CHAPTER 2

THE ROLE OF MARKETS, THE STATE, AND INSTITUTIONS

2.1 Introduction

Development requires efficient markets, an effective state, and strong institutions. Markets, prices, and competition are critical for the efficient allocation of resources and creation of entrepreneurial incentives. The state is needed to establish strong institutions, intervene where markets fail to work efficiently, and promote social equity. Strong institutions ensure orderly functioning markets and state accountability. In practice, the state is usually responsible for regulating markets and maintaining the rule of law, providing education and health care, investing in infrastructure, redistributing income through taxes and social protection, managing the macro-economy, and protecting the environment. In many countries, the state is also involved in coordinating development and supporting industries.

In Asia, the role of markets and the state has evolved significantly over the past 50 years. Japan, recovering from the devastation of World War II, relied on market competition and private enterprises to drive growth, while the government proactively promoted investment, manufacturing exports, and technological innovation. These led to more than 20 years of rapid growth from the early 1950s. Many developing Asian economies adopted import substitution industrialization policies with strong state control for nation-building and development immediately after the war. From the 1960s, however, Hong Kong, China; the Republic of Korea (ROK); Singapore; and Taipei,China followed Japan's model and shifted toward export-promotion and market-friendly policies. They grew into what are now known as the newly industrialized economies (NIEs). In the 1970s, Indonesia, Malaysia, and Thailand opened up to trade and foreign direct investment (FDI). They too became high-performing Asian economies during the following 2–3 decades.

Inspired by these successes, more Asian economies from the late 1970s embarked on far-reaching market-oriented reforms and opened up to the outside world. After 3 decades of central planning that led to serious resource misallocation and widespread shortages, the People's Republic of China (PRC) began in 1978 its transition toward a more market-oriented economy. Over the next 40 years, it achieved remarkable development. In South Asia, after decades of state-led industrialization hampered growth, India also began economic reforms in 1991 to reduce government control, rely more on market forces, and open up trade and FDI. As these reforms progressed, development accelerated. From the early 1990s, Central Asian countries started the transition toward market economies after the collapse of the Soviet Union. And in recent years, many Pacific island countries also embraced market-oriented reforms.

Since the 1980s, there has been a growing recognition in development thinking that the quality of governance and institutions matters. Good governance and institutions make countries more likely to adopt the right policies, and once adopted, implement them more effectively. Strong state capacity—a major aspect of governance and institutions—was often considered a key contributing factor to Asia's postwar economic success. Some associate strong state capacity with the so-called "developmental state."[1] In some countries in the region, it has been argued that weak governance led to conflict, instability, and economic failure. In recent years, efforts intensified across Asia and the Pacific to strengthen government effectiveness, regulatory quality, the rule of law, and control of corruption, and to promote transparency, accountability, and wide citizen participation.

[1] World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press.

This chapter reviews the evolving role of markets, the state, and institutions in Asian development over the past half century. Section 2.2 provides a conceptual discussion on the role of markets and the state. Section 2.3 examines the evolution of development thinking and policy. Section 2.4 discusses the rising importance of good governance and strong institutions in recent development thinking. Sections 2.5–2.12 look at country experiences of markets, the state, and policy reforms. Section 2.13 highlights future policy priorities.

2.2 The role of markets and the state

The role of markets and the state is one of the most important issues in development policy. There is now a consensus globally and in Asia that markets, prices, and competition should play the dominant role in resource allocation and in driving economic growth. But there are areas where market solutions fail to deliver socially optimal outcomes, and state intervention is needed to address these market failures. The state plays an important role in establishing strong institutions and promoting social equity.

Markets, prices, and competition have existed for several thousand years in human history. The idea they can act as an "invisible hand" to efficiently allocate resources was conceptualized by the British economist Adam Smith in his 1776 work, *An Inquiry into the Nature and Causes of the Wealth of Nations*.[2] Smith theorized that the unobservable market forces driven by profit motives of private actors could ensure optimal resource allocation, leading to the sustained creation of wealth. Since then, this free market doctrine has had a profound influence on economic thinking and policymaking across the world.

But relying on markets for resource allocation does not preclude the important role of the state. Even in ancient times, there were rules and laws introduced by the state to protect private property and support fair market transactions. In the PRC, for example, these can be traced back to the Qin dynasty (221–206 BC).[3] Historically, it was also common for the state to provide public infrastructure such as roads and irrigation. Dujiangyan, a massive water control and

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[2] Smith, A. 1776. *An Inquiry into the Nature and Causes of the Wealth of Nations*. London: William Strahan and Thomas Cadell.

[3] Qian, M. 2013. *Chinese Economic History* [in Chinese]. Beijing: Beijing United Publishing House.

irrigation system built by the government in 256 BC in today's Sichuan Province, still plays an important role.

Modern economic theory highlights several important roles governments can play in a market economy.

The first is to establish institutions that help create markets and support their orderly functioning. This requires a government to introduce laws and regulations that maintain rule and order, protect property rights (including intellectual property), enforce contracts, ensure fair competition, maintain financial stability, and protect consumers. These are all essential institutions in a modern market economy that underpin trade, investment, and innovation. Currencies and central banking are parts of these institutions as well. Reforms that strengthen laws and regulations to foster open trade and investment regimes have been key elements of the region's economic success over the past half century (Chapter 9).

The second relates to what are known as "market failures" and "public goods" in economic theory. Government intervention is needed to address market failures that arise due to "externalities," "imperfect competition," and "information asymmetry," all making market solutions inefficient. Monopolies often arise due to high initial investment costs that deter potential competitors from entering markets. Regulation is needed to ensure they do not engage in unfair pricing and market practices. Banks need government regulation because they know more on their liquidity and solvency condition than their diverse deposit account holders. Externality can be either positive or negative—it exists when private costs or benefits deviate from the costs or benefits to society as a whole. One important example of negative externality is environmental pollution, where the social cost is not borne by polluters. Pollution must be addressed by governments through regulations and taxes (Chapter 13).

One important form of market failure relates to public goods—such as flood control, street lighting, police services, diplomacy, and national defense. Markets cannot provide these services efficiently because they are non-excludable (difficult to charge a fee) and non-rival in consumption (consumption by one person will not reduce consumption by others). Education and public health can be provided for specific consumers and paid for by charging fees—but they are considered "quasi-public goods" because of their large positive externality to the society (Chapters 6 and 8).

The third is to promote industries and support innovation. Governments in both developing and developed countries have used targeted "industrial policies" to support "infant industries" or, more generally, domestic industries, using a range of instruments such as tariffs and subsidies, especially at the early stage of development. Governments have also promoted research and development (R&D), for instance, by providing tax incentives and giving access to preferential credit through government-affiliated financial institutions. In the United States (US), government support to the National Aeronautics and Space Administration (NASA) and defense technology led to the development of new industries and later to commercial applications of new technologies (for example, the internet, the global positioning system, and advanced medicine). Governments can address "coordination problems" among multiple private players. For example, in many Asian countries, governments provide guidance for private investment through long-term plans, public investment, and financial incentives to promote industrial clusters and foster new, strategic sectors (Chapter 5).

The fourth is to maintain macroeconomic stability. In a modern market economy, the government plays an important role in managing business cycles and maintaining macroeconomic stability through monetary and fiscal policies. This idea gained wide acceptance after the Great Depression began in 1929, and underpinned the New Deal policies of the US and similar policies in Europe and Japan during the 1930s. British economist John Maynard Keynes' 1936 *The General Theory of Employment, Interest and Money* provided the theoretical argument for using active fiscal policies to cope with economic downturns when aggregate demand was deficient.[4] Monetarist theory in the 1960s highlighted the importance of stable and rule-based money supply to maintain economic stability and control inflation.

Over time, new theories and ideas of fiscal and monetary policies emerged, sometimes leading to contradicting policy prescriptions. Nevertheless, today there is a broad consensus that governments should use fiscal stimulus and monetary easing in times of economic downturns, and fiscal and monetary tightening in times of overheating. During the 2008–2009 global financial crisis, central banks in many developed countries injected large amounts of liquidity to support banks. After the crisis, they combined quantitative monetary easing

[4] Keynes, J. M. 1936. *The General Theory of Employment, Interest and Money*. London: Macmillan.

with countercyclical fiscal measures to support economic recovery. However, there is much less agreement on how to deal with prolonged slow growth with very low inflation in the developed world, a problem in recent years (Chapter 10).

The fifth is to promote equitable income distribution. Free markets do not automatically generate equitable income distribution because of differences in people's inherited wealth and access to opportunity such as land, finance, and education, for example. Excessive inequality in income and asset distribution is both unfair and detrimental to economic development and wealth creation. Government intervention is needed to address poverty and income inequality through taxation and spending on education, health, and social protection (Chapter 11). Promoting gender equality is also an important policy priority (Chapter 12).

Governments in Asia and the Pacific have done all these, although there were wide variations in policy priorities across countries and over time. And there are differences in views among countries and scholars on how proactive government should be.

The view in favor of a proactive government and government intervention has often been contested. One argument from the 1960s that became stronger in the 1980s was about "government failure."[5] The argument was that excessive government intervention can introduce new distortions leading to large deviations from optimal resource allocation. Government failure can arise when production subsidies protect inefficient firms; consumer subsidies (such as for energy and water) encourage inefficient and excessive consumption; price regulations cause shortages or overproduction; and excessive welfare payments lead to moral hazard, abuses, and fiscal imbalances.

Another argument relates to the effectiveness of industrial policy. Targeted industrial policy has often been criticized as it can lead to rent-seeking, unfair competition, and inefficiency over time. However, as discussed, it is widely accepted that industrial policy has a role to play, especially at the early stage of development. Many consider industrial policy useful even in more advanced development stages, especially where there are significant positive spillovers such as innovation, or when coordination is essential, such as in developing new, nontraditional industries. Many also believe that industrial policy will more likely succeed when it is performance-based and promotes

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5 Krueger, A. 1990. Government Failures in Development. *Journal of Economic Perspectives*. 4 (3). pp. 9–23.

competition, and if it is implemented transparently with clear policy targets, sunset clauses, and an effective implementation mechanism.[6]

Finally, there is an argument that giving government too much power can potentially create problems of policy biases, "elite capture" (privileged elites abuse rules), and usurpation. This is the rationale for checks and balances, accountability and transparency, control of corruption, and wide citizen participation as key elements of good governance (section 2.4).

2.3 Evolving development thinking and policy on market versus state

In practice, the role of the state in an economy, especially in promoting industrialization and economic development, differs significantly across countries and over time. These variations reflect differences in country history, political system, policy experience, and stage of development. They are also influenced by changes in development thinking and shifts in policy paradigm.

State-led industrialization after World War II

After World War II, state-led industrialization dominated economic policy across the developing world. Many countries gained independence from colonial rule but were mired in widespread poverty. There was a strong desire to accelerate the pace of development and catch up with advanced countries through industrialization—which was also considered a matter of national pride and regaining economic independence from foreign powers. Because industrialization required large-scale investment, it had to be led by the state—as only the state had the power to mobilize the needed resources. Moreover, socialism was gaining wide acceptance across a large part of the developing world given the Soviet system's ostensible success. Socialist countries such as the PRC pursued centrally planned industrialization.

State-led industrialization strategies of the 1950s–1970s, accompanied by "import substitution" trade policies, had intellectual backing. New economic ideas, such as the "big push" (through coordinated large investment),[7] "unbalanced growth" (emphasizing

[6] Rodrik, D. 2004. Industrial Policy for the Twenty-First Century. *KSG Working Paper Series*. No. RWP04-047. Cambridge, MA: Kennedy School of Government, Harvard University.

[7] Rosenstein-Rodan, P. 1943. Problems of Industrialisation of Eastern and South-Eastern Europe. *Economic Journal*. 53 (210/211). pp. 202–211.

targeted industries and concentrated investment in specific industries),[8] the "dual economy" (considering the transfer of surplus labor from rural subsistence to urban capitalism as a key source of growth),[9] and "stages of growth" (traditional society, precondition for takeoff, the stage of takeoff, drive to maturity, and age of mass consumption),[10] attracted a great deal of attention among both academics and policy makers. A common belief of these ideas was that poor countries, which failed to generate sufficient investment for economic growth and were stuck in a low-level equilibrium trap, needed state interventions such as coordinated investment programs in order to break out of the trap.

State-led industrialization needed state-owned enterprises (SOEs) to implement large investment in key sectors, especially capital-intensive heavy industries. And it was often supported by import substitution. High tariffs would protect domestic infant industries. Also, as industrialization required importing capital goods and developing countries uniformly faced foreign exchange constraints, import substitution was also considered a way to save on foreign exchange.

The import substitution policy was also influenced by the then popular "dependency" or "center–periphery" theory that sees increases in the wealth of advanced nations as coming at the expense of developing countries. According to this theory, rising prices of industrial products relative to primary commodities caused terms of trade to deteriorate for developing countries and were a major cause of their economic problems. These ideas advocated an inward-looking approach to industrial development.[11]

The state's active role in the economy and public ownership of key industries was widely accepted by developed countries as well after World War II, especially in Europe, as many governments already had large-scale control of the economy when the war ended. Furthermore, socialist ideology and concerns over market failure strongly influenced government policy. In the United Kingdom (UK) and France, for example, many industries were nationalized after the war.

