic Miracle*” from the perspective of relation-based governance.

**Q5:** Is relation-based governance a **substitute** for rule-based governance or does it **compliment**?

**Q6: WHY** does the author argue that the **Japanese Model** is based on relation-based governance?



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## ■ What is the Main Argument of this Paper?

- ❖ The author conceptualizes **a theory of relation-based governance** to clarify both the “*East Asian Miracle*” & the “*Asian Monetary Crisis*”.
- ❖ He analyzes the **nature & dynamics** of **relation-based governance** & compare its **benefits & costs** with that of “rule-based governance” in terms of **verifiability, commitment & transaction costs**.
- ❖ He focuses on the **Japanese model** as a **particular relation-based governance structure** & explains **HOW** it is responsible for the “*East Asian Miracle*” & the “*Asian Monetary Crisis*”.



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## ■ Distinction between Rule-based Governance & Relation-based Governance in Terms of “Nature”?

### ❖ Relation-based governance

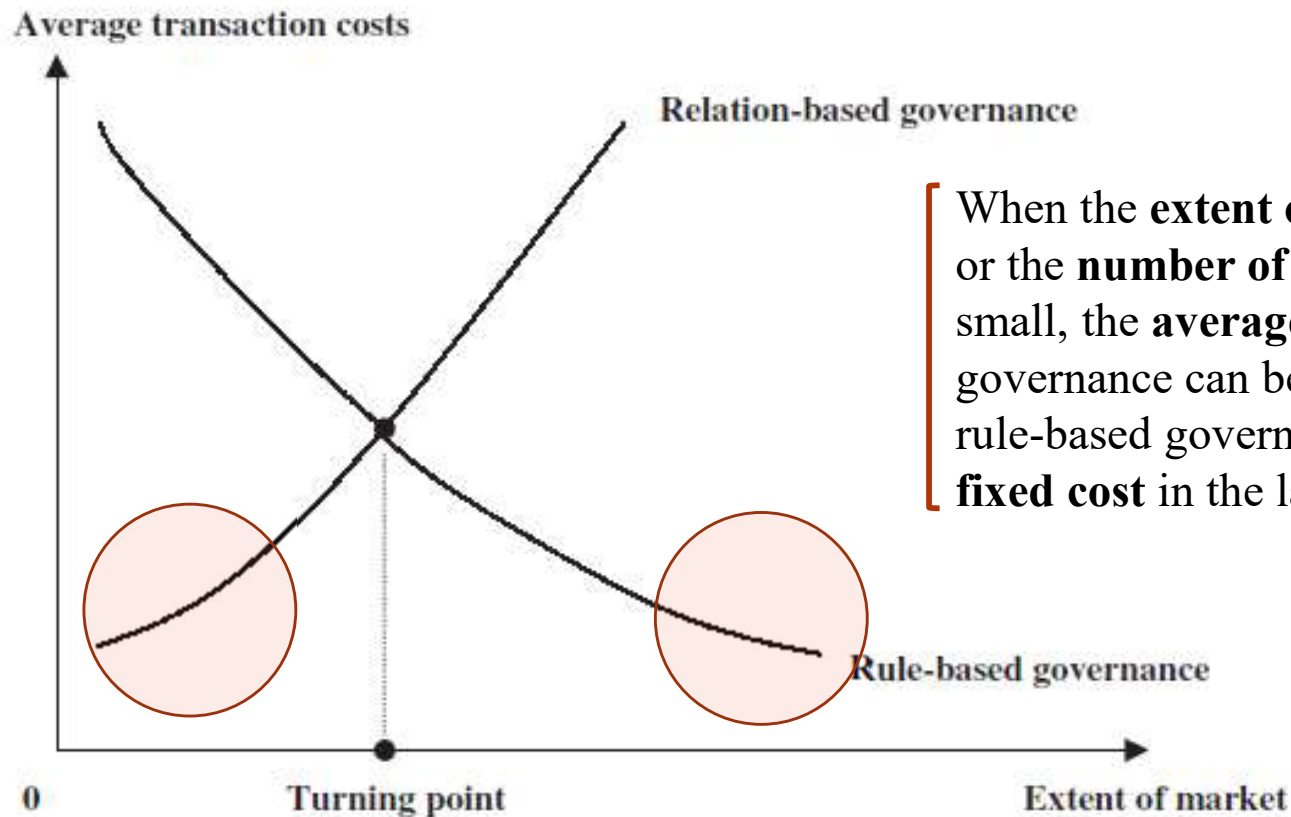
- **Personal & implicit** agreements.
- **“3”** branches of government are **not sufficiently separate, checked, & balanced**. → Political influence dictates the verdict.
- Enforcement by **community sanctions**.
- **Local information** (mutually observable by the ‘2’ transaction parties).
- **Non-verifiable & nontransparent**.

