

Slouching Towards Utopia?: An Economic History of the Long Twentieth Century

XX. East Asia's Rise

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20.1. The Surprise of East Asia

20.1.1. The View from 1945

Back in 1945, most outside observers regarded East Asia like observers today regard Africa: the part of the globe facing the biggest development challenges, and most likely to stay poor, and desperately poor, for the longest period of time—if not indefinitely. Japan, it was agreed, was different: it had entered the modern age with a strong, functional government; an elite that rapidly saw the need for westernization and was willing to rapidly defenestrate the landlord *samurai* class to remove its power to absorb wealth and block change; a population that could limit itself and avoid the Malthusian trap; a high and respected place in society for commerce and industry; and an enthusiasm for not just elite but mass education. But the rest of East Asia was seen as different.

Thus the remarkable economic growth trajectory of the Asian Pacific rim since the end of World War II has been astonishing and unexpected.

20.1.2. “Developmental States”

Lots of countries have attempted to grow their economies rapidly under the aegis of a “developmental state”. Yet, most of the time, it has not worked.

Latin America and the Soviet bloc of really-existing socialists are the principal cautionary tales. The Soviet bloc attempted central planning via control of key

commodities via material balances, plus lots of network-based bargaining, corruption, and influence to govern exchanges outside of key commodity flows in order that managers could try to fulfill their plan-imposed goals. In Latin America planning was with a lighter hand: tariffs and subsidies, and government ownership and operation of key industries and sectors.

Why do East Asian “developmental states” work when other attempts to supplant the Smithian logic of the free market—the South American sad stories not so much of the death of kings but of the failures of tariffs and subsidies aimed at building national capabilities and national champions, the inability of the Soviet Stalinist model to do much of use other than building a heavy military-industrial complex beyond the Urals where it can still roll tanks off the assembly line when the Nazis are at the gates of Moscow and Stalingrad—did not?

One reason is that Latin America to some extent and the Soviet Bloc overwhelmingly aimed—ideologically—for autarky and planning, walling their economies off from world market prices and, indeed, from prices altogether: Juan Peron and his successors did not care whether the railroads they nationalized made a profit, or whether the auto companies they subsidized could sell abroad.

20.1.3. Invention vs. Catch-Up

There is no reason to think that the economic organization best at inventing the industrial future is the one best-suited to catching up with a known target. The King of England did not call a meeting of barons, bishops, bankers and a few mechanics and say: let’s have an Industrial Revolution. But that is pretty much what Japan did, from Meiji onward. Run-and-find-out with ample room for free play and free markets succeeded at not only inventing wholly new technologies that became giant industries but proving the idea of industrial development. The verdict is very clear: for catch-up development, whatever it is the “East Asian development model” works.

East Asian development states have been enthusiastic—compulsive—trading nations, but not open economies. Perhaps the most striking contrast with Latin America has been the largely-successful restriction of imports to intermediate and capital good useful for economic development, in striking contrast to those that are items of middle class and elite consumption. It was and is not just exchange-rate manipulation—although an undervalued exchange rate is one of the most powerful positive levers of industrial development as long as relatively-low import shares keep the adverse terms-of-trade effects small and as long as export demand

elasticities are favorable. Non-tariff barriers both large-scale and small-scale also appear to have played critical roles: specific stories of protection, promotion and organization in first one particular industry and then another and yet another strongly suggest that the bird's-eye overview of key macro aggregates misses a huge amount of the picture.

20.1.4 The Macro Picture

The East Asian model has very high rates of savings and investment sustained year after year. It has a relative price structure tilted at making those capital goods that embody so much of modern technologies cheap relative to consumption goods, especially elite consumption goods. These mean, of course, a heavy, hidden tax on labor, especially relatively skilled labor. These mean financial repression relative to Smithian prices: squeezing returns to savers, and shifting those returns to the industrial companies who access the savings, and to those who end up owning them. These also mean export surpluses via undervalued exchange rates—subsidies relative to Smithian prices to foreigners who purchase the exports, in the hope that the human- and organizational-capital gains via learning-by-doing from producing exports successfully will outweigh the cost of the implicit subsidies. And, indeed it does—as long as an undervalued exchange rate does not rob domestic businesses of their ability to obtain access to the first world-produced capital goods and the first world-invented technology that they need

Thus the East Asian developmental model is predicated on other nations—cough, the United States of America—operating on a different, open economy model, absorbing those exports and running those trade deficits. This means that it is a development model restricted to a few. The United States cannot be the importer of last resort for everyone.

