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TMD DISCUSSION PAPER NO. 45

ECONOMIC GROWTH AND POVERTY REDUCTION IN INDOCHINA: LESSONS FROM EAST ASIA

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September 1999

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ABSTRACT

Differences and similarities in the development paths taken by six East Asian economies (Indonesia, Malaysia, Philippines, Thailand, South Korea, and Taiwan) provide a fertile ground for policy analysis from which important lessons are drawn and major challenges identified for the Indochinese transitional economies (ITEs for short, including Cambodia, Laos, Myanmar, Viet Nam, *and China*) in advancing the twin objectives of economic growth and poverty reduction. The paper first examines the comparative growth performance of these two groups of Asian economies over the period 1970-1997, describes the significant features of transition and development in the ITEs, and analyzes the relationship between development performance and policies among the East Asian countries. The following major policy challenges for ITEs are discussed towards the end of the paper: (1) sustaining reform efforts toward market orientation; (2) promoting broad-based agricultural growth; (3) supporting labor-intensive, export-oriented industries; (4) dealing with macroeconomic imbalances; and (5) building a strong financial system.

Paper presented at the Symposium on Critical Food Policy Issues in Indochina in the Emerging Globalization Context, sponsored by IFPRI and the Ministry of Agriculture and Rural Development, held in Hanoi on March 1-2, 1999.

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Introduction

In the current anxiety about the Asian crisis and the prospects for economic recovery in the afflicted countries, it is easy to lose sight of the need for many low-income countries in the region to focus attention on longer run development efforts that promote economic growth and reduce poverty. Because of currency nonconvertibility and other impediments to capital movement, the *Indochinese transitional economies* (ITEs for short) namely, Cambodia, China, Laos, Myanmar, and Viet Nam[1] have not been subject to the financial contagion risk that significantly affected East Asian market economies with a liberalized capital account. However, there are strong trade and investment links between these two groups of Asian countries, so that an economic downturn in the latter countries is bound to have an adverse impact on the ITEs.

For most of the period since the early 1970s, the growth performance of East Asia's market economies has been one of unparalleled success. Economic growth among the Asian NIEs (newly industrialized economies), consisting of Hong Kong, Singapore, South Korea, and Taiwan, is widely acknowledged to be spectacular. The other countries included in the East Asia category, the more heavily agricultural ASEAN-Four countries namely, Indonesia, Malaysia, the Philippines, and Thailand also show generally very impressive growth performance.[2] Moreover, rapid economic growth in most of these East Asian countries has been accompanied by substantial poverty reduction. Their remarkable development record has been frequently held as a shining example for developing countries both within and outside Asia. Emphasizing the relatively open and market-oriented policies pursued by the high-performing East Asian economies, the World Bank (1993) has coined the term "East Asian miracle" in extolling the region's development achievements.

The adoption of major reforms toward a market economy in the formerly centrally planned economies in Indochina which began in China in 1978, in Viet Nam and Laos in 1986, in Myanmar in 1988, and Cambodia in 1993 was generally motivated by the need to address persisting problems of macroeconomic imbalances and slow growth. The earlier

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[1] For our purposes in this paper, it is convenient (albeit unusual) to stretch the country coverage of the Indochina region to include China.

[2] The sole exception is the Philippines, where the rapid economic growth during 1965-80 was not sustained (see below).

successes of the neighboring economies were presumably an important positive influence. Geographical proximity to the rapidly growing NIEs and ASEAN countries also led early on to investment in joint ventures and the establishment of wholly owned subsidiaries in Indochina. On the other hand the Indochinese economies suffered, in varying degrees (Viet Nam being the hardest hit), from losses of financial assistance from the former Soviet bloc and from the disruption of trade links within the CMEA (Council for Mutual Economic Assistance).

While the size and growth of population in the five ITEs differ widely, it has remained largely rural in each country. The share of the rural population ranges narrowly from 68 percent in China to 79 percent in Viet Nam and Cambodia (Table 1). Agriculture's contribution to total output is large, especially in Cambodia, Laos, and Myanmar where it exceeds 50 percent of GDP. China and Viet Nam are relatively more industrialized, based on the comparative industry shares among the five countries. Indeed, the contribution of industry to GDP is greater than the agricultural share for China and Viet Nam; in labor employment, however, both countries show a substantially larger share of agriculture compared to industry. In all five countries more than 70 percent of the labor force ("economically active population") is engaged in farming, implying that underemployment and low labor productivity continue to characterize agriculture in the region. This is particularly notable in China, the highest income ITE and the earliest to implement agricultural reforms (see below), presumably because its economy prior to the transition was the most centralized and its structure of production and prices the most distorted. Where agricultural products are underpriced due to domestic market distortions, as is commonly the case in low-income countries (Bautista and Valdes 1993), the share of agriculture in total employment is a more meaningful indicator of its importance to the national economy than the agricultural share in GDP.

The transitional Indochinese economies have grown at varying rates since the mid-1980s. At the low end of the GDP growth spectrum is Myanmar, while Viet Nam and China show remarkably high average annual rates of 8.6 and 11.9 percent, respectively, during 1986-97 (Table 1). By international standards, the average annual GDP increases for Laos and Cambodia, each exceeding 6 percent, are also relatively high. Despite such economic expansion in the region, per capita income has remained relatively low. GNP per capita for 1997 in each of the ITEs is lower much lower if China is excluded than the average (over US$900) for developing countries in East Asia and the Pacific.

At any given income per capita, the incidence of poverty is determined by the distribution of national income. Conceptual problems and weaknesses in existing data, especially in centrally planned economies that do not follow international accounting conventions, make it difficult to be precise in the measurement of income distribution and even more so, of the extent of poverty. The simplest and most commonly used measure of poverty is the headcount index, which represents the proportion of the population that falls below (but ignoring how far below) a specified poverty line. Recent World Bank estimates of the national headcount index for four of the ITEs, based on internationally comparable

PPP (purchasing power parity) U.S.$1 per person per day (at 1985 prices), are given in Table 2. They range from 26.9 percent for China to 50.9 percent for Viet Nam, which are significantly higher than the estimate of 13.7 percent for East Asia and Pacific countries as a group (excluding China) for 1993 (World Bank 1996:4).[3] As is typically the case in low-income countries, poverty in the region is predominantly rural. In each of the four countries included in Table 2, at least 86 percent of the poor reside in rural areas.

The lower incidence of poverty in China is reflected in the more favorable social, or quality-of-life, indicators (also shown in Table 2) not only compared to the four other ITEs but also relative to East Asia and Pacific developing countries as a group. There is a close positive association of the poverty index with child malnutrition across countries, and a rather weak negative correlation with access to safe water. It is striking that Viet Nam, which has a higher poverty incidence and also a lower income per capita than Cambodia and Laos, ranks second only to China among the five countries in terms of life expectancy and infant mortality. However, these two indicators are less favorable for Viet Nam than for East Asia and Pacific countries on average.

The Diverging Performance of Asian Economies

Table 3 shows the comparative values of GNP per capita for 1970 and 1997 in the five ITEs and six East Asian economies.[4] They are expressed in U.S. dollars, using nominal exchange rates as the conversion factor. It would have been preferable to use PPP-adjusted income estimates which are a better measure of living standards, especially in low-income countries. Unfortunately, such income estimates are not available for some of the Indochinese countries in 1997 and for all 11 Asian economies in 1970.

A striking observation from Table 3 is that three decades ago, Indochina was not too distant from East Asia in terms of income levels. Myanmar's GNP per capita in 1970, the lowest in the Indochina group, was comparable to Indonesia's, while those of the other ITEs

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[3] By the headcount measure, there were about 400 million poor people in the four ITEs in 1993-94, of which 82 percent or 327 million are Chinese. The official estimate of poverty in China for 1994 is 6.9 percent or 80 million people, based on the national poverty line of 500 yuan per capita per year (representing the cost of a subsistence consumption basket comprising essential food and nonfood items). This poverty line translates into U.S.$0.60 per day in 1985 prices (World Bank 1996:6). The large disparity between the two estimates of the number of people in poverty, arising from a shift in poverty line, illustrates the subjectivity that underlies poverty measurement in a given country and even more so, across countries.

