MERCANTILISM AND THE ASIAN DEVELOPMENT MODEL

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In this essay Eimear Sexton discusses the mercantilist nature of the *Asian Tigers*' institutions and policies since the 1960s as well as examines their governments' position regarding balance of trade, balance of payments on current account and exchange rate regime. After looking at the Asian Crisis of 1997, she goes on to conclude that mercantilist policies of the Asian Development model are sound policy prescriptions for other developing economies.

Introduction

While the assertion by a Harvard expert on Asian Studies that "there are at least three models of East Asian development" (O'Hearn, 1998) is generally seen as understated, there are a number of common characteristics of economic development present in most of the newly industrialised countries of East and Southeast Asia. These characteristics together form what has been termed the 'Asian development model'.

There has been phenomenal growth in this region over the past number of decades. A glance at Asian tiger growth rates over the 30 year period from 1960 is staggering, and when put in the context of OECD growth rates of 2-3% over the same period, the significance of the statistics are highlighted. While growth in the Asian economies then slowed, annual growth rates of 5.2% to 8.3% in the first half of the 1990s are still quite impressive (Numazaki, 1998).

Table 1: Average annual GDP growth rate

	1960-70	1970-80	1980-89
South Korea	8.5	8.7	9.2
Taiwan	9.2b	9.7	8.0
Singapore	8.8	9.0	6.9
Hong Kong	10.0	9.5	6.3

Source: Chowdhury and Islam, 1993.

The four Southeast Asian nations grew at an average annual rate of 6-7% between 1965 and 1980 and, excluding the Phillipines. These economies grew at 5-7% per annum during the 1980s. Late industrialiser China grew at 6.9% on average for the period 1965-1980 and 9.7% for the 1980s.

While neither 'East-Asian' nor 'Southeast Asian' accurately reflects the regional distribution of the countries being considered in this paper, for the purpose of clarity, they will be collectively referred to as the 'Asian Economies'. They include: Japan, South Korea, Taiwan, Hong Kong, Singapore, Thailand, Malaysia, Indonesia, the Philippines and China. Similarities of both policies and structures are readily observed across the Asian Economies, although many are at different stages of development.

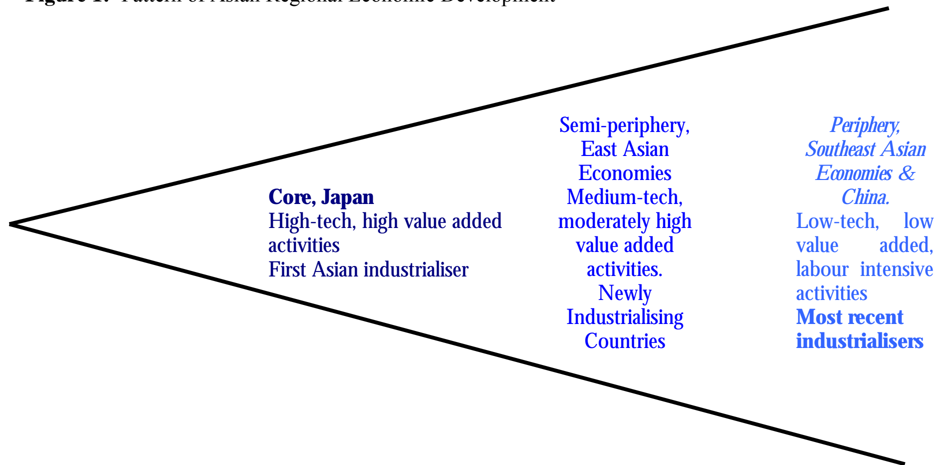
There have been three waves of industrialisation in the region. Japan was the first non-Western economy to industrialise, with economic growth taking off soon after the end of World War II. Following Japan, the East Asian tigers of South Korea, Taiwan, Singapore and Hong Kong emerged in the early 1960s.[1] In later years rapid economic growth occurred in Thailand, Indonesia, Malaysia, the Philippines,[2] and finally China.

The development of the region as a whole has largely been due the industrialisation of Japan. As Japan developed over the latter part of the 20th century, and moved its production up the value chain, in other words, producing more technically advanced and value added goods, it began first to import raw materials from its Asian neighbours and then to outsource lower value added elements of the production process. This process 'stimulated… economic growth in less developed nations along the western Pacific Rim' (Hill and Fujita, 1995). What emerged was an inverted 'V' or what Akamatsu Kaname (O'Hearn, 1998) calls the 'flying geese' pattern of regional development of the Asian economies with Japan at the forefront (See Figure 1).