20.2. Japan

After World War II, whether Japan's economy would successfully surmount the shock of defeat hung in the balance. The Meiji Restoration had enabled Japan—along with only Thailand and the interior of China—to escape colonization. Its best and brightest had sent off to Europe and the United States to learn the new industrial skills, technologies, methods and attitudes and bring them back to Japan to create a rich country and a strong army. It was clear by the end of 1941 that it had worked. But then came the war. Defeat in World War II ripped its raw material- and labor-supplying empire away from it.

With its factories leveled, without oil, without iron ore, starting from ground zero and having to purchase from abroad nearly every input needed for industrial civilization save rice and coal, what were Japan's chances?

Things changed when the Korean War starting in 1950 made Japanese industry a valuable hot-war resource, and made Japanese economic success an important Cold War goal. It became a keystone of American policy that Japan become a prosperous, democratic and unsinkable ally and base in the troubled regions of East Asia. By 1955 the Japanese economy was as strong as it had been on December 7, 1941. And growth thereafter was the fastest the world had hitherto seen.

From 1960 to 1973 the Japanese economy sustained a 10%/year average growth rate, quadrupling the economy in a short sprint and raising GDP per capita from 25% that of the USA to 57%. From 1973 to 1990 GDP grew at 4.5%/year, doubling the economy and bringing Japanese per capita GDP up to 78% of America's.

The micro pieces of Japan's post-WWII industrial economy involved:

- strong domestic protectionism through an intricate network of non-tariff economic and social network barriers
- the universal-bank-keiretsu system of interlocking corporate control and preferential industrial relationships,
- a highly competent and development-focused politically-independent industrial-policy bureaucracy,
- financial repression that produced easy access to capital for successful exporters at and extremely low cost and yet maintained a very high savings rate.

Economists oppose protectionism because it hurts consumers by increasing prices while benefiting producers who have done nothing productive to earn it. An economy of protectionism produces firms that are good of getting what they want out of the capital, but bad at running efficient current operations and improving technology. It is true that Japan's protectionism did have some such elements: rice protection was a price to buy-off small farmers and the LDP politicians who serve them. But Japanese protection was, it seemed, smart. Over time it appears that there were sufficient accumulating gains to producers to offset the static losses. Overpaying, they grew rich.

Those same Japanese firms that were protected against imports produced abroad and were protected against foreign headquarters branches' producing at home were, in international markets, forced to hone their competitive abilities and match international standards of not just innovation and quality but also price—or else their MITI subsidies would go away. Very patient cheap capital helped. And by the 1980s it was clear that something remarkable was going on with Kawasaki and Nippon in Steel, Toyota, Nissan and Honda in automobiles, eventually Bridgestone in tires, Komatsu in construction equipment, and Toshiba, Matsuhita (Panasonic), and Nikon, Fugitsu, Sharp, Sony, and Canon in electronics.

Americans see government bureaucracy as the DMV or the post office. Bureaucracy is different in Japan: meritocratic, uncorrupt, discretionary, well-informed. Formal specific laws, rules and targets were kept to a bare and vague minimum. And like the French system—or the Pentagon system—ranking Japanese bureaucrats would retire to take ranking and very well-paid positions in the companies they had overseen.

But meddling politicians? Firms that are actually competent not at production and exporting but only at having hired the previous assistant to the vice minister? Halliburton profited enormously in the 1990s from hiring ex-US defense secretary Dick Cheney as head of its government liaison and calling him CEO, but aside from the profits from government relations his effect on the firm's operations and finance appear to have been limited to making it buy a huge loss in the form of liability for asbestos cases. How could Japanese industrial policy be any different?

Somehow, parliamentary politics and politicians were kept out of policy for the industrial core. They went elsewhere: the rent-seeking logic of politics governed agriculture, wholesale and retail trade, and construction. These were industries that employed many more people than export-oriented manufacturing. And these were industries that the technocrats of MITI stayed very far away from.

In economist Paul Krugman's view, the case for free trade has "irretrievably lost its innocence...shifted from optimum to reasonable rule of thumb. There is still a case for free trade as a good policy, and as a useful target in the practical world of politics, but it can never again be asserted as the policy that economic theory tells us is always right..." In Krugman's view, there are four reasons why free trade remains good policy and a useful target in the practical world of politics:

- Attempts to craft successful internationally-oriented industrial policies are highly likely to call forth retaliation and trade war, and end in a truly bad equilibrium.

To figure out what really are the industries of the future is, for Hayekian information reasons, beyond the competence of bureaucrats.

Rent-seeking interests can easily deploy the rhetoric of industrial policy to convince governments to adopt negative-sum interventions.

Even successful industrial policies build economically powerful and politically canny interests that then keep the policies subsidizing them going long-past the sell-by date.

