ASIA’S JOURNEY TO PROSPERITY

Policy, Market, and Technology over 50 Years

Chapter 2: The Role of Markets, the State, and Institutions
Outline

01  The role of markets and the state: conceptual discussions
02  Evolving development policy paradigm since World War II
03  Japan’s postwar economic recovery and growth
04  The emergence of newly industrialized economies
05  Economic liberalization in Southeast Asia
06  From state-led industrialization to market-led growth in South Asia
07  Building a socialist market economy in the People’s Republic of China
08  Economic transition in Central Asia
09  Recent reforms in the Pacific island countries
10  Looking ahead
11  Questions and list of readings
1. The role of markets and the state: conceptual discussions

1. Evolution of thinking

- Adam Smith’s *The Wealth of Nations* in 1776
- Marx’s *Capital* in 1867
- Neo-classical economics since the late 1800s and early 1900s
- Keynes economics
- Market failure and government failure

2. Postwar development economics

- Big push
- Unbalanced and balanced growth
- Stages of growth
- The dual economy
- Dependency theory
3. The role of market versus state

- Markets play a dominant role in allocating resources and incentivizing firms, while state interventions address market failure.

- **Sources of market failure**: imperfect competition, externality, imperfect information, public goods, coordination failure

- **Forms of state interventions**: market regulation; provision of public goods and services; support for domestic industries and firms through import protection, foreign exchange allocation, tax incentives, subsidies, and directed credit; and state ownership of industries

- In a modern economy, the state also:
  - establishes and maintains institutions;
  - redistributes incomes; and
  - maintains macroeconomic stability.

- Continued debate on the role of market versus state
2. Evolving development policy paradigm since World War II

- The development policy paradigm has evolved since World War II, influencing the role of markets and states.

01 State-led industrialization and import substitution after World War II
- The desire to gain economic independence after political independence
- Socialism and socialist ideas
- The perceived success of the Soviet Union
- New thinking in development economics

02 The rise of neo-liberalism and the move toward free markets in the developed world from the late 1970s

03 The lost decade in Latin America and the Washington Consensus in the 1980s

04 Emphasis on the role of good governance from the 1990s

05 Rethinking the role of markets versus the state in the past 20 years

- 2000s-2010s
3. Japan’s postwar economic recovery and growth

Modernization and industrialization during the Meiji period (1868-1912)

Postwar restoration and key reforms

Evolution of targeted industrial policy

Explaining postwar economic growth

- Favorable external factors: United States’ financial aid; the Korean War
- Prewar legacy: institutions of a modern market economy; human capital; skills and technology
- Favorable demographics
- The role of the state: reforms in land, labor and the corporate sector; public investment in human capital and infrastructure; targeted industrial policy

Average Annual per Capita GDP Growth (%)

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<tr>
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<tr>
<td>France</td>
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<td>3.4</td>
<td>1.8</td>
<td>1.6</td>
<td>0.8</td>
<td>1.0</td>
</tr>
</tbody>
</table>

GDP = gross domestic product
4. The emergence of newly industrialized economies

01 Initial conditions of newly industrialized economies (the Republic of Korea (ROK); Taipei, China; Hong Kong, China; Singapore) in the 1950s

02 Export-promotion from the 1960s through:
   • export targeting and state guidance;
   • preferential credit, foreign exchange allocation, and import tariff in favor of exporters;
   • tax incentives; and
   • export processing zones.

03 The role of foreign direct investments

04 The private sector versus state-owned enterprises

GDP per Capita, 1960-2018
(constant 2010 $)

Average Annual per Capita GDP Growth (%)

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</thead>
<tbody>
<tr>
<td>Japan</td>
<td>9.1</td>
<td>3.1</td>
<td>3.7</td>
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<tr>
<td>NIEs</td>
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</tbody>
</table>

GDP = gross domestic product, NIEs: newly industrialized economies

5. Economic liberalization in Southeast Asia

### Malaysia

Independence in 1957; continued colonial open-door and pro-market policy; rural development to redress ethnic and regional disparity; mild import substitution; foreign direct investment (FDI) welcome

New Economic Policy to promote economic participation of ethnic Malays; promotion of labor-intensive manufacturing exports; special economic zones to attract FDI from Japan and elsewhere; growth accelerated

Heavy industrialization in the early 1980s; macro-imbalance promoted shift to trade and FDI liberalization; private investment encouraged to promote manufacturing exports; emerged as a world leading semiconductor exporter; growth acceleration.

