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In Search of a New East Asian Development Paradigm: Governance, Markets and Institutions

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1 Introduction

Viewing the 20th century as a competition of economic models, many observers claim that capitalism proved its superiority in the semi-finals of the 1980s. Frankel and Roubini (2003) describe how some claim that the "American brand of capitalism beat the Japanese brand of capitalism in the finals of the 1990s". In an opposing view, Stiglitz (1998), in his Prebisch lecture, argues that despite the financial crisis that devastated East Asia, many of the alleged institutional weaknesses blamed for the collapse may well have played a minute role. In his assessments, East Asia was no more vulnerable to the crisis than other parts of the world, and in fact, East Asia may be the best model of development the world has seen to date. Stiglitz adds that the East Asian miracle was real and was based on a set of sound fundamentals and public policies.[2]

Between these two opposing views, there is a third – that increasing demands for economic governance reform and unwavering commitment to open trade and financial regimes, together with strong fundamentals under more transparent and democratic auspices provide the basis for

[1] This chapter heavily draws upon Park (2003a, 2003b).

[2] Stiglitz (2001) remarks that the Asian crisis has only slightly tarnished the economic record East Asia had achieved and, if anything, together with the strong recovery in several of the countries, may have reinforced the conclusion that there is something very special about these countries.

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substantial optimism for the future of the East Asian development paradigm (Haggard 2000, pp. 236-37). In fact, Stiglitz and his supporters acknowledge that East Asian countries now face a new set of challenges as their economies become increasingly open and as they are further exposed to the vagaries of international markets as a consequence. At the same time, most of the countries are well poised to take advantage of many of the opportunities that are afforded by globalisation and the new economy (Stiglitz, 2001).

Six years after the crisis, East Asia is at the crossroads. If Frankel and Roubini (2003) are correct in their description, East Asian countries should not hesitate to entirely replace the pre-crisis model of economic development with an Anglo-American system of capitalism. On the other hand, if the problems are associated with imperfections in international financial markets, in particular panic and herding of market participants, Asia would be better off maintaining the traditional East Asian model and at most reforming it to be compatible with changes in the domestic and global economic environment.

In this chapter, we search for a new development paradigm that could help East Asian countries adapt to societal and political changes taking place in the region while retaining their persistent vitality and competitiveness for sustainable growth in integrating into the global economy. Is the East Asian development model, described by a World Bank study (1993) as *The East Asian Miracle*, so outdated and out of touch with the realities of a new global economy that it should be repudiated in favour of an alternative model, such as Anglo-American capitalism? If not, can the model be reformed in a way that will make it as viable for post-crisis development as it was in the past in East Asia?

At the outset, it should be emphasised that East Asia covers a huge area, is home to almost 2 billion people, and in 2000, accounted for 23 percent of the total world gross domestic product. It indeed would be presumptuous to talk about a new development paradigm for all East Asian countries. Our focus is placed mainly on crisis-hit countries in East Asia.

This chapter is organised as follows. Section 2 analyses some of the structural strengths and weaknesses of the pre-crisis East Asian model and asks whether the general features of the model can survive the global economy of the 21st century, driven by innovation in information and communication technology. Section 3 discusses some key reforms for the financial, corporate and public sectors, necessary for rejuvenating the model as a new paradigm for post-crisis development in East Asia. Section 4 concludes.

2 Strengths and Weaknesses of the East Asian Model

Strengths of the Model

East Asia is often referred to as a sub-region of Asia that includes the 10 ASEAN member states and China, Japan, South Korea, Taiwan, and Hong Kong. It should be noted that while a single set of broad characteristics of the East Asian development model could be identified, in reality, there may be as many East Asian models as there are East Asian countries, each with different cultural and historical backgrounds and at different stages of development. However, the East Asian countries share some economic characteristics that distinguish them from many countries in other regions of the world.

Among the economic successes of East Asia before the crisis, rapid growth stands out. From 1960 onward to the early 1990s, the East Asian countries grew three times as fast as Latin America and South Asia. Between 1960 and 1985, real income per capital more than quadrupled in Japan, Taiwan, Hong Kong, Singapore, and South Korea. Another accomplishment was declining inequality: the rewards of the rapid growth were evenly spread throughout the populations. A third notable achievement was the quick reduction of the technology gap via massive investment in human capital, importation of foreign technology, export orientation, and the opening of markets for foreign direct investment as a means of introducing advanced technology.

