

**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 “Definition” & “Nature”?

❖ Relation-based governance

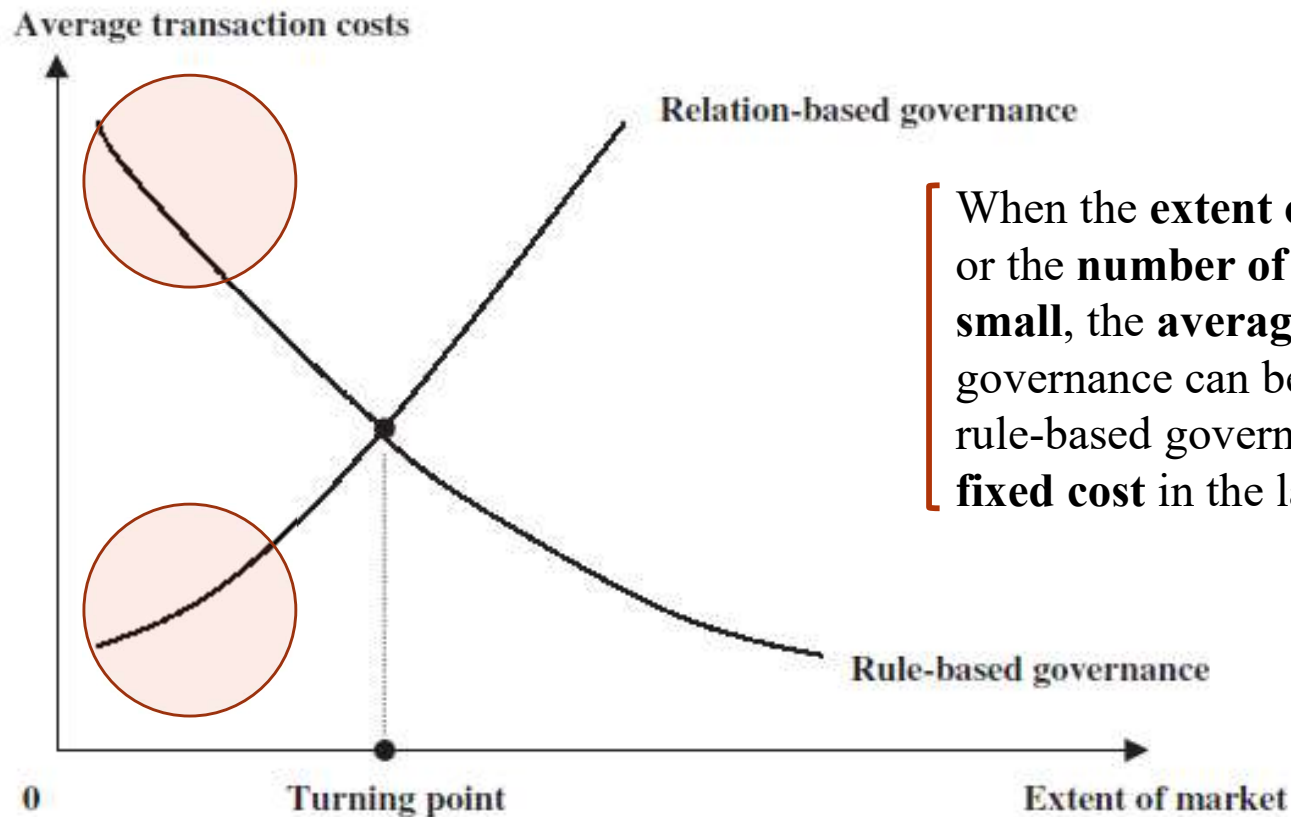
- **Personal** & **implicit** agreements.
- **“3”** branches of government are **NOT sufficiently separate, checked, & balanced**. → Political influence dictates the verdict.
- Enforcement by **community sanctions**.
- **Local information** (mutually observable by the ‘2’ transaction parties).
- **Non-verifiable**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