### ❖ Rule-based governance

- Heavy reliance on **public information**.
- **Large transaction costs** (*i.e.*, costs of drafting, interpreting, & implementing contracts & corporate law by the legislative, judiciary, & executive branches)
- Contracts are **explicit, impersonal, & standardized**.
- **Business transactions** are **verifiable** by a third party.



## ■ Average Transaction Cost Curves (“Nature”)

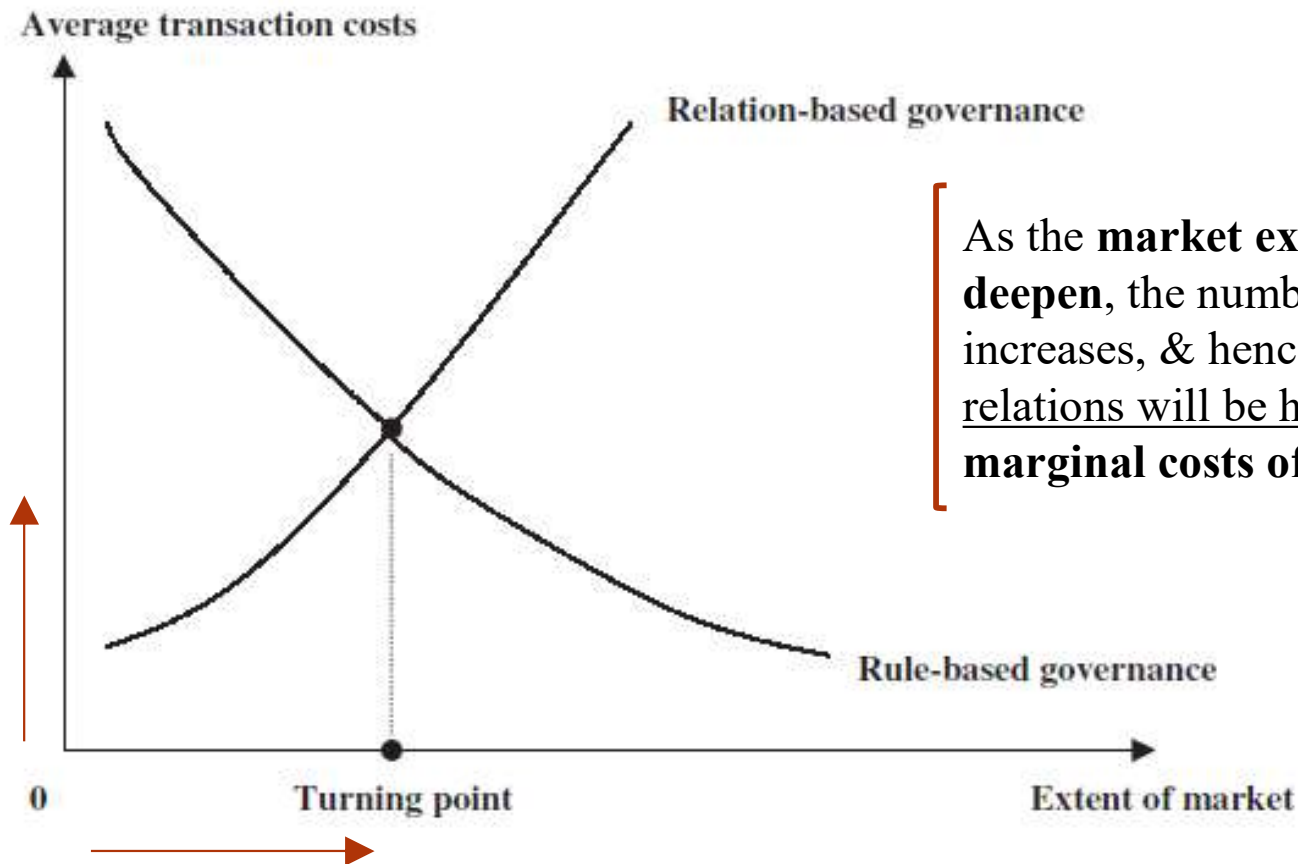


When the **extent of the market** is small, or the **number of transaction partners** is small, the **average cost** in relation-based governance can be **smaller** than that in rule-based governance owing to the **large fixed cost** in the latter.