Voluminous literature exists on economic and social factors that contributed to East Asia's rapid growth-with-equity, which led to a dramatic reduction in poverty rates. Of these contributions, the World Bank miracle study (1993) was the most rigorous and comprehensive analysis of East Asia's development experience. It described the East Asian development model as a functional framework of growth in which macroeconomic stability, superior accumulation of physical and human capital, efficient allocation, and catching-up with advanced foreign technology were important elements supporting rapid growth with equity.

The World Bank study concluded that East Asia's rise could be attributed, in large part, to getting the basics right. Some of the basics or fundamentals included responsible and disciplined fiscal and monetary policies that helped maintain moderate rates of inflation. Relative price stability, in turn, contributed to providing a stable economic environment conducive to private investment and financial savings. Large investments in education, i.e. improving and expanding primary and secondary education, promoted rapid growth in human capital. This emphasis together with post-secondary education that focused on vocational and technical skill training, nurtured a better educated labour force, suited for rapid economic development.

In line with the market friendly approach, East Asia's strategy of social protection also focused on promoting an expansion of employment and enhanced real wages through rapid growth. The European model of social welfare with various entitlements to government transfers, including publicly funded retirement programmes, was considered inconsistent with East Asia's outward-looking development strategy. It was bound to undermine the competitiveness of their exports. As a result, the East Asian policymakers resisted organised labour's demand to legislate a minimum wage and unemployment insurance and suppressed the formation of industry and economy-wide unions. They avoided intervention in the labour markets to the greatest extent possible, so that wages and employment were determined largely by demand and supply factors.

Rapid growth could not have been sustained had it not been backed by high rates of investment and domestic saving. To secure a foundation for high and rising saving rates, the East Asian governments managed its spending programmes within the revenues available so that they could be net savers. This spending discipline restrained large increases in social expenditure and gave the East Asian policymakers moral latitude to extol virtues of saving and to introduce various voluntary and involuntary saving schemes.

Finally, East Asia's model also included actively seeking foreign technology through foreign licensing, capital good imports, and liberalisation of foreign direct investment. One might question whether this policy indeed constitutes market friendly policies. Most East Asian countries did not take any significant steps to liberalise their trade regimes until the late 1990s, and when they did open, they did so under foreign pressure. They needed foreign technology to remain competitive in global markets. Liberalisation of foreign capital imports and foreign investment was therefore dictated by the export promotion strategy; it was not part of trade liberalisation.

East Asia's development model is fundamentally a traditional model of a mixed economy in which the government plays an important role. Within the confines of the mixed economy model, there is little that is unique about the development strategies of the East Asian countries. According to Stiglitz (1996) and the World Bank (1993), East Asian policymakers realised the severity of the numerous market failures associated with the inefficiency of existing markets, non-existence of several markets, technological and marketing spill-overs, coordination problems, and increasing returns to scale. They could therefore easily justify their intervention in various markets. What set East Asian policymakers apart from their counterparts elsewhere, however, was that unlike communist state planners, they were intent on complementing markets rather than replacing them.

An interesting question is: Why did the market complementation or the "fundamentals plus interventions" strategy work well in sustaining rapid growth with equity before breaking up with the onset of the 1997 crisis?

While espousing a market friendly strategy, in reality the East Asian policymakers did not hesitate to intervene in various markets in a systemic fashion and through multiple channels to encourage savings, promote exports, and to achieve the desired allocation of resources. Interventions were not confined to traditional areas in which significant externalities were present, such as developing technological capabilities by building research and development centres and industrial parks and supporting all levels of education. Instead, interventions included import substitution of a wide range of intermediate products, the promotion of heavy and chemical industries as in Korea, government ownership and subsidisation of many financial institutions, mechanisms for mandatory saving, and even setting export targets at the firm and industry levels. Financial policies were repressive in that they kept bank deposit and other interest rates below a market clearing level and maintained ceilings on lending rates.