### Thailand

The only country not colonized in Southeast Asia; the economy was relatively open and market-oriented; import substitution industrialization

Import protection increased favoring textiles, pharmaceuticals and car assembly; the economy weakened by two oil shocks

Shift to promotion of labor-intensive manufacturing exports; expansion of the mandate of Board of Investment to promote exports through various incentives, trading companies, and export processing zones; broader-based import liberalization from the mid-1980s; rapid rise of FDI; growth acceleration

### Indonesia

Independence in 1945; inward-looking and heavy state intervention and import substitution; economic deterioration brought down the Sukarno government in 1967

New Order policies under the Suharto government in favor of markets initially; commodity boom enabled heavy state investment; growth accelerated; tightening control of private investments and imports later

End of commodity boom led to macro imbalance; shift to export-promotion in 1986; deregulation of private investment and financial sector; growth acceleration
5. Economic liberalization in Southeast Asia (cont.)

**Philippines**

**Up to 1960s**

1960s or before: Independence in 1946; import substitution industrialization; poor economic performance and balance of payment crisis

**1970s**

1970s: Martial law under Marcos government from 1972 to 1981; growth was higher but driven by large external borrowing; export incentives introduced but with limited impact

**1980s**

1980s: Twin deficits led to ballooning debt; falling into political and economic crisis following the assassination of an opposition leader in 1983; People Power brought down the Marcos government in 1986; the new democratic government started reforms to restore stability

**1990s**

1990s: The debt problem in the 1980s and continued political instability led to much less foreign capital inflows than its neighbors; the country was affected by the Asian financial crisis, but to a lesser extent; speedy recovery; and post-crisis reform
5. Economic liberalization in Southeast Asia (cont.)

- The 1997-1998 Asian financial crisis (AFC) and post-crisis reforms
  - Economic liberalization and growth acceleration made these countries popular FDI destinations;
  - to attract more foreign investment, they quickened the pace of capital account liberalization;
  - foreign capital inflows surged, including portfolio capital, but due to weak domestic financial regulation, a large part was invested in real estate and infrastructure, leading to currency and maturity mismatches;
  - at the same time, rising imports, with de facto pegged exchange rates, led to large current account deficits, especially in Thailand and Indonesia;
  - investors’ panic triggered a currency crisis in Thailand starting from July 1997 initially; the crisis developed into a twin currency and banking crisis and spread to Indonesia, Malaysia, the Republic of Korea (ROK), and to a less extent, the Philippines;
  - international rescue (International Monetary Fund (IMF), World Bank, Asian Development Bank (ADB), other countries);
  - Asia’s speedy recovery;
  - Post-crisis reforms in macroeconomic management, financial regulation, corporate governance, exchange rate system, and macro-prudential policy;
  - strengthening regional monetary and financial cooperation under the Association of Southeast Nations (ASEAN) and ASEAN+3 (ASEAN plus the People’s Republic of China (PRC), Japan, and the ROK) and frameworks;
  - being affected by global financial crisis, but only mildly;
  - growing trade with and investment from the PRC.
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, at differing speeds. Support from bilateral and multilateral institutions in both finance and policy advice contributed much to the CLMV transition.

**Viet Nam.** The first to embark on market-oriented economic transition among the CLMV; adopted central planning after the Viet Nam War and unification in 1975; decided to adopt a socialist-oriented market economy and started market-oriented reform, known as “Doi Moi”, in 1986; joined ASEAN in 1995 and the Asia-Pacific Economic Cooperation in 1998; signed a Bilateral Trade Agreement with the United States in 2000 and joined the World Trade Organization (WTO) in 2007; joined the Comprehensive and Progressive Agreement for Trans-Pacific Partnership in 2018.

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

**Lao PDR.** Introduced central planning after the civil war (which was affected by the Vietnam War) ended in 1975; began pro-market reforms by launching a “new economic mechanism” in 1986, involving introducing market incentives, abandoning rural collectivization in favor of family-based farming, introducing state-owned enterprises (SOE) reform, developing the private sector, and opening up the economy to trade and foreign investment.

