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Reconsidering the Washington Consensus: The Lessons of Asian Industrial Policy

by Marcus Noland, Institute for International Economics

As disappointing results worldwide have shaken the faith in the "Washington consensus" about how best to encourage development (openness to foreign trade and investment, secure property rights, fiscal discipline, sectorally neutral tax and expenditure policies, financial liberalization, unified and competitive exchange rates, etc) one response has been to reconsider more "dirigiste" industrial policy strategies that the consensus marginalized.

Japan, Korea, and Taiwan are sometimes promoted as models that have derived great benefits from globalization by pursuing activist industrial policies without surrendering national autonomy in the economic or cultural spheres – in effect beating the West at its own game by promoting specific industrial sectors.

In my recently published book, *Industrial Policy in an Era of Globalization*, co-authored with Howard Pack of the Wharton School, we address the key issues for developing country policymakers considering these alternative paths: was industrial policy – the selective promotion of individual manufacturing sectors – a major source of economic growth? If so, can it be replicated? And if it can, is it worth replicating, or would contemporary developing countries be better off embracing a suitably refined orthodoxy?

Was Industrial Policy Responsible for Growth in Asia?

Table I (page 2) reports data for a number of countries from the mid-1950s on the levels of per capita income and human capital. What is immediately noticeable is that Japan and Korea had the world's highest ratio of human capital to per capita income. The physical capital stocks of both countries had experienced considerable wartime devastation, and as a consequence, the level of per capita income was relatively low. Yet these countries were

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TABLE 1
HUMAN CAPITAL AND PER CAPITA INCOME, MID-1950s

COUNTRY	YEAR	HUMAN CAPITAL INDEX	PER CAPITA INCOME	RATION OF HUMAN CAPITAL INDEX TO PER CAPITA INCOME
Japan	1955	1673	519	3.2
Korea	1955	494	217	2.3
The Philippines	1956	738	277	2.7
Israel	1954	1200	609	2.0
Thailand	1955	302	181	1.7
Greece	1956	693	468	1.5
Malaysia	1957	334	351	1.0
US	1955	2293	2443	0.9
Italy	1956	787	971	0.8
Turkey	1955	267	365	0.7
Argentina	1955	760	1059	0.7
Mexico	1955	352	637	0.6
Spain	1955	389	652	0.6

SOURCE: NOLAND AND PACK, 2003, TABLE 2.1
NOTE: HUMAN CAPITAL INDEX IS EDUCATIONAL EXPENDITURE EMBODIED IN THE LABOR FORCE.

"deceptively" poor – contemporary levels of income per capita were downwardly biased indicators of their underlying social capacities. Moreover, the rate at which they subsequently accumulated human capital was more rapid than other countries.

Japan, Korea, and Taiwan had experienced varying degrees of industrialization, undergone substantial political upheavals, and initially were attempting to re-establish production in sectors in which they had at least some prior experience. Even after this was achieved and they began to enter new industries and activities, they remained well behind the technological frontier defined by the US, and were essentially engaged in catch-up along a reasonably well-defined industrial path.

To this end the three countries pursued a variety of industrial policies, including direct subsidies, indirect subsidies through public sector financial institutions, tax breaks, subsidization of research and development, international trade and investment protection, and lax competition policies. But did these policies accelerate growth and development?

To make this assessment one can study a variety of evidence including econometric studies of total factor productivity, input-output based studies of the likelihood of large cross-sectoral externalities, and case studies. Yet a comprehensive review of this evidence reveals only modest support for the proposition that these policies accelerated growth.

So why would policymakers consistently intervene in ways that did not apparently enhance welfare or accelerate growth? One possible answer that policymakers just did not adopt the right economic policies. Another is that the interventions observed were largely determined by political competition among various self-interested groups. For example, in the case of Japan, more than 90 percent of on-budget subsidies went to the declining agricultural and mining sectors – not the emergent high technology sectors of popular lore (Figure 1, page 3).

Industrial policies perhaps accelerated growth by 0.3 percent annually – non-trivial if maintained for decades, but not the predominant explanation of Asian achievement during a period in which these economies were growing at 10 percent a year.

Did These Policies Have Side-Effects?