Contrary to conventional wisdom, both the World Bank (1993) and Stiglitz (1996) argue that these market interventions were not inefficient; in fact, they were associated with high rates of investment and productivity growth in many cases. One explanation for this success is the high level of institutional capacity in East Asian countries, backed by strong bureaucracies capable of administering and implementing interventionist policies. Many East Asian countries, some of which were authoritarian, were "strong" in that they had the ability to seriously commit themselves to long-term development goals and choose those policies that would enable them to attain those goals. The export push, which has been the most conspicuous feature of the East Asian development model, did not allow unnecessary or costly interventions, largely because to be successful it required meeting the efficiency standards of global markets.

Weaknesses of the Model

Notwithstanding its strengths, even before the outbreak of the crisis in 1997, the East Asian model had also been showing various structural weaknesses. The three decades of rapid growth imbedded institutional weaknesses and rigidities in the East Asian system which in turn bred resistance to changes that were necessary to facilitate societal and economic adjustments to political democratisation, economic liberalisation and globalisation of the world economy. More specifically, the East Asian countries failed to restructure their systems in line with democratisation and market liberalisation and to be credible in their interfaces with global markets. We identify four critical failures.

The first failure was the inherent conflict between East Asia's governance mechanism on the one hand and democratic polity and market liberalisation on the other. East Asian countries were slow in developing a democratic governance mechanism at various levels of the economy to replace the system of "consultative polities" that, as described by Campos and Root (1996), characterised these authoritarian regimes. By the early 1990s, it was clear, at least in some East Asian countries, that the consultative mechanisms of coordination and cooperation between the government and private sector – and between the different groups within the private sector – were crumbling and degenerating into collusion, political cronyism and corruption.[3]

The collapse of consultative polities revealed serious coordination problems at the national, industrial and enterprise levels. Large family-owned firms and industrial groups were growing more politically powerful – to the point of dictating national economic policy. Their predatory pursuit of large shares in many markets, including financial ones, brought on further concentration of both economic power and industrial structure. Yet many of the East Asian governments literally did not want to know what the large, family-owned enterprises and their main banks were doing. Governments acted as if they should not be involved in monitoring the behaviour of banks and corporations, lest it should be misunderstood as unnecessary intervention in a market economy. In addition, banks did not seem to know what their client firms were doing. Furthermore, in the case of Korea, labour movements became more militant, disrupting not only workplaces but also

[3] Under authoritarian rule up to 1987, the "hard state" nature of Korean developmental state dominated the governance mechanism. The government could order large firms to exit when their performance was not proved.

at times entire national economies. Yet the government could no longer mediate disputes between labour and management.

The transition process to liberal democracy and deregulated market capitalism needed a new governance mechanism to fill the vacuum resulting from the disappearance of the old governance mechanism. In particular, financial institutions could have played a role as a disciplining mechanism, but they did not do so. The East Asian model's second failure arose from the delay in developing a proper financial infrastructure as well as legal and regulatory systems that could support a market-oriented and open financial system. In the relationship banking that characterised the East Asian financial system, banks were supposed to play an important role in governing corporations, but it was unclear who was to monitor the banks. In the end, it was the government's responsibility.

Toward the latter part of the 1980s, East Asian policymakers embarked on financial market deregulation and opening. Financial deregulation sought to diversify financial instruments and markets. Due in part to this effort, banks, non-bank financial institutions and capital markets all grew quickly and became more active in the 1990s. However, the financial deregulation was not accompanied by institutional reform for strengthening regulatory, governance, legal and judiciary systems that would improve accounting, auditing and disclosure requirements of financial institutions and firms. Consequently, without proper institutional reforms in place, such a transition led to difficulties in preventing moral hazard and the eventual financial crisis when banks and regulators lacked adequate human capital and resources.[4]

Advanced market infrastructures, such as competent accounting and securities law firms, investment banks, credit rating agencies, corporate restructuring specialists and fund managers were understandably slow to develop. In the absence of these market-supporting institutions, it is questionable whether incipient capital markets could have been buffered against speculation and served as stable sources of investment financing. As far as the financial system is concerned, the failure of the East Asian development model did not lie in bank domination but was instead rooted in poor management and regulation of the banking