8 Hirschman, A. 1958. *The Strategy of Economic Development*. New Haven: Yale University Press.
9 See Lewis, W. A. 1954. Economic Development with Unlimited Supplies of Labor. *The Manchester School*. 22 (2). pp. 139–191.
10 See Rostow, W. 1959. The Stages of Economic Growth. *Economic History Review*. 12 (1). pp. 1–16.
11 Prebisch, R. 1962. The Economic Development of Latin America and Its Principal Problems. *Economic Bulletin for Latin America*. 7 (1). pp. 1–23.

While these ideas and development theories significantly affected economic policy in the developing world for a considerable time, their influence was limited in some Asian economies, including Japan, the NIEs, Malaysia, and Thailand. From early on, these economies moved away from import substitution toward outward-oriented and market-friendly policies.

Shifting to market-led growth since the 1980s

From the late 1970s, economic policy shifted in some developed countries away from strong state intervention toward greater reliance on free markets, and it influenced the policies in developing countries.

One reason was the poor performance of nationalized industries and the observed inefficiencies of the economy more generally in many developed countries. Around that time, there was a rise of “neoliberal” economic philosophy in the West. Rooted in the classical liberalism of the 19th century, neoliberal economic thinking advocated free markets, private enterprise, and minimum government intervention. This ideology was embraced by the Margaret Thatcher government in the UK (1979–1990) and the Ronald Reagan administration in the US (1981–1989). In the UK, many nationalized industries were privatized in the 1980s. In Asia, Japan also privatized several public corporations during the period, including the Japanese National Railways and the Nippon Telegraph and Telephone Corporation, and, more recently, Japan Post (including postal savings).

The neoliberal economic thinking also had a significant impact on economic policy in the developing world, especially in Latin America, which experienced a “lost decade” in the 1980s due to a region-wide debt crisis. The crisis had external causes—including the two oil price shocks in the 1970s—but also had roots in domestic policy. It was believed that excessive state intervention and trade protection made Latin American economies inefficient and uncompetitive.[12] This led to policy discussions that focused on government failure and the belief that it could be worse than market failure. In response to the debt crisis, multilateral financial institutions and bilateral lenders provided financial assistance based on “structural adjustment programs”—that came with policy conditions following neoliberal economic thinking. The policy advice, later known as the

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[12] Ferguson, R. W. 1999. *Latin America: Lessons Learned from the Last Twenty Years.* Speech given to the Florida International Bankers Association, Inc. Miami. 11 February.

"Washington Consensus," called for growth led by free markets and for liberalization, deregulation, and privatization.

In the 1980s, there was a wave of market-oriented reforms in other parts of the developing world as well as socialist countries. The former Soviet Union and Central and Eastern European countries started economic reforms from the mid-1980s in an attempt to revive their stagnant economies (before the Soviet system collapsed in 1991). In Asia, economic difficulties in the PRC due to the Cultural Revolution, the fiscal crisis in Indonesia at the end of the oil boom in the mid-1980s, and the weak economic performance and balance of payments crises in South Asia triggered a review of policies in many countries. The PRC launched market-oriented reforms in 1978, Viet Nam in 1986, India in 1991, and Central Asian countries in the 1990s after independence. These reforms were also inspired by the impressive economic achievements in Japan, the NIEs, and several Southeast Asian economies.

Over the past 20 years, however, there have been growing criticisms over neoliberal policy and the Washington Consensus.[13] Radical reforms mechanically following the Washington Consensus without due consideration of countries' circumstances did not lead to better economic performance, especially in Latin America and Africa. The "shock therapy" of rapid liberalization and mass privatization plunged the Russian economy into years of deep recession. On the other hand, many believed that the PRC's economic success was the result of gradual reforms combining market forces with state intervention.[14] The 2008–2009 global financial crisis also highlighted the problem of overreliance on unfettered market forces.

The discussion on the role of market and state will continue. This book's position is that the PRC's success is essentially due to market-oriented reforms after 1978. More broadly, the policies pursued in Asia can be explained by standard economic theories and may not be so different from those prescribed by the Washington Consensus. What made the difference was that many Asian countries took a pragmatic approach to implementing these policies.

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[13] Stiglitz, J. 2016. The State, the Market, and Development. *WIDER Working Paper*. No. 2016/1. Helsinki: United Nations University World Institute for Development Economics Research.

[14] Lin, J. Y. 2012. *New Structural Economics: A Framework for Rethinking Development and Policy*. Washington, DC: World Bank.

2.4 Importance of good governance and strong institutions

Since the 1980s, there has been growing recognition of the importance of good governance for sustained economic growth and wealth creation in development thinking. This followed the growing influence of "new institutional economics" in the 1980s.[15] Empirical observations show that country economic performance depends not only on the nature of policies pursued by government, but also the quality of governance and institutions.[16] The same government interventions can lead to different outcomes depending on the quality of governance and institutions.

It is now widely agreed that governance is about how the government exercises its power in managing a country's economic and social resources. Good governance requires transparency, accountability, and wide citizen participation; rule of law and political stability; and control of corruption. Good governance also requires strong state capacity to design and implement good policies. Asia's development experience thus far suggests that strong state capacity must be supported by competent bureaucracy, and success is also often associated with forward-looking and visionary political leaders.[17] There have been efforts to promote good governance in Asia and worldwide in the past 20–30 years.

Good governance and strong institutions are preconditions for market forces to efficiently allocate resources, for maintaining fairness within society, and for achieving sustained and inclusive growth. Institutions are either formal or informal. Formal institutions refer to constitutions, statutes, and explicit rules and regulations enforced most importantly by the state with its coercive power. Informal institutions, on the other hand, include the unwritten rules such as traditions, norms and codes of behavior, taboos, and other social mechanisms based on and enforced through interpersonal ties and relationships.

Development practitioners have devised various measures to assess the quality of governance and institutions, but they are mostly focused on six dimensions: (i) voice and accountability, (ii) political stability and the absence of violence, (iii) government effectiveness,

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15 North, D. 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.

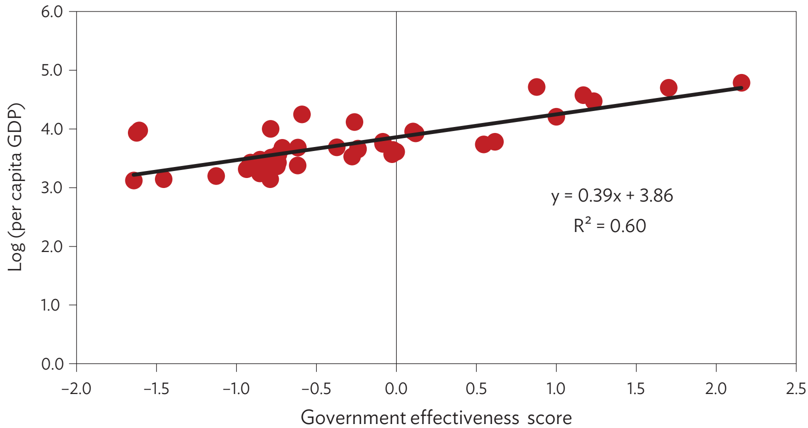
16 Acemoglu, D., and J. A. Robinson. 2012. *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*. New York: Crown Publishing Group.

17 World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press.

(iv) regulatory quality, (v) the rule of law, and (vi) control of corruption.[18] A global cross-country study by the Asian Development Bank (ADB) finds a positive association between the quality of governance and pace of economic development.[19] This relationship varies across different dimensions of governance, depends on a country's stage of development, and differs among individual indicators of development (such as the growth rate, poverty reduction, education, and health).

In Asia, the same ADB study found that government effectiveness has the highest correlation with per capita gross domestic product (GDP) (Figure 2.1), followed by regulatory quality. The study also found that government effectiveness and regulatory quality have a much stronger correlation with the pace of economic growth in Asia than other regions of the world.

Figure 2.1: Government Effectiveness Score and Per Capita GDP in 2011, Developing Asia



GDP = gross domestic product.

Source: Asian Development Bank. 2013. *Asian Development Outlook 2013 Update: Governance and Public Service Delivery*. Manila.

[18] Kaufmann, D., A. Kraay, and M. Mastruzzi. 2007. The Worldwide Governance Indicators: Answering the Critics. *Policy Research Working Paper*. No. 4149. Washington, DC: World Bank.

[19] ADB. 2013. *Asian Development Outlook 2013 Update: Governance and Public Service Delivery*. Manila.

Countries at different stages of development may face different constraints.[20] At the low-income stage, igniting growth is a priority, and government effectiveness (that ensures adequate investment in education and infrastructure) and regulatory quality (that promotes private investment) are important. At a higher income level, the development priority will likely be sustaining growth, and transparency, accountability, and wide citizen participation could become more important.

These findings appear to support the argument that strong state capacity played a critical role in producing Asia's economic "miracle." Visionary political leaders, such as President Park Chung-hee in the ROK, Prime Minister Lee Kuan Yew in Singapore, Prime Minister Mahathir Mohamad in Malaysia, and reformist leader Deng Xiaoping in the PRC, provided long-term visions and guidance for economic and social development. Competent and politically neutral bureaucracies based on meritocracy played an important role in achieving these visions, through development planning, industrial policies, and effective implementation.

Some have argued that the workings of informal institutions also contributed to Asia's postwar economic success.[21] Examples include a diligent work ethic, prioritizing education, and a strong sense of trust and cooperation in society. For instance, according to the World Values Survey, trust among people in Asian countries measured higher on average than the rest of the world.[22] Grameen Bank, a microfinance institution and community-based development organization founded in Bangladesh, is another example of how formal and informal forces can work together to support development.

A related concept is "social capital," which is a subset of informal institutions and focuses on social relationships, networks, and associations that create shared knowledge, mutual trust, social norms, and unwritten rules. Some argue that social capital can bridge

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[20] Rodrik, D. 2008. Thinking about Governance. In North, D., D. Acemoglu, F. Fukuyama, and D. Rodrik, eds. *Governance, Growth, and Development Decision-Making*. Washington, DC: World Bank.

[21] Berger, P. L., and H. H. M. Hsiao, eds. 1988. *In Search for an East Asian Development Model*. New Brunswick, NJ: Transaction Books.

[22] Zhuang, J., E. de Dios, and A. Lagman-Martin. 2010. Governance and Institutional Quality and the Links with Growth and Inequality: How Asia Fares. In Zhuang, J., ed. *Poverty, Inequality, and Inclusive Growth in Asia*. London: Asian Development Bank / Anthem Press.

gaps created by market and government failures, supporting efficient resource allocation and facilitating growth.[23]

2.5 Japan's postwar economic recovery and growth

Modernization and industrialization during the Meiji period

Japan started modern economic growth shortly after the 1868 Meiji Restoration, which returned the governing power from the Tokugawa Shogunate to the emperor. The country encountered modern Western powers in the 1850s and opened up to the outside world at their request after more than 200 years of isolationist foreign policy. Several treaties were signed, beginning with the US in 1854. Influenced by the Opium War between China and the UK, Japan realized it needed to modernize and strengthen its economic and military power.

Thus, the Meiji period (1868–1912) ended feudal privileges based on class and established key economic and political institutions of modern capitalism following the Western models. These included (i) markets for land, labor, and capital; (ii) a modern tax system, banks, a stock exchange, a central bank, and commercial and company laws; (iii) compulsory primary education (from 1886) and universities (the University of Tokyo was founded in 1877 with departments of medicine, science, law, and literature initially, and engineering, agriculture, and economics added later); and (iv) a political system based on constitutional rule, a parliament (which was established in 1890 and achieved male suffrage in 1925), and a governing cabinet. As Japan initiated its drive toward large-scale industrialization, authorities emphasized the importance of learning from advanced Western countries and promoting trade. Many of Japan's early technological and knowledge achievements came through imported foreign machinery and hired foreign experts, and by sending students abroad.

Since the Meiji modernization, Japan's industrialization—except for the militarist period from the 1930s to the years immediately after World War II—was primarily driven by the private sector, modeled after the UK and the US. In its early years, the government established publicly owned pilot companies to transfer western

[23] Hayami, Y. 2008. Social Capital, Human Capital and the Community Mechanism: Toward a Conceptual Framework for Economists. *The Journal of Development Studies*. 45 (10). pp. 96–123.

technology (such as textiles, coal, and steel) that were later privatized. Even important infrastructure services were provided by private firms. For instance, electricity has always been provided by region-based private companies (except from 1939 to 1951). Many railway lines were built by Japanese merchants who had accumulated capital, even from the pre-Meiji period, to transport silk from inland to coastal areas, before being nationalized by the Railway Nationalization Act of 1906. Electric railway networks in urban suburbs were developed from the 1910s to the mid-1930s by many private companies, together with new residential and commercial areas with leisure facilities.

By the early 1900s, Japan had already become a major global industrial power. However, its economic success was interrupted by imperial and expansionist ambitions and subsequently military disaster, with the economy devastated by its defeat in World War II.