[4] The latter group excludes Hong Kong and Singapore which, apart from their considerably smaller size and higher income levels (even in 1970), differ structurally from the other East Asian countries in their lack of a significant agricultural sector.

were 48 to 63 percent of the East Asian average. In sharp contrast, by 1997, the income per capita in the four Indochinese countries were only 5 to 15 percent of the East Asian average. It is also notable that Indonesia, while showing a low 20 percent of the average GNP per capita of the East Asian countries in 1997, had gone ahead of the Indochina group. In the latter group China, which already had the highest income level in 1970 and grew the most rapidly during 1986-97 (as indicated above), extended its income advantage over the other four ITEs by 1997. On the other hand Viet Nam, which ranked second to China in 1970, fell behind Cambodia and Laos; given their comparative growth rates during 1986-97 (see Table 1), Viet Nam's lagging economic performance can be reasonably assumed to have taken place in the earlier period 1970-85. Over the entire period the ITEs are shown in Table 3 to have performed well below the six East Asian countries as a group. Therefore, instead of "convergence" as suggested in cross-country regressions that show faster growth of lower income economies (Barro 1991, Levine and Renelt 1992) the comparative growth rates among Asian economies during 1970-97 indicate growing income disparities. The extent to which the Indochinese countries have been left behind is indicative of the national welfare foregone due to economic isolation, political instability, and civil war.

Income levels within the East Asia group differed much more significantly in 1997 than in 1970. The superlative growth performance of South Korea and Taiwan between 1970 and 1997 is evident from Table 3, to which can be attributed the marked decline in relative income position of each of the ASEAN-Four countries. Among the latter countries, Malaysia maintained the highest income level and Thailand had overtaken the Philippines for the second rank in 1997. Indonesia, which started from a low income base indeed the lowest GNP per capita (with Myanmar) in 1970 grew rapidly and nearly closed its income gap with the Philippines by 1997. During this period the Philippines, its income per capita relative to the East Asian average declining from 83 to 21 percent, was clearly the laggard in this economically very dynamic region. Differences in development paths taken by the East Asian countries, including the outcomes in income growth and distribution, provide important lessons for the ITEs, as will be discussed below.

Transition and Development in Indochina

The ITEs are in transition to a market economy not because of an ideological conversion from Marxism-Leninism to capitalism but because of aspirations to achieve long-term improvements in living standards. Global changes are rapidly taking place that create new opportunities for expanding production, employment, and incomes through free markets. This has especially been so in the last quarter century, and neighboring East Asian countries have provided evidence of the advantages of a market-oriented economy. The experiments with an economic system that centralizes control of production and allocate scarce resources through state planning apparently failed, not only in Indochina but also in the former Soviet Union and in Eastern Europe. Bureaucratic control and inefficiency, distorted relative prices, and improperly functioning markets weighed down heavily on these economies, preventing a sustained growth of productivity and living standards.

Central planning, before the reforms, was more firmly established in China than in the other ITEs. While northern Viet Nam adopted the Soviet approach to planning beginning 1954, the southern part of the country had only a decade of experience with central planning before reverting to private entrepreneurial behavior when the transition process was started in 1986; moreover, the collectivization of agriculture was only completed in 1985, a year before decollectivization was undertaken. In Laos, despite a commitment made to central planning in 1975, only the country's relatively small modern sector had been under effective state control, as the poor infrastructure left the country economically unintegrated. Central planning in Cambodia after 1979 was hampered by the government's lack of internal control and by international ostracism. Myanmar was committed to a socialist path after 1962; under the "Burmese Way to Socialism," however, agricultural land was never collectivized and effective state control did not extend down to the level of individual farms.

Each of the five ITEs began the transition process at very low income levels, so that the problems of transition interacted with the characteristics of underdevelopment. Deficiencies in human resources and physical infrastructure presented difficulties in formulating and administering policy and institutional reforms towards a market economy. The extreme example is Cambodia, in which infrastructure had been ruined by civil wars and high emigration rates had eroded the country's human capital. Placing the economy on a sound development path through human and infrastructure development was as important an objective as the successful transformation to a market-oriented economic system. Two aspects of underdevelopment served the ITEs well in the transition process by facilitating the shift from agriculture to industry, namely: (1) the small share of industry in the national economy, especially in terms of the labor force, and (2) the relative absence of heavy industries and attendant massive capital investments made obsolete by the end of autarky and the comparative advantage of ITEs. These characteristics of the ITEs distinguish them from the transitional economies in the former Soviet Union and Eastern Europe, which at the outset had a more developed but highly distorted and inefficient industrial sector.

The initial emphasis of economic reforms in *China* was on agriculture. The household responsibility system was introduced in 1978, giving farmers claim to additional output beyond that contracted to be sold to state marketing agencies at the official prices. Further benefitting farmers, official prices of agricultural products were gradually raised. The supply response was immediate and substantial. Agricultural production increased sharply even with declining land area under cultivation, which led to an average annual rise in rural income per capita of 14 percent between 1978 and 1984 (World Bank 1997:11). In the manufacturing sector, township and village enterprises (TVEs) expanded output at an annual rate of 20 percent from 1978 to 1983, which further accelerated to more than 50 percent in 1984-85. This reflected the increased purchasing power of farm households as well as the growing investment in small-scale rural enterprises producing consumer goods, housing materials and other products that state enterprises failed to supply in rural areas. After the initial productivity gains associated with the early reforms, growth of agricultural output decelerated, causing a decline in the annual increase in rural income per capita to less than 3 percent until 1990. Subsequent reform measures added to the improvement in the terms

of trade for agricultural products and helped boost the growth of rural income per capita to an average 5 percent annually during 1991-96 (State Statistical Bureau 1997). However, urban income per capita continued to grow faster at 7 percent over the same period, fueled by the rapid growth of manufactured exports.

Overall growth of the Chinese economy since 1978 has been outstanding. Real GDP expanded sharply by an average 10 percent annually during the first three years of reforms, and continued to grow rapidly, albeit with some fluctuations, at about that average rate through the mid-1990s. Over time the favorable impact of the adoption of an open door policy which permitted foreign investment and loosened government control of foreign trade as part of the economic reform program became evident. The gradual opening of the previously closed economy boosted exports from the pre-reform level of about 5 percent of GDP to 9.9 percent in 1985 and 21.0 percent in 1995, while foreign investment reached 4.5 percent of GDP by 1995 (Table 4). The dramatic increases in foreign investment and in manufactured exports in the 1990s contributed significantly to the sustained rapid growth of the Chinese economy. However, problems of macroeconomic instability continued, manifested by the sudden acceleration of growth in some years (1984, 1987, 1992) followed by high inflation and large trade deficit, and by the widening budget deficit as government incomes especially from the poorly performing state enterprises failed to keep pace with the rapid economic growth (Pomfret 1996:20). Macroeconomic and financial reforms were allowed to lag, effectively slowing the reform in the state enterprise sector (which continued to be subsidized through the budget and more recently, through the banking system).

The transition process in *Viet Nam*, which was started in 1986 and accelerated in 1989, also emphasized agricultural reform and an open door policy. Other reforms addressed the financial sector to assert monetary control and the budget constraint for state enterprises. The collectivization of agriculture was abandoned early on, returning the land to family farming, and prices of food and most other commodities were decontrolled. Before 1989 a dual pricing system existed, requiring producers to sell to the state at "official prices" that were much lower than the "market prices" prevailing in the non-state sector. Price reform formally removed the distinction between official and market prices. A major beneficiary was the rice sector, which increased production by 12 percent in 1989 and a further 14 percent in the next three years (Bautista 1999). Viet Nam quickly became the world's third biggest exporter of rice after years of being a rice importer, which contributed to a substantial improvement in foreign exchange availability. The reforms also opened the economy to foreign trade and investment with favorable results despite a U.S.-led embargo and encouraged new private businesses in many areas.

Viet Nam's reform program led to a significant acceleration of economic growth from about 3.4 percent annually in 1984-86 to an average 7.2 percent in 1986-96 (based on World Bank data). Moreover, there was a marked decline in fiscal deficit, a major source of inflation in the pre-1989 period: overall budget deficit was reduced from 10.4 percent of GDP in 1989 to 1.8 percent in 1995. Domestic inflation was brought under control, slowing down from 3-digit rates in 1986-88 to 42 percent in 1990, 14 percent in 1993, and 6 percent

in 1996. On the other hand Viet Nam's current account deficit increased markedly from the pre-reform level of 3 percent (in 1985) to about 11 percent of GDP in 1995-96, while domestic savings remained low at 15 percent of GDP (Table 4). Also a potential hindrance for future growth, government has been disinclined in recent years to further deregulate and foster private-enterprise development in the industrial sector, not willing "to loosen its grip over economic decision making, so that too many microeconomic decisions require central government approval" (Pomfret 1996:65).