But what if you are not trying to invent the future but merely to copy the present? You know that, as Marx wrote, the more advanced economy shows the less advanced the image of its own future. And what if your bureaucrats are, for some complicated historical reasons, actually more akin to the guardians of Plato's Republic than to the corrupt bought rent-seekers of Romulus's Sewer?

20.3. South Korea

No one watching South Korea in the 1950s anticipated that it would become one of the world's fastest-growing economies. It has been devastated by a bitter war that had seen its capital and major industrial center, Seoul, change hands four times. Its savings rate was low. Its exports were low. More than half of imports in the late 1950s were paid for by U.S. assistance, either foreign aid or the expenditures to support the U.S. military presence in South Korea.

The government of Syngman Rhee sought to control the flow of foreign affairs and imports. They overvalued their currency (so as to charge the U.S. as much as possible for support of its military), they imposed high tariffs and they imposed stringent quantitative import restrictions as well. The result was slow and erratic growth, and continued dependence on the flow of resources from the U.S.

With the takeover of the government by Chung Hee Park in 1961, everything changed. Chung Hee Park was a somewhat brutal (although quite ordinarily so by the standards of the twentieth century) but remarkable leader who shifted Korea's development strategy to one of export-led industrialization, rather than import-substitution. The consequences were astounding. The growth rate of income per capita averaged more than 7 percent of GDP for the three decades after 1960. Exports grew from three percent of GDP to forty percent of GDP.

20.4. China's Opening

Now China, with its system-bursting scale, has pushed the model to its limits—and perhaps beyond.

It started from an awful position. Per capita grain production at the end of the 1970s was the same as in the mid-1950s. By contrast, all of China's immediate capitalist neighbors had leaped ahead. The factions of the Chinese Communist Party were unable to coexist after Mao's death. Those soon to be reviled as the Gang of Four demanded that Hua Guofeng, the compromise party chairman appointed by Mao, purge Deng Xiaoping once again. The Canton military district, in which Deng had taken refuge, professed to be unable to find him for shipment to Beijing and a subsequent show trial. Perhaps China came close to Civil War. We do not know. By December 1978 Deng Xiaoping had sufficient control to begin dismantling the Maoist central planning apparatus.

In the countryside the agricultural collectives were dismantled. Up until 1985 the state maintained and effective monopoly over “key” agricultural commodities like grain. Peter Timmer estimates that only some eight percent of agricultural output was sold on an open market in 1978; some eighty percent was traded on relatively free markets by 1990. The response of agricultural production to the end of collective farms and to the use of the market to allocate agricultural productivity was enormous. Agricultural output doubled between 1978 and 1992, with most of the gain coming in the first six years.

The proportion of the labor force employed in agriculture dropped from 71 percent in 1978 to 54 percent in 1994. The proportion of real GDP exported rose from 5 percent in 1978 to 23 percent in 1994. And the proportion of non-agricultural commodity output produced by the command economy's government-run enterprise dropped from four-fifths to one-third.

China disciplined itself to the macro levers of the basic model: repressed rates of consumption, high rates of savings, high rates of investment, export surpluses. And China's sustained performance in each of these macro drivers has been more than extraordinary. Investment in China has climbed to over 50% of GDP—two-thirds again higher than Japan in the High Growth Period. Savings has kept pace. Exports have climbed to 30% of GDP. Consumption has been repressed to only 34% of GDP.

At the beginning, reforms were tentative: controllable experiments in bounded areas that could be shut down swiftly without having contaminated the vast Red rest of China. There was no shared consensus on just how far-reaching reform would be or where it would lead. There was a mere choice of direction: not the Soviet Union, not the cult of personality, and somehow towards the successes of the fast-growth Asian Pacific Rim economies, all to be called—as it still is—“Communism with Chinese Characteristics”.

Stalin’s greatest and most murderous failure was his brutally forced collectivization. It was intended to enable the State to control agricultural output (and the peasants) and take it (and the peasants’ sons) off the farm to build the dams, roads, electrification, and factories of the Five-Year Plans. It kept Soviet agriculture a lagging sector for generations, employing vastly more than its normal share of the labor force at productivity incredibly low even by Soviet standards. It turned the Ukraine from a grain-exporting region rivaling the U.S. midwest into an economic drain.

Similarly, forced collectivization under Mao had failed to generate increases in agricultural output and productivity to support industrialization. Deng and his reformers inverted the model and succeeded: shifting peasants out of low, often zero, productivity work in agriculture and into manufacturing—producing goods with machines.