Postwar restoration

Immediately after the war, the priority was to restore the economy under state planning and control. The country had to address serious resource constraints including finance and foreign exchange during the recovery from the devastation of the war. This was also in a way a continuation of strong state intervention prevailing immediately before and during the war period. The government controlled prices, introduced rationing, and managed trade and foreign exchange. It implemented a Priority Production Plan, focusing on several key industries (coal, steel, and fertilizers), supported through price controls and subsidies, low-interest loans, and allocation of restricted material imports. Three major economic reforms were introduced: (i) land reform to redistribute land from landowners to tenant farmers at nominal prices, (ii) dissolution of big business (zaibatsu) to break up monopolies and promote market competition, and (iii) labor reform to grant workers the right to organize labor unions.

After the initial reconstruction, Japan saw rapid, sustained economic growth from 1950 to 1973—more than 8% annual growth in per capita GDP—known as the postwar economic miracle. During this period, government direct control over the economy was gradually relaxed or removed, partly under pressure from the allied occupation authorities, and markets increasingly determined resource allocation. Japan did not have a large SOE sector before the war, and those that did exist were dissolved or privatized after the war. There were no SOEs in manufacturing.

While growth was driven by private firms and market forces, the government played an important role in proactively promoting investment, manufacturing exports, and technological innovation, especially during the early years of the postwar period. It designed medium-term economic plans at the macro level beginning in 1955 and implemented targeted industrial policy at the micro level. The macro plans set targets for growth and various sector, social, and economic indicators, but the targets were more indicative than directive. The 1960 Income Doubling Plan aimed to double Japan's per capita income in 10 years—the target was achieved in 7 years.[24]

Evolution of targeted industrial policy

The focus and tools of Japan's targeted industrial policy evolved over time. It began with direct controls and price subsidies to implement its Priority Production Plan immediately after the war. In 1949, the government established the Ministry of International Trade and Industry (MITI) to implement industrial policy, succeeding the Ministry of Commerce and Industry. In the 1950s and 1960s, the policy focus shifted to industrial "rationalization" (for instance, by supporting firms to exit from coal mining) and "support for advanced knowledge and technologies." Over time, Japan's targeted industrial policy priorities shifted from raw materials and light industries to heavy and chemical industries and to high-technology products. Japan was thus able to constantly upgrade its manufacturing capability and move up value chains.

In the 1950s–1960s, the targeted industrial policy tools were mainly (i) the preferential allocation of scarce foreign exchange to priority industries and firms; (ii) high import tariffs and quotas, and regulating FDI to protect infant industries; (iii) preferential credit, largely channeled through public financial institutions such as the Development Bank of Japan and Export–Import Bank of Japan; and (iv) tax incentives (e.g., accelerated depreciation) for investment. There were well-defined eligibility criteria. MITI also used a system of consultative arrangements—"deliberation councils" comprising sector leaders, company executives, academia, and civil society—and "Administrative Guidance" to share information and reconcile diverse interests over policies.

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[24] Ito, T. 1996. *The Japanese Economy*. Cambridge, MA and London: The MIT Press.

In the 1960s, Japan increasingly integrated its economy globally. It liberalized trade and foreign investment, while preferred foreign exchange allocation, import quotas, high tariffs, and FDI regulations were gradually phased out. Japan joined the Organisation for Economic Co-operation and Development (OECD) and became an Article 8 member of the International Monetary Fund (IMF) in 1964. The liberalization of trade, inward FDI, and foreign exchange was part of its obligations as member of these international organizations. It was also influenced by the pressure from trading partners.

By 1973, Japan's per capita GDP (in 2010 US dollars) reached $22,138, surpassing that of the UK and approaching nearly 90% that of the US—from about 50% in 1960. It reemerged as a major industrial power globally. Industry's share of GDP was 43% and services 52%. It began leading world manufacturing production and led exports in many sectors, particularly consumer electronics, automobiles, shipbuilding, machine tools and equipment, and semiconductors.

How to explain Japan's postwar economic miracle

Numerous studies ask what explains Japan's postwar economic miracle. It is likely a variety of factors were at play. Some were external, such as US financial assistance, which provided needed capital during the initial stage of recovery, and the Korean War, which created external demand for Japan's industries in the early 1950s. The prewar legacy of industry and technology—including shipbuilding, airplanes, and precision machinery for the military—was also important. While much of its industrial capacity was damaged or destroyed, Japan already had the basic human capital needed for restoring and expanding industries after 1945. Other important aspects of Japan's prewar legacy were the solid institutions of a modern market economy.

Japan also benefited from favorable demographic change. In the 1950s and 1960s, the growth of Japan's working-age population exceeded total population growth—generating a demographic dividend of nearly 1 percentage point annually, on average, in per capita GDP growth (Chapter 6). The rising share of the working-age population also contributed to a large increase in the savings rate, along with other factors such as rapid economic growth and government policy that encouraged savings—such as the Postal Savings Program. Japan's gross domestic savings rate increased from about 24% of GDP in 1955 to 42% in 1970. This provided needed financing for high domestic investment, which rose from 24% of GDP to 41% during the same period. High investment led to rapid capital accumulation, industrial upgrading, and labor productivity growth.

While Japan's postwar growth was largely driven by the private sector, the government also played important roles.

First, major reforms introduced immediately after the war—including land reform, labor reform, and the breakup of big business; broad access to education; job creation supported by rapid growth in manufacturing; and job security (life employment)—significantly improved wealth and income distribution, widely sharing the benefits of growth. This helped maintain social stability, foster vigorous consumption, and sustain the economic expansion. Indeed, from the 1950s to the 1970s, Japan's rapid growth was accompanied by equity in income distribution, as shown by the Gini coefficient of per capita disposable income (Chapter 11).

Second, large public investment in infrastructure and education enabled growth to accelerate without hitting bottlenecks. During 1960–1980, Japan's paved roads increased from 23,800 to 511,000 kilometers. From 1960 to 1970, annual electricity generating capacity increased from 23.7 million to 68.3 million kilowatts. After the war, compulsory education was extended from 6 to 9 years. During 1950–1970, Japan's mean years of schooling of its working-age population increased from 7.6 to 9.8.[25] It also introduced universal health coverage in 1961. These contributed to improving the country's overall human capital.

Third, the government's targeted industrial policy succeeded in promoting industry—although not in every targeted industry. In the beginning, the country resorted to targeted industrial policy in order to address serious resource constraints. Over time, the policy has moved to outward-oriented instead of import substitution, and has relied on market competition and private enterprises to drive growth, while the government took some proactive roles. Various support for manufacturing exports enabled Japanese firms to compete in international markets and benefit from economies of scale. In the early stage, Japan restricted car imports and inward FDI in the automobile industry, but it promoted competition among domestic firms. When more developed, car markets were opened to foreign competition.

[25] Godo, Y. 2011. Estimation of Average Years of Schooling for Japan, Korea and the United States. *PRIMCED Discussion Paper Series*. No. 9. Tokyo: Hitotsubashi University.

After 1973, Japan's pace of growth slowed due to several factors, including the 1973–1974 and 1979 oil shocks, and convergence forces as Japan reemerged as a major industrialized nation. Nevertheless, it continued to grow substantially faster than other industrialized countries during the 1970s and 1980s. From the 1990s onward, after the burst of the asset bubble and population aging turned the demographic dividend into a tax, Japan's growth slowed further. As the economy matured, the role of industrial policy shifted toward promotion of collaborative research in high-tech industries such as semiconductors, computers, biotechnology, and robotics. Since the late 1990s, Japan initiated a series of structural reforms, including deregulation in services, to stimulate growth and respond to the aging population.

Japan's postwar economic miracle inspired many other countries as they pursued industrialization and modernization. Japan offered both a workable growth model and technology transfer and FDI. In the early 1960s, scholars used the so-called "flying geese" model[26] to describe Asia's sequential postwar development process (Chapter 9). According to this model, economies in earlier development stages align behind industrial nations, such as Japan in Asia, in a "wild geese formation." Economies behind the leaders are engaged in low-wage production, but as costs rise, they, in turn, pass on this type of production to countries further behind. Today, Asia's economic landscape has changed significantly, with more leaders in different sectors. Asian economies are now linked more as a network than as a wild geese formation.

2.6 Industrialization of Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China

The four NIEs were among the low-income economies in the world in 1960, with per capita GDP (in 1960 US dollars) ranging from $160 for the ROK and Taipei,China (5% of the US) to around $430 for Hong Kong, China and Singapore (14% of the US). Over the subsequent 3 decades, the per capita GDP of the NIEs, as a group, grew by an average 7.2% per year. The NIEs are now all high-income economies, with 2018 per capita GDP (in 2018 US dollars) ranging from $25,000 for Taipei,China to $64,600 for Singapore (US per capita GDP was $62,600). The NIEs' remarkable success in stimulating growth, accelerating structural

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[26] Akamatsu, K. 1962. A Historical Pattern of Economic Growth in Developing Countries. *The Developing Economies*. 1 (August). pp. 3–25.

transformation, and building strong technological innovation capabilities has inspired many countries. They have become a model for the developing world.

With the exception of Hong Kong, China, which was a British colony until 1997 and maintained a free market economy, the NIEs largely followed Japan's postwar economic model, with growth driven by market forces and a proactive government promoting manufacturing exports. While there were similarities, there were also differences among the NIEs.

Their initial conditions were quite similar in many respects. They all experienced years of war and conflict before their economic takeoff. Taipei,China was under the rule of the Kuomintang government after 1945; the ROK gained independence in 1948 and battled the north from 1950 to 1953; Singapore separated from Malaysia in 1965; and Hong Kong, China was under British rule until 1997. Like other developing economies at the time, they had limited modern industry and lacked capital, skills, and other resources. In 1960, agricultural employment accounted for 66% in the ROK and 56% in Taipei,China. Manufacturing employment was higher in the two city economies of Hong Kong, China (35%) and Singapore (22%).[27] From the 1950s, all had begun industrializing.

The ROK; Singapore; and Taipei,China all began with import substitution in the 1950s. But they moved quickly to adopt export-promotion strategies in the 1960s. The NIEs' industrialization began by promoting labor-intensive light industries such as textiles and footwear. As income and labor costs rose, they gradually moved to more capital-, skill-, and technology-intensive industries.

For example, the ROK invested significantly in heavy and chemical industries in the 1970s, under the strong leadership of President Park Chung-hee (1963–1979); from the late 1980s–1990s, its focus shifted to information and communication technology. Singapore, under Prime Minister Lee Kuan Yew (1959–1990), promoted petrochemicals and pharmaceuticals along with finance and regional headquarters services in the 1980s and 1990s. Taipei,China also began to develop high-tech industries in the late 1980s–1990s, such as semiconductors and high precision machinery.

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[27] Chowdhury, A., and I. Islam. 1993. *The Newly Industrializing Economies of East Asia*. London: Routledge.

To promote exports, the NIEs used a variety of instruments: export targeting; export credit, preferential foreign exchange allocations, and duty-free imports for exporters; tax incentives; low-interest loans; and export processing zones (EPZs). Support was often linked with export performance to create competition and strengthen incentives. They also established mechanisms such as "councils" to enhance communications between businesses and government and to help address coordination issues. In the ROK, for example, the council held monthly export-promotion meetings in the 1960s and 1970s—often presided by the President and joined by top bureaucrats and business leaders. Over time, export promotion became more nondiscriminatory, for example, through investments in R&D.

Apart from providing export incentives, the ROK and Taipei,China also used import tariffs and nontariff barriers to protect domestic infant industries at the initial stage of economic takeoff. However, compared with other developing economies, their level of protection was lower and, from the 1970s, they began liberalizing trade by reducing tariffs and nontariff barriers.[28] Hong Kong, China and Singapore adopted much freer trade policies early on. Import liberalization gave the NIEs access to essential intermediate inputs for producing final goods for export.

The NIEs also benefited significantly from foreign ideas and technology. They acquired these in a variety of ways, such as importing capital goods, promoting exports, purchasing licenses, and attracting FDI (through providing incentives, reducing restrictions, or both). From the mid-1980s, after the yen appreciated following the Plaza Accord, large amounts of Japanese FDI went to the NIEs, starting the process of creating a regional production network.

The NIEs did differ on FDI policy. Early on, the ROK emphasized national technological capacity in domestic firms and restricted inward FDI, so inward FDI was relatively small. In 1965–1984, for example, FDI accounted for only 2% of its domestic capital formation.[29] By contrast, Singapore offered incentives to attract FDI, especially by multinationals. In 1965–1984, inward FDI accounted for 10% of domestic capital formation. Singapore is considered a success story of FDI-led industrialization. Hong Kong, China also adopted

[28] World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press.

[29] World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press.

an open FDI policy, although it did not provide many incentives. In Singapore and Hong Kong, China, a large proportion of exports were produced by foreign-invested firms. Taipei,China also welcomed FDI, for example, by creating EPZs, but these had certain conditions such as local content requirements and export performance.

The NIEs were all market economies with the private sector playing a major role in driving growth. However, compared with Japan, SOEs were also important in the NIEs—with the exception of Hong Kong, China, which was close to being a laissez-faire free market economy. In the ROK, growth was mainly driven by private firms, some of which later developed into chaebols—family-based business conglomerates. But the government also established many SOEs to support its economic takeoff from the 1960s. One example was state-owned Pohang Iron and Steel Company (POSCO), which later grew into one of the world's top steel manufacturers. From the 1980s, the government started a privatization program. In 1985, SOEs accounted for only 2.7% of the ROK's total nonagriculture employment.[30] POSCO was privatized in the early 1990s.