**Myanmar.** The country was under military rule until 2011; started comprehensive reforms since then, including introducing an electoral democracy, working toward reconciling ethnic groups, strengthening macroeconomic policy (including unifying exchange rates), and implementing various market-oriented structural reforms.
6. Building a socialist market economy in the People’s Republic of China

**Soviet-style central planning in 1949-1978**
- Economic restoration: 1949-1953
- First 5-year plan: 1953-1957
- Rural collectivization
- Great Leap Forward in 1958-1959
- People’s commune movement
- Three years of natural disasters
- Readjustment and recovery
- Cultural revolution: 1966-1976
- The downfall of the “Gang of Four”

**Market-oriented reform and opening since 1978**
- The December 1978 Communist Party of China (CPC) meeting
- Rural household responsibility system
- “Moganshan” meeting in 1984/“Bashanlun” conference in 1985
- Urban industrial reform, the “dual track system,” and contract responsibility system
- Deng Xiaoping’s Tour of the South
- The socialist market economy set as the reform goal in 1992
- Privatization of small and medium sized SOEs in the 1990s
- Joining the WTO in 2001
- The 19th Congress of the CPC in October 2017 reaffirmed allowing market forces to play a decisive role in resource allocation
6. Building a socialist market economy in the People’s Republic of China (cont.)

Explaining the People Republic of China’s economic success

❖ Market-oriented reform and opening
❖ A gradual and pragmatic approach to reform
❖ Government’s proactive promotion of development
❖ Following a right growth strategy:
  ✓ High capital accumulation
  ✓ Improvement in infrastructure
  ✓ Investment in education
  ✓ Opening to the outside world
  ✓ Promoting manufacturing

GDP per Capita, 1960, 1990 and 2018
(2010 constant $)

<table>
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<tr>
<th>Country</th>
<th>1960</th>
<th>1990</th>
<th>2018</th>
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<tr>
<td>Developing Asia</td>
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<tr>
<td>Bangladesh</td>
<td>330</td>
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<td>4,903</td>
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<tr>
<td>India</td>
<td>372</td>
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<td>1,012</td>
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<td>Republic of Korea</td>
<td>944</td>
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<td>Viet Nam</td>
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<td>Developed Asia</td>
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India

1960s to 1970s: Heavy state control under import substitution industrialization strategy; the control tightened from 1965 after Prime Minister Indira Gandhi assumed office with a greater focus on income distribution and in response to two years of serious drought, three wars with neighbors, and losses in some state elections by the Congress Party, through more stringent import licensing; nationalization; restrictions on foreign companies and use of foreign exchange; restrictions on investment by large firms in sectors “reserved” for small firms; and barriers to laying off workers by firms with 300 or more employees.

1980s: Weak economic performance led to relaxing some state controls from the second half of the 1970s, including reducing the scope of industrial and import licensing. Export incentives were also introduced. But essential economic management through licensing and controls remained unchanged.

1990s-2000s: A balance of payment crisis in the early 1990s led India to ask IMF and World Bank for emergency assistance and to move away from the old state planning and control framework. Since 1991, India has introduced sweeping market-oriented reforms, ranging from abolishing industrial licensing, liberalizing trade and FDI, deregulating the financial sector, taxation, and fiscal management. India also streamlined business regulations—including those for starting a business, obtaining construction permits, and electricity connections. In 2016, it passed an Insolvency and Bankruptcy Code, unifying laws for insolvency and bankruptcy.
Pakistan

**1950s-1970s**: In the 1950s and 1960s, state-led import substitution industrialization policy supported specific sectors through import licensing, export subsidies, and multiple exchange rates; but with a thriving private sector. The 1960s saw growth acceleration, driven by expanding manufacturing, Green Revolution, and foreign aid/investment related to Cold War. Rising inequality between East and West Pakistan led to civil conflict, war with India and the separation of East Pakistan in 1971 as an independent Bangladesh. Subsequently, it pursued socialist-inspired nationalization by taking over large manufacturing enterprises and establishing SOEs.

**1980s**: New military government reversed many of the early 1970s socialist policies and privatized much of the industry. While Pakistan returned to electoral democracy at the end of the 1980s, balance of payments crisis led to IMF program, with policy conditions on privatizing banks and SOEs, and liberalizing trade and investment.

**1990s-2000s**: 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.
7. From state-led industrialization to market-led growth in South Asia (cont.)

**Bangladesh**

**1970s:** Gained independence in 1971 and pursued a state-led development strategy initially, with banks and major industries nationalized. Under military rule (from 1975 to 1990), some nationalized industrial firms were handed back to their former owners and private sector development and export-oriented growth were encouraged.

**1980s:** Foreign aid poured into the country in the early 1980s, and international donors encouraged the government to privatize SOEs and liberalize the economy. A series of market-oriented reforms allowed the private sector a greater role in procuring, distributing, and importing agricultural inputs.