But who in China could buy the output of these factories? The peasants had no money. Effective domestic demand could only increase slowly, too slowly for rapid industrial growth. Only exports could absorb the output, grow its volume vertiginously, yielding rich gains of learning-by-doing—the very essence of real development—promote improvement in its quality and sophistication, and provide the foreign exchange to purchase the machines needed for sustaining that expansion and upgrading. That, after all, is the obvious lesson China could read from the high-growth economies of East Asia: Japan and Korea, Singapore and, yes, Taiwan.

But who would teach the Chinese how to produce, and provide the know-how, the technology and access to foreign markets? A bold and rather fundamental reform addressed this question. It came at near universal surprise: China, Communist China, opened its economy to foreign companies, indeed, eagerly courted them. Foreign companies would bring technology, know-how, access to export markets, and even capital. They had, of course, to be kept on a tight chain, carefully supervised and made to contribute what they had to the Chinese economy.

Entrepreneurs from Hong Kong Taiwan would be the middlemen, managing the relationships both with Chinese whose grandparents had known their grandparents and the North Atlantic companies the Chinese government hoped to attract.

20.5. “Predatory” Investment

Technology transfer was central to China’s plans for foreign firms; it still is. Over one-third of Chinese exports during the past two decades came from what the Chinese call Foreign Invested Companies. And a very, very considerable part of Chinese firms’ climb up the ladder of industrial sophistication came, one way or another, from foreign firms: witness, the latest and to-date grandest, example: very fast trains, solar panels and networking equipment. Japan based its own rapid growth on a successful determination to keep foreign companies out. China invited them in, more and more openly and cordially, and used them to its own purpose ever more effectively. China turned out not to need foreign capital for very long; its own savings rate could finance things. What it needed, more and more, was foreign technology and know-how. All companies coming in to produce, or to sell, or both, were required to have Chinese companies as partners. The Chinese partner would provide such valuable things as official permissions and permits and the connections necessary to access the Chinese market or do just about anything else. But the partner was also there also to make sure that technology and know-how poured out of the joint venture and was quickly transferred into Chinese hands.

At a peak of 50% of GDP, China’s investment spending has reached a proportion that no other country has ever attained or sustained. Local governments in China are not like local governments (or even state governments) in the US or Europe. They, of course, provide basic services: roads, water and sewers, transportation, police and fire, and the like. But Chinese local (and provincial) governments also play a major role in promoting and steering industrial investment and production: village, township, and provincial enterprises. They are big, perhaps the biggest, players in economic development—not just infrastructure and urban services.

From one perspective, China’s pushing the value of its currency down and providing very low cost land and capital to its producers so that they can cut the prices of their exports was an enormous foreign-aid program by China to America. China has now bought \$3 trillion in U.S. assets at an average price of 7 yuan to the dollar—that’s 21 trillion yuan. When it sells those assets off in some future generation, it is going to be lucky to get a dollar for 3 yuan. That means that 12 trillion yuan—\$2 trillion—have been borrowed by the Chinese government from

its citizens and given to Americans in the form of goods at discounted prices in return for the American government's acceptance of the migration-production-export-more migration political-economy cycle that has fueled Chinese growth recorded at 8% per year for the past generation and a half. That is a \$2 trillion payment by China to America in return for our providing its leadership with a form of political risk insurance and its people with a place on the escalator to modernity.

If the United States had taken that \$2 trillion, taken a look at whether and which of the changes in industrial structure grasping that windfall required should be accepted and which should be neutralized, and invested that \$2 trillion in schemes of social utility, valuable factors of production, and technological and organizational capabilities in the productive industries of the future—well, if the U.S. had done that then the entire ball of wax conventionally referred to as “global imbalances” would have been genuinely win-win.

20.6. Assessing the Model

Periodically, outside neoliberal observers have reported that the model has led its countries into dead ends.

They have reported that indicative planning and state-led development have distorted their economies away from proper balance. First it was that Japan had overinvested in light manufacturing. Then it was that the Japanese development model could not flourish without cheap global energy. Last—with some truth this time—that Japan’s economic model could catch-up in mass production and flexible manufacturing, but could not forge ahead and could not rationalize its low-productivity retail and food-processing sectors.

But were Japan’s retail and food-processing sectors really low productivity, or was it just a different quality-cost tradeoff?

In the 1980s there were claims—partly true—that the Korean economy had focused on heavy manufacturing to an extent that imbalanced growth and added risks. In the 1990s there were critiques of the model as based on resource mobilization rather than productivity growth. However, factor price trends—stable profits and rapidly rising wages—demonstrated to my satisfaction that those were not true. And there are always predictions of imminent, drastic slowing of growth in the economy of coastal China.

Perhaps there will come a time when one of these predictions happens to come true.