These regional patterns also map out the balance of economic power, with core, technology rich Japan holding the most power in the region to attract high value industry.

[1] These four will be called the 'East Asian Economies'
[2] These four will be called the 'Southeast Asian Economies'

Figure 1: Pattern of Asian Regional Economic Development



Source: O'Hearn, 1998

It is my hypothesis that the policies and structures present in the Asian Economies since the 1960s are largely mercantilistic. The model of Asian development is undeniably similar in spirit, even if not by intent, to the policies and structures which dominated economic thought in Western Europe from the Middle Ages, nearing 1600, to the publishing of Adam Smith's *Wealth of Nations* (1776). In evaluating the weight of this proposal, I shall examine the prevalence of policies and structures present in the East Asian region, which mirror those present in the mercantile era, the notion of economic power as political power, the support of such policies by structures held in place by the 'strong' or 'developmental' nation state and policies towards trade including import-substituting industrialisation and export-led growth. I shall also discuss the desire for balance of trade and current account surpluses and foreign exchange reserves and the 1997 financial crisis in Asia. Based on my conclusions, I shall comment on the validity of mercantilist policies as policy prescriptions for emerging economies.

Economic Power as Political Power and Structures of the strong developmental nation state

In his book entitled *Mercantilism*, Professor Heckscher (1935) described mercantilism as a uniform body of doctrine built up on five different parts, in which "The Pursuit of Power" was the most important. In his view, economic measures were the primary weapon used to secure political unification and national power. This has been the defining feature of Asian economic and political policy.

Japan's imperial ambitions at the turn of the 20th century are well known. The Meji era, brought about by the death of the emperor in 1912, was marked by huge government domestic and overseas investments and defence programmes in an effort to increase its political power. During the following Taisho era, in an effort to expand its influence in China, Japan declared war on Germany[3] and occupied German-leased northern territories in China and its islands in the Pacific. Japan's power in Asia grew with the demise of the tsarist regime in Russia and the 1917 Bolshevik Revolution. The year 1919 saw Japan sitting among the 'Big Five' powers at the Versailles Peace Conference, a confirmation of its rise in political significance. The extent of Japan's ambitions were shown by their invasion of China in 1931 and the now infamous attack against US forces at Pearl Harbour in December 1941. However, following 14 years of war, their humiliating defeat and the annihilation of Hiroshima and Nagasaki in 1945, the death toll in Japan had risen to over 3 million. The country was in ruins and a huge occupation army of US and British soldiers remained in Japan as part of the surrender agreement.

This put paid to Japan's pursuit of power through militaristic means. After WWII Japan re-oriented its policy towards the attainment of power and influence in the world through the build up of economic might. Japan had effectively been thrust towards the mercantilist ideal of "state making and national economy making at the same time" (Schmoller, 1896). It was through economic growth that Japan's power would be realised. By the 1970s, Japan had achieved so much progress that it was predicted to overtake the US as the world's number one economy.[4]

Most pieces of mercantilist policy that were put forward identified the merchant's profit with the national good. This was based on the perceived link between trade and power – that 'trade' tended to 'follow power' (Magnusson, 1994). This perceived connection prompted Child to stress in 1693 "…that Profits and Power ought jointly to be considered" (Magnusson, 1994). With the pursuit of the power of the nation state at the forefront of public policy, and economic growth through trade the means to attain this power, state intervention was an essential part of mercantilist doctrine. The notion of the strong nation state has been at the heart of the Asian development model. Alvin So (1995) effectively sums up the regional mentality towards Asian economic governance when he says that "states have a strategic role to play in taming international and domestic forces and harnessing them to national ends."

While neo-classical economists argue that East Asian economic success has been based on its relative economic efficiency in world markets, those who take institutional approaches to economic change contend that Asian governments have

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[3] In August 1914.

[4] See, for example, Vogel (1980) and Kahn (1970).

intervened, often in a market-distorting way, to ensure the prosperity of domestic industries. While the World Bank (1993) has used the East Asian 'miracle' economies to extol the virtues of export-led growth paired with openness to international markets, O'Hearn (1998) notes that a large number of experts have argued that Asian successes were largely the result of effective state interventions, which strategically protected key industries to build them up until they were able to compete in export markets. The developmental role of Asian states has been facilitated by their autonomy and independence from the pressures of social groups and classes.