The New Economic Mechanism in *Laos* was launched in 1986, initially emphasizing reforms aimed at reducing government intervention in price determination, especially for agricultural products. Other aspects of the transition process included the unification of the exchange rate and adoption of a floating exchange rate, liberalization of foreign investment (which attracted investors mostly from Thailand), removal of subsidies to the state-owned sector, and privatization of state enterprises. Increasing openness of the economy is reflected in the expansion of exports from 4 percent of GDP in 1985 to 23 percent in 1995-96, and of direct foreign investment from virtually nothing to 5.5 percent of GDP over the same period (Table 4). Improved economic incentives and increasing public and private investments have contributed to sustained economic growth at an average annual rate of 6.1 percent during 1986-96. Macroeconomic stability was promoted by improved monetary, fiscal, and exchange rate policies that helped restore confidence in the banking system and in the domestic currency. Interest rates were liberalized, including those for foreign currency deposits and loans, and private banks were allowed to operate and compete freely with state-owned banks. While the government continued to rely on external assistance to finance the fiscal deficit, public expenditure was cut and the tax base expanded significantly, which led to a marked reduction in the fiscal deficit during 1990-95. The multiple exchange rates were unified in 1988, after which the official rate was allowed to depreciate significantly and to move closely with the parallel rate. In late 1995 the government adopted the floating exchange rate system and removed all foreign exchange restrictions. Trade liberalization was also promoted by the phasing out of direct import controls, reducing tariffs, and exempting exporters from tariffs on imported inputs. Both exports and imports have grown rapidly, but the current account deficit continued to range above 10 percent of GDP and domestic savings remained low (Table 4).

Cambodia, which since 1970 has struggled with civil war, foreign intervention, and political instability, did not begin a comprehensive reform program until 1993, after the establishment of a democratic coalition government with United Nations support.[5] The international community responded by committing substantial amounts of aid and providing technical assistance. The government has since achieved some successes in stabilizing the macroeconomy. Through new tax measures and improved tax administration, current

[5] Some partial and ad hoc reforms were implemented in 1985-89 under the Vietnamese-supported government towards decollectivization of agriculture and liberalization of foreign trade and investment, which were mostly unsuccessful.

revenue increased to over 9 percent of GDP and the budget deficit reduced to 1.4 percent in 1994-95. By restricting the monetary financing of the budget, domestic inflation was reduced from three-digit rates in 1990-92 to less than 5 percent in 1995-96 (Table 4). Measures to liberalize foreign trade and investment were adopted, enabling exports to increase to nearly 30 percent and direct foreign investment to 7.4 percent of GDP by 1995-96. The exchange rate was stabilized, and the spread between the official and parallel market rates narrowed to less than 2 percent. In terms of economic growth, real GDP expanded by 4 percent in 1994, and by over 7 percent in 1995 and 1996. Such favorable macroeconomic situation and growth performance, however, may not be maintained in the medium term, considering the unsustainably high level of external support to Cambodia. This is reflected in the extremely low domestic savings and large current account deficits (Table 4), attributable in part to the "delays in implementing structural reforms" (World Bank 1997a:78).

While *Myanmar* has also taken steps away from central planning since the SLORC (State Law and Order Restoration Council) government came to power in late 1988, the reforms have so far been insubstantial and "failed to achieve a fundamental transformation in the economic system" (IMF 1997:86). An open-door policy to foreign investment and the formation of public-private joint ventures were announced in late 1988. Some fiscal reform measures were introduced, reducing income tax rates for companies, foreigners, and joint ventures at the same time that subsidies on fertilizer, paddy, kerosene, and electricity were cut (Wai 1991). This was followed by banking reforms in 1991 to improve monetary control, and a gradual reform in foreign trade permitting the private sector (including joint ventures) to engage in exports and imports. The sector that has attracted significant foreign investment, coming mostly from Singapore, Malaysia and Thailand, has been hotels and tourism. Plans for privatizing "state economic enterprises" were announced in 1994, but the degree of domestic or foreign interest in entering into such ventures has not been high. Myanmar's trade and payments regime has remained highly restrictive, reflecting the slow pace of the transition process and contributing to the low economic growth rate observed above.[6] Direct controls on trade and foreign exchange have continued, the foreign exchange rate has remained fixed, and the structure of import tariffs and export taxes has changed little from the earlier period. Indeed, exports of goods and services even declined from 4.6 percent of GDP in 1985 to 1.0 percent in 1995-96 (Table 4). There has been increasing pressure from the international community not only for major economic reforms to accelerate the transition process but also for a resolution of political problems in Myanmar (Taylor 1995).

The above review of the transition experience of the ITEs indicates a generally

[6] Greater openness to trade has been strongly associated with more rapid economic growth among developing countries; see, for example, Sachs and Warner (1995).

impressive growth performance (except in Myanmar),[7] but varying degrees of success in dealing with the initial macroeconomic imbalances. The latter has implications for the sustainability of economic growth in these countries. Political uncertainty also clouds the medium-term development prospects of one or two of the ITEs.

The challenge of development for low-income economies is not only economic growth but also poverty reduction. This view is consistent with the pronouncements of ITE governments as well as with the declared objectives in moving to a market-oriented economic system. Except for China, however, there has been very little documentation of the changes in poverty incidence in the ITEs since the start of the transition process.

The general trend in China since 1978 has been towards a reduction of poverty. The poverty estimates differ for different years, for the rural and urban populations, and by source, especially concerning the changes since the mid-1980s. There is wide agreement that poverty was drastically reduced during the initial period of reforms. As estimated by the State Statistical Bureau (SSB), rural poverty was halved from 30.0 to 14.8 percent from 1978 to 1985, which are very close to the estimates of 30.3 and 14.0 percent for 1980 and 1985 derived by Khan (1998:3) using SSB's grouped data on personal income distribution. Even more dramatically, a World Bank (1992) study finds that the proportion of rural population in poverty declined from 33 percent in 1978 to 11 percent in 1984. From 1985 to 1989, however, SSB data show an increase in rural poverty, and then a continuous decline through 1995. This is corroborated by the World Bank (1997a:47) finding of a 2.1 percentage point rise between 1985 and 1990, followed by a reduction of 2.2 percentage points from 1990 to 1993.

Urban poverty in China had been not only much lower than rural poverty but also more stable over time. The annual estimates made by Chinese analysts from 1991 (when statistics on urban poverty were first collected) to 1995 range from 4.4 to 5.8 percent, as cited in Cook and White (1998:10). World Bank figures indicate even lower levels of urban poverty, which have been criticized for severely understating the poverty threshold for the urban population (Khan 1998:8).

Since a very large majority of the poor in China reside in rural areas, changes in the national poverty index might be expected to be dominated by the annual pattern of rural poverty as described above. The following World Bank (1996:6) estimates of the proportion of total population living on U.S.$1 per day (PPP-adjusted at 1985 prices) are consistent with observed changes in rural poverty: 31.5 percent for 1987, 29.4 percent for 1993, and 26.9 percent for 1994. They support the inference of a generally declining trend of poverty in China during the transition process.

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[7] Especially in comparison to the dismal record of economic growth among the transitional economies in the former Soviet Union and Eastern Europe (see, among others, Rana 1995).

The above discussion also suggests that economic growth in China since 1978 has been a major influence on poverty reduction. Both the rate and nature of economic growth need to be considered. The initial growth was agriculture-led, driven by decollectivization and increasing terms of trade for farm products leading to large productivity and income gains that were widely distributed. Broad-based rural income growth in turn raised household demand, especially for locally produced labor-intensive manufactured goods and services. Moreover, the release of labor and capital from the agricultural sector facilitated the establishment of labor-intensive industries that catered to the growing domestic market for light consumer goods and over time responded to the increasing openness of the Chinese economy by rapid expansion of manufactured exports. As a result of the latter development, the major source of economic growth in China began to shift in the mid-1980s from agriculture to labor-intensive industry.

Because labor is the most abundant asset of the poor, increasing demand for (unskilled) labor associated with the expansion of industrial exports served to sustain the participation of the poor in the growth process. Income inequality in China apparently increased during 1985-95 significantly more so in the urban than rural population (World Bank 1997a:27); however, in the 1990s, its adverse effect on poverty was more than offset by rapid economic growth. Such complementarity between economic growth and poverty reduction generally characterized the development experience of East Asian market economies in earlier periods, as will be evident in the discussion below.