Compared with the ROK, the SOE sector was much larger in Taipei,China. In addition to public utilities, SOEs were involved with manufacturing such as petroleum refining, petrochemicals, steel, shipbuilding, heavy machinery, transport equipment, and fertilizer; and they were usually large. While SOEs were important, the private sector, comprising numerous small and medium-sized firms, was critical in driving growth. In the 1960s and 1970s, SOEs accounted for 13%–14% of GDP and 28%–35% of gross fixed capital formation.[31] In the late 1980s, the government began a privatization program. By the early 2000s, SOE importance had declined, accounting for 11% of gross domestic capital formation.

In Singapore, the government established many government-linked corporations (GLCs) after independence to lead in establishing new industries and attract private investment. GLCs covered seaports, shipbuilding, airports, airlines, shipping, steel, banking, housing, and other manufacturing. In 1974, GLCs were estimated to account for 14%–16% of manufacturing output. The government established Temasek Holdings Private Limited in 1974 to hold and manage GLC

[30] Savada, A. M., and W. Shaw, eds. 1990. *South Korea: A Country Study*. Washington, DC: GPO for the Library of Congress.

[31] Wade, R. 1990. *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. Princeton: Princeton University Press.

investment and assets owned by the government to ensure they would be run commercially. As a shareholder on behalf of the government, Temasek's policy was not to direct business operations of the companies in its portfolio. Instead, it left business decisions to their respective boards and management. During 2008–2013, GLCs, with the government as the controlling shareholder, accounted for 37% of Singapore's stock market capitalization.[32]

The NIEs' policy of outward-orientation and combining market forces with proactive government support succeeded in promoting exports and technological advancement. In 1970–1985, annual manufacturing export growth was 28% in the ROK; 24% in Singapore; 26.4% in Taipei,China; and 15% in Hong Kong, China.[33] Similar to Japan, rapidly rising exports enabled firms to benefit from economies of scale and compete globally. Exports also brought in much-needed foreign exchange that was used to import foreign technology and raw materials. Over time, the NIEs' exports became more diversified and technologically sophisticated. During 1965–1994, the share of electrical machinery in total non-oil exports increased from just 0.3% to 20.8% in the ROK; from 1.4% to 15.1% in Taipei,China; from 1.8% to 23.4% in Singapore; and from 3.1% to 13.1% in Hong Kong, China. Outward-oriented trade and industrial policies allowed these economies to become an integral part of global value chains in manufacturing.

The NIEs also benefited from large investments in infrastructure and human capital. Fiscal prudence put them in a strong position for governments to invest in education, transport and power, and water and sanitation, while maintaining fiscal sustainability and macroeconomic stability. From 1960 to 2000, mean years of schooling of the working-age population increased from 4–5 to 10–12. They also benefited from high domestic savings and demographic dividends. In the ROK, the gross domestic savings rate increased from 9% in the 1960s to 38% in the 1990s. In Singapore, the savings rate increased from 10% to 49% over the same period. In the ROK, the rising share of the working-age population generated a demographic dividend equivalent to 1.4 percentage points in annual per capita GDP growth during the 1970s–1990s (Chapter 6).

32 Tan, C., W. Puchniak, and U. Varottil. 2015. State-Owned Enterprises in Singapore: Historical Insights into a Potential Model for Reform. *NUS Law Working Paper*. No. 2015/003. Singapore: National University of Singapore.

33 Chowdhury, A., and I. Islam. 1993. *The Newly Industrializing Economies of East Asia*. London: Routledge. p. 17.

Also, compared with many other economies in Asia, the NIEs had strong state capacity for designing and implementing development policies. Their technical bureaucrats were more insulated than many other Asian economies from political pressures and changes in the government. This allowed them to pursue more consistent policies for promoting economic growth. They also benefited from forward-looking political leaders with a clear vision of their economic future, and were enthusiastic about learning from advanced economies and absorbing advanced technologies.

2.7 Economic liberalization and openness in Southeast Asia

Most countries in Southeast Asia were under colonial rule before World War II. After the war, one by one, they gained independence. Over the following 20–30 years, the region was buffeted by instability. Cambodia, the Lao People's Democratic Republic (Lao PDR), and Viet Nam suffered from prolonged wars. There were conflicts between countries as well. In some countries, there were fears over the perceived threat from the growing influence of communism, leading to domestic conflicts, such as in Indonesia. In others, domestic power struggles led to military coups, such as in Thailand, or the imposition of martial law, such as in the Philippines.

To promote peace and security in the region, Indonesia, Malaysia, the Philippines, Singapore, and Thailand took a historical step in 1967 to establish the Association of Southeast Asian Nations (ASEAN). As conflicts subsided and wars ended, more countries joined ASEAN: Brunei Darussalam in 1984; and Viet Nam, the Lao PDR, Cambodia, and Myanmar in the 1990s. Over time, ASEAN was transformed from primarily a security arrangement to a regional grouping to foster economic cooperation and market-oriented policy reforms (Chapter 15).

When Southeast Asian countries gained independence, their economies were dominated by subsistence agriculture and primary commodity exports. Governments were proactive in pursuing development. Like the NIEs, development policies were initially dominated by an import substitution industrialization strategy with state control to various degrees. But it failed to deliver good economic outcomes. The decline in commodity prices in the 1980s after the 1970s boom created macroeconomic difficulties, prompting many governments to shift toward export orientation, economic liberalization, promotion of inward FDI—from Japan;

the ROK; Taipei,China; and elsewhere, along with market-led growth. Governments were also influenced by policy advice from developed countries and multilateral financial institutions such as ADB, the IMF, and the World Bank at the time market-oriented policies were gaining acceptance. While this broad pattern applies to most Southeast Asian countries, there were differences among them.

Indonesia, Malaysia, the Philippines, Thailand, and Brunei Darussalam

In Indonesia, in the first 2 decades after independence was declared in 1945, development policy was inward-looking and involved heavy state intervention. A licensing system was used to control imports and investment. Newly established SOEs took over large portions of the economy. Economic mismanagement and political instability led to economic deterioration and brought down the Sukarno government in 1967.

From 1968, the new Suharto government took a more favorable view of domestic and foreign private investment as a part of his New Order policies. The Ministry of National Development Planning (BAPPENAS) played an important role in designing and planning policies—while its role evolved as the country's policy shifted from state control toward greater market orientation. The government introduced a Foreign Investment Law providing a 30-year guarantee of non-nationalization and abolished import licensing.

From 1974 to 1981, Indonesia benefited from the oil and commodity boom, enabling the government to invest heavily in capital- and resource-intensive industries, and in infrastructure, education, and health. Annual per capita GDP growth accelerated from less than 1.0% in the 1960s to 4.5% in the 1970s. As the state's role in the economy grew with the increased revenue from commodities, the government changed its policy and gradually tightened regulations on foreign and domestic private investment. It also tightened control over imports to protect domestic industry.

In the first half of the 1980s, the end of the oil and commodity boom led to macroeconomic imbalances and problems for SOEs. The government responded with a combination of fiscal, monetary, and exchange rate policy adjustments, including an early attempt at SOE reform. In 1986, the government launched a program of broad trade and regulatory reforms, signaling a major policy shift to promote exports. A package of financial incentives, currency devaluation, and reforms of export and import procedures was introduced to promote non-oil exports. Major exporters were given unrestricted, duty-free access to imports. Domestic and foreign private investment and the financial sector were also deregulated. Following these reforms, growth in manufacturing production, exports, investments, and GDP all accelerated. In 1986–1990, Indonesia's per capita GDP grew 4.3% annually, compared with 3.2% in 1980–1985. To further boost investment and liberalize trade, the second wave of policy adjustments was implemented in the early 1990s.

In Malaysia, the first decade after independence in 1957 saw the government largely continuing colonial-era open-door and market-oriented policies on trade and industry. The government also attempted to redress ethnic and regional economic disparities through rural development as well as social and physical infrastructure. To reduce rural poverty, the government established the Federal Land Development Authority in 1956 to facilitate and implement settlements of rubber and palm oil smallholders. During this period, while some import-competing industries were protected, the government did not target individual sectors and protection was lower than in many other developing countries. Inward FDI was welcomed—although its impact on the economy was limited.

In 1971, the government adopted its New Economic Policy (NEP) following racial riots in 1969. The NEP contained many elements intended to promote the economic participation of *bumiputeras,* mainly ethnic Malays. While commodities (such as rubber, timber, palm oil, and petroleum) continued to account for the majority of the country's exports throughout the 1970s, the government began more actively promoting labor-intensive manufacturing exports such as textiles, footwear, garments, and electronics. This came after it recognized the limitation of import substitution given the country's small domestic market. Incentives offered to export-oriented ventures included tax concessions and low-interest rate credit. The government also established special economic zones (SEZs) to attract foreign investors (from Japan and elsewhere) to assemble or process duty-free imported materials for export. By 1980, an estimated 70% of manufacturing exports originated from SEZs, mostly from foreign-owned firms.[34] In the 1970s, per capita GDP grew 5%–6% annually, compared with 3.5% in the 1960s.

[34] World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press. p. 135.

In the early 1980s, the government started a heavy industrialization program using earnings from resource exports. The objective was to develop industries such as steel, cement, automobiles, and chemicals through public investment, import protection, and other incentives for domestic firms with "pioneer" status. However, the attempt was short-lived. From the mid-1980s, the decline in commodity prices and fiscal imbalances prompted the government to shift away from state-led industrialization. Under Prime Minister Mahathir Mohamad, the country promoted exports, liberalized trade and FDI, and developed the private sector. Private investment was encouraged across a broad range of manufacturing exports. The government also divested many SOEs. Malaysia's manufacturing exports, as a share of total merchandise exports, increased from 20% during 1975–1985 to 54% during 1985–1995. Inward FDI as a share of gross domestic capital formation increased from 10.8% in 1981–1985 to 14.7% in 1986–1991.[35] By the 1990s, Malaysia had become the world's leading exporter of semiconductor chips.

Like its neighbors in Southeast Asia, the Philippines' development policy also shifted from import substitution to trade liberalization and export promotion over time. However, its shift took much longer than many of its ASEAN neighbors. After gaining independence in 1946, the government pursued industrialization. In 1949, it introduced import and foreign exchange controls in response to a balance of payments crisis. They evolved into an import substitution policy aimed at building a national industrial base. Some priority industries were identified but oriented toward supplying the domestic market instead of exports. The policy, however, did not succeed in promoting either manufacturing or economic growth. Per capita GDP grew at just 1.8% annually in the 1960s, compared with 4.6% in Thailand and 3.5% in Malaysia. The policy also made the Philippines vulnerable to external shocks and balance of payments crises.

From 1972 to 1981, President Ferdinand Marcos placed the Philippines under martial law with the stated reason of tackling communism and Muslim insurgencies. Growth was higher but driven in large part by debt, particularly foreign currency borrowing. The introduction of export incentives in the early 1970s after a balance of payments crisis provided some relief to export-oriented activities,

[35] Jomo, K. S., ed. 2001. *Southeast Asia's Industrialization: Industrial Policy, Capabilities, and Sustainability*. New York: Palgrave.

but its overall impact on trade was limited due to the widespread use of quantitative restrictions.[36] An overvalued Philippine peso, a raft of large-scale government projects, and persistent twin (current account and fiscal) deficits led to ballooning debt, placing the economy under severe stress. In 1983, the country fell into political and economic crises in the aftermath of the assassination of opposition leader and former Senator Benigno Aquino. The gradually escalating crisis brought down the Marcos government in 1986 after the "People Power" revolt.

Successive Philippine governments since 1986 have introduced various reforms to restore economic stability, stimulate growth, and reduce poverty. But episodes of political instability continued, making growth volatile until the early 2000s. The economy contracted in the mid-1980s. Per capita income grew a mere 0.55% annually in the 1990s and only recovered to its 1982 peak in 2004. Philippine per capita income was among the highest in developing Asia in the early 1960s. But unlike its neighbors, it was unable to develop a robust manufacturing sector, benefit from manufacturing exports, and attract FDI. Steady growth returned after 2000 as political stability was restored and governments introduced more reforms to improve fiscal conditions and macroeconomic management, strengthen financial regulation, liberalize trade, promote exports, attract FDI, address infrastructure bottlenecks, and tackle governance issues.

Thailand was the only country not colonized in Southeast Asia. Historically, the Thai economy was relatively open and market-oriented, with growth largely driven by the private sector. However, throughout the 1960s and 1970s, the government also adopted an import substitution industrialization strategy. In the 1970s, import protection increased, particularly favoring textiles, pharmaceuticals, and automobile assembly. The oil shocks of the 1970s exposed weaknesses in the economy, and as a result, the industrialization strategy from the 1980s shifted away from import substitution toward export orientation. The government reduced export taxes, devalued the Thai baht, and reduced tariffs. The Board of Investment (BOI), established in 1960 with the mandate of attracting FDI, was given a new role of promoting exports, especially labor-intensive manufacturing goods, by using export incentives, promoting trading companies, and establishing EPZs. From the second half of the 1980s, Thailand introduced broader-based import liberalization.

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[36] Hill, H. 2013. The Political Economy of Policy Reform: Insights from Southeast Asia. *Asian Development Review*. 30 (1). pp. 108–130.