Source: Li, J. (2003: 660). 'Relation-based versus Rule-based Governance: an Explanation of the East Asian Miracle and Asian Crisis', *Review of International Economics*.



## ■ Average Transaction Cost Curves (“Dynamism”)



As the **market expands & labor divisions deepen**, the number of transaction partners increases, & hence the average cost of relations will be higher due to the **rising marginal costs of private monitoring**.

Source: Li, J. (2003: 660). 'Relation-based versus Rule-based Governance: an Explanation of the East Asian Miracle and Asian Crisis', *Review of International Economics*.



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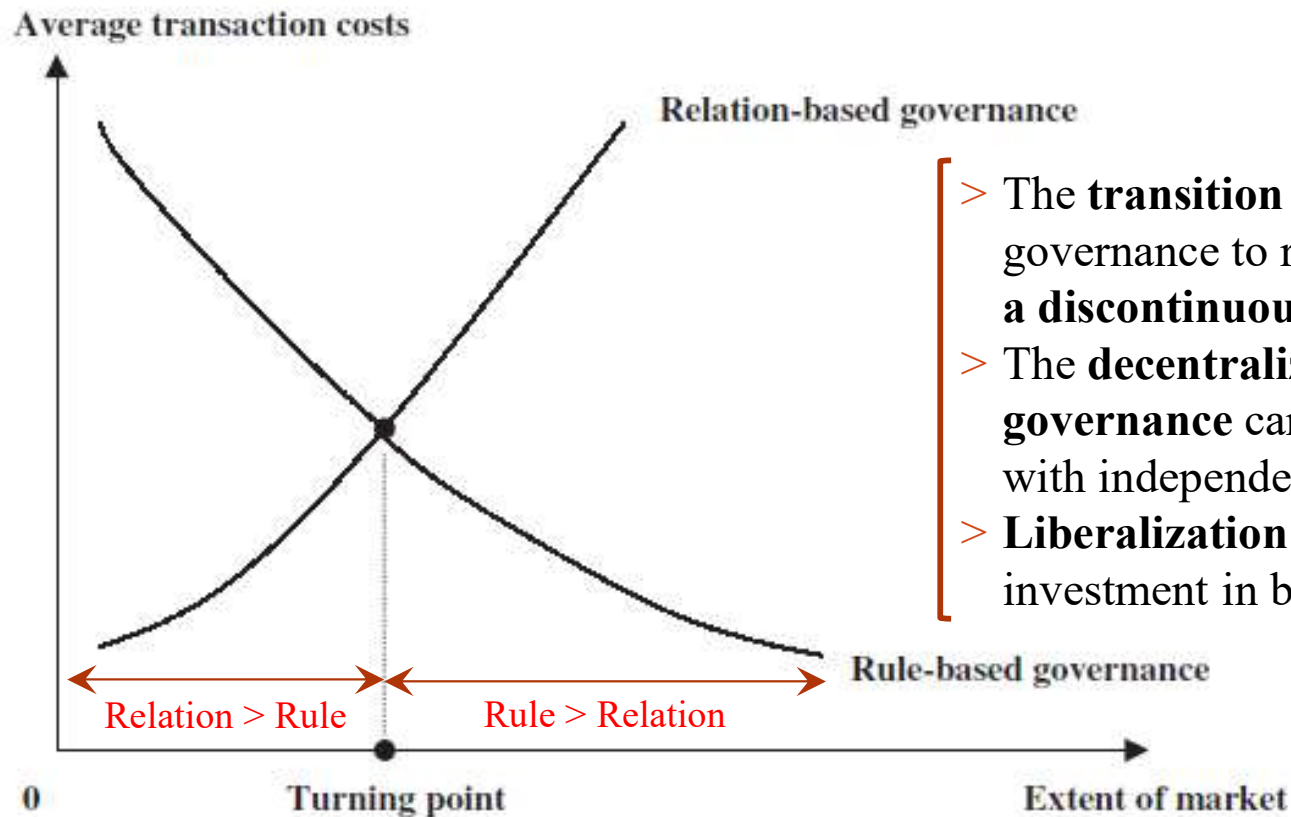
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## ■ Average Transaction Cost Curves (“Dynamism”)