So did these policies have unintended consequences that should be weighed against possible benefits? The short answer is "yes."

State intervention in the economy encouraged corruption and a "dumbing-down" of the financial system. An open issue is why the Asians rank closer to Denmark than to Nigeria in cross-national surveys of corruption. It appears that in all three economies, corruption has been concentrated at the top of the political system with decisions then implemented in a relatively efficient manner by a competent state bureaucracy. The Asians have by and large avoided the sort of "cascading" corruption that imposes a much larger burden on the economy.

Capital channeling required the repression of the financial system. State influence on the allocation of capital encouraged a bureaucratization of the banking function, and as a consequence, bankers did not develop the necessary skills to evaluate alternative business plans and models. Current banking problems, with expected net clean-up costs amounting to more than 10 percent of GDP in all three countries, cannot be blamed on their industrial policies, though their legacy clearly contributed to financial sector woes.

Are These Outcomes Replicable?

Would a developing country today be able to achieve 0.3 percent additional growth annually with corruption closer to the Danish than Nigerian standard? There are multiple reasons to think that they would not. First, Japan, Korea, and Taiwan are characterized by a high degree of political stability. Second, all have relatively equal distributions of income and wealth. Finally, the factor endowments of the Asia trio are different from almost every other country in the world: they have a very high ratio of people to arable land and other natural resources, and have accumulated physical and human capital at an astonishing rate. Given their factor endowments, these economies could be expected to specialize in manufacturing activities early and intensively in their development experience. In this situation, industrial policies are effectively "leaning with the wind" and a relatively non-controversial politically, giving rise to "growth with equity."

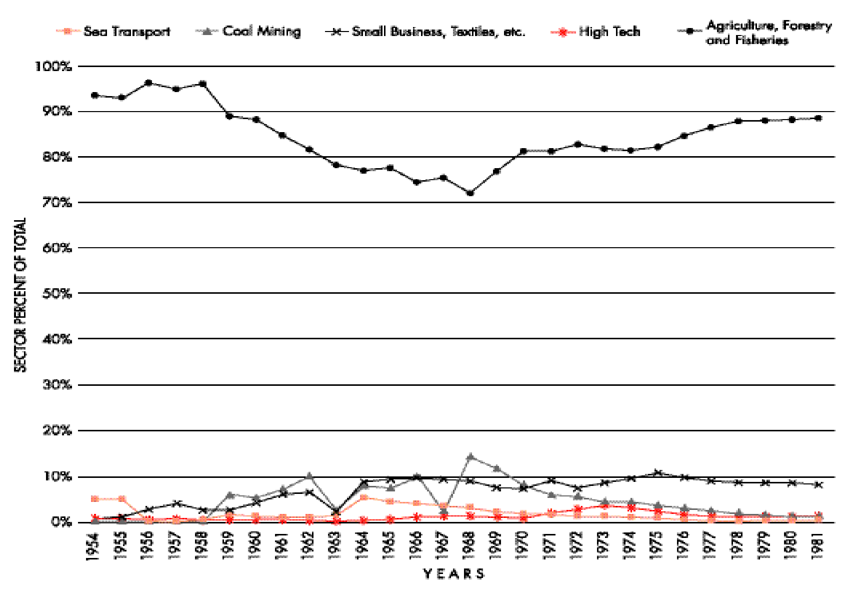
Beyond these economic fundamentals, the institutional environment was more amenable to industrial policy in the past. The World Trade Organization (WTO) has tightened up the rules, making some policies that the Asians used a generation ago, such as export subsidies, illegal for all but the poorest countries. More importantly, the end of the Cold War has meant that the dominant players, especially the US, are less constrained about pressing their advantage under the strengthened dispute settlement system of the WTO.

So What, if Anything, is to be Emulated?