States were involved in supporting some activities while discouraging others, or what Amsden (1989) refers to as the use of 'carrots' and 'sticks'. This involved, for example, the imposition of quantitative restrictions and tariffs on the imports of some sectors, while other industries were exempt from such restrictions. As development and growth took place and economies shifted towards export-led growth, support of indigenous and desirable industries was made by direct subsidies, enabling them to make a profit with higher than average costs and still sell at prices lower than international market equivalents.

Interventionist policies had become so rampant during the early stages of economic growth, that, for example, Ed Mason dubbed the Korean state "Korea Incorporated", arguing that the South Korean economy was like a huge corporation, with the state as its board of directors (O'Hearn, 1998). Although the heights of the economy were dominated by huge *Chaebol*, like Hyundai and Samsung, these in turn were strategically directed by the state.

Interventionist behaviour of the type practiced in this region is largely frowned upon in the global arena. However, Asian countries have remained largely camouflaged from the piercing lens of Western focus for the past number of decades. This has been the result of a long history of geopolitics that has been prevalent in this region since the beginning of the Cold War. As front-line states in this political war of Western capitalism versus Soviet-led communism, in addition to receiving financial aid for accepting a Western military presence, the East Asian states essentially exempted themselves from economic policy rules with no obvious repercussions (Cumings, 1984; So, 1995).

The Mercantile System and its Policies Towards Trade:

Import-Substituting Industrialisation

A key element of early mercantilist industrial policy was the practice of what is now termed Import-Substituting Industrialisation (ISI). ISI endorses the protection of domestic industry from foreign competition behind high tariff walls

and the provision of a range of incentives and subsidies for favoured industries. The creation of work and employment and the nursing of industries, both as ends in themselves and as means of strengthening the country, became the aims of state policy at the end of the 17th and throughout most of the 18th centuries. The methods used were tariffs and embargos on imports, prohibitions of the export of tools and skilled craftsmen, the encouragement of the import of raw materials or of their production at home, the supervision of the quality of products and subsidies to those who were developing new industries.

Import substitution was used extensively as a policy for growth in Asian economies. This type of inward-oriented strategy of economic development was adopted in Japan in the years post WWII, in the East Asian Economies in the 1960s and in South East Asian Economies in the 1960s and 1970s.

Import substitution policies are closely correlated with the early stages of industrialisation in these Asian economies. Import licensing and quantitative restrictions were the most far-reaching instruments of protectionist policy at that time, but they also led to most abuses, both in their administration and in permitting inefficient manufacturing enterprises to be established (ADB, 1971).

While import substitution has become almost completely redundant in the Asian economies since the 1970s, the encouragement of home consumption is a feature still found in many of the Asian economies, especially in the area of food production. Japan, for example, actively and overtly pursues a policy of agricultural protectionism. Despite the obvious cost disadvantage of maintaining agricultural production in a country with high labour and land costs, [5] this is considered subordinate to its desire to maintain self-sufficiency in the interest of its national security. In 2003, Japanese rice production was supplemented by only 7.5% of total consumption in imports in this area (of the 8,658,000 metric tons of rice consumed in Japan in 2003, only 650,000 tons came from abroad). Similarly, China's modernisation began in 1978, with reform of its agricultural sector with the goal of becoming fully self-sufficient in food production. This goal was largely reached by the 1990s and today China, the world's biggest consumer of rice imports less than 1% of its total consumption.

Desire for Balance of Trade and Current Account Surpluses

Mercantilists looked upon the economic process from the point of view of the primitive stage which capitalism had reached at that time and were thus led to identify money with capital, identifying "…precious metals as the sole constituents of the wealth of the nation" (Viner, 1930). Professor Heckscher has given an interesting account of the "fear of goods", the almost fanatically exclusive concern

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[5] Heckscher-Olin theory, the textbook treatment of land and labour costs

with selling, which characterised mercantilist thought. In sharp contrast with the aim of securing an abundance of goods, which had characterised earlier state policy, the mercantilists thought, in the words of their greatest German representative, Johann Joachim Becher, “that it is always better to sell goods to others than to buy goods from others, for the former brings a certain advantage and the latter inevitable damage” (Heckscher, 1935).

It was particularly in the sphere of foreign trade that the ‘fear of goods’ showed itself, resulting in the mercantilist search for an export surplus, a relative surplus. Davenant, writing in 1697, argued that in domestic trade the nation in general did not grow richer, only a change in the relative amounts of wealth of individuals took place; but foreign trade made a net addition to a country’s wealth.

