FRBSF Economic Letter

1997-20 | July 11, 1997

More Economic Letters

Government Intervention and The East Asian Miracle

Reuven Glick and Ramon Moreno

Monetary and Economic Studies within the FRBSF's Economic Research Department.

In recent years, the increasingly prosperous East Asian economies of Japan, Hong Kong, Singapore, Korea, and Taiwan have been hailed as models of achievement for other emerging economies. While a number of explanations may be offered for East Asia's economic success, many observers are convinced that an outward-looking development strategy, particularly a dynamic export sector, has been a crucial ingredient.

To varying degrees, East Asian economies have maintained an outward-orientation through interventionist, yet "market friendly," policies involving some use of export promotion, selective import barriers, and industrial policies (World Bank 1993). These interventionist aspects of trade policy in East Asia have had great appeal to a number of more recently emerging economies. How essential were these interventionist elements to East Asia's growth success? Can this approach be replicated by other countries, particularly in the current international environment? This *Letter* discusses the reasons that greater openness can be conducive to growth and the benefits and costs of interventionist government policies in East Asian economies. It also reviews the lessons of the East Asian experience for other developing countries. (For a fuller discussion, see Glick and Moreno 1997.)

Growth and openness

creating a channel for the diffusion of technological and managerial know-how. Second, outward-oriented policies create an incentive for domestic firms to become more efficient and innovative in order to compete in world markets. Third, international trade may promote growth by providing access to larger markets and generating increasing returns to scale in production.

Given the evident merits of more open economies, how can openness best be achieved? One approach is to move towards free trade by progressively eliminating import tariffs and quotas, and dismantling other measures that protect domestic industries. Another approach is to leave some existing import barriers in place, but to add policies promoting exports in order to overcome, at least in part, the bias against exports created by a protected domestic market. An export promotion policy counterbalances the incentives to produce for the domestic market created by import barriers with offsetting incentives to produce goods for export. Often this strategy is accompanied by efforts to maintain the exchange rate at levels that do not penalize exporters by overvaluing the domestic currency.

If markets are very competitive, a strategy that relies on free trade is theoretically superior to one that relies on a combination of import barriers and export promotion. However, more interventionist government policies can, at least in theory, be justified in models with imperfect competition. For example, a protectionist or "strategic" trade policy may benefit a country if such a policy can shift profits from foreign to domestic producers. In some cases, firms may underinvest because they do not consider aggregate bene [illegible] more skilled workforce or a higher technological level) that may result from their own investment. Government subsidies to remedy the resulting underinvestment can produce a socially preferred outcome. In achieve industrialization and correspondingly higher income levels.

In spite of the potential benefits of government intervention suggested by theory, in practice, it is not clear that governments seeking to exploit these benefits will consistently succeed. One important risk is that government subsidies will target unproductive industries (due to political pressures or corruption), imposing significant costs on taxpayers and the financial sector. In addition, distortions created by import restrictions may not be easily remedied by offsetting export subsidies.

East Asian trade and industrial policies

With the exception of Hong Kong, government intervention has played an important role in East Asian economies. To varying degrees, East Asian economies maintained significant tariff and nontariff barriers through much of their initial rapid growth periods. Through its rapid growth phase of the 1950s and 1960s Japan maintained high tariff rates, though after successive rounds of multilateral trade negotiations under GATT, they were in line with those of other industrial countries by the early 1970s. Korea's and Taiwan's tariff rates declined more gradually than Japan's. Korea's nominal tariff rates averaged nearly 40% in the mid-1960s, 21% at the beginning of the 1980s, and around 12% at the beginning of the 1990s; the corresponding levels for Taiwan were 35%, 31%, and 10%. Significant non-tariff barriers also were maintained, although they too were later reduced. For example, in Japan, almost 60% of all imports were subject to formal quotas in 1960, though these restrictions were reduced significantly later in th [illegible] 40% of import items were either prohibited or r [illegible] this ratio had fallen, but to a still high 25%. Only in Hong Kong and Singapore were all restrictions on imports removed relatively quickly.

power, and fertilizer industries. Inputs to these industries could be imported duty-free, and firms in these sectors enjoyed preferential loans from government banks. In the 1950s, the automobile industry was targeted, while computers became the focus in the 1960s. Although industrial targeting was scaled back in the 1970s and 1980s, the Japanese government has continued to promote the development of certain sectors, such as high definition TV and computer technology.

In the late 1960s and early 1970s, the Korean government targeted infant industries, typically by supporting the creation of large-scale enterprises which were accorded temporary monopolies. Notable examples include cement, fertilizer, and petroleum refining in the early 1960s, steel and petrochemicals in the late 1960s and early 1970s, and shipbuilding, capital goods, and durable consumer items in the mid-to-late 1970s. More recently, preferential treatment has been given to more medium and small-sized firms, particularly in the electronics sector. Taiwan has provided preferential support to certain "strategic" industries since the early 1980s. Since the late 1960s, the Singaporean government has invested in state-owned enterprises and provided incentives attracting private investors into certain key sectors.