[4] Under the old governance mechanism, direct government control over the management and credit allocation at banks and other financial institutions left little room and few incentives for the regulatory authorities to develop and improve their capacity for prudential supervision and regulation. It also meant that the banks and other financial institutions did not develop their own risk management capacities.

sector. There is no theory or empirical evidence suggesting that bank-based financial systems *per se* are more vulnerable to financial crisis than market-based ones. Without due consideration of the level of financial market development, identifying a simple dichotomy between banks and markets may not help much in assessing financial vulnerability to crises. The problem was that East Asian policymakers abused their financial systems as a means of industrial policy before the crisis. That abuse rather than any structural characteristics of East Asian financial systems may have been responsible for the 1997 crisis.

A third failure of the system can be found in the closed and non-transparent corporate sector, which did not fare well with market liberalisation and opening. In the early 1990s, major corporations from East Asia were beginning to borrow heavily from international financial markets and expand their direct investment throughout East Asia, and even in Europe and North America, as part of their globalisation strategy. Although these corporations were becoming more active on the global scene, they were slow in reforming themselves to accept global norms and practices in accounting, disclosure and corporate governance. Western investors were attracted to the growing economies of East Asia and to owning a stake in these large corporations that looked invincible with a global reach. Up close, however, these corporations were riddled with poor accounting and auditing irregularities, non-transparent management and little protection for minority shareholders. Once again, East Asian economies failed to build a modern corporate sector that was transparent and accessible to foreign investors.

The seriousness of crony capitalism, or widespread corruption in East Asia, was well known to foreign investors. However, there is corruption in every society. When campaign contributions lead to corporate welfare, rent-seeking activities are the optimal responses from the corporate sector. Stiglitz (2001) says: "It is easy enough to say that the government should do everything it can to reduce corruption, and that government intervention should be designed in such a way as to mitigate the risk of corruption. It is also easy enough to explain why corruption has adverse effects on economic growth. But it is harder to design and implement corruption-resistant strategies. It is even harder to assess with any precision the impact of the particular level and forms of corruption on the growth of the economy. Many rankings show China at the high end of the corruption scale. Does this suggest that but for the corruption, the economy would have grown significantly faster?"

It has been shown that export-led development strategy was the most conspicuous, as well as successful, feature of the East Asian development model. However, it was predisposed to a number of serious domestic risks, which were overlooked or improperly addressed, resulting in market distortions, concentrated industrial organisation and private economic power, an inflexible exchange rate system, and in some cases, perpetuation of government control of markets and the financial system. This is the fourth failure of the East Asian model.

Policy Implications

The rapid industrial development experiences of the East Asian countries under their export-oriented regimes suggest four sets of policy implications. First, they point to the importance of an export-oriented industrialisation strategy, which in turn requires price stability, high savings and a realistic exchange rate in macroeconomic management. Second, industrial policy for manufactured exports should not only be flexible to meet the changing environment, but it should also be accompanied by development in finance, human resources and infrastructure. Third, both technology acquisition and indigenous research and development promotion should be consistently emphasised to ensure rapid industrial growth. Last, latecomers' industrial policies in the form of sector specific incentives, if applied to the permissible degree in today's increasingly globalising environment, should be disciplined using strict performance criteria.

Ahn (2001) provides an overview of the three East Asian countries' industrial policy regimes and resulting competitiveness in an increasingly globalising world economic order. In his study, he finds that despite their common emphasis on export-led industrialisation, the three countries – Korea, Malaysia and Taiwan – have been differentiated according to industrial strategies. These primarily include a big business approach for Korea, FDI-triggered industrial development for Malaysia and SME-based industrialisation for Taiwan. However, except for Taiwan, financial sector development has not been parallel with industrial development. During their respective high growth periods, in both Korea and Malaysia a crony partnership developed between business and political elite. This granted nearly unlimited expansion for big businesses through "administered credit" from the financial sector in the case of Korea and "connected lending" in the case of Malaysia.[5]

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[5] See Ahn (2001) for more detailed description of the three cases of Korea, Malaysia and Taiwan.