The experiences of the Asian countries hold three obvious

Continued on page 8

FIGURE 1
SECTORAL COMPOSITION OF ON-BUDGET SUBSIDIES



SOURCE: NOLAND AND PACK, 2003, TABLE 2.1

Japan's ODA at a Crossroads: Striving for a New Vision

by Izumi Ohno, National Graduate Institute for Policy Studies

Japanese foreign aid policy is at a crossroads. First, a decade of prolonged economic recession has forced the government to cut Japan's foreign aid budget (Official Development Assistance, or ODA) – once regarded as sacred – by 0.2 percent in FY2000, 3.0 percent in FY2001, 10.3 percent in FY2002, and 5.8 percent in FY2003, in yen terms. For the first time in ten years, the US replaced Japan as top donor in 2001. Stark budget realities are requiring Japan to strategically prioritize its aid in order to maintain ODA's effectiveness.

Second, Japan does not wholly accept the mainstream thinking by Western aid community[1] about development. Japan continues to believe that East Asian development experience, which is widely regarded as a "success story," and to which Japan itself made significant contribution through aid, trade and investment, has also been a good model.

Moreover, the September 11 tragedy prompted a major shift in the Bush Administration's foreign policy and also strongly affected the thinking of the entire aid community – poverty alleviation through foreign aid is now considered to be another tool in fighting terrorism. As a direct result, the US and the EU aspire to boost aid to levels[2] unimaginable just two years ago.

Budgetary pressures at home and shifting motivations for increased foreign aid by other countries have created a sense of urgency in Japanese development experts and officials. Some innovative efforts, both within and outside the government, have emerged in a means to move away from the traditional reactive mode and to project Japan's own ideas more strongly in the global arena.

Global Development Trends

Current thinking in the global development community has four major features, with which Japan feels considerable unease.

- The combination of a drive to reduce poverty and a neo-liberal economic framework – under this regime, public actions are justified only in direct pro-poor targeting and/or macroeconomic management. Consequently, the contents of the growth strategies, including industrial promotion and infrastructure development, are often superficially treated or simply ignored.
- Re-direction of ODA to the poorest countries, assuming that middle-income countries have access to private capital and thus do not need ODA.
- An increase in grant components and the reduction of concessional loans.
- Aid harmonization in favor of non-project aid and pooled funding, and the marginalization of project aid.

Strategic convergence rather than diversity is epitomized in the two currently dominant aid policies: the Poverty Reduction Strategy Paper (PRSP) initiated by the World Bank in late 1999 and the United Nations Development Goals adopted in 2001. Both regard poverty reduction as the ultimate goal of development and contend that aid must be evaluated mainly by the contribution to this goal.

Furthermore, it is argued that the polarization of developing countries where some countries perform well and others remain stagnant—some even call it the "Africanization of global poverty"[3] —provides a strong case for concentrating ODA on the poorest countries, particularly those in Sub-Sahara Africa, with increased grant components with no obligation to repay[4]. Since many Sub-Saharan African countries are highly aid-dependent under the proliferation of donors and projects, there is a call for reducing "transaction costs" associated with multiplicity of aid to lift administrative burdens from recipient countries[5]. Now, donors are encouraged to harmonize or even completely unify their aid disbursement procedures.

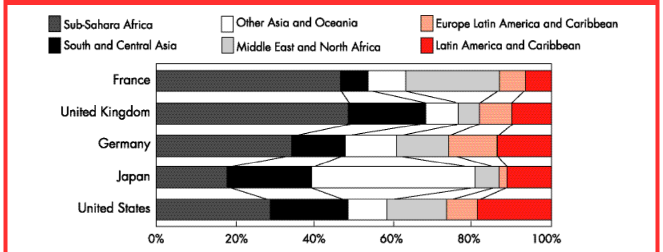
Indeed, the UK has announced its intention to phase out specific project aid in favor of budget support and common basket funding. These initiatives are a European reaction to the disappointing records of African development in the past and the latest desperate attempt to meet the African challenge.