The BOI's special promotion privileges made the country attractive to foreign investors. Most FDI in the 1960s and 1970s was concentrated in production for the protected domestic market. With the policy shift toward promoting exports, those produced by foreign-invested firms increased over time. In 1983, the government revised the criteria on foreign ownership of businesses to allow majority foreign ownership of firms in EPZs. This contributed significantly to Thailand's boom in FDI and manufacturing exports—including assembled cars—in the 1980s and early 1990s. Between 1980 and 1988, Thailand's inward FDI increased by more than five times. In the early 1990s, more than half of Thailand's exports were manufactures, including electrical appliances, machinery, transport parts and assembled cars, and chemicals. Most of these exports were produced by foreign investors, mostly Japanese, or joint ventures.

By the late 1980s and early 1990s, the major economies in Southeast Asia had substantially liberalized trade. Rising imports, with de facto pegged exchange rates, led to large current account deficits, especially in Thailand and Indonesia. At the same time, 2 decades of robust growth and an increasingly market-friendly business climate made these economies attractive destinations for foreign investors—including short-term portfolio investors. The Philippines was an exception, as it just emerged from economic and political crises and continued to suffer lingering political instability. To attract more foreign investment, these countries quickened financial market and capital account liberalization, partly influenced by the prevalent policy thinking at the time, including that of international financial institutions such as the IMF. Capital inflows surged, but due to weak financial regulation and poor risk management, a large part of the inflows were short-term bank loans denominated in foreign currencies, with much of these going to long-term investments in non-tradable sectors such as real estate. This led to currency and maturity mismatches.

With vulnerability building, investor speculation and the ensuing panic triggered sudden capital flow reversals, causing the collapse of de facto fixed exchange rate systems across the region. The currency crisis began in Thailand in July 1997 and spread to Malaysia, the Philippines, and Indonesia, and later to the ROK. It quickly developed into domestic banking crises. The "twin crises" plunged these countries into deep recession in 1998. Thailand, Indonesia, and the ROK requested emergency balance of payments support from the IMF, together with large-scale borrowing from the World Bank, ADB, and bilateral partners (Chapter 10).

After the 1997–1998 Asian financial crisis, economic recovery in affected countries was swift. Governments launched major reforms to strengthen financial and banking regulations, reform corporate governance, and improve macroeconomic management, along with corporate and financial restructuring. Central banks were given greater independence. Public debt management was strengthened. Exchange rates became more flexible. Measures were introduced to monitor capital flows more closely. They also continued to deepen market-oriented structural reforms. As a result, these countries weathered the 2008–2009 global financial crisis well.

Brunei Darussalam is one of the two high-income countries in Southeast Asia. It gained independence from British rule in 1984 and joined ASEAN the same year. Based on its rich oil and natural gas resources, it has a small, yet wealthy, economy and has maintained high living standards, with per capita GDP at $31,628 (in current US dollars) in 2018. For many decades, Brunei Darussalam has been a major producer and exporter of oil and natural gas in the region. It will continue to be an important player in the oil industry in the near future. For many years, the primary goal of the government has been to diversify the economy away from hydrocarbon production and encourage private sector investment and employment. This remains a key challenge.

Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam

Cambodia, the Lao PDR, Myanmar, and Viet Nam (CLMV) were latecomers to developing Asia's rapid economic takeoff because of the many years of wars, conflicts, political instability, and economic mismanagement. Since the mid-1980s, one after another they have started the transition from central planning to market economies and from inward-looking to outward-oriented development strategies, all at differing speeds.

Viet Nam was the first to embark on market-oriented economic transition among the CLMV. Before the end of the Vietnam War and unification in 1975, Viet Nam was divided—a North under socialist central planning and a South under a market system. The first decade after unification saw the government extend central planning across the entire country. But in December 1986, the Sixth National Congress of the Communist Party of Viet Nam decided to adopt a socialist-oriented market economy.

The change in direction was triggered by three factors: the failure of agricultural collectivization following reunification; the looming cessation of Soviet aid, which was equivalent to about 10% of GDP at that time; and the evident success of the PRC's 1978 reforms, against which Viet Nam traditionally benchmarked itself.

Known as *Doi Moi*, the market-oriented reforms were sweeping and comprehensive. Prices were liberalized. Farmers were allowed to own land and sell crops on the open market. The government initially granted increased decision-making authority to SOEs, and later privatized many of them. It allowed private firms to be established and grow. It also opened up trade by replacing import licensing with tariffs, attracted FDI by lowering the cost of doing business and establishing SEZs, and promoted manufacturing exports.

Viet Nam joined ASEAN in 1995, the Asia-Pacific Economic Cooperation (APEC) group in 1998, the World Trade Organization (WTO) in 2007, and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in 2018. Along the way, it signed the US–Viet Nam Bilateral Trade Agreement in 2001, which normalized relations with its former adversary and facilitated access to US markets. The government also invested heavily in infrastructure and human capital.

Viet Nam's market-oriented reform transformed the country from one of the poorest in the world into a middle-income economy and one of the most dynamic emerging markets in Asia. It has become a hub for FDI in Southeast Asia, with many multinational companies setting up ventures. Its manufacturing exports as a share of GDP increased from 16.2% in 1997–1999 to 58.2% in the 2010s. In 2017, Viet Nam was the largest exporter of clothing and the second-largest exporter of electronics (after Singapore) in Southeast Asia. Viet Nam's economic reform has continued. Its Five-Year Socio-Economic Development Plan of 2016–2020 emphasized the importance of continued efforts to reform SOEs, develop the private sector, improve the investment climate, and deepen integration with the global economy.

The Lao PDR introduced central planning after the civil war (which was affected by the Vietnam War) ended in 1975. It introduced agricultural collectivization in the countryside and nationalization of industry and commerce in towns and cities. From 1986, it began pro-market reforms by launching a "new economic mechanism," to introduce market incentives, abandon rural collectivization in favor of family-based farming, reform SOEs, develop the private sector, and open up the economy to trade and foreign investment.

Cambodia suffered the most tragic conflicts for many years, finally ending in 1979. International support strengthened over time, marked by the signing of the Paris Peace Agreements in 1991. Since then, Cambodia has also pursued market-oriented reforms. The country has become a major exporter of garments, supported by accession to the WTO in 2004 and the Multifibre Arrangement in 2005.

Myanmar was under military rule until 2011. Since then, the country has started comprehensive reforms. It introduced an electoral democracy, worked toward reconciling ethnic groups, strengthened macroeconomic policy (including unifying exchange rates), and implemented various market-oriented structural reforms. It enacted a commercial law and FDI legislation, and strengthened bank regulation and supervision. It also scaled up investment in transportation, energy, and communications. Myanmar's growth rate has been one of the highest among Asian countries in recent years, with a rapidly expanding domestic market and increasing FDI.

Support from bilateral and multilateral institutions in both finance and policy advice contributed much to the CLMV transition. ADB financed many infrastructure projects and provided reform recommendations. Viet Nam resumed borrowing from ADB and the World Bank in the early 1990s after repaying arrears with the support of donors. Similarly, bilateral official development assistance and new lending from multilateral development banks returned to Myanmar quickly after military rule ended (ADB restarted lending to Myanmar in 2013 after the settlement of arrears). In 1992, ADB started the Greater Mekong Subregion (GMS) program of regional cooperation, which today includes the CLMV countries plus Thailand and the PRC. The initiative aims to maintain and strengthen economic linkages between these countries as their transition advances.

2.8 Building a socialist market economy in the People's Republic of China

Pre-1949 efforts to develop national industries

Pre-1949 efforts to develop modern industries can be traced back to the 1860s. After being defeated by Western powers in the Opium Wars in 1842 and 1860, the Qing government attempted to introduce western advanced technologies and establish state-owned modern industries, known as the "Westernization Movement," initiated by pro-West bureaucrats. The reform was implemented but was not as comprehensive as Japan's modernization program because of opposition from the Empress Dowager Cixi and conservative bureaucrats. The Qing government's focus initially was on developing industries for defense purposes—such as steel, weapon manufacturing, and shipbuilding. This was later extended to include light industries such as textiles, paper and printing, pharmaceuticals, and glassware manufacturing for civilian consumption. Over time, more enterprises were set up by indigenous merchants and entrepreneurs, and overseas Chinese.

The Westernization Movement, however, failed to stop the downfall of the Qing dynasty. The Xinhai Revolution in 1911 led to the establishment of a new republic. During that period, domestic industries continued to grow, despite persistent political turmoil and civil war. Early industrialization peaked during World War I, when rising foreign demand for the country's goods and falling imports provided a golden opportunity for national industries to expand. The government of the newly established republic supported national industries through measures such as the introduction of a patent system and preferential taxation.

From the early 1930s, however, domestic industries were badly hit by several major events: the Great Depression, the war of resistance, and the war of liberation. By 1949, when the Communist Party of China (CPC) established the PRC, the economy was precarious, dominated by subsistence agriculture. Domestic industries were small, accounting for 12.5% of national income,[37] with some mining and heavy industries scattered in the northeast and light industries in coastal cities such as Shanghai and Tianjin.

The experience of postwar central planning

PRC leaders set the ambitious goal of modernizing through socialist industrialization, by pursuing a Soviet-type command economy with public ownership of the means of production. Land was redistributed from rich landowners to poor farmers. The State Planning Commission took charge of economic planning. Under the first five-year plan of 1953–1957, the PRC implemented close to 1,000 large-scale investment

[37] China State Statistical Bureau. 1990. *China National and Provincial Historical Statistics Collection*. Beijing.

projects to develop heavy industry, many supported by technical and financial assistance from the Soviet Union. The socialist transformation brought most industrial and commercial firms under state ownership and organized more than 90% of handicraft firms and household farms into cooperatives under collective ownership.

During 1958–1962, the PRC suffered severe economic difficulties. The Great Leap Forward led to huge waste and large economic disruption. The people's commune movement weakened farmers' production incentives, which, together with severe floods, led to a significant drop in agricultural output, causing large-scale food shortages. At the same time, the withdrawal of the Soviet Union assistance and continued blockages imposed by Western countries cut off the PRC from the world. In response, the government began focusing in 1961 on readjustment and recovery, giving greater priority to agriculture and light industry and decentralizing decision-making. In some provinces, local governments piloted what later would be called the "household responsibility system" to give farmers incentives to increase crop production. The initiative was short-lived and stopped. The readjustment and recovery took 3 years until 1965 and was followed by the Cultural Revolution from 1966 to 1976.

The Cultural Revolution was primarily a political upheaval and did not involve major changes to the basic economic model, except that economic policy shifted further left. Its impact was felt throughout the economy. Government economic agencies were paralyzed, with planning and coordination curtailed. Factory management was taken over by revolutionary committees with limited technical or managerial expertise. The role of markets was dismissed, and private production stopped in both rural and urban areas. The economy was largely cut off from world markets and foreign technology.

Despite all of this, the PRC still made progress in economic and social development between 1949 and 1977. Industry expanded, especially heavy industry. In the first half of the 20th century, the economy expanded just 0.23% annually. PRC per capita income grew 2.7% annually during 1961–1970 and 4.3% from 1971 to 1980, although official national accounts statistics before 1978 covered only material production and were based on administrative prices. Human development indicators improved markedly, for example, in education and health. However, until 1978, rigid central planning; the absence of a private sector, market, and competition; isolation from the rest of the world; and frequent political upheavals made the PRC economy inefficient and lacking dynamism, with widespread shortages of consumption goods.

Market-oriented reforms and opening up after 1978

Following the downfall of the "Gang of Four" in 1976, new leaders, led by the long-time reformist Deng Xiaoping, launched a far-reaching program of market-oriented reform and the "opening-up" policy. The historic CPC meeting in December 1978 accepted that "practice is the sole criterion for testing the truth" and declared that the country will put ideology aside and focus instead on economic development. In 1977–1978, top leaders made more than a dozen trips to Japan, the US, and Europe to see personally the economic achievements of advanced countries. They realized how the PRC lagged behind after decades of isolation and that the only way out was reform. For instance, when Deng Xiaoping visited Japan in October 1978, he was very much impressed by the bullet train system—shinkansen—and Panasonic's color TV production lines. He remarked that the PRC "really needs to run" to catch up.[38]

Notably, the reforms since 1978 have been gradual and pragmatic; in Deng Xiaoping's words, they were carried out like "crossing the river by feeling the stones." This is in contrast to the "shock therapy" adopted by the former Soviet Union and Eastern European countries years later.

The reform began in rural areas by piloting and later introducing nationwide household responsibility systems, dismantling the commune system to restore production incentives for farmers. Initially, these were not policy choices of the top leadership, but a response to many spontaneous and self-driven initiatives from local governments and village leaders in several provinces—including Anhui, Sichuan, and Tianjin. At the same time, reforms in the procurement system allowed agricultural products to be sold at market prices. These rural reforms became a great success, leading to significant increases in agricultural productivity, farm production, and rural incomes, and a reduction in rural poverty.

[38] China Daily. 2014. *What Did Deng Xiaoping Learn during His Visit to Japan in 1978?* [in Chinese]. 15 August. https://world.chinadaily.com.cn/dxpdc110znjn/2014-08/15/content_18323338.htm.