Immediately after the 1997-98 crisis, exports provided the only way out of the crisis and sustaining recovery for the crisis-hit countries, since they were not able to implement expansionary monetary and fiscal policy to expand domestic demand. Since the crisis, interest rates have come down to a historically low level, leaving little room for additional monetary expansion. East Asia has traditionally valued fiscal prudence, and with the IMF on the watch, these countries have never seriously considered fiscal expansion as a means of expanding domestic demand regardless of its effectiveness. Given these macroeconomic policy constraints and their traditional orientation toward export-led growth strategy, most East Asian countries have naturally turned to exports as the major source of growth. More importantly, most East Asian countries had to generate current surpluses to replenish their foreign reserves. In recent years, with domestic demand remaining sluggish, they have continued to rely on exports to sustain recovery.

As Stiglitz (2001) points out, the export-led strategy may encounter difficulties as such policies become widely imitated and the world becomes saturated with the goods that represented the traditional comparative advantage of East Asian economies, and more broadly, as they become larger relative to the rest of the world. This can be a problem, especially for China. In this regard, East Asia will have to seek new sources of dynamic comparative advantage rather than relying on price competitiveness. Clearly, the export-led growth strategy also has an undesirable side effect in that it is prone to creating a boom-bust cycle. An export boom that is accompanied by a current account surplus brings in large capital inflows, thereby magnifying a cyclical upswing while an export slowdown deepens a cyclical downturn. Without imposing capital controls, conventional monetary and fiscal policy may not be enough to moderate cyclical swings.

3 The Reform Agenda

Although the 1997-98 crisis exposed a number of structural problems and damaged the universal applicability of the model, East Asia's experience with the crisis by no means proves that the Anglo-American model surpassed the East Asian system, as Frankel and Roubini (2003) claim. A review of the characteristics and evolution of the East Asian model suggests that despite its structural weaknesses and failures in fending off financial crises, some of the main features of the system remain intact. These main features could serve well for the post-crisis development of East Asia, although as a whole, the model is in need of a major structural repair (Park 2003b). However, one must hasten to add that this conclusion does not mean that East Asia can remain content with its vintage 1960-70s model, placing the blame for the 1997 crisis on foreign speculators. In fact, except for the basic building blocks of economic fundamentals, all aspects of the model, in particular institutions governing the financial system, the corporate sector and the labour market will have to be reformed. This need for reform is not surprising in view of the fact that an old development paradigm designed to serve the interests of authoritarian regimes during an era characterised by tightly controlled and closed markets, as well as protectionist trade practices, would be no longer viable. What, then, are the necessary reforms and how could they be implemented to make the model as effective in a new East Asian and global environment as it was before?

Although the liberal policies of the Washington consensus still find many proponents, the virtues of the mixed economy are now better appreciated than before. As Rodrik (2000) points out, "the idea of a mixed economy is possibly the most valuable heritage the twentieth century bequeaths to the twenty-first century in the realm of economic policy". Reflecting on this heritage, a new paradigm is most likely to be one of a large variety of mixed economy models that combine the state and market (*laissez faire* and intervention), as was the case in the old East Asian development model. The major challenge facing East Asian economies in the coming decades, therefore, is to nurture the evolution of their own specific models of a mixed economy. In this evolutionary process, East Asian policymakers will come to realise that democratisation has imposed a different participatory mechanism for consensus building. Economic liberalisation has reduced the scope of industrial policies and other types of market intervention. It has also required the creation of a new set of institutions for financial regulation and supervision, corporate governance and the management of industrial relations for the efficiency and stability of the market.

While East Asia may not have to embrace Anglo-American capitalism, the global realities leave the region with no choice but to conform to international standards of transparency, disclosure, corporate governance and banking – all established by the advanced countries in Europe and North America. Cultivating compatibility between the new East Asian system on the one hand, and global standards and codes on the other will be important because most of the East Asian Countries will continue to rely on North America and European markets for their exports and will integrate themselves into a new global economy, which is likely to be dominated by the United States and European Union.