Development Performance and Policies in East Asia

Economic growth

Table 5 shows generally very impressive growth rates for the six East Asian economies during each of the three subperiods from 1970 to 1997, at least in relation to the growth performance of developing countries as a group. The only exception is the Philippines, in which economic growth is seen to have slowed considerably during the 1980s. Developing countries faced a more unfavorable external economic environment in the 1980s compared to the 1970s. The slowdown in world economic activity and deterioration in the terms of trade for most agricultural commodities posed severe difficulties for many developing countries that were still adjusting from the oil crisis-induced turbulence of the international economy in the preceding decade (Singh and Tabatabai 1990). Moreover, real interest rates were at record high levels during the 1980s, placing an additional constraint to the development efforts of heavily indebted countries. Economic growth in the East Asian countries faltered in the 1980s (except in Thailand), but they appear to have coped with the adverse external conditions more successfully (except the Philippines) than other developing countries. The generally rapid economic expansion in East Asia continued on to the next subperiod. During 1990-97, whereas growth in developing countries as a group slowed to an average annual 2.8 percent, each of the six East Asian economies had higher growth rates

than in the 1980s. The Philippines shows a 3.3 percent GDP growth rate, which is significantly higher than that for the 1980s, while those for the other East Asian economies are remarkably in the high 7.2 - 8.7 percent range. This is despite the advent of the economic crisis in the second half of 1997 that sharply reduced GDP growth rates for some of the East Asian countries in that year.

Differences in the growth rates among the East Asian economies, attributable in part to the nature of domestic policies adopted (see below), are the principal explanation for the changes in their economic status between 1970 and 1997 shown earlier (in Table 1). It matters that rapid economic growth was not sustained in the Philippines, which is why Thailand overtook the Philippines in the income per capita race and why the latter's initially very large income gap with Indonesia was nearly closed.

Economic growth is of course not the sole indicator of a country's development performance. Indeed, its importance as a measure of the success of development policy has in the past been downgraded, in favor of such policy goals as meeting "basic human needs" and poverty alleviation. However, the problem is not with the growth objective as such, but with the development process that may or may not distribute widely the benefits of economic growth.

Changes in poverty

Other things remaining the same, economic growth will result in a reduction of poverty. An improvement in income distribution serves to reinforce the favorable effect of growth on poverty. The record of East Asian countries with respect to changes in income inequality is mixed (Bautista 1992:8-11). Taiwan appears to be a clear case of continuous decline in income inequality, measured by the Gini coefficient, over the period from 1953 to 1980. Income distribution in South Korea also improved, especially during 1970-76. On the other hand, the Gini coefficient for the ASEAN-Four countries had been highly stable or changed only slightly (upward or downward), at least through the mid-1980s.

Examining poverty and growth data for 18 developing countries, Fields (1989:15) finds that "rapid economic growth tends strongly to reduce poverty." A World Bank (1990:40-41) analysis also reveals a significant decline in poverty over time in rapidly growing economies, even in those "that are often thought to have followed inegalitarian paths of development." Poverty estimates from these two studies pertaining to the six East Asian economies for specified years are given in Table 6. Since the definition of the poverty line differs across countries, it is not meaningful to make *inter-country* comparisons of poverty estimates and their quantitative changes over time. However, the intertemporal poverty data for each country can be usefully examined *seperately*, bearing in mind that the procedure

used in making the country estimates "consistent over time" may not be ideal.[8]

Table 6 indicates, unsurprisingly, that poverty was reduced in Taiwan and South Korea at a rapid rate over the indicated periods (indeed, as observed in the two studies, more rapidly than the decline in poverty for other developing countries). Poverty reduction in Indonesia and Malaysia was also relatively rapid in the 1970s and 1980s, while Thailand had a slower pace but also a significant decline in poverty. The Philippines is again an outlier, showing a higher headcount index in 1985 than in 1971 when income per capita was higher. Two relevant considerations in the latter case are: (1) real GDP fell by 7.3 percent each year in 1984 and 1985, related to the adoption of an IMF-prescribed stabilization program to deal with the financial crisis that began in late 1983; and (2) estimates of the poverty trend for the Philippines are plagued by extraordinarily severe problems in data and measurement (Bautista 1992:15). Later estimates of the World Bank (1997) indicate a very slight decline in the poverty headcount index for the Philippines from 35.7 in 1975 to 32.4 in 1985.

The foregoing discussion has focused on the income-based approach to defining poverty. While this is common practice, it abstracts from other aspects of social welfare and "quality of life." Analyzing changes from 1965 to the mid-1980s in two widely used social indicators, Riedel (1988:21-22) finds generally larger increases in life expectancy and school enrollment for the East Asian market economies than for other developing countries. As shown in Table 7, substantial progress was also achieved in other aspects of social development between 1970 and 1990. It is particularly notable that adult illiteracy was reduced to about half the initially very high levels in Indonesia and Malaysia, and to 10 percent or less in the other four East Asian economies by 1990. Similarly, the increased access to safe water, especially in rural areas, and the decline in infant mortality in the ASEAN-Four countries are remarkable.

The development experience of the East Asian market economies thus suggests a considerable scope for complementarity between economic growth and poverty reduction. Rapid growth in these economies has not prevented the achievement of a more egalitarian income distribution, a wider participation of the poor in that growth, and substantial progress in various aspects of social development.

Role of development policies

Three sets of explanatory factors bearing on East Asian development performance can be usefully distinguished: initial conditions, development policies adopted, and other exogenous influences. The appropriateness of government policies, and their consequences

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[8] A typical problem relates to the use of an appropriate price index for adjusting the poverty line from one survey year to another. Frequently, the general consumer price index is utilized rather than a price series based on the poverty basket of goods and services.

on economic growth and poverty, would depend in part on the country's initial conditions, relating particularly to the resource endowment and economic structure. Concerning the "other exogenous influences," there has been much discussion, in the context of the East Asian economies, of various special circumstances purporting to explain their "unique success" over the last three decades, and various assessments of those non-policy factors have been made (Lee 1981, Hughes 1989). Does the Confucian heritage confer a special advantage in promoting socio-economic development? Does it help to have an authoritarian government? How strongly does the perception of an external security threat motivate the society to achieve economic success? These and other non-policy issues are not addressed in this paper. The primary interest here is in showing how government policies have influenced the development path of the East Asian economies, especially the outcomes in economic growth and poverty, based on historical analysis and the results of policy modeling from existing studies.

Except for Thailand, the East Asian countries were formerly under colonial rule, and their economies before independence were closely integrated with those of the colonizing countries. After independence, development policy promoted rapid industrialization, with a view to diversifying the economy and reducing the reliance on primary production and, more generally, to redirect the country's production capacity away from the goals of the former colonial powers and toward establishing a basis for modernizing the economy. The colonial pattern of production and trade, in which income derived from agricultural plantations and large mines flowed mostly out of the country, was rejected in favor of a domestic market-oriented, industry-based approach to economic development.

The need for economic independence led, at least initially, to an industrialization strategy based on import substitution involving the promotion of domestic industries through high tariff walls, quantitative import restrictions, or both. This strategy benefitted mainly producers of final consumption goods and in effect discriminated against other manufacturing industries and the agricultural sector. The East Asian countries differed in the comprehensiveness, intensity, and duration of their import-substitution policies, and this accounts in part for differences in the present state of their industrial development and in their past economic performance. However, all of them switched eventually to an "outward-looking approach" to industrial development.

Taiwan and *South Korea*, beginning in the late 1950s and early 1960s, respectively, encouraged the exporting of unskilled labor-intensive consumer goods through trade liberalization and more realistic exchange rates as well as the development of export infrastructure. Economic disincentives to exporting were reduced substantially, including import tariffs and other trade barriers, that earlier promoted import substitution in industrial consumer goods. Moreover, especially in the case of South Korea, export producers received credit subsidies, tax exemption on export-related activities, and assistance in export marketing. By the early 1970s, after the sustained large increases in labor-intensive industrial exports in the previous decade, relative factor supplies had shifted away from the abundance of unskilled, low-wage labor. At that time they began exporting more skill- and

capital-intensive products, which contributed significantly to the continued rapid growth of their economies. The average annual export growth rate during 1965-80 was an unprecedented 27 per cent for South Korea and 38 percent for Taiwan; by 1980 the share of manufactures in their merchandise exports had gone up markedly to about 90 percent.