A number of general features of East Asian trade and industrial policies are worth highlighting. First, the adverse incentives of import barriers to produce only for protected domestic markets were avoided by export promotion through access to rationed credit, tax breaks, and other preferential measures for exporters.

Second, government support was by and large according to their success in world markets. Ea largely avoided the temptation to direct resources to subsidize loss-making firms or to benefit well-connected rent-seekers.

imported also increased, accounting for some of the tendency towards liberalization cited above. For example, in Korea, the number of automatically approved import items increased from 800 in the late 1960s to 5,600 in the early 1980s and nearly 10,000 in the early 1990s. This partially reflected the impact of exemptions for goods directed to the export sector. As the export sector boomed, so did the volume of imported inputs and intermediate goods. This may explain why import/GDP ratios in East Asian economies increased to much higher levels than in Latin America, even in the more protected Korean and Taiwanese economies.

Benefits and costs

In spite of East Asia's remarkable economic performance, the net benefits of industrial policies targeting certain favored sectors are uncertain. Clearly, government intervention policies appear to have allowed Japanese as well as some Korean firms to establish themselves in imperfectly competitive industries, such as steel, ship-building, and automobiles, where the costs of entry were high. However, there were evident costs and risks associated with these efforts.

For example, in both Japan and Korea, efforts to subsidize some industries in the 1970s turned out to be counterproductive and costly. Beason and Weinstein (1996) find that industrial policies in Japan were not directed towards the higher-growth industries; the cross-sectoral correlation between sectoral growth and the degree of government support provided by various industrial policy in

negative. In Korea, support for bankrupt comp
required the write-off or rescheduling of billions of dollars in loans. Poor quality policy loans extended by domestic banks to poorly performing firms are still a concern.

whether continued support of an industry was warranted. The ability to export competitively became the “market test” that was used by the authorities. The expectation that firms should eventually export provided clear discipline for both businesspeople and government officials.

Lessons for other countries

This suggests that other emerging markets should pursue a development strategy that relies on integration with the world economy, rather than one that relies on insulation. The viability of this approach is disputed by “export pessimists,” who maintain that export-oriented industrial development is bound to fail sooner or later because markets for labor-intensive manufactures are limited and increasingly constrained by protectionist policies in industrial countries. However, pessimism about the opportunities for exports flies in the face of empirical evidence and ignores the dynamics of international trade. Other countries in East Asia have steadily increased their exports of manufactures to industrial countries and, more recently, to each other in the form of burgeoning intra-regional trade.

At the same time, the growth policies in some East Asian economies did involve interventionist and protectionist elements. However, three important problems associated with an interventionist growth strategy suggest that other emerging countries should be very cautious in considering it.

First, East Asia’s experience reveals that government intervention may not be consistently effective in “picking winner

very costly. A particular concern is that, in respo

pressures, or lack of profit incentives, government intervention may subsidize loss-making enterprises rather than investment in productive

Another difficulty in pursuing such a strategy today is that closing domestic markets to imports while encouraging exports involves measures that are not permitted by current international trade agreements and that are less likely to be tolerated by major trading partners. In particular, overt limits on imports by countries whose growth depends on international trade can lead to retaliation by trading partners and ultimately prove counterproductive.

Finally, as has apparently been recognized by policymakers in the more advanced East Asian economies, industrial policies may succeed in promoting certain types of firms, but may discourage the type of innovation and entrepreneurship needed to achieve higher levels of development. It is apparent that the development of some of the most innovative industries in the world today (such as electronics or biotechnology) require the type of flexibility and intense competition that only the most open markets can provide.

Reuven Glick
Vice President

Ramon Moreno
Senior Economist

References

Beason, Richard, and David Weinstein. 1996. “Growth, Economies of Scale, and Targeting in Japan (1955-1990).” *Review of Economics and Statistics* 78(2) pp. 286-295.

Glick, Reuven, and Ramon Moreno. 1997. “The E[illegible] Growth because of Government Intervention and Protectionism or in Spite of It?” *Business Economics* (April) pp. 20-25.

Pacific Basin Notes are published occasionally by the Center for Pacific Basin Studies. Opinions expressed in FRBSF Economic Letter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco or of the Board of Governors of the Federal Reserve System. This publication is edited by Sam Zuckerman and Anita Todd. Permission to reprint must be obtained in writing.

More Economic Letters

Please send editorial comments and requests for reprint permission to
Research Library
Attn: Research publications, MS 1140
Federal Reserve Bank of San Francisco
P.O. Box 7702
San Francisco, CA 94120