From 1984, the reform focus shifted to the urban economy, industry, and SOEs. The government introduced a dual-track system to minimize shocks: production within state plans continued to be subject to controlled prices, while production outside the state plan could be traded at market prices. The dual-track price system allowed enterprises to react to demand and supply and allowed private enterprises to grow, simultaneously keeping the planning system running. The approach was considered fit for the PRC and adopted by top leaders after extensive discussions among academics, government officials, and foreign experts including Nobel laureates, with two symposiums playing an influential role: the Moganshan Conference (in a mountain resort in Zhejiang province) in 1984 and Bashanlun Conference (during a cruise on the Yangtze River) in 1985. The dual-track system lasted until the early 1990s, when it was gradually phased out and most prices decontrolled, partly due to concerns over growing rent-seeking and associated corruption. By the early 2000s, prices covering 90% of PRC products had been liberalized.[39]

The enterprise reform initially involved granting more autonomy to SOEs. Contract responsibility systems and performance-based bonuses were introduced to incentivize enterprise management and workers that were employed under a fixed-wage and permanent employment system. At the same time, private enterprises and rural village- and township-enterprises were allowed to grow, often supported by local governments. The Shanghai Stock Exchange was reestablished in 1990 after being closed for more than 40 years and the Shenzhen Stock Exchange opened in 1991. After years of political and ideological debate on the role of planning and markets involving senior-level officials, in 1992, the 14th Congress of CPC declared a "socialist market economy" was the ultimate goal of reform. In 1993, the Constitution was amended to remove the term "planned economy."

PRC reforms accelerated after Deng Xiaoping's "Tour of the South" in 1992. The government embarked on comprehensive macroeconomic policy reforms including of the fiscal system, monetary policy, banking sector, and foreign exchange regime. It began privatizing small and medium-sized SOEs as part of a new enterprise reform strategy focusing on restructuring major SOEs and relaxing

[39] Huang, Y. 2015. From Economic Miracle to Normal Development. In Zhuang, J., P. Vandenberg, and Y. Huang, eds. *Managing the Middle-Income Transition: Challenges Facing the People's Republic of China*. London: Asian Development Bank / Edward Elgar.

control over small ones. As a result, the number of SOEs fell to 4% of all enterprises by 2010. In 2017, SOEs produced 25% of industrial value added, owned 48% of industrial capital assets, and employed 18% of the industrial labor force (Table 2.1). Remaining SOEs are mostly large companies listed on stock exchanges but majority-owned by the government. They are mostly in resources, public utilities (power and transport), finance, and telecommunications. SOE reform remains an important challenge for the PRC.

Table 2.1: Shares of State-Owned Enterprises in the Industry Sector, People's Republic of China, 1995–2017

(%)

	1995	2000	2005	2010	2017
Value added	53.8	54.3	37.6	31.3	25.3
Employment	65.2	53.9	27.2	19.2	17.9
Fixed assets	73.7	72.6	56.1	49.3	47.5

Note: The share of employment in 1995 refers to 1996 data, and the share of total fixed assets in 1995 refers to 1998 data.

Sources: CEIC Data Company Ltd. CEIC Database. https://www.ceicdata.com/en (accessed 3 June 2019); and National Bureau of Statistics of China. *China Statistical Yearbook 2018.* http://www.stats.gov.cn/english/Statisticaldata/AnnualData/ (accessed 3 June 2019).

The opening-up policy since 1978 has mainly involved trade, foreign investment, and knowledge exchange. The government initially replaced administrative restrictions on exports and imports with tariffs, quotas, and licensing; gradually phased out the use of quotas and licensing; and over time reduced tariffs. It also established many SEZs and designated several coastal cities as open cities to promote exports and attract FDI. To reform the foreign exchange system, the government eased administrative control initially, introduced a dual exchange rate system from the mid-1980s, unified the dual rates in 1994, and moved toward a managed floating exchange rate system. The government also promoted academic and technical knowledge exchanges between PRC scientists, scholars, and students with their foreign counterparts. Since 1978, tens of thousands of PRC students have been sent abroad for university studies, mostly to the US, Japan, the UK, Australia, and Canada. In 2001, the PRC joined the WTO.

The introduction of market-oriented reforms and the opening-up policy was followed by accelerating economic growth. The PRC's annual per capita GDP growth rose to 8.2% in the 1980s, 9.2% in the 1990s–2000s, and 6.9% in 2011–2018. The PRC is now the world's second-largest economy and largest merchandise exporter. Rapid growth of manufacturing exports and inward FDI has made the PRC the world's factory. Increasingly, the country's growth is supported by indigenous innovation. Rapid growth has reduced poverty and improved living standards. When reforms started, more than 80% of the population lived in extreme poverty (at the $1.90 per day international poverty line). By 2017, it had declined to less than 1%.

Explaining the People's Republic of China's 4 decades of rapid development

What can explain the PRC's success? Introducing market-oriented reforms and the opening-up policy was key—as these unleashed the society's entrepreneurship and creativity potential. It led to more efficient resource allocation and integrated the economy globally. In addition, two other factors played critical roles: (i) a pragmatic approach to reform, and (ii) the government's proactive role in promoting development.

The pragmatic approach to reform involved several institutional innovations that helped gradually develop market institutions, minimizing disruption. One was the responsibility system, first used in rural reform and later applied to SOE reforms and central–local government fiscal relations. Another was the dual-track system on prices, SOEs, and foreign exchange reform. A further innovation was piloting policy reforms before nationwide implementation, increasing the chance of success.

While the PRC economy became increasingly market-oriented and private sector-driven, the government has remained proactive in supporting development, more than most other Asian countries. Local governments played an important role in developing local economies. They provided cheap land and tax incentives to foreign investors and helped local private firms access finance. They also invested heavily in infrastructure, often financed by monetizing land—promoting urbanization and boosting growth. In recent years, the government has stepped up support for innovation and new industries.

The PRC is well on its way to becoming a high-income country. However, sustaining rapid growth has become increasingly harder as rural surplus labor disappears and the demographic dividend ends. Growth must increasingly come from gains in productivity. Attaining high-income status requires continued and deeper reforms.

The Decision on Major Issues Concerning Comprehensively Deepening Reforms by the Third Plenum of the 18th Congress of the CPC in November 2013 highlighted goals of future economic reform. The PRC will continue to develop a socialist market system where both public and private ownerships are important; all types of enterprises (private and public, and domestic and foreign) have equal access to markets; and "market forces play a decisive role in resource allocation." SOE reforms will deepen by separating ownership from management and strengthening corporate governance. At the same time, the government will continue to promote, support, and direct development of the non-state sector and proactively develop a mixed economy with cross-ownership shareholdings. The 19th Congress of the CPC in October 2017 reaffirmed these goals while stressing the central role of the party.

2.9 Toward market-led growth in India

In South Asia, two centuries of British colonial rule ended with newly independent nations (except Nepal and Bhutan, which were never colonized) in precarious conditions in the late 1940s. The top priority of the new governments was to accelerate growth through industrialization. Socialist ideology had a strong influence in South Asia since the early 20th century, and it was often closely associated with independence movements and a desire to avoid foreign influences. But instead of adopting a Soviet-type socialist model, South Asian countries allowed private firms to coexist with the public sector and opted for a mixed-economy model. Heavy state control over the economy, however, led to dismal growth and slow development. From the 1980s, South Asian countries began liberalizing markets, and as a result, growth accelerated. This section focuses on India.

Pre-independence industrial development

India had well-developed traditional industries during the Mughal Empire (1526–1858). Economic historians estimate it produced about 25% of world industrial output in 1750 and was a major contributor to global textile exports.[40] However, a long-run decline began around 1750 due to (i) political instability and battles between competing groups as the Mughal empire began to weaken, and (ii) massive imports of cheap factory-based textiles and other manufacturing goods from Europe, particularly the UK, in the 1800s.

The development of modern industries was slow under British rule (first through the East India Company from 1764 to 1857 and later through direct British government control from 1858 to 1947). An important reason was that British policy focused on using Indian resources to meet British needs rather than supporting indigenous industrial development—for example, by keeping tariffs low compared with other countries and discouraging Indian suppliers of manufacturing inputs.

Nevertheless, there was some success in India's industrial development, led by a small group of merchants and traders. Jamsetji Tata (1839–1904) was able to use capital generated from trade with Japan, the PRC, and other parts of East Asia and Southeast Asia, to establish modern cotton textile factories. He later diversified into steel production, in 1907 establishing Tata Iron and Steel Company (TISCO). Many other Indian merchants and traders followed his example, investing profits generated from World War I and the economic boom following the war to set up industrial enterprises. Industries included textiles, sugar, paper, cement, steel, shipbuilding, and even some automobile production by the 1940s. Thus, in 1946, the share of modern manufacturing in national income was 8.7%, compared with 1.9% in 1900.

Post-independence state-led industrialization

After independence in 1947, India used state-led industrialization to accelerate economic growth, address widespread poverty, and modernize the economy. The government chose key sectors to become state monopolies (for example, railways), and established exclusive rights to new investment in industries such as iron and steel, shipbuilding, mineral oils, coal, aircraft production, and telecommunications, where new private investment was not allowed. While private firms were allowed in many other sectors, they faced regulatory requirements such as licensing (to guide the sector, location,

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40 The 25% covers the entire Indian subcontinent. See Bairoch, P. 1982. International Industrialization Levels from 1750 to 1980. *Journal of European Economic History*. 11 (2). pp. 269-333.

and quantity of private investment) and import, foreign exchange, credit, and price controls. The government established a planning agency to devise and implement five-year plans. Import controls included high tariffs, quotas, and licensing. These were deemed necessary to develop a diversified industrial base and ensure scarce foreign exchange was used to import capital goods.

Although the economy was under heavy state control with an inward-looking import substitution industrialization strategy from the 1950s to the 1970s, state control changed in intensity over time.[41] Policies in 1951–1965 were considered more liberal than afterward. Investment licensing and import controls were less stringent until foreign exchange shortages grew serious. Some also considered the FDI regime relatively open during this period, as Prime Minister Jawaharlal Nehru saw the need for both foreign capital and technology.

But state control tightened from 1965 in response to a series of shocks and resulting economic problems. They included 2 years of serious drought, three wars with neighbors, a 1966 currency devaluation that largely failed, and losses in some state elections by the dominant Congress Party. Prime Minister Indira Gandhi assumed office in 1966 and drove economic policy further toward state control with a greater focus on income redistribution. Measures included more stringent import licensing; nationalization of banks, oil companies, and coal mines; restrictions on foreign companies and on the use of foreign exchange; restrictions on investment by large firms in sectors "reserved" for small enterprises; and barriers to laying off workers by firms with 300 or more employees (the 1976 threshold of 300 was further tightened to 100 in 1983).

India's state-led import substitution industrialization strategy had mixed results. The economy expanded 4% annually in the 1960s and 3.1% in the 1970s. This was much better than the less than 1% annual growth in the first half of the 20th century. However, in per capita terms, annual growth was just 1.8% in the 1960s and 0.6% in the 1970s, well below those in East Asia and Southeast Asia.

Market-oriented reforms

The weak economic performance in the 1960s and 1970s led some officials to begin advocating for relaxing state controls. Subsequently, in the second half of the 1970s and 1980s, successive governments

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41 Panagariya, A. 2008. *India: The Emerging Giant*. Oxford: Oxford University Press.

attempted to introduce economic liberalization, with each more significant than the preceding one. In industry, reforms mainly involved adjusting the existing industrial licensing system by reducing the number of industries covered. Similarly, in trade, measures were introduced to modify import licensing by reducing the number of import items banned or restricted. In the 1980s, several export incentives were introduced. Yet, despite these reforms, the essential economic management framework through licensing and controls remained until 1991, when India was hit by a balance of payments crisis.

Throughout the 1980s, India ran current account deficits. They grew particularly large during the second half of the decade, especially over the 3 years leading to the 1991 crisis. This was partly due to steady growth of private investment and merchandise imports in response to liberalization. At the same time, there was a rapid rise in central government spending, leading to a massive buildup of fiscal deficits—nearly 10% of GDP, on average, during 1985–1990. External debt increased rapidly and foreign exchange reserves dropped to just 1 month of imports in 1990–1991. As a result, India entered an IMF stand-by program in January 1991 with large financial support.

Yet the situations continued to deteriorate. The Gulf War in 1990 resulted in an oil price hike and drop in remittances from the Middle East—worsening the balance of payments. Prime Minister Rajiv Gandhi was assassinated in May. In mid-1991, India's credit rating was downgraded, limiting the country's access to world financial markets. The government had to ask the IMF and the World Bank for further emergency assistance in July 1991.

The IMF stand-by programs and World Bank structural adjustment loan came with policy conditions. ADB financial sector policy-based loan and bilateral assistance followed. Many of the proposed policy reforms were in line with the emerging consensus among Indian policy makers at the time. Most significantly, the 1991 reform program under Prime Minister P. V. Narasimha Rao and Finance Minister Manmohan Singh (who later became Prime Minister) was a departure from the old licensing and control framework. India abolished industrial licensing subject to a negative list (Table 2.2); ended public sector monopolies in many industries; initiated a policy of automatic approval of FDI up to 51% ownership; and significantly reduced import licensing. Over time, India also reduced tariffs on nonagricultural goods.