The ASEAN-Four countries have had varying experiences in the promotion of domestic industry. With the exception of Malaysia, these countries underwent a relatively long period of import substitution behind heavy protection, resulting in significant domestic price distortions and excessive use of scarce capital resources relative to labor employment. The *Philippines*, in 1970, had already two decades of import-substitution policies and the attendant high-cost structure of manufacturing production. Trade and exchange rate policies became more outward-oriented in the first half of the 1970s, but reverted to a strong anti-export bias later in the decade. Policy reform efforts in the 1980s were not sustained, owing to the advent of an external debt-induced foreign exchange crisis in late 1983 and related conditions of political instability and economic disarray which even a new government during the second half of the decade could not adequately deal with. Significant liberalization of the foreign trade and investment regime occurred in the early 1990s associated with the tariff reform under Executive Order 470 and the 1991 Foreign Investment Act. It led to an acceleration of export growth (averaging 17.4 percent in 1994-96) and an increasing share of manufactured goods to 84 percent in 1996 (Table 8).

Malaysia's trade and investment policies had been the least restrictive among the ASEAN-Four countries. In 1968 the Investment Incentives Act was passed, giving fiscal incentives to export-oriented enterprises, especially those with low capital-labor ratios. Free trade and export processing zones were also established in various parts of Malaysia and an export insurance system was created to provide export infrastructure support. Rapid export growth in labor-intensive manufactures since the early 1970s had raised significantly the overall export growth rate and the share of manufactures in total exports (Table 8) that historically was dominated by primary commodities.

In *Thailand*, the government began to place emphasis on export promotion in the early 1970s, after a decade of heavy tariff protection and subsidization of import-substituting industries. The Export Promotion Act of 1972 provided for a rebate of import duties and business taxes on imported inputs (among other fiscal incentives), at the same time that the Bank of Thailand started to offer preferential interest rates to industrial export producers. In the 1980s the price bias against manufactured exports was further reduced by a tariff reform that significantly lowered the protection for import-competing industries. There was a considerable supply response, evidenced by the phenomenal growth of labor-intensive industrial exports by an average 32 percent during 1983-87, while total exports continued to increase at double-digit rates through the mid-1990s (Table 8).

Under the "New Order" government which came to power in *Indonesia* in 1966, the economy's infrastructure (including transport, power, and communications) was rehabilitated after years of neglect. Regulation of private-sector activity was reduced substantially, economic incentives were restored, and access to imported raw materials and capital goods

were made easier for both foreign and domestic firms. This led to a rapid growth of Indonesian manufacturing during the 1970s, which was driven by domestic demand expansion and import substitution. Indonesian manufactured exports began to expand significantly only in the 1980s as the trade regime was liberalized and export promotion measures were introduced, raising the share of manufactures in total exports from 2 percent in 1980 to 51 percent in 1996 (Table 8).

The generally impressive industrial export performance of the ASEAN-Four countries over the last quarter century is attributable not only to a reduction in the anti-export bias of sectoral policies but also to their improving international competitiveness resulting from a substantial decline in real exchange rate overvaluation (Intal 1992). The latter in turn was influenced by trade liberalization as well as by the adoption of prudent macroeconomic policies that prevented the occurrence of sustained high inflation rates, large fiscal and current-account deficits, and other symptoms of macroeconomic imbalances.[9] The exception is again the Philippines, in which real exchange rate overvaluation during the 1980s has been estimated to average about 34 percent, in sharp contrast to Malaysia's 6 percent (Bautista 1990:122). These comparative estimates reflect the more restrictive trade policy as well as the more severe trade imbalance in the Philippines during the period.

The failure to move to a "realistic and competitive" real exchange rate also affected adversely Philippine agricultural performance in the 1980s, not only in terms of exports but also of overall production (Table 9), in view of the high degree of tradability of the country's agricultural products. Moreover, given the importance of agriculture in the Philippine economy, GDP growth slowed considerably during the decade, with presumably unfavorable repercussions on poverty (Tables 5 and 6). While agricultural growth also decelerated in the other ASEAN-Four countries in the face of declining international commodity prices, the slowdown in both agricultural and GDP was not as severe as in the Philippines. Indeed, the economic growth rate in Thailand was even higher in the 1980s than in the preceding decade, implying that non-agricultural production picked up and more than offset the slowdown in agricultural growth. Relatedly, industrial growth during 1980-90 was much more rapid in Thailand (9.9 percent) than in the Philippines (-0.9 percent), Indonesia (6.9 percent), and Malaysia (7.2 percent).

The strong growth performance of the agricultural sector in the ASEAN-Four countries from the mid-1960s to the early 1980s is attributable to the widespread adoption of improved technologies, especially the high-yielding rice seeds in the Philippines and Indonesia, and to the diversification of agricultural exports in Malaysia and Thailand. Public investments had been generally supportive in terms of rural infrastructure development in irrigation, transport, electrification, health, and education that helped overcome various production

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[9] An analytical discussion of the determinants of the real exchange rate in developing countries can be found in Edwards (1988); in application to the Philippines, see Medalla et al. (1995:38-44).

constraints (Vyas 1983). It is in agricultural pricing policies that government intervention in the ASEAN-Four countries had frequently not worked to the benefit of farmers (Bautista 1990). Producer prices of many farm products had been suppressed through the operation of marketing agencies, the imposition of export taxes, and direct price controls. While subsidies for farm inputs (fertilizer, irrigation water, credit) had been provided, they did not fully compensate for the low prices of agricultural output.

It has been argued that rapid agricultural growth in the Philippines during the "green revolution" period 1965-80 did not provide a strong stimulus to overall economic growth in part because the agricultural income gains were not widely shared (Bautista 1995). The latter is related to the existing inequality of land ownership in which large-scale farms ("haciendas") established during the colonial period continued to co-exist with small landholdings.[10] Moreover, the benefits of the high-yielding rice varieties, for example, effectively bypassed a large segment of the farm population, including small-scale and upland farms, that had little or no supply of irrigation water. Although there was widespread adoption of modern seed varieties, the new tecfnclogy was notably much less effective in raising yields in farms where water levels could not be strictly regulated. Also contributing to the bias against small farmers was the greater access of large producers to credit and fertilizer subsidies and to infrastructure investments (electricity and roads).

A broad-based pattern of agricultural income growth among rural households would have been conducive to demand increases for labor-intensive consumer goods produced in the local economy. This in turn would have led to secondary increases in labor demand, employment, and income, promoting a self-reinforcing and equitable growth process. On the supply side, the inability of rapid agricultural growth to be translated into rapid and sustainable overall growth of the Philippine economy can be attributed to inappropriate domestic policies that weakened the non-agricultural production response to the demand stimulus generated by the increased rural incomes. Two relevant aspects of the policy environment during the 1970s and 1980s are the foreign trade regime and public expenditure. Their distortionary effects on producer prices and on infrastructure development had an adverse impact on the supply response of rural non-agricultural producers which was critical to the further linkage effects of agricultural growth to the rest of the economy.

The contrasting development experience of Taiwan is instructive. In the early 1960s the Taiwanese economy had many similarities with the Philippines in terms of per capita income, production structure, and degree of openness, among others. Between 1965 and 1973 the agricultural sector in Taiwan expanded by an average 4.8 percent annually, while manufacturing registered an astonishing 21 percent growth rate. Rapid growth of farm

[10] A dualistic structure also characterized land ownership in Malaysia, which is in contrast to the predominantly small size of landholdings in Indonesia and Thailand. This would explain in part the more unequal income distribution in the Philippines and Malaysia during the 1970s (Bautista 1992:32).

output occurred despite the resource movement out of agriculture into industry. The output composition changed from rice and other staples to higher-value products (livestock and horticulture), and nontraditional agricultural exports (mushrooms. asparagus, etc.) became important. Early Taiwanese industrialization was rural-based, small-scale, and labor-intensive (Galenson 1979), catering mainly to the domestic market. Subsequently, rural industries became a major participant in Taiwan's export-led growth, initially exporting in the early 1960s manufactured products with high unskilled labor content.

A remarkable aspect of Taiwan's development record is the continuous improvement in income distribution over the three decades from the 1950s to the 1970s (Kuo 1983). This represents a significant departure from the inverted U-shaped relationship commonly postulated between economic growth and income inequality in developing countries, demonstrating the possibility that worsening income distribution is not an inevitable accompaniment to the growth process, even in the early stage of economic development. Thus, in Taiwan, the improvement in income distribution reinforced the positive effect of economic growth on poverty reduction. By contrast, a significant reduction in income inequality was not achieved in the Philippines during 1970-90 which could have alleviated poverty in the face of slow or negative economic growth.