❖ 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”)

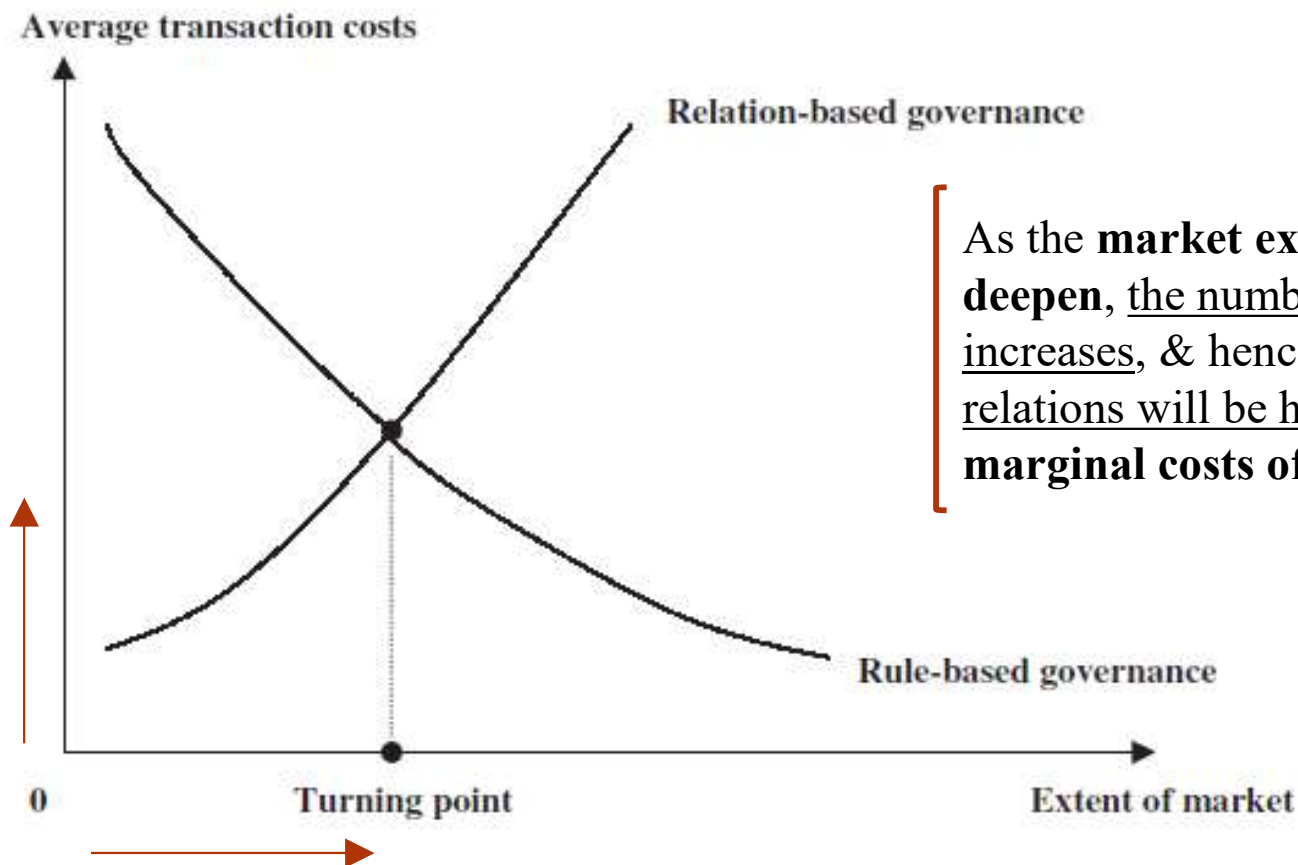


When the **extent of the market** is **small**, or the **number of transaction partners** is **small**, the **average cost** in relation-based governance can be **smaller** than that in rule-based governance owing to the **large fixed cost** in the latter.