Japan's Development Vision

By sharp contrast, the East Asian development experience strongly affects the Japanese approach to development aid. Japan's ODA intends to support the industrialization of latecomer countries and has the following features:

- Geographical concentration in Asia [Figure 1]
- High priority on infrastructure development [Figure 2]
- A broad aid menu, including loans [Figure 3]

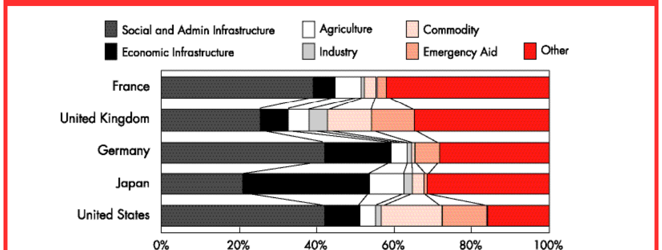
FIGURE 1 TOP 5 DONORS: REGIONAL DISTRIBUTION OF ODA 2000-2001



NOTE: 1) PERCENT OF TOTAL NET DISBURSEMENTS.
2) INCLUDING IMPUTED MULTILATERAL FLOWS, I.E. MAKING ALLOWANCE FOR CONTRIBUTIONS THROUGH MULTILATERAL ORGANIZATIONS, CALCULATED USING THE GEOGRAPHICAL DISTRIBUTION OF MULTILATERAL DISBURSEMENTS FOR THE YEAR OF REFERENCE. EXCLUDING AMOUNTS UNSPECIFIED BY REGION.

SOURCE: OECD "REGIONAL DISTRIBUTION OF ODA BY INDIVIDUAL DAC DONORS", TABLE FROM THE STATISTICAL ANNEX OF THE 2002 DEVELOP,MENT CO-OPERATION REPORT. AVAILABLE AT HTTP://WWW.OECD.ORG/EN/DOCUMENT/0,,EN-DOCUMENT-15-NODIRECTORATE-NO-1-2674-15,00.HTML

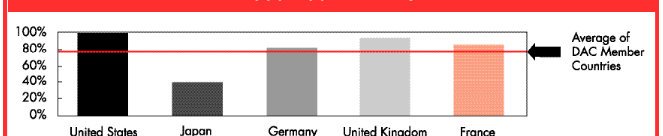
FIGURE 2 TOP 5 DONORS: SECTORAL SPENDING 2000-2001



NOTE: 1) PERCENT OF TOTAL BILATERAL COMMITMENTS.
2) ON A DISBURSEMENTS BASIS.

SOURCE: OECD "MAJOR AID USES BY INDIVIDUAL DAC DONORS", TABLE FROM THE STATISTICAL ANNEX OF THE 2002 DEVELOPMENT CO-OPERATION REPORT. AVAILABLE AT HTTP://WWW.OECD.ORG/EN/DOCUMENT/0,,EN-DOCUMENT-15-NODIRECTORATE-NO-1-2674-15,00.HTML

FIGURE 3 TOP 5 DONORS: GRANT SHARE OF BILATERAL ODA 2000-2001 AVERAGE



NOTE: EXCLUDING DEBT REORGANIZATION. EQUITIES ARE TREATED AS HAVING 100% GRANT ELEMENTS, BUT ARE NOT TREATED AS LOANS.

SOURCE: OECD, "FINANCIAL TERMS OF ODA COMMITMENTS, "TABLE FROM THE STATISTICAL ANNEX OF THE 2002 DEVELOPMENT CO-OPERATION REPORT. AVAILABLE AT HTTP://WWW.OECD.ORG/EN/DOCUMENT/0,,EN-DOCUMENT-15-NODIRECTORATE-NO-1-2674-15,00.HTML

Two historic factors make Japan's aid and development vision quite distinctive from those of other donors. First, Japan is the only non-Western donor with a history of early and successful industrialization. Furthermore, many Japanese personally experienced the post-WWII destruction and poverty that were gradually overcome by hard work. Japan's success in strengthening its manufacturing base contributed in turn to the trade-and investment-driven development and poverty reduction in the rest of East Asia.

Second, Japan's postwar decision to abandon military force pushed ODA to play a special role in diplomacy. Indeed, ODA has been the principal means by which Japan contributed to globally shared goals and addressed specific external needs, such as war reparation payment in the 1950s, trade promotion in the 1960s, securing imported energy and raw materials in the 1970s, and the "recycling" of the trade surplus in the 1980s.

These factors heavily influence the way development visions are

Continued on page 6

Japan's ODA at a Crossroads: Striving for a New Vision

shaped and the kind of relationship that Japan wishes to foster with developing countries through aid. Japan embraces the following latecomer perspectives that are unlikely to emerge from the West.