- > The **transition** from relation-based governance to rule-based governance is a **discontinuous process**.
- > The **decentralization** of relation-based governance can result in **corruption** with independent monopolists.
- > **Liberalization & decentralization** is an investment in building **new institutions**.

Source: Li, J. (2003: 660). ‘Relation-based versus Rule-based Governance: an Explanation of the East Asian Miracle and Asian Crisis’, *Review of International Economics*.



## ■ Causes of the Asian Economic Miracle from the Japan Model as a Relation-based Governance

### ❖ ‘3’ Key Features of the Japan Model?

- (1) The government **monitors** banks that **monitor** non-financial firms.
- (2) Owing to **entry restrictions**, **one political party** holds a monopoly in the political sector, **some dozens of banks** are dominant in the financial sector, & **some dozens of industrial groups** are dominant in the industrial sector.
- (3) Agreements are **implicit, personal, & enforced outside of courtrooms**.

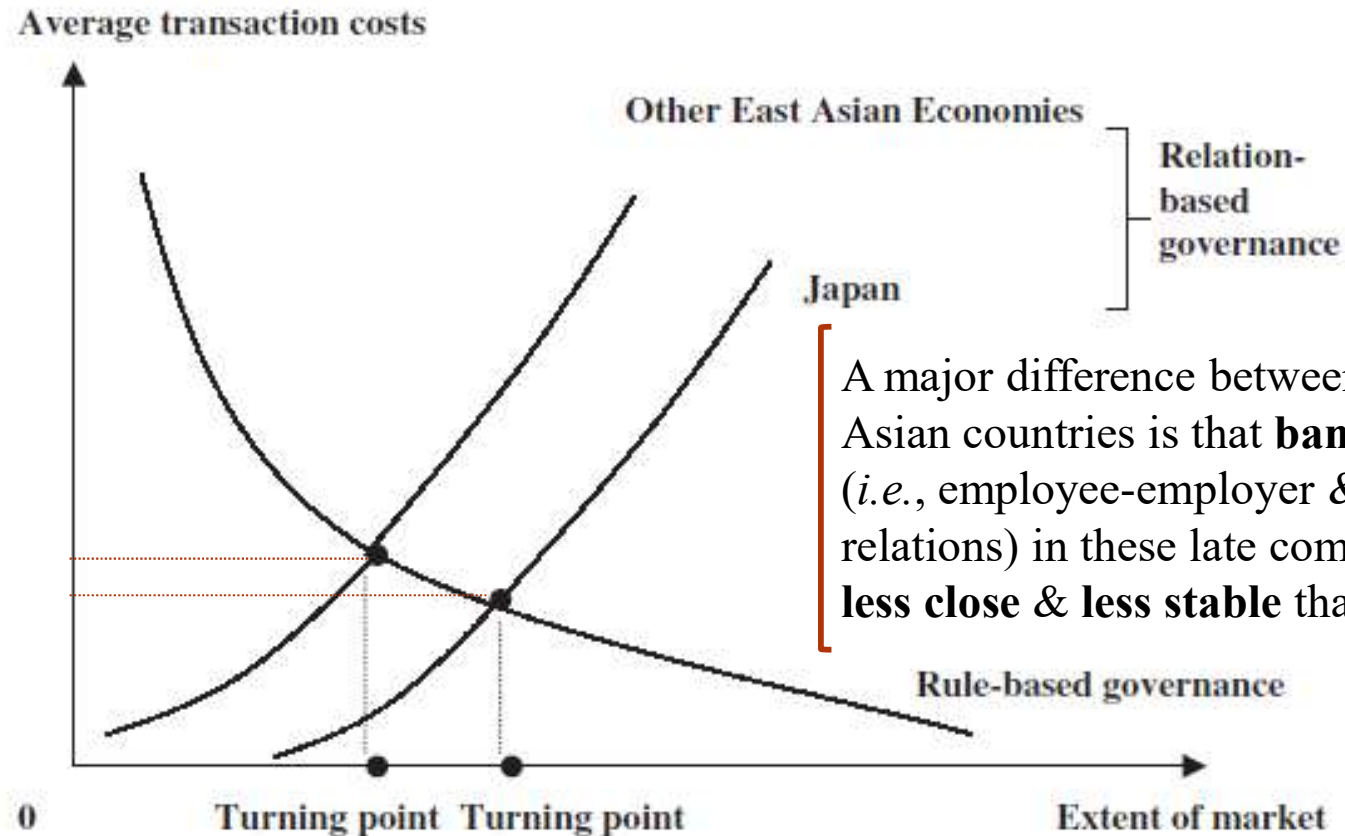
### ❖ ‘6’ Broad Factors in Relation-based Economies?

- (1) Government agencies etc. “**coordinated**” activities & enforce agreements.
- (2) Activities were “**observable**” by the monitor & the monitee.
- (3) The “**number**” of transaction partners/the “**extent**” of the market was “**small**”.
- (4) “**Cross**”-shareholding & “**long-term**” employment.
- (5) Creation of “**a main bank system**” & “**business association/amakudari**”.
- (6) “**Information**” about how to conduct industrial policies.