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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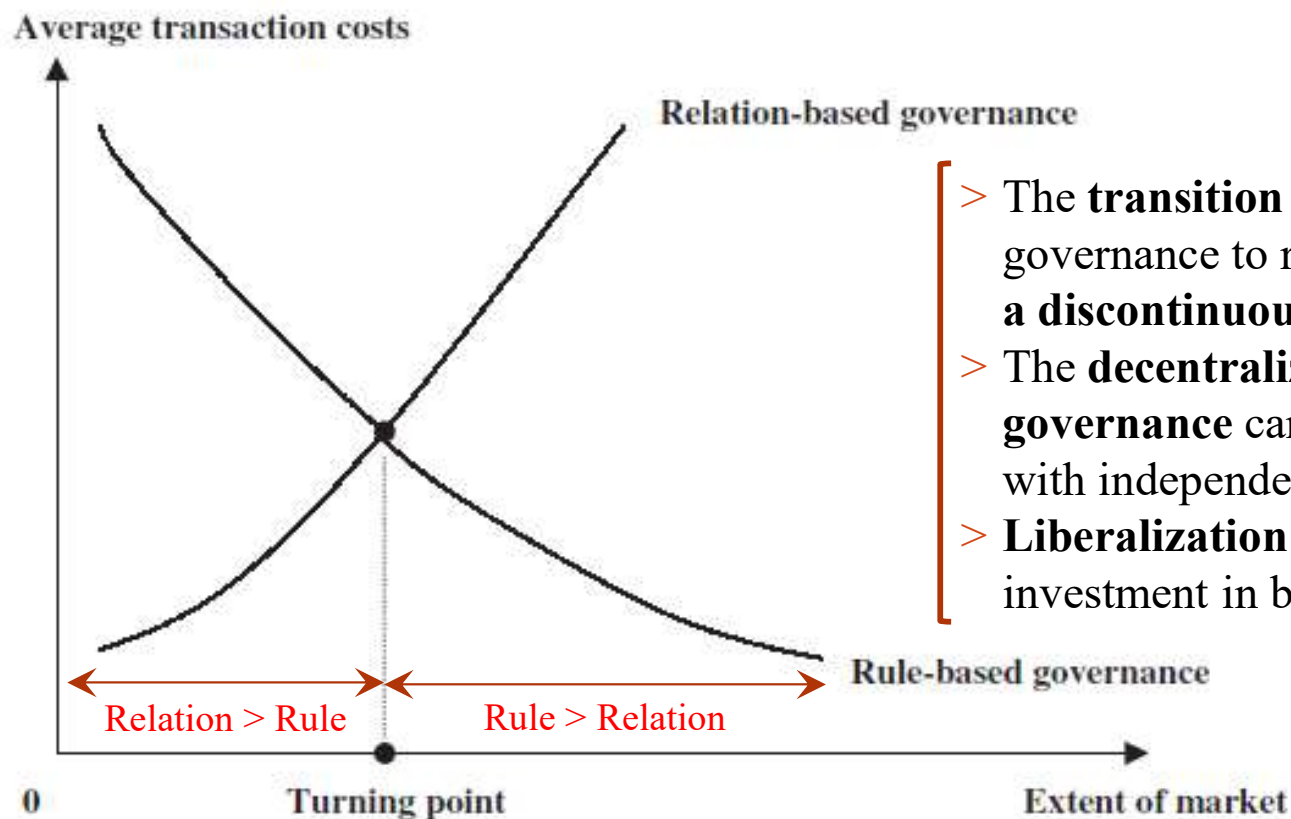
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■ Average Transaction Cost Curves (“Dynamism”)



- > 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?