**1990s-2000s:** Industry has been dominated by ready-made garments (RMG), largely the result of market forces. 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 after the independence in 1971. Emerged as one of the fastest-growing countries in Asia (and globally) in recent years, driven by strong domestic demand and robust RMG exports, improving infrastructure, higher agricultural growth, and surging remittance inflows.
Sri Lanka

1940s-1970s: Pursued an inward-oriented policy of import substitution and state-led industrialization during the first 30 years after independence in 1948. The state nationalized strategic industries and introduced import licensing and high tariffs. 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.

1980s: A change in government in 1977 paved the way for extensive trade liberalization and market-oriented reforms in the 1980s. Tax incentives and export processing zones were introduced to encourage FDI. Most price controls were removed. However, the ethnic conflict from the early 1980s stalled promising benefits from market-oriented reform.

1990s-2000s: Despite the civil war, the government continued with a “second wave” of liberalization in the 1990s, including privatizing some SOEs and reverting large plantations to private management, reducing tariffs, and in 2001, introducing a floating exchange rate. 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 civil war that started in July 1983 finally ended in May 2009. The country began reconstruction and reconciliation.
8. Economic transition in Central Asia

- Central Asian countries became independent after the collapse of the Soviet Union in 1991 and started transition to a market economy;

- Most of them took a gradual approach to reforms, rather than a “big bang”, which the Russian Federation and East Europe did;

- At the beginning, macroeconomic stability was a priority, with measures including introducing national currencies, tax reform and reducing fiscal deficits, and reducing direct subsidies to SOEs. Inflation declined from 3-4 digits to single digit in early 2000s;

- More structural reforms were introduced over time, including price and trade liberalization, privatization of small-sized SOEs, among others.

### Average Annual GDP Per Capita Growth (%)

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<td>5.1</td>
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<td>4.0</td>
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<td>0.8</td>
<td>(1.6)</td>
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<tr>
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<td>(19.9)</td>
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<td>6.0</td>
<td>5.2</td>
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<td>(8.7)</td>
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<td>4.7</td>
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<td>3.1</td>
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<td>4.5</td>
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<tr>
<td>Uzbekistan</td>
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<td>4.1</td>
<td>6.6</td>
<td>5.9</td>
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<td>8.2</td>
<td>2.6</td>
</tr>
</tbody>
</table>

( ) = negative, GDP = gross domestic product.

These countries were former colonies and gained independence mostly from the 1970s onward. Compared with other subregions, economic growth in the Pacific has been slow and unstable. Pacific island countries are small (except Papua New Guinea), have limited natural resources (except Papua New Guinea and Timor-Leste) and narrowly based economies; are remote from major markets, vulnerable to external shocks, and highly dependent on external assistance. They also face climate-related challenges such as rising sea levels and more frequent extreme weather events.

SOEs dominate core infrastructure services such as transport, power, telecommunications, and water and sanitation, in addition to education, health care, and other essential social services. 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.

There are efforts to privatize SOEs, liberalize trade and strengthen institutional capacity in recent years.

9. Recent reforms in the Pacific island countries
10. Looking ahead

- Fifty years of Asian development show that sustained growth and poverty reduction require efficient markets, an effective state, and strong institutions. Going forward, developing Asia should continue efforts in the following areas.

  **First**, make **markets** work **better** and more efficiently.

  **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 that do not constrain **competition**. Continuing SOE reform is also a priority.

  **Third**, governments should continue to improve **capacity** in providing quality **public goods**, addressing **market failure**, and responding to emerging **challenges**.

  **Fourth**, governments should pay more attention to **income redistribution**, **social equity**, and **equalizing opportunity** through progressive taxation and public transfers.

  **Fifth**, countries should continue to **reform** public sector **governance**.
11. Questions and reading list

• Questions:
  - What is the role of markets and the state in a modern economy? How has economic thinking on this evolved?
  - What are the underlying causes of market failure and government failure?
  - Why were there strong state role and government interventions in both developing and developed economies after World War II?
  - What were the underlying reasons for the shift toward greater market-orientation globally and in major economies since the late 1970s?
  - Is there an Asian development model that differs from the so-called “Washington Consensus”?
  - What lessons can be learnt from Asian development experiences on the role of markets and the state?
11. Questions and reading list (cont.)

- **Reading list**
Thank you!

The soft copy of the book can be downloaded at

https://www.adb.org/publications/asias-journey-to-prosperity