Table 2.2: Delicensing and Trade Liberalization in India, 1980–1997

	1980	1985	1990	1997
Cumulative share of three-digit industries delicensed	Nil	36.6	39.3	91.1
Cumulative share of real output delicensed	Nil	47.7	56.9	92.6
Cumulative share of employment delicensed	Nil	43.1	47.8	88.1
Tariff rate	119.2	142.3	132.5	47.6

Note: The dataset covers 64 three-digit registered industries in 16 Indian states.

Source: Aghion, P., R. Burgess, S. Redding, and F. Zilibotti. 2008. The Unequal Effects of Liberalization: Evidence from Dismantling the License Raj in India. *American Economic Review*. 94 (4). Table 1, p. 1400.

Since 1991, India has introduced more sweeping reforms, ranging from taxation to finance, telecommunications, electricity, and transport. Competition was enhanced in finance through, for example, the entry of new private and foreign banks, interest rate deregulation, and listing of almost all public sector banks. Monetizing fiscal deficits ended in the late 1990s. The 2003 Fiscal Responsibility and Budget Management (FRBM) Act strengthened fiscal discipline. One of the most prominent recent reforms was the introduction of a Goods and Services Tax in 2017 under the administration of Prime Minister Narendra Modi, replacing fragmented state taxes. India also streamlined business regulations—including those for starting a business, obtaining construction permits, and electricity connections. In 2016, it passed an Insolvency Bankruptcy Code, unifying laws for insolvency and bankruptcy.

These systematic reforms helped improve India's economic performance significantly. Annual per capita GDP growth rose to 4.7% in 1991–2017 from about 2% during the 1960s–1980s. Annual trade growth (including both exports and imports of goods and services) reached more than 11% in 1991–2017, compared with 5%–6% in the 1960s–1980s. Average annual FDI inflows increased by 14 times between the 1990s and the 2010s. Accelerating economic growth also led to more rapid poverty reduction. From 1990 to 2015, India's extreme poverty rate at the $1.90 per day international poverty line declined from 47.4% to 13.4%. India still needs deeper integration with the global economy and further reforms in labor and land markets, national railways, and the banking system to sustain high growth.

2.10 Pursuing reforms in other South Asian countries

Pakistan

During the first 3 decades after independence in 1947 with the partition of British India, Pakistan pursued a state-led import substitution industrialization policy. In the 1950s and 1960s, the government supported specific sectors (mainly sugar, jute, and chemicals) through import licensing, export subsidies, and multiple exchange rates; but the interventions were considered relatively benign and the country had a thriving private sector.

The 1960s saw an acceleration of growth, driven by expanding manufacturing production, the Green Revolution that boosted the agriculture sector, and inflows of foreign aid and investment due to geopolitical factors related to the Cold War. However, growth came with rising inequality, especially between East Pakistan and West Pakistan, culminating in civil conflict, which led to war with India and the separation of East Pakistan in 1971 as an independent Bangladesh. Subsequently, Pakistan pursued socialist-inspired nationalization by taking over large-scale manufacturing enterprises and establishing many SOEs.

Toward the end of the 1970s, economic and political instability led to the second military takeover in 20 years. The new government reversed many of the early 1970s socialist policies and privatized much of the industry the previous government took over. High private investment, inflows of foreign aid, and increased remittances from the Middle East contributed to solid growth. While Pakistan returned to electoral democracy at the end of the 1980s, twin trade and fiscal deficits resulted in a balance of payments crisis, leading to a structural adjustment program with the IMF. The program included policy conditions on privatizing banks and SOEs, introducing a managed floating exchange rate, and liberalizing trade and investment.

Implementing these structural reforms proved difficult. Pakistan continued to suffer from rising public debt and frequent balance of payments difficulties in the 1990s. There was another military takeover in 1999. The country enjoyed a period of high growth from 2001 to 2006, partly due to large foreign aid associated with the war against terrorism. But the oil price shocks of 2007–2008 hit Pakistan hard, and it had to enter into multiple IMF programs in the following 10 years to stabilize the economy. After 2010, the pace of growth gradually picked up, partly supported by increasing FDI, especially as economic cooperation with the PRC strengthened. Economic growth, however, slowed sharply from mid-2018, following fiscal and monetary policy tightening to rein in high and unsustainable twin deficits.

Pakistan's economic growth has been volatile over the past half century, affected by frequent political instability, geopolitical factors, and balance of payments crises. With electoral democracy now taking root, the new government under Prime Minister Imran Khan is taking on a wide range of structural reforms with the help of an IMF program in 2019 complemented by financing from ADB, the World Bank, and some bilateral partners. These reforms cover consolidating fiscal conditions, strengthening corporate governance of SOEs, and improving the investment climate. It is hoped that these reforms will address the chronic balance of payments problems and build more sustained and stable growth.

Bangladesh

As one of the world's most impoverished and least developed countries at the time of independence in 1971, Bangladesh initially pursued a state-led development strategy. The government nationalized banks, shipping companies, and major industries (including textiles, jute, and sugar mills). The country was under military rule from 1975 to 1990. During this period, some nationalized industrial companies were handed back to their former owners and private sector development and export-oriented growth were encouraged. Foreign aid started to pour into the country in the early 1980s, and international donors encouraged the government to privatize SOEs and liberalize the economy.

From the 1980s, a series of market-oriented reforms allowed the private sector a greater role in procuring, distributing, and importing agricultural inputs, while reducing subsidies. The government also removed urban and rural food rationing and subsidies in favor of targeted, in-kind assistance such as "food for work" programs.[42] A successful population control program helped keep population growth in check. Public investment and the Green Revolution helped increase agricultural productivity and made Bangladesh self-sufficient in food.

[42] Ahmed, R., S. Haggblade, and T. Chowdhury, eds. 2000. *Out of the Shadow of Famine: Evolving Food Markets and Food Policy in Bangladesh*. Baltimore: Johns Hopkins University Press.

Industry has been dominated by ready-made garments (RMG), which accounted for 6% of employment and 84% of total exports in 2018. The RMG success was largely the result of market forces. A 1979 joint venture with a company from the ROK catalyzed and fostered the RMG industry, with most early entrepreneurs learning skills and obtaining technology from the joint venture (Chapter 5). The state helped the RMG industry by setting up bonded warehouses and allowing exporters to use export orders as collateral to borrow.

Unique to Bangladesh is the contribution of nongovernment organizations (NGOs) to development. NGOs emerged soon after the independence in 1971 as a civil society response to assist those affected and address social issues in this war- and disaster-ravaged country. With the increased foreign aid, NGOs proliferated and became a prime channel for implementing many social development projects supported by international donors. NGOs provided microcredit services, health care, sanitation, and education. They also partnered with government in providing other services such as safety net programs, agricultural extension, social forestry, disaster management, and skills training.[43] Microfinance has played a critical role in agriculture and rural transformation.[44]

Bangladesh has emerged as one of the fastest-growing countries in Asia (and globally) in recent years, driven by strong domestic demand, robust RMG exports, improving infrastructure, higher agricultural growth, and surging remittance inflows. To sustain this momentum in the medium to long term, the government under Prime Minister Sheikh Hasina now focuses on mobilizing domestic resources by creating a broader tax base and better revenue collection; upgrading education including science, technology, engineering, and mathematics (STEM), including for girls; diversifying its industrial base (including generic pharmaceuticals); and improving the business climate.

Sri Lanka

Sri Lanka also pursued an inward-oriented policy of import substitution and state-led industrialization during the first 30 years after independence in 1948. The state nationalized basic and strategic industries and introduced import licensing and high tariffs to control

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[43] World Bank. 2006. *Economics and Governance of Nongovernmental Organizations in Bangladesh*. Washington, DC.

[44] Sawada, Y., M. Mahmud, and N. Kitano, eds. 2018. *Economic and Social Development of Bangladesh: Miracle and Challenges*. London: Palgrave.

imports.[45] In agriculture, most plantations—including tea and rubber—came under state ownership through the Land Reform Act of 1972. These policies, coupled with a 1971 oil shock, resulted in reduced economic growth and a deterioration of macroeconomic conditions.

A change in government in 1977 paved the way for the extensive liberalization and market-oriented reforms in the 1980s. Trade liberalization was forcefully pursued. Tax incentives and export processing zones (EPZs) were introduced to encourage FDI. Most price controls and multiple exchange rates were removed. However, the ethnic conflict from the early 1980s stalled promising benefits from trade liberalization, hampered foreign investment, and hurt tourism.

Despite setbacks brought about by civil war, the government continued with a "second wave" of liberalization in the 1990s. These reforms included privatizing SOEs in telecommunications and reverting large plantations to private management under a 100-year leasing arrangement. The tariff structure was simplified, import duties reduced, and in 2001, a floating exchange rate was introduced.

Sri Lanka was able to weather the 1997–1998 Asian financial crisis, but suffered a series of natural disasters and external shocks during the following 10 years, including prolonged droughts, terrorism, the 2004 Asian tsunami, and the 2008–2009 global financial crisis. These forced the government to repeatedly seek IMF assistance. The prolonged civil war that started in July 1983 finally ended in May 2009. The country began reconstruction and reconciliation, especially in the northern provinces. From 2010 to 2012, Sri Lanka saw growth pick up, benefiting from a peace dividend and continued market-oriented reforms. Yet growth slowed during 2015–2019 due to balance of payments difficulties.

Compared with other South Asian countries, Sri Lanka has had relatively better social indicators such as high literacy and low infant mortality rates over the decades. However, because of domestic conflict, political instability, and frequent shifts in economic policies, it has been difficult to sustain high growth. To reach its growth potential—including agribusiness and tourism, for example—Sri Lanka needs to continually work toward effectively managing its external debt, maintain macroeconomic stability, and implement structural reforms. It should attract more FDI to integrate more deeply with the regional and global trading system.

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[45] Athukorala, P., et al., eds. 2017. *The Sri Lankan Economy: Charting a New Course.* Manila: Asian Development Bank.

Afghanistan, Nepal, Bhutan, and Maldives

Since the late 1970s, Afghanistan had been ravaged by external aggression, then a civil war, and now continued conflicts and security threats. As a result, many people died, much of the country's infrastructure was destroyed, trade and investment disrupted, large amounts of capital lost, and GDP contracted substantially. In 2001, after the fall of Taliban rule and the signing of the Bonn Agreement, an interim administration was established and the process of reconstruction and reform started.

Afghanistan has the natural advantage of being a geographical hub to connect Central Asia with South Asia and holds potential in agribusiness and specific manufactured products. Since 2001, the country has harnessed international support to rebuild its political system, institutions, infrastructure, and economy, and shown improvement on various economic and social indicators. However, security threats and conflicts continue to be major challenges to the economy and foreign investment. The country's development needs remain huge and sustained international assistance is critical in helping the country achieve sustained and inclusive growth. Since 2002, ADB has provided a total of $5.6 billion in assistance to support sectors such as transport, energy, agriculture, natural resources, and rural development.

Nepal was never colonized, and the 1951 revolution ended the rule by the elite Rana family, restoring direct rule by the King with a cabinet led by the Nepali Congress, the largest political party at that time. Since then, Nepal had seen continued domestic conflict until the mid-2000s. It has gone through absolute monarchy, constitutional monarchy, and a federal republic. The first five-year plan for 1956–1961 and subsequent plans followed an import substitution policy focusing on industrialization through price controls and public corporations. Land reform in 1964 gave land entitlement to many landless people.

Nepal has promising potential in hydropower, a variety of agricultural products given the different elevations of arable land, and tourism based on its historical heritage and the Himalayas. The successful political transition from a constitutional monarchy to a federal republic in 2008, the declaration of a new Constitution in 2015, and successful elections under the new Constitution for all three tiers of governments in 2017 paved the way for future development based on market-oriented reforms, strong investment supported by the international community, and regional cooperation.

Bhutan was never colonized either. It remained almost entirely closed off to the outside world until the 1960s—when it had no roads usable by motor vehicles, the economy depended on subsistence agriculture, and life expectancy and per capita income were among the lowest in the world. Its first five-year plan began in 1961 with large-scale development programs supported by India. Over the years, the focus of planning shifted from basic infrastructure to hydroelectricity and services. The construction and generation of hydroelectricity have driven Bhutan's economic growth.

Since the 1960s, the economy has undergone extensive transformation and reforms toward more open policies resulting in large development gains. "Gross National Happiness" was instituted as the government's primary goal and enacted in its 2008 Constitution. In the 2010s, the government adopted reforms to improve the investment climate, identify high potential sectors, renew focus on small and cottage industries, and promote public–private partnerships.

Maldives gained independence from the UK in 1965 and became a republic in 1968. It was one of the poorest countries in Asia at that time. Since then, it has developed many resorts across its dispersed islands and transformed the country into a major tourist destination. In 2018, tourism accounted for more than a quarter of GDP. The public sector, including SOEs, dominates the economy, accounting for 40% of total employment.

Challenges to Maldives include the impact of global warming and its scattered geography. The country has more than 1,000 islands, of which 187 are inhabited. Eighty percent of its territory is less than 1 meter above sea level. The government is now taking measures to strengthen environmental protection, promote sustainable tourism, and diversify the economy.