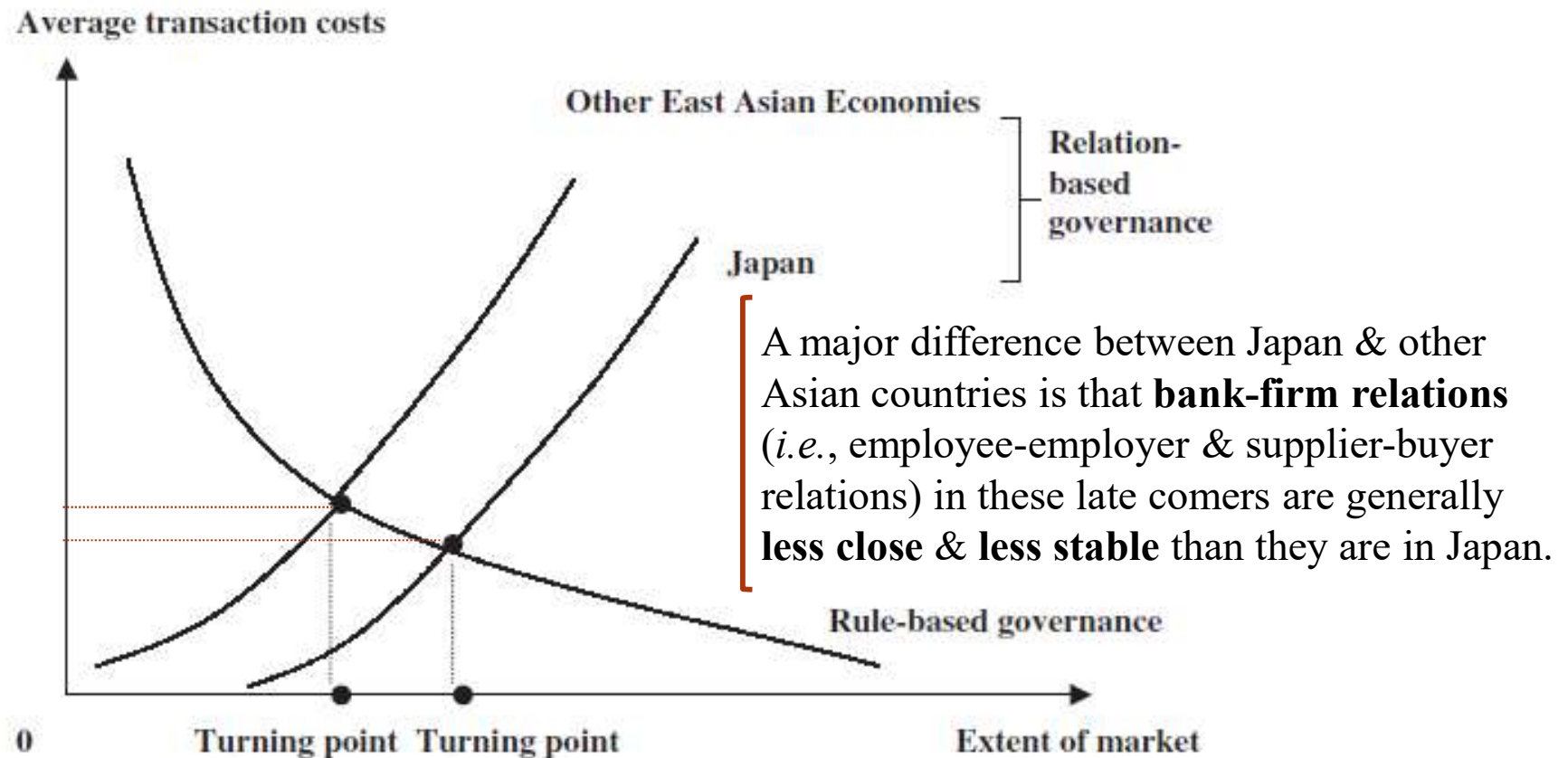
- (1) The government **monitors** banks that **monitor** non-financial firms.
- (2) Owing to **entry restrictions**, **one political party** holds a monopoly in the political sector, **some dozens of banks** are dominant in the financial sector, & **some dozens of industrial groups** are dominant in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

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

- (1) Government agencies “**coordinate**” 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.