The growth and equity effects of development policies can be more rigorously shown from the results of economic modeling. Historical associations and cross-country correlations such as those indicated above are suggestive, but do not establish causal relationships. Empirical models of the "computable general equilibrium" (CGE) type have been used in the quantitative evaluation of the growth and distributional effects of economic policies adopted in East Asian economies. CGE models take into systematic account the intersectoral linkages in production, consumption, and trade, as well as the endogenous determination of relative prices subject to relevant macroeconomic and institutional constraints. Evaluation of the economy-wide effects of government policies is based on comparisons between the model's counterfactual equilibrium solutions and the base-period or base-run values.

A seminal contribution is the dynamic CGE model developed by Adelman and Robinson (1978) for South Korea, in which 29 producing sectors and several socio-economic classes of households are distinguished. In model simulations over a nine-year period, import substitution as an industrialization strategy is found to result in higher prices of manufactured goods (30 percent above the base run) and in lower prices of agricultural products (37 percent lower), the worsening terms of trade leading to significant shifts in income distribution and poverty incidence. The urban elite benefit at the expense of rural households whose average income decreases by 45 percent, and the proportion of households in poverty increases by 66 percent. The effect on economic growth is negative, the GDP growth rate being cut by about half a percentage point every year. Compared to import substitution, the strategy of labor-intensive, export-led industrial development actually followed by South Korea from the mid-1960s to the mid-1970s is also shown in model simulations to lead to a more rapid economic growth, lower income inequality, and reduced

poverty incidence.

In a later study, Adelman (1984) investigates the comparative growth paths of a low-income, open economy implementing two alternative development strategies, based on simulation experiments on a CGE model of the South Korean economy with benchmark data for 1963. In that year South Korea exemplified the economic situation in many developing countries suffering from large deficits in food supply-demand and in the trade balance. The two development strategies are characterized (1) by industrial export-led growth, in which exporting sectors are given 60 percent export subsidies, import tariffs are eliminated, and the domestic currency is depreciated by 10 percent, and (2) by agricultural demand-led (ADL) growth, in which the agricultural share in public investment is initially doubled and then gradually returned to the base-year level during the 15-year simulation period. The results of model simulations indicate that the ADL strategy "generates the same rate of industrialization as does export-led growth but leads to a higher rate of labor absorption, a better distribution of income, better balance-of-payments results, less poverty, and a higher rate of growth per capita gross domestic product (GDP) than export-led growth" (Adelman 1984:939). The significantly more equal distribution of income associated with the ADL strategy is attributable to the relatively much larger income increases for rural households (than for urban households) which initially accounted for the bulk of the poor population. Not surprisingly, the expansion of domestic demand, especially consumption demand of rural households, is found to be a major source of industrial growth in the ADL strategy bearing out the significance of consumption linkage effects. The resulting industrial structure is labor-intensive and geographically dispersed, matching the pattern of rural consumption expenditure.

The economy-wide effects of crop productivity increases in the Philippines during the Green Revolution period 1965-80 are examined quantitatively in Bautista and Robinson (1997) using an agriculture-focused CGE model with 16 production sectors and five household groups. The effect on real GDP is found to be significant nearly 5 percent of base (1979) level but the redistributive impact is negative under the historical, highly restrictive trade regime: incomes of the more affluent large-farm and Metro Manila households increase proportionately more than those of small-farm and "other rural" households. This implies a greater demand stimulus for urban-based (rather than rural-based) industrial growth, reflecting the concentration of productivity gains to the large farms. Under a counterfactual policy scenario, trade liberalization increases the income benefits from crop productivity growth for poorer households, favoring rural over urban households and small-farm over large-farm households. The positive effect on GDP (11 percent under complete free trade) is also larger than in the historical scenario, so that the movement towards an open trade regime does not involve a tradeoff between the twin objectives of growth and equity.

While there are several other economy-wide modeling studies of East Asian economies, the above discussion suffices to illustrate the quantitatively significant influence of trade and investment policies in shaping the outcomes in income growth and distribution.

The simulation results indicate, among other things, that what happens to the agricultural terms of trade is a critical determinant of whether and to what extent the rural poor will benefit from farm productivity-enhancing policies. Therefore, the anti-agricultural price bias of government interventions noted above served to reduce the scope for poverty reduction in some East Asian economies. Also, the effects of development policies on national income and its distribution are determined significantly by the induced changes in labor demand; hence, consumption linkage effects favoring domestically produced labor-intensive goods and services, such as those arising from income increases for small-farm households, have important implications for overall income growth and poverty alleviation. Finally, the results from counterfactual model simulations reinforce the argument that import protection policies and associated exchange rate overvaluation can distort relative incentives heavily against export industries and the agricultural sector. The trade liberalization and macroeconomic policy reforms adopted at different times by East Asian countries would then have contributed to economic growth and poverty reduction to the extent that comparative advantage was improved for internationally competitive industries (including labor-intensive and agricultural) which benefits low-income farmers and unskilled workers.

Major Challenges for ITEs

The collective development experience of the six East Asian economies over the last three decades has provided a fertile ground for policy analysis from which some lessons can be drawn and major challenges identified for the ITEs in advancing the twin objectives of economic growth and poverty reduction.

Sustaining reform efforts toward market orientation

Despite the generally far-reaching policy and institutional reforms earlier implemented, the ITEs are still a long way to having an efficient system of market-based resource allocation. They need to continue loosening distortionary government control of economic activities and provide an incentive framework that does not penalize agricultural production, expansion of exports, and private enterprises. While East Asian governments have intervened in domestic markets, in some cases heavily, relative price distortions were limited and smaller in the more successful countries. Especially in Taiwan, the encouragement of agriculture and labor-intensive industry through public investments proved beneficial in addressing concerns about the distribution of income gains from economic growth. Export-push policies such as fiscal incentives, export credits, and marketing assistance that at times more than compensate for the anti-export bias of the trade regime, as exemplified in the Korean case, could be justified on efficiency grounds in view of significant externalities to exporting.[11] What has not worked is the selective promotion of specific industries, such as

[11] Thus, competing in international markets leads producers to more quickly adopt improved technologies and learn new skills (for example, in marketing and management),

the "basic industrial projects" in the Philippines and the heavy industries drive in Malaysia during the early 1980s which not only caused inefficiency in resource allocation and use but also threatened to undermine macroeconomic stability.

It is neither necessary nor desirable that the ITEs be completely open to foreign trade or that their public assets be completely privatized, which none of the six East Asian countries did. What is critically important is for markets to be "contestable," which requires that existing barriers to market entry and special privileges for favored enterprises are removed. Promoting competition among all potential suppliers private and public, domestic and foreign, small- and large-scale, rural and urban represents a major challenge for ITE governments. In particular, there is need to rationalize policies toward state-owned enterprises whose preferential access to critical inputs such as land and capital, import and export quotas, and other monopoly privileges continues to impede private-sector development in the ITEs. Especially in China and Viet Nam, effective state enterprise reform is a key ingredient to unleashing the full potential of the private sector and to attaining equitable growth.

The extent to which a "level playing field" is being achieved can be indicated in part by the relationship between domestic prices of tradable goods and their international prices, which in turn is determined by sectoral protection levels and the real exchange rate. These two relative price measures, including a differentiation of protection rates for different suppliers of the same product, need to be monitored over time in the ITEs to be able to assess the progress in one important aspect of their transition to a market economy.

Most of the ITE countries undertaking trade policy and sectoral price reforms have been able to obtain external financial support, particularly from the World Bank and IMF. The policy targets, performance criteria, and other aspects of loan conditionality will undoubtedly have a bearing on the medium-term prospects of these economies and on whether government commitment to policy reforms will be maintained.

Promoting broad-based agricultural growth-based agricultural growth;

The vast majority of each ITE's population, its labor force, and its poor are located in rural areas where agriculture provides the primary means of livelihood. Without agricultural growth and rural development that can raise the real income of the rural poor, it is difficult to envisage rapid growth of the national economy that is equitable and sustainable. Accelerated agricultural growth is not enough, however. A critical determinant of whether the effects on overall growth and equity will be favorable is the structure of agricultural growth and its linkages to the rest of the economy. Broad-based agricultural growth is associated with strong labor-intensive linkages on the consumption side, enhancing the

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increasing total factor productivity faster than would have taken place if they did not export.

employment and income multiplier effects that cut across rural and urban sectors. On the other hand, if the rural income gains from agricultural growth are concentrated in the more affluent households, the pattern and growth of rural household expenditures will favor capital-intensive products and imported goods rather than labor-intensive, locally produced goods and services, weakening therefore the impetus to a rapid and equitable overall growth of the national economy.