2.11 Transition in Central Asia and Mongolia

After the dissolution of the Soviet Union and gaining independence in 1991, the five Central Asian countries (Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan) and the three South Caucasus countries (Armenia, Azerbaijan, and Georgia)—collectively the Central Asian subregion—embarked on transition to a market economy. Unlike countries in Central and Eastern Europe and the Russian Federation—which adopted a "big bang" approach of rapid liberalization and mass privatization—most Central Asian countries adopted a more gradual approach, though with large variations. The transition has proven complex and has often been marked by multiple economic crises, reform reversals, and instability along the way. While the transition is far from complete, significant progress has been made, especially in price and trade liberalization, privatization of small-scale SOEs, the development of the private sector, and macroeconomic stabilization.

Independence created shock waves across these economies. It led to an immediate collapse of demand and supply networks among tightly integrated former republics under central planning. They were hit hard partly because their economic role in the Soviet system was primarily as suppliers of raw materials to more industrialized areas, with most lacking an independent industrial base. Production slowed dramatically with per capita GDP declining at double-digit rates for several years in many countries (Table 2.3).

Those rich in natural resources—such as Kazakhstan (oil), Azerbaijan (oil and gas), and Turkmenistan (gas)—fared better. But even they could not escape sharp economic downturns. Accompanying the production collapse was skyrocketing inflation (three- to four-digit levels) due to declining output, a widespread shortage of consumer goods, large fiscal deficits, and rapid expansion of money supply by several central banks—in the early transition years, Central Asian countries continued to use the Russian ruble as currency.

Faced with these challenges, macroeconomic stabilization became a key part of reform. To bring inflation under control, they all introduced national currencies: Azerbaijan in August 1992; the Kyrgyz Republic in May 1993; Armenia, Kazakhstan, Turkmenistan, and Uzbekistan in November 1993; Tajikistan in May 1995; and Georgia in October 1995. Over time, their central banks gained more independence. Governments also worked to reduce fiscal deficits through tax reforms, including the introduction of a value-added tax, and personal and corporate income taxes, and by reducing government expenditures, in particular, direct subsidies to SOEs. These stabilization measures, together with other structural reforms, were effective in bringing inflation under control: declining to double-digit levels in the late 1990s and single digits by the early 2000s for most countries. The fiscal situation also improved, with deficits falling in oil-importing countries and turning to surpluses in oil-exporting ones.

Table 2.3: Average Annual Per Capita GDP Growth, Central Asia and Mongolia, 1991–2018
(%)

	1991–1995	1996–2000	2001–2005	2006–2010	2011–2015	2016–2018
Central Asia	**(11.4)**	**3.1**	**8.4**	**6.7**	**3.6**	**1.8**
Armenia	(8.2)	6.1	12.9	5.1	4.1	4.0
Azerbaijan	(16.8)	6.1	12.4	15.2	0.8	(1.6)
Georgia	(19.9)	8.8	8.3	6.0	5.2	4.1
Kazakhstan	(8.7)	3.8	10.0	4.7	3.2	1.7
Kyrgyz Republic	(13.2)	4.1	2.8	3.4	3.1	2.2
Tajikistan	(18.7)	(1.0)	7.8	4.4	4.5	4.7
Turkmenistan	(10.9)	3.4	4.1	8.9	8.6	4.5
Uzbekistan	(6.0)	2.2	4.1	6.6	5.9	3.4
Mongolia	**(3.5)**	**1.9**	**5.4**	**5.0**	**8.2**	**2.6**

( ) = negative, GDP = gross domestic product.

Sources: Asian Development Bank (ADB). Key Indicators Database. https://kidb.adb.org/kidb (accessed 16 September 2019); World Bank. World Development Indicators. https://databank.worldbank.org/reports.aspx?source=world-development-indicators (accessed 2 August 2019); and ADB estimates.

GDP growth returned in the second half of the 1990s, despite the impact of the 1998 Russian financial crisis. The early 2000s saw strong per capita GDP growth across the entire Central Asian subregion—8.8% annually on average—supported by strong commodity exports, rapid credit expansion, and high remittances. Growth in resource-rich countries was particularly high, due to the commodity boom. But these countries, together with remittance-dependent economies, especially the Kyrgyz Republic and Tajikistan, were hit by the 2008–2009 global financial crisis and the 2014 downward oil price shocks.

Centrally administered prices were a key feature of the Soviet economic system, and it led to severe resource misallocation and widespread shortages. While price liberalization initially triggered inflation, it contributed subsequently to economic stabilization as markets responded to price signals. In 1992, the Kyrgyz Republic became the first Central Asian country to fully liberalize prices and abolish state production orders. Other countries adopted a more gradual approach. For instance, Kazakhstan liberalized most prices in 1994; Tajikistan, affected by civil war, did so in 1996. By 1998, all countries were well advanced in price liberalization, except Turkmenistan and Uzbekistan.

Accompanying price liberalization was trade liberalization. The Kyrgyz Republic was again the front-runner, introducing full current account convertibility in 1995. In 1998, it became the first Central Asian country to join the WTO. As trade reform progressed, more countries joined the WTO—Georgia in 2000, Armenia in 2003, Tajikistan in 2013, and Kazakhstan in 2015. Uzbekistan recently renewed its WTO accession process. Regional cooperation has also progressed, especially in trade and connectivity, through frameworks such as the Eurasian Economic Union (Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and the Russian Federation) and the 11-member Central Asia Regional Economic Cooperation (CAREC) Program, supported by ADB since it was formally established in 2001.

Privatization of SOEs was another key step of the transition toward a market economy, but it proved to be complex and difficult. Again, the privatization approach adopted by Central Asian countries was much more gradual than those in Central and Eastern Europe and the Russian Federation. Small-scale privatization advanced rapidly in most countries. There were greater variations for large SOEs. Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, and Tajikistan used voucher schemes, while Turkmenistan and Uzbekistan opted for manager- and employee-buyouts. While SOEs remain an important part of their economies, the private sector expanded rapidly. In 2010, by some estimates, the private sector contributed 45%–75% of GDP in most Central Asian countries.

Mongolia was also seriously affected by the demise of the former Soviet Union because of their close ties. Under the Soviet system, the country's economy and living standards were sustained by large Soviet aid flows, including energy, food supplies, raw materials, capital equipment, and market access. These disappeared virtually overnight following the Soviet collapse. Together with the "big bang" approach to transition adopted by Mongolia—involving rapid liberalization and mass privatization—the economy plunged into deep recession during the first half of the 1990s.

Mongolia is a resource-rich economy with large reserves of copper, coal, and gold. Relatively stable growth returned from 1995, and the country joined the WTO in 1997. While the economy was briefly disrupted by a debt crisis in 2000–2001, per capita GDP recovered to its pre-transition level by 2003. Mongolia had a sharp, but short-lived, growth slowdown in 2009 due to the global financial crisis, but enjoyed a period of rapid growth in 2010–2014, when it was briefly one of the world's fastest-growing economies, fueled mainly by a mining boom. Mongolia has been and remains vulnerable to external shocks coming from fluctuations in commodity prices.

Given their land-locked geography, resource-based economies, and the need to diversify industry to sustain growth, Central Asian countries and Mongolia can draw on deeper regional cooperation and greater investment in connectivity and human resources. They will gain from continued reforms—such as privatizing larger SOEs, strengthening financial institutions, introducing competition policy, and reforming governance in firms and state institutions.[46]

2.12 Seizing opportunities in the Pacific

Pacific island countries share a unique set of challenges and opportunities. Most are small (except Papua New Guinea [PNG], which has a relatively large population of 8 million);[47] have limited natural resources (except PNG and Timor-Leste, which have large natural gas reserves) and narrowly based economies; and are remote from major markets, vulnerable to external shocks, and highly dependent on external assistance. The lack of sufficient human and institutional capacities constrain development. They also face climate-related challenges such as rising sea levels and more frequent extreme weather events.

Compared with other subregions, economic growth in the Pacific has been slow and unstable. These countries were former colonies and gained independence mostly from the 1970s onward. Like many other newly independent economies, the state plays an important role in the economy. SOEs dominate core infrastructure services such as transport, power, telecommunications, and water and sanitation, in addition to education, health care, and other essential

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[46] The European Bank for Reconstruction and Development provides assessments of transition progress for all the formerly socialist countries in Central and Eastern Europe, the Russian Federation, and Central Asian countries in their annual Transition Report.

[47] Pacific island countries in this chapter refer to ADB's 15 Pacific members: the Cook Islands, the Federated States of Micronesia, Fiji, Kiribati, the Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

social services. And with opportunities for profitable business ventures limited by geography, SOEs also often provide services and products that the private sector would normally run, such as hotels, shipping services, and manufacturing.

Pacific governments have worked to reform their economies toward greater reliance on markets and the private sector, and to strengthen institutional capacity to seize opportunities from globalization, technological progress (such as digital technologies), and Asia's rapid economic growth.

One notable area is SOE reform. The poor performance of SOEs has long been a constraint on growth. Fiji began SOE reform in the early 1990s. In recent years, many more countries have initiated SOE reform through partial privatization and public–private partnerships; and by strengthening legal, regulatory, and governance frameworks. For instance, Fiji privatized 51% of Ports Terminal Limited and entered into a management contract for Suva and Lautoka ports in 2013. Kiribati adopted an SOE Act in 2012 and privatized Kiribati Supply Company Limited, a hardware company in business for over 30 years, in 2013. Samoa privatized SamoaTel in 2010 and adopted an SOE divestment and ownership policy in 2015. These reforms improved SOE performance.[48]

Supported by development partners such as ADB and the World Bank, Pacific island countries are working on broad public sector governance reforms and strengthening institutional capacity. The public sector, including SOEs, represents over a third of GDP on average. Recent reforms aim to strengthen budgetary management, accounting frameworks, internal auditing and financial reporting, debt management, and capacity development and training.

Another structural reform is trade liberalization, which can be traced back to the late 1980s.[49] In recent years, Pacific island countries pursued trade liberalization mainly through regional and multilateral agreements. In August 2001, they signed the Pacific Agreement on Closer Economic Relations (PACER), providing an umbrella agreement between 16 members of the Pacific Islands Forum (which also includes

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[48] ADB. 2016. *Finding Balance 2016: Benchmarking the Performance of State-Owned Enterprises in Island Countries*. Manila.

[49] Narayan, P., and B. C. Prasad. 2006. Trade Liberalization and Economic Growth: Empirical Evidence for Fiji from the Computable General Equilibrium Model. *Discussion Paper Series*. No. 07/06, Vol. 1. Queensland: Faculty of Business and Economics, Griffith University.

Australia and New Zealand) on the trade liberalization process. In 2001, they signed the Pacific Island Countries Trade Agreement (PICTA), a free trade agreement on trade in goods among 14 members of the Pacific Islands Forum (excluding Australia and New Zealand), which entered into force in 2003. PICTA members are required to gradually lower tariffs on goods traded among island states over a 10-year period and remove nontariff barriers. More recently, negotiations were concluded for PACER Plus—a regional development-centered trade agreement covering goods, services, and investment.

At the multilateral level, six Pacific countries are WTO members— Fiji, PNG, Samoa, Solomon Islands, Tonga, and Vanuatu.

Pacific island countries can promote sustainable tourism by preserving their cultural traditions and the environment. Expanding communications and internet access, supported by ADB and others, have provided greater connectivity to global markets. International support for structural reforms, building institutional and human capacities, climate adaptation, disaster risk management, and financial inclusion remain important for the subregion.

2.13 Looking ahead

Fifty years of Asian development show that sustained growth, poverty reduction, and economic catch-up require efficient markets, an effective state, and strong institutions. Market-oriented reforms, open trade and investment regimes, effective government support, and strong state capacity together have transformed developing Asia into one of the world's most dynamic regions.

Going forward, developing Asia should continue efforts in the following areas.

First, make markets work better and more efficiently. Depending on individual country circumstances, governments should continue to implement structural reforms in the labor market, the financial sector, and trade and investment regimes to reduce and eliminate market rigidities, distortions, and barriers. Also, most countries have room to strengthen competition policy, intellectual property protection, contract enforcement, and corporate governance.

Second, as a country becomes more developed and the private sector matures, government support for growth should gradually move toward measures that have large spillovers to the wider economy and do not constrain competition—such as supporting innovation and R&D, investing in higher education, and maintaining an enabling environment for private enterprises. Continuing SOE reform is another priority, by making SOEs compete on an equal footing with the private sector, and by privatizing them when appropriate.

Third, governments should continue to improve capacity in providing quality public goods, addressing market failure, and responding to emerging challenges. They must build and maintain good physical infrastructure; make adequate investment in education and health; and respond to challenges such as environmental degradation, climate change, urbanization, and population aging. They should also effectively pursue macroeconomic stability.

Fourth, governments should pay more attention to income redistribution, social equity, and equalizing opportunity through progressive taxation and public transfers. Good quality public education and health services also contribute to inclusiveness. While the region's extreme poverty has declined dramatically, income inequality has widened in many countries and remains stubbornly high in others. If the benefits of growth are not equally shared and many are left behind, there will be less incentive for people to participate in national development, and social tensions and instability can rise and may undermine growth and its sustainability.

Fifth, countries should continue to reform public sector governance. Maintaining the rule of law, improving regulatory quality, and scaling up anticorruption efforts offer large gains. Greater participation and accountability are increasingly important as citizens demand a greater say in national affairs with rising incomes and increasing access to advanced technology.