These two economies will dictate the rules governing international trade, foreign direct investment and international financial transactions. At the same time, viability of the new East Asian model would require consistency with the rules of the World Trade Organization and the capacity to accommodate the global activities of multinational companies. It would also require the flexibility needed to adjust to the ongoing revolution in information technology. The scope and speed of the overall economic reform will have to be adjusted to the quality of government, institutional capacity to reform, and the other political and societal constraints to which East Asian emerging and developing economies are subject.

What type of a new model could satisfy all of these old and new conditions and specifications? There would be little disagreement that the fundamentally sound development policies of the earlier periods will survive political and economic liberalisation in East Asia. Indeed, East Asian countries would be better off if they continued to adhere to the sound policies from which they benefited during the rapid growth period. These policies include: (i) continuing incentive schemes for promoting high rates of saving and investment; (ii) ensuring large investments in education in general, and research and development in particular; (iii) sustaining macroeconomic stability; (iv) maintaining market openness to acquire foreign technology and exposure to foreign competition; and (v) complementing social welfare policies with the growth-with-equity strategy.

As for the restructuring of the pre-crisis model, the discussion of the failures of the system in the preceding section leads one to identify the following areas where fundamental reform is required.

Governance

One of the priorities of reform falls on building a new governance system by embracing a set of new democratic institutions, rules and norms, and complementing it with a host of new institutions for conflict management, social insurance and regulations so that the market system can function better. In particular, regulatory and judicial mechanisms for enforcing investor and creditor rights need to be improved by reforming securities, commercial and bankruptcy law. Many of these institutions are Western concepts and will have to be transplanted on an inhospitable East Asian cultural terrain. However, blind and wholesale borrowing will not work. Unless this transplantation is carefully managed with due consideration of the capacity and constraints of the reforming economies, the reform may not succeed. Specifically, legal and judiciary reform will be met by strong political obstacles set up by bureaucracies and large family-owned enterprises, the two principal groups of architects of the East Asian paradigm of development. Instead of blindly introducing an ideal set of institutions and rules borrowed from the West, East Asian countries would be better advised to enact rules that they can enforce within existing legal and judicial frameworks.

East Asian countries will also be struggling with the question of why democracies have not been effective in moderating social conflict and political instability, improving government effectiveness and establishing the rule of law. The following agenda includes East Asia's priorities for institutional reform for more effective governance: (i) establishing and enforcing procedural and constitutional rules for the democratic system and market-supporting institutions; (ii) improving the quality, effectiveness and efficiency of the delivery of public services; (iii) enhancing the effectiveness of the judiciary and regulatory system; (iv) reducing the incidence of corruption.

The Role of Government

While accelerating their plan for building democratic and market institutions is critical, most East Asian governments cannot ignore the fact that their role has been undergoing a fundamental change from leading economic development to leading social development. However, less-developed East Asian countries may have a better chance of making a smooth transition to a democratic and market-oriented regime if they first succeeded in developing a strong but limited government. And within this framework of governance, these economies may be able to design industrial policies consistent with the World Trade Organization to facilitate technology transfers and manage limited intervention in the market when market failures dictate stronger actions. To these countries, the priorities of public sector reform are likely to be directed to establishing rules and norms that could provide government officials with incentives to act in the collective interest while controlling corruption and arbitrary actions.

Social Protection

There is widespread consensus that East Asian countries, even after recovering from the crisis, may not be able to return to the high growth path of the pre-crisis period. This deceleration of economic growth has undermined the viability of the growth-with-equity strategy for social welfare. However, this does not necessarily mean that the European welfare system would be an alternative mechanism for social protection for East Asia. To the extent that targeting the poor is the objective of social welfare policy, one can make a strong case for East Asia's social contract that places emphasis on investment in people and communities.

Individual countries in East Asia will find it increasingly difficult to produce public goods for social welfare on their own as a result of economic globalisation. This difficulty suggests the need for collective social security and harmonisation of the tax system through economic integration at the regional level.