On the supply side, the government can help enhance the growth linkage effects by investing in rural areas (infrastructure, agricultural research and extension, and human resources), by removing the anti-agricultural price bias of existing policies, by improving the delivery of rural financial services, and by ensuring that small- and medium-scale rural producers gain access to these policy improvements. As can be discerned from the contrasting experiences of the Philippines and Taiwan described above, rapid agricultural growth can provide a basis for the structural transformation and long-run growth of the economy, but it has to be broadly based for the various linkage mechanisms to work to their fullest extent.

Among the ITEs, China and Viet Nam have apparently gone the farthest in improving the institutional and policy environment for broad-based agricultural growth. It is not a coincidence that their industrial sector has advanced much more than in the other ITEs. At the present stage of their development, all five of them would benefit from the expansion and diversification of rural income sources, involving both farm and off-farm activities. The government has a key role in promoting rural diversification as a means of achieving economic growth and poverty reduction simultaneously (see, for example, World Bank 1990). A major influence is the state of rural infrastructure. Taiwan's success in agricultural diversification and rural industrialization has been attributed in large part to its highly developed rural infrastructure in terms of household access to electricity, paved roads per square area, and railway coverage (Ranis and Stewart 1987). The extensive and high-quality transport network in Taiwan was especially important for industries (such as food processing and textiles) supplying urban and export markets.

Supporting labor-intensive, export-oriented industries-intensive, export-oriented industries;

As in most low-income countries, labor is the primary income-generating asset of the poor in the ITEs. Landless agricultural workers and unskilled (especially, informal) laborers in industry and services benefit from the expansion of labor-intensive industries through the induced creation of better-paying jobs and upward pressure on wage rates. The income of the poor thus depends crucially on the state of demand for and the productivity of labor, and what happens to the share of labor earnings to total income over time will largely determine the course of poverty. Moreover, the region's comparative advantage lies in labor-intensive production, considering the abundance and low cost of unskilled labor. In light of the East Asian experience in export-led development in which success came through increased use of the abundant resource (labor), ITE governments would do well to encourage labor-intensive industries with an eye to outward-oriented industrial growth. This will require

active support for private-sector development, directed particularly to small- and medium-scale enterprises, in the form of technology, training, and export marketing assistance as well as improved access to credit. The Taiwanese experience shows the importance of public investments in rural infrastructure and education, which contributed to the rapid growth of rural-based, labor-intensive industries catering to the export market.

In contrast to the development record of successful East Asian market economies, Viet Nam's recent industrial growth experience to a varying extent, shared by the other ITEs has been characterized by increasingly capital-intensive production based on inefficient, low-return investments that are uncompetitive at world prices (World Bank 1997b:25-26). These activities are dominated by large-scale, state-owned enterprises with significant direct foreign investment. Unsurprisingly, they are import-substituting rather than export-oriented, and favored by high rates of effective protection. Such industrial investments can only inhibit progress in achieving equitable growth during the transition to a market economy.

With respect to foreign investment, which has become sizable in most of the ITEs during the 1990s, its relative concentration in import-substituting industries is understandable. Foreign investors will be attracted to where the highest commercial profitability is forthcoming. If the trade regime continues to be highly restrictive in the ITEs, foreign investment will tend not to favor export production. This policy stance would ignore the lesson from East Asia that the sooner import-protection policies are abandoned, the more quickly will foreign investments be export-oriented, using the country's abundant factor (labor) more intensively and contributing to economic growth with equity.

Dealing with macroeconomic imbalances

A necessary condition for sustained growth is macroeconomic stability, which provides a congenial environment for private savings as well as for investment and productivity growth. This is demonstrated by the high-performing East Asian economies, in which prudent macroeconomic management and associated low inflation rates, fiscal deficits, and external debt levels have been a long tradition. Sustained macroeconomic imbalances inevitably lead to rapid inflation, real exchange rate appreciation, and chronic balance of payments difficulties. These in turn result in low savings and investment, inefficient allocation of scarce resources, loss of international competitiveness, and slow (or negative) growth. Macroeconomic instability can also seriously undermine attempts at structural policy reform. In the Philippines, for example, the government had to discontinue the implementation of a trade liberalization program that began in 1980 owing to the external debt crisis of 1983, which resulted from heavy foreign borrowing that financed the markedly large public spending and fiscal deficits during the period (Bautista 1989).

Among the ITEs, China has had the most frequent bouts with macroeconomic instability, evidenced by the recurring high inflation rates and large fiscal deficits, which also led to a reversal or delayed implementation of some aspects of the reform program. Viet

Nam, Cambodia, and Laos have been plagued by large current-account deficits and low domestic savings (Dodsworth et al. 1996) which, in the face of a deteriorating external environment, could have substantial adverse effects on these countries' growth performance and policy liberalization efforts. It is a continuing challenge for the reforming ITE governments to promote the effectiveness and efficiency of public spending while ensuring that fiscal deficits are manageable and domestic inflation rates low. Moreover, the recent competitive devaluations of East Asian currencies point to the need for greater flexibility in exchange rate management in the ITEs and for further reforms to improve economic efficiency and price competitiveness in world markets.

Building a strong financial system

An important lesson from the recent Asian crisis is that state-directed bank lending and a weak financial sector can ultimately prove very costly. In the afflicted East Asian countries, the impressive macroeconomic performance served to conceal, for a long time, some structural problems notably, a banking system with weak prudential controls and an over-leveraged corporate sector. These countries' financial institutions have traditionally been subject to government influence, even if most of them are not state-owned. Governments interfered in the allocation of credit, giving preference to specific industries and enterprises, at times with doubtful economic rationale. This was the case in South Korea from the mid-1970s to the early 1980s when heavy industries were heavily promoted by the government and more recently, in the mid-1990s, with overinvestment in semi-conductors, which added to global excess supply and depressed world prices of computer chips. At various times, state-directed lending in Indonesia and in the Philippines served the interest of ruling families and their cronies, contributing to an eventual economic crisis and change in political leadership.

The IMF holds the view that such structural problems were the primary cause of the Asian financial crisis (Fisher 1998). When the investment booms ended and the profitability of heavily indebted companies sharply declined (because the real estate market weakened in the case of Thailand, or export prices fell in the case of South Korea), concerns were raised about the health of the financial sector. International credit lines began to dry up and capital rapidly moved out, precipitating a foreign exchange crisis which quickly led to a full-blown economic crisis. Other analysts such as Radelet and Sachs (1998) point to the intrinsic instability of international financial markets as the main culprit, arguing that the markets simply overreacted and exposed the Asian economies to the sudden reversal in financial flows triggered by dramatic shifts in creditor expectations. Clearly, however, a stronger domestic financial sector and better prudential controls would have lessened any country's vulnerability to the systemic instability of global financial markets.

By virtue of their background, banks and finance companies in the ITEs are unsophisticated, with limited experience in asset management and often with inadequate supervision. It takes time, training, and experience to develop an effective system of prudential regulations for them to be protected from both internal and external shocks. Until

a strong, well-functioning domestic financial sector is in place, there should no rush among the ITEs to fully integrate into the international financial system. However, as Radelet and Sachs (1998) have suggested, the operation of foreign banks in developing countries is desirable, owing to the stabilizing effect of their presence.

To strengthen the financial sector, ITE governments should to do away with their distortionary interventions in the credit market and encourage rapid improvement in the prudential, regulatory, and accounting framework within which domestic banks operate. The cost of inaction consists not only of the induced inefficiency in credit allocation and deficiency in resource mobilization. The recent economic crisis in East Asia draws attention to the eventual severe penalties of maintaining an underdeveloped, government-compliant banking system in the face of increasing globalization of financial markets. Moreover, as with any policy or institutional reform, it is better to address the weaknesses of the financial sector in normal times than during a crisis, and to do it sooner than later.

The East Asian crisis also underscores the need to confine short-term capital flows to the financing of short-term trade transactions. This may warrant a policy of restricting short-term liabilities, as Chile has adopted for some time already, rather than the IMF's open market prescription. On the other hand, long-term capital flows, especially direct foreign investments, should be encouraged, provided that they are drawn into economically (not just commercially) viable areas as discussed above with reference to the East Asian experience.