- *Self-help effort (ownership) and growth aspiration:* Aid is neither charity nor the moral obligation of the rich. Aid should support self-help efforts of developing countries and contribute to fostering their national pride, even if it means the recipient could overtake the donor country in the long run.
- *Real-sector concern:* In the early stages of development, government should take an active role in promoting and even creating a market economy. Greater attention should be given to the dynamic contents of the real economy such as key industries, investment and competitiveness, rather than frameworks.
- *Long-term perspective:* Development is a long-term, path-dependent undertaking. It is thus necessary to consider the history, society and culture of a country in designing its unique strategy.
- *A flexible and pragmatic approach:* While accepting general principles, each country should interpret and adapt them to the local context. Diversity, not rigid rules and conditions, should be permitted and encouraged in both aid strategy and delivery.

By contrast, the Western countries and international organizations often prefer farsighted frameworks, convergence toward a single system, and emphasis on macroeconomic and financial issues[6].

Japan is also unique in offering a relatively large share of loans in bilateral aid. Because loan aid can mobilize larger resources (e.g., for financing large-scale infrastructure projects or supporting reforms), it can be very effective in promoting broad-based growth if combined with a good growth strategy. At the same time, loan aid requires discipline on the recipient side including strong ownership and debt management capacity, and donor responsibility for ensuring project sustainability. The time scope of the recipient-donor relationship under loan aid is much longer than grant aid and goes far beyond project completion to the last repayment. In this sense, each party assumes shared responsibility in the long run.

Aid harmonization should be promoted whenever feasible and effective. But we must proceed with a sense of realism and careful identification of country-specific bottlenecks of exactly where aid fails. A broad range of options for improvement should be considered, because the "transaction cost" is just one factor among many. Other factors, such as the quality and contents of development strategy, institutional capacity of recipient countries and the degree of aid dependency, may play a bigger role. Moreover, appropriate matching of aid modalities with sector conditions and intervention type is necessary. The thrust of successful aid policies should be aimed at self-sustained development and not the permanent aid dependency of recipient countries, with an eventual graduation from aid.

Suggested Actions

As a non-Western industrialized country, Japan should bring diversity and the latecomer perspective to the global development debate and aid practice. Japanese development experts and officials should:

- Take initiative in designing and implementing a good growth strategy by conducting country-specific in-depth industrial studies and engaging various development partners. The ongoing intellectual ODA to Vietnam and Laos are good examples – they provide policy advice on the overall strategy for marketization, from a long-term perspective. For latecomer countries in Asia, it is particularly important to offer concrete industry-specific policy advice, not just general counsel, taking account of intense integration pressure. To this end, Japan should continue to offer a right mix of aid menu (loans, grants, and technical assistance) tailored to each country.

- Compile and widely disseminate the East Asian development experience, so that it can be understood by policy-makers and researchers in both developing and advanced countries. To maximize policy impact, a sophisticated dissemination strategy is needed for each targeted audience.
- Bring pragmatism and flexibility into the discussion on aid harmonization. Introduce Asian experiences in order to add variety and country context to the current debate, which is too narrowly focused on African experiences. At the same time, Japan should also reform its own aid procedures where necessary.
- In policy-making, strengthen strategic coordination in Tokyo by regular consultation among various ministries charged with ODA (especially the Ministry of Foreign Affairs, the Ministry of Economy, Trade, and Industry, and the Ministry of Finance) and the two key executing agencies (JICA and JBIC). Delegate decision-making to the country team in the field (Embassy of Japan, JICA, JBIC, and JETRO as appropriate). The country team should be made fully responsible for conducting policy dialogue and partnership activities.

These actions may require a fundamental reform in the current ODA system, which is politically sensitive and are likely to take time. But I am not too pessimistic. Under a shared strategic vision, it is possible and quite effective to build intellectual networks among Japanese policy makers, aid practitioners, academics, NGOs, and other shareholders. Websites and email propel ideas across geographical and institutional boundaries and be transformed into policy-oriented actions. Such activities have already begun by the GRIPS Development Forum and the Washington DC Development Forum, as well as by country teams in Vietnam and Bangladesh. Hopefully through these interactions, good practice from the Japanese perspective can be widely shared and disseminated, and impact global development strategy. ■

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[1]This includes the World Bank and the UNDP at the international level, and at the level of individual countries, the members of the Anglo-Saxon camp with the US and the UK in the lead, and the Nordic group of donor countries.