Industrial Relations

The region will be searching for ways to accommodate labour's growing demand for political participation. In managing industrial relations, East Asia's task would be to weigh the relative advantages of the Anglo-American system favouring labour market flexibility to the European "corporatist" approach, which places more emphasis on labour's participation in economic and social choices. After many years of suppressive labour policies, East Asian countries will benefit from making room for labour's political participation without compromising labour market flexibility. As far as labour participation is concerned, unlike other areas of economic management, there cannot be a single approach acceptable for all of East Asia. Each country is expected to fashion its own mechanism of participation and bargaining with labour compatible with its political system.

Financial Reform

Despite the structural problems that crippled the functioning of the financial system when it fell victim to speculative attacks, East Asia may have to depend on a bank-oriented financial system for an extended period of time in the future. This system would remain until a legal and regulatory structure is established that provides adequate protection to outside investors as a foundation for efficient securities markets.

Theory and experience do not prove that a capital market-oriented financial system is more effective in promoting economic development and financial market stability in emerging market economies. In fact, in many East Asian countries, particularly those at earlier stages of development, the sequencing of financial reform would begin with improving efficiency and stability of the banking system before setting out to develop money and capital markets because they have not established an efficient and stable payment system and a legal and regulatory system capable of supporting securities markets.

If there is one lesson to be learned from the crisis, it is that East Asian corporations will not be able to maintain robust growth unless they reduce their leverage by going directly to capital markets rather than to banks for their investment financing. In this regard, the backwardness of capital markets could serve as one of the major constraints on future growth in East Asia. Therefore, more developed East Asian countries may attempt to simultaneously develop both market-based and bank-based financial systems. Both require prudential regulation, supervision and administrative rules, although the development of capital markets requires a more elaborate system of regulations and legal infrastructure. Development of the regulatory and legal infrastructure may in turn require a medium-term strategy in which reforms involving capital adequacy, loan classification, loan-loss provisioning, risk management and corporate governance introduce and enforce international codes and standards.

Reform of Industrial Organisation

East Asian countries will gain little by dismantling large, family-owned businesses. What is needed at this stage of development is the strengthening of bank-based corporate governance and other legal and judiciary reform that will improve the transparency and accountability of these enterprises and provide better protection of minority stockholders.

Despite their problems of inefficiency, non-transparency and inadequate governance, the break-up of East Asian family-owned industrial groups may cause more harm than good. The experiences of Western economies also suggest that the building of market institutions, better governance, transparency and the protection of minority stockholders over time will strengthen market discipline to which the East Asian industrial groups will be subjected and which will weed out the inefficient groups. Increased competition from domestic market liberalisation and integration into the global system will also weaken the traditional advantages of a large, family-owned group. In particular, the growth of knowledge-based industries could accelerate the break-up of these groups (World Bank, 2000). It is also worth noting that East Asian industrial groups are not so much products of Asian values as they are of a certain stage of economic development. Some of today's industrial icons, such as Ford, Thyssens and Siemens, started out as family businesses. Over time, they have become modern, transparent and shareholder-friendly corporations (The Economist, 2000).

The Exchange Rate System

In the aftermath of the East Asian crisis, emerging market economies have been given two alternatives choices for their exchange rate regimes: a free-floating or a currency-board system. The experiences of East Asian and other emerging market economies do not support viability of the two corner solutions. Instead, they suggest that the policymakers of the East Asian countries may be justified in operating a managed floating system that allows intervention in the foreign exchange market to smooth high-frequency movements in nominal exchange rates (Dooley, Dornbusch, and Park, 2002; Goldstein, 2002).

Regional Integration and Cooperation

During the last decade, more advanced East Asian economies have gone so far into Western reform based on the Anglo-American capitalism that they cannot, and in fact should not, turn back the clock to return to the old East Asian development model. However, in a Washington Consensus milieu, other less-developed countries in the region could be thrown into a disorderly and confusing process of market deregulation and opening without adequate preparations. East Asian countries may desire to determine an appropriate scope and control the speed of economic reform that will facilitate their gradual and smooth integration into the global economy. However, unless they are prepared to coordinate their policies and pool resources to guard against future crises through forming regional cooperative arrangements, there is the concern that their institution-building reforms and future policies regarding market opening are likely to be dictated by international financial institutions and advanced economies in Europe and North America.