A final point worth making is that the Asian crisis was compounded by poor corporate management related to the close relationships between government and private enterprise, widespread corporate guarantees (ensuring that even weak companies received credit), and incomplete financial reporting (e.g., the Korean *chaebols* did not have to publish consolidated financial statements). Lack of transparency in official financial data (e.g., on international reserves, foreign debt, forward exposure, and non-performing loans) also contributed to severity of the crisis. The latter consideration is especially relevant to the current situation in most of the ITEs, where official data on many areas are opaque and incomplete. Under uncertain market conditions, "no news" is likely to be interpreted by investors and other economic agents as "bad news."

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Table 1. Indochina: Basic indicators, 1997

Population			Agriculture	
	Total (million)	Growth rate (%) 1990-97	Percent rural	GNP per capita (US$)
GDP growth rate (%) 1986-97	Percent of GDP	Percent of labor force	Cambodia	11
2.7	78.7	300	6.2	51
74	China	1227	1.1	68.1
860	11.9	20	72	Laos
5	2.6	77.7	400	6.7
52	78	Myanmar	47	1.7*
73.4	n.a.	3.3*	60*	73*
Viet Nam	77	2.1	78.9	290
8.6	27	71		

Source: Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries, Vol. 29 (1998); World Bank, World Development Report (1998/99); World Bank, World Development Indicators, CD-Rom (1998).

Note: * For 1986-96 only.
Data on agricultural shares of GDP and labor force are for 1996.

Table 2. Indochina: Poverty and social indicators

	Cambodia	China	Laos	Myanmar	Viet Nam	East Asia and Pacific countries
Population in poverty (%)	30.0	26.9	46.1	n.a.	50.9	n.a.
% of poverty in rural population	86.3	93.6	88.1	n.a.	89.1	n.a.
Social indicators						
Access to safe water (% of population)	13	90	39	38	36	68
Life expectancy at birth (years)	53	70	53	60	68	39
Infant mortality (per thousand live births)	105	33	101	80	40	39
Child malnutrition (% under 5 years)	38	16	40	31	45	n.a.

Source: World Bank, World Development Indicators, CD-Rom (1998); World Bank (1996 : 6) for China's poverty index.

Notes: Poverty indicators are for the year 1994 in Cambodia and China, and 1993 for Laos and Viet Nam.
Social indicators are latest year estimates during 1990-96.

Table 3. East Asia and Indochina: GNP per capita, 1970 and 1997

	1970 (US$)	Index*	1997 (US$)	Index*
East Asia				
Indonesia	80	32	1,110	20
Malaysia	380	151	4,680	83
Philippines	210	83	1,220	22
Thailand	200	79	2,800	50
South Korea	250	99	10,550	187
Taiwan	390	155	13,510	239
Average	252	100	5,645	100
Indochina				
Cambodia	130	52	300	5
China	160	63	860	15
Laos	120	48	400	7
Myanmar	80	32	n.a.	n.a.
Viet Nam	150**	60	320	6

Source: World Bank Atlas (1972); World Development Report, (1998/99).

Notes: * Index is relative to East Asian average.
**Average of North and South Viet Nam.

Table 4. Indochina: Macroeconomic indicators for 1985, 1990 and 1995-96-96;

	Cambodia	China	Laos	Myanmar	Viet Nam	
	(percent of GDP)	Exports				
		1985	n.a.	9.9	4.0	
		1990	6.1	14.8	11.3	
		1995-96	29.2	21.0*	23.3	
		Direct				
4.6	14.8	foreign	0.0	0.4	0.0	
2.6	26.4	investmen	0.0	0.9	0.6	
1.0	38.7	t	7.4	4.5	5.5	
		1985				
		1990				
		1995-96				
		Current				
0.0	0.0	account	n.a.	-3.7	-4.4	
0.7	0.0	balance	-3.5	-3.4	-6.3	-11.7*
0.1	6.7	1985	-16.2*	0.5		
		1990				
		1995-96				
		Gross				
n.a.	-3.1	domestic	n.a.	33.7	1.3	
n.a.	-5.4	savings	2.3	38.7	n.a.	
n.a.	-10.7	1985	4.8	43.0	11.8	
		1990				
		1995-96				
		Overall				
11.5	n.a.	budget	n.a.	-7.3	-11.1	
11.7	2.9	balance	-2.3	-0.8	-12.2	
11.1	15.3	1985	-7.4	-0.9	-8.8	
		1990				
		1995-96				
			(percent)	Domestic		
0.9	-21.2			inflation **	146.0	
-2.8	-7.2			1990	7.5	
-2.9	-0.3			1995-96		
				Real		

5.7	38.0	18.7	42.1	exchange rate	100.0
9.4	16.2	20.8	12.8	index***	57.0
				1990	
				1995-96	
100.0	100.0	100.0	100.0		
103.2	68.9	16.0	30.6		

Source: World Bank, Trends in Developing Economies (1996) and World Development Indicators, CD-Rom (1988). Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries, Vol. 29 (1998).

Note: * For 1995 only.
**Annual change in the implicit GDP deflator.
***In domestic currency per U.S. dollar; an increase means a depreciation.

Table 5. East Asia: Average annual real GDP growth in 1970-80, 1980-90, 1990-97-80, 1980-90, 1990-97; (percent)

	1970-80	1980-90	1990-97
Indonesia	7.2	6.1	7.5
Malaysia	7.9	5.2	8.7
Philippines	6.0	1.0	3.3
Thailand	7.1	7.6	7.5
South Korea	10.1	9.4	7.2
Taiwan	9.8	8.1	7.8
Developing countries (low and middle-income economies)	5.2	3.0	2.8

Source: Basic data from World Bank, World Development Report (1995 and 1998/99); Asian Development Bank, Key Indicators of Developing Member Countries (1983); and Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries (1998).

Table 6. East Asia: Changes in poverty incidence

	Headcount index
Country and period	First year
Last year	Indonesia (1970-84)* Indonesia (1970-87)**
57 58	23 17
Malaysia (1970-84)* Malaysia (1973-87)**	49 37
18 15	Philippines (1971-85)*
49	59
Thailand (1968-81)* Thailand (1962-86)**	39 59
24 26	South Korea (1965-80)*
41	10
Taiwan (1964-72)*	35
10	

Source: * Fields (1989); ** World Bank (1990).

Table 7. East Asia: Social indicators, 1970 and 1990

	Access to safe water				
	Rural	Urban	Life expectancy at birth (years)	Infant mortality (per thousand live births)	Adult illiteracy(%)
	(% of population)				
Indonesia					
1970	1		10	48	118
1990	43		68	62	61
		Malaysia			
43	1970		6	100	64
23	1990		66	66	71
			Philippines		
45	42		1970	20	67
16	22		1990	79	85
				Thailand	
58	71		17	1970	10
64	41		10	1990	72
					South Korea
60	57		73	21	
87	66		27	7	1970
					1990
38	84		60	46	12
76	100		71	17	5
Taiwan					
1970	27		20	69	17
1990	n.a.		n.a.	74	6

*
9

Source: World Bank, World Development Report (various years); Asian Development Bank, Key Indicators of Developing Member Countries (1983); Asian Development, Key

Indicators of Developing Asian and Pacific Countries (various years).

Note: *Less than 5 percent.

Table 8. ASEAN - Four: Growth of exports and export share of manufactures- Four: Growth of exports and export share of manufactures;,
1970 - 96 (in percent)

	Average annual growth rate		Export share of manufactures
	1970-80	1 9 80-90	1990-96
	1970	1 9 80	1996
	(1)	(2)	(3)
	(4)	(5)	(6)
Indonesia	8.7	2.2	10.4
	1	2	51
Malaysia	7.4	10. 8	14.2
	6	19	76
Philippines	7.0	5.8	12.3
	6	21	84
Thailand	11.8	14. 2	11.3
	5	25	73

Source: Bautista (1992 : 349) for columns (1), (2) and (4); others from World Bank, World Development Indicators, CD-Rom (1998).

Table 9. ASEAN - Four: Growth of agricultural value added and exports- Four: Growth of agricultural value added and exports; (in real terms, percent)

	Agricultural value added		Agricultural exports
	1970-80	1980 - 90	
1979-89	Indonesia	3.8	3.2
	6.6	Malaysia	5.1
4.0		3.9	Philippines
4.9	2.1		5.4
Thailand	4.7	4.0	
6.0			

Source: Bautista (1993 : 351,359).