[2]For example, the US has said it will add $5 billion annually during the next three years for the benefit of poor countries with "good practices." To this end, the "Millennium Challenging Account" is to be established to provide performance-based grants to eligible countries.

[3]World Bank, African Poverty at the Millennium: Causes, Complexities, and Challenges, 2001.

[4]In the IDA 13 replenishment negotiations, the US strongly insisted on a drastic increase in grant components of IDA's concessional funding to low-income countries. After a long negotiation, it was finally agreed to raise the grant components to 18-21%, with particular emphasis on post-conflict assistance, natural disaster relief and coping with HIV/AIDS.

[5]In the mid-1990s, Tanzania had 40 donors implementing 2000 projects without coordination.

[6]For different views on poverty, market and integration, see Izumi Ohno and Kenichi Ohno (2002), "Global Development Strategy and Japan's ODA Policy," GRIPS Development Forum Discussion Paper No. 1.

Reconsidering the Washington Consensus: The Lessons of Asian Industrial Policy

Continued from page 3

lessons. First, political stability is important. No one will invest in an unstable environment.

Second, investment is important. The Asians accumulated both physical and human capital for a sustained period of time. The development of indigenous engineering talent was critical, insomuch as a key to development is the adaptation and exploitation of technology developed elsewhere, and this cannot be efficiently accomplished without a cadre of technologically capable people. The striking thing about the Asians is found not so much in rapid rates of total productivity growth, but rather maintaining decent rates of return on capital and total factor productivity growth in the face of adding 30 percent of GDP to the physical capital stock year after year.

Finally, export orientation was key and it accomplished three things: a vent for output; avoidance of balance of payments problems; and a clear, neutral, standard to evaluate the performance of firms receiving industrial policy favors. As one old practitioner put it, "[the export statistics] were the only numbers that couldn't be faked." Moreover, there is considerable evidence that exporting was essential to integration into world supply networks and that through these cross-national contacts, significant technology transfer occurred. ■

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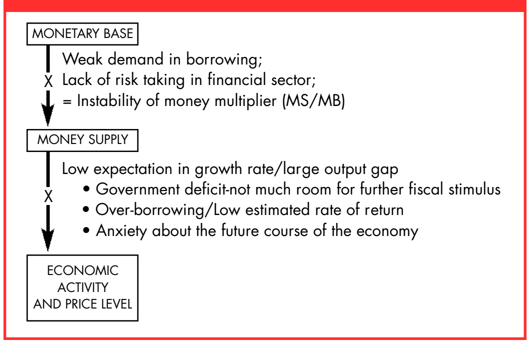
CHART 1

CURRENT ECONOMIC SITUATION IN JAPAN



Some text was inadvertently dropped from the tables accompanying the March 2003 article entitled, *The Role of Monetary Policy in Japan*, by Osamu Takemoto, the Bank of Japan. The tables are corrected as shown.

CHART 2

MONEY MULTIPLIER (M2 + CDs/MONETARY BASE)

CHART 3

MONETARY BASE, MONEY MULTIPLIER, AND MONEY SUPPLY (NUMERICAL EXAMPLE)

Case B. (current economic situation)

	Ex. 1	→	Ex. 3	→	Ex. 4
Monetary Base (MB)	$100	(50% or $50)	$150	(33% or $50)	$200
Money supply (MS)	$1,200	(5% or $60)	$1,260	(4.8% or $60)	$1,320
Money Multiplier (MS/MB)	12		8.4		6.6

NOTE: AN INCREASE IN MB WOULD PUSH UP MS—A DOLLAR-FOR-DOLLAR OR SO, BUT THIS EFFECT IS LIMITED. IT IS MORE IMPORTANT TO RESTORE THE TRANSMISSION MECHANISM FROM MB TO MS, OR TO RAISE THE MONEY MULTIPLIER (MS/MB). THIS IS WHAT THE QUANTITATIVE EASING POLICY SEEKS TO ACHIEVE IN CONJUNCTION WITH OTHER POLICY MEASURES.

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