## ■ Average Transaction Cost Curves: Japan & Other EAs

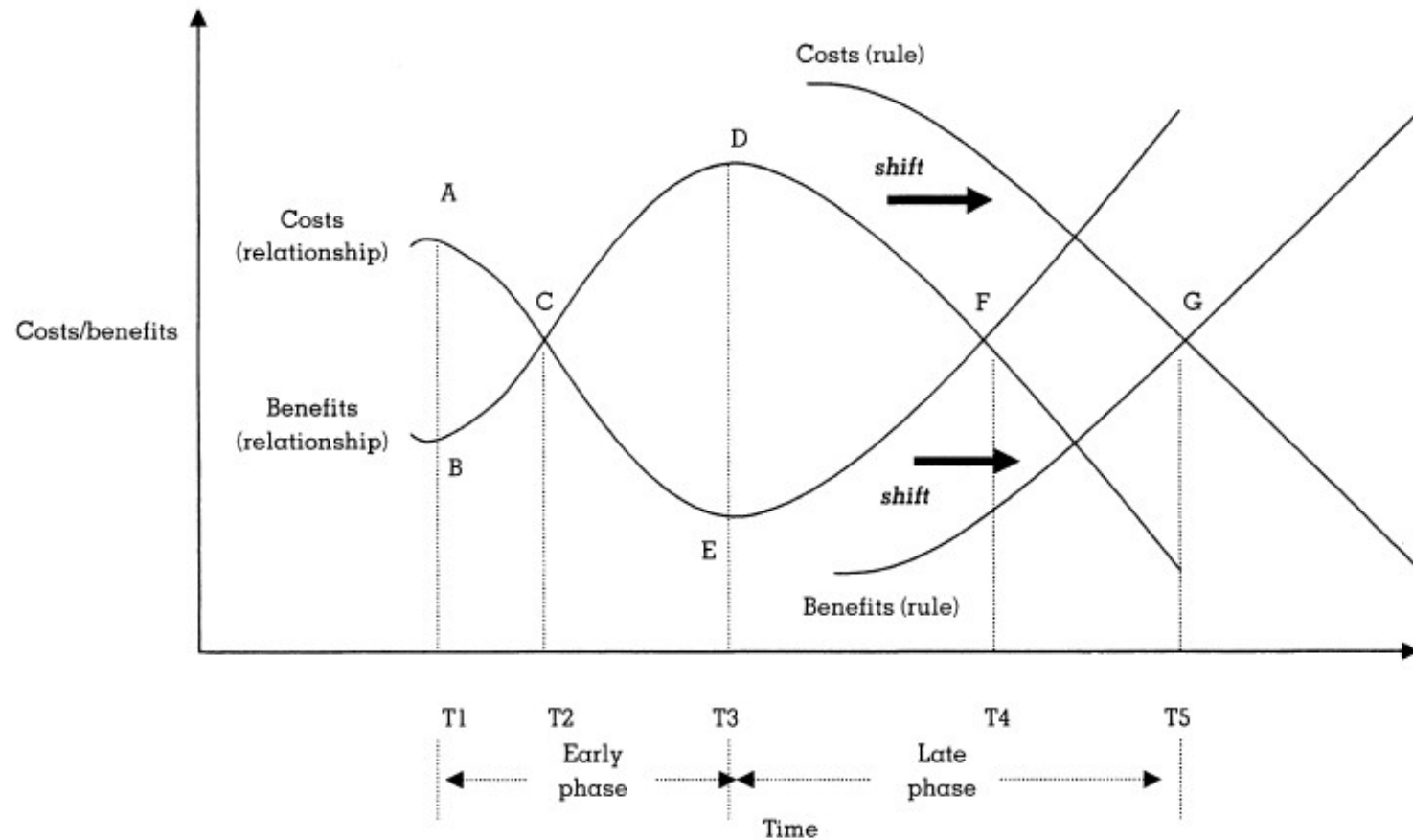


A major difference between Japan & other Asian countries is that **bank-firm relations** (*i.e.*, employee-employer & supplier-buyer relations) in these late comers are generally **less close & less stable** than they are in Japan.

Source: Li, J. (2003: 664). 'Relation-based versus Rule-based Governance: an Explanation of the East Asian Miracle and Asian Crisis', *Review of International Economics*.



## ■ Peng's (2003) Two-Phase Model of Institutional Transition



Source: Peng, M. (2003: 281). 'Institutional Transition and Strategic Choice', *Academy of Management Review*.



## ■ Conclusive Remarks

### ❖ Theoretical Validity

- (1) The theory of relation-based governance can shed some light to understand **the crisis of catching-up economies** in general.
- (2) Relation-based governance is the **norm** in developing & catching-up economies (e.g., southern Africa, Egypt, & Mexico).
- (3) Historically, **financial or economic crisis** has often taken place after **financial liberalization**, especially when **a legal system is not yet well developed** (e.g., Russia suffered from a severe currency crisis in 1998 after its massive economic & political liberalization of the early 1990s.).
- (4) ‘**Economic development**’ is fundamentally a process of establishing relation-based governance & subsequently making **a transition to rule-based governance**.
- (5) There is **little difference** between East & West or between North & South other than they are at different stages of development.

# The End of Today's Lecture



ご清聴有難う御座いました。

**Thank you so much!**

**Vielen Dank für Ihre Aufmerksamkeit!**

**Grazie mille!**

**Merci beaucoup!**

## **【Contact Address】**

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