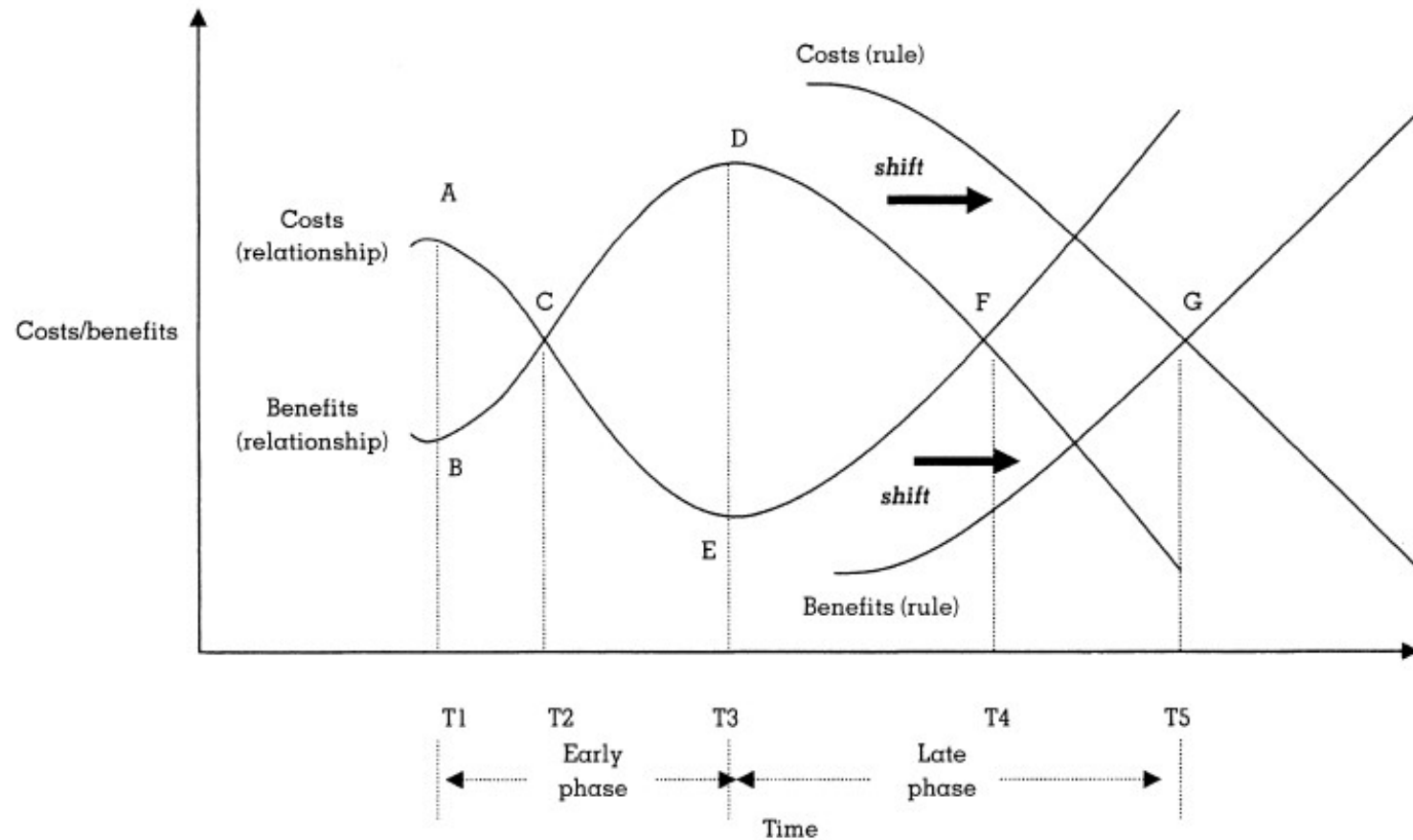
■ Average Transaction Cost Curves: Japan & Other EAEs



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!

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