Small East Asian countries have found it increasingly difficult to provide many of the important public goods such as social protection, combating corruption, securing financial stability, and resolving the conflict between domestic politics and global economics. These public goods may be more efficiently produced at a regional level. Recognising this reality, combined with the need for solidifying regional defences against future crises, they have initiated serious discussions on the need and modality for regional integration in East Asia through trade liberalisation and financial cooperation at various intergovernmental forums. These efforts have resulted in a number of regional agreements for integration, including the Chiang Mai Initiative in 2000. In this initiative, the 10 members of the Association of South-East Asian Nations (ASEAN), along with China, Japan and South Korea (known as ASEAN+3), agreed to establish a system of bilateral swaps, which is a facility for liquidity support for those participating countries suffering from short-run balance of payments problems. However, receding fear of another crisis has combined with Japan's deepening recession to considerably dampen the initial enthusiasm for regional cooperation and integration. The China-Japan rivalry over political and economic leadership in East Asia and other regional disputes on trade, territory and historical issues have also been formidable barriers to advancing the regional movement for integration.

4 Conclusion

With the growing acceptance of the liberal ideology of the Washington Consensus throughout East Asia since the early 1990s, many countries in the region embarked on liberal reform, deregulating and opening their markets for goods and services as well as financial assets. Democratic transition and economic globalisation accelerated the reform process even before the crisis. Unable to manage the speculative attack on their own, the three crisis-hit East Asian countries – Indonesia, Korea, and Thailand – sought IMF rescue financing and accepted a structural reform programme aimed at transplanting Anglo-American free market capitalism in place of a development system that had served them well for the three decades preceding the crisis. Many detractors of the IMF were critical about the reform programmes, arguing that these programmes were so misguided and out of touch with the realities of these countries that they could not work. Although the jury is still out, growing evidence suggests that the IMF-directed reforms covering the financial, corporate and public sectors have not been as successful as initially expected, and in many instances, they resulted in little more than cosmetic changes.[6]

Over the last three years, the rapid recovery has renewed a re-evaluation of the East Asian miracle and a search for the kinds of institutional reforms East Asia cannot avoid or delay in order to regain its pre-crisis dynamism and strength. The rethinking centres on the question of whether the East Asian model in the old structure still provides a better framework for development than an American free capitalism model for emerging markets and developing economies in the region. This question arises because many of the structural problems in East Asia may not have been any worse than those faced by other countries (including advanced countries) and may not have been directly responsible for the crisis (Stiglitz, 1998; 2001). Nevertheless, the crisis itself, and the subsequent revelation of the weaknesses in the crisis-hit countries, provide good reasons to think about whether East Asian countries can stay with the old regime, reform it while keeping major elements intact, or eschew it altogether in favour of an Anglo-American model of free capitalism.

The discussion of the failures of the pre-crisis East Asian model leaves little doubt that it will have to undergo an extensive overhaul to be credible as a development paradigm, not because it was susceptible to crises, but because it may have become too outdated to cope with the changes taking place in both domestic and global economies. For example, many of the policies, such as the export push that worked well at early stages of development, may no longer be relied on, and the old governance system that befits authoritarian governments has become irrelevant to democratic regimes. The East Asian development model is not a static concept, but rather path dependent in the sense that its formation has been greatly influenced by cultural, historic and political factors. A new system will also evolve over time with societal, political, and economic changes taking place in East Asia and throughout the global economy. But without proper reform, it may not be viable.

Although the pre-crisis East Asian development model is outdated in many respects, neither the crisis itself nor the structural failures have necessarily rendered the model dysfunctional. Certainly, the structural

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[6] Six years after the crisis, many banks and other non-bank financial institutions have yet to restore soundness of their balance sheets as they are still burdened by large amount of non-performing loans (NPLs). As far as NPLs are concerned, China and Japan have not of course fared any better.

weaknesses of the model do not support the view that East Asian countries will find it in their interest to emulate Anglo-American free capitalism. Institutions and policies should be likewise reformed to support the indigenisation of such a paradigm for post-crisis development rather than grafting the Anglo-American model on East Asia. Reforming the existing system would make it better suited for, and more flexible to adjust to, the new realities of East Asia and the rest of the world.

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