The Asian Economies have vigorously pursued a current account surplus as a major part of its economic policy. Their generally impressive current account surpluses have been led by the shift in policy towards export-led growth. Over the 15 year period 1970-1985, manufactured exports grew annually by more than 25% in South Korea, Taiwan and Singapore (O’Hearn, 1998). The conventional wisdom is that these rapidly expanding exports drove higher economic growth rates in general. The exceptional growth over the period in question has been illustrated. Average export growth per annum over the period 1970-1979, a strong period in terms of economic growth in the region, is shown below:

Table 2: Average Export Growth per Annum, 1970-1979

East Asia	South Korea	37.9%
	Taiwan	30.8%
	Singapore	28.0%
	Hong Kong	22.1%
South East Asia	Indonesia	34.9%
	Malaysia	23.3%
	Philippines	17.6%
	Thailand	25.2%

Export-led Growth

By 1994, combined exports from the four Asian tigers, the four ‘cubs’ and China had grown steadily to 17.3% of total world exports from 8.3% of world exports in 1981 and 13.9% of exports in 1991. The composition of these exports has changed over the course of development of these economies, however, evolving from food and textile exportation in the earlier phases of development to more manufactured, more technology reliant goods as economies mature.

Pursuing a policy of export-led growth in Asia has not been without its difficulties. For many of the Asian Economies, natural resources in terms of fertile land, metal and mineral reserves have not been in large supply. For these countries, comparative advantages were not endowed but have been built or captured over time. However, one area in which they held a considerable advantage was in their abundant supply of cheap labour. The condition of high-density population in a country was strongly regarded by mercantilists as a propeller of economic growth. Indeed, with the rise of the Netherlands as an economic power in the 18th century, many mercantilist writers identified this as one of the sources of its increased affluence over this period. The general lack of substantial natural resources has had its consequences for production. The industrial strategy of export-led growth in Asian economies has generated a double incidence of dependence (or 'double dependency': Numazaki, 1998) on the United States as a substantial market for exports and a dependence on Japan for imports as a consequence of Japanese 'out-processing'[6].

Accumulation of Specie and Foreign Exchange Reserves

While during the mercantilist era countries accumulated stocks of gold over time as a result of their policies to encourage balance of trade surpluses, such stocks of wealth held by Asian financial institutions are held primarily in US dollars. Since the collapse of the Bretton Woods accord, the US dollar has assumed the role of the World's international reserve currency of choice. In effect, the dollar has replaced gold and other precious metals as the primary store of wealth for most countries.

The extent to which the Asian Economies hold reserves is well in excess of that, which is standard in Western economies. Immediately prior to the Asian financial crisis, in 1996, international reserves of these countries were as indicated in Table 3.

These quantities of reserves are even more substantial when one takes into account the huge volumes of imports such countries had, with many exporting firms reliant on raw materials from abroad and the cross-country trading of subcomponents in line with the vast networks of Original Equipment Manufacturers (OEM) established in the Asian region.

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[6] The success of most Asian economies is based on the passing on of certain parts of the production process through Original Equipment Manufacturer (OEM). To this end, such economies are reliant on Japanese imports to fulfil their role in the production process

Table 3: International reserves immediately prior to the Asian financial crisis

Country	International Reserves (months of imports)
Japan	8.5
Taiwan	10.3
Hong Kong	10.9
Singapore	7.0
South Korea	2.8
Indonesia	6.1
Thailand	6.6
Malaysia	4.3
Philippines	4.4
China	9.1

Source: Hong Kong Monetary Authority, (2004); CEPD for Taiwan, (2004); APEC (2004).

While reserves of gold were built up in the mercantilist era in a somewhat passive way, reserves in these Asian economies were used to buttress their fixed exchange rate regime. Foreign exchange reserves also serve to hedge against the relatively massive amount of foreign-held debt in all Asian economies of this time against dips in confidence. Easy bank loans made available by 'relationship banking' and the government-guided 3B trilogy of bureaucrats, bankers and businessmen (Choi, 2000) facilitated the evolution of the huge debt to equity ratios of financial institutions. Large US dollar and other international reserves are also seen as a sign of economic power.

'All Fall Down' - The End of the Asian Miracle (Krugman, 2000)

Many commentators believed that the Asian financial crisis of 1997 signalled the end of the Asian miracle. The Asian crisis began on the 2nd July 1997, when the Thai government devalued the Baht in response to overwhelming speculative pressure. What followed was a spate of attacks on the currencies of the region. Indonesia, Korea, Malaysia and to a lesser extent the Philippines, Taiwan, Singapore and Hong Kong all fell victim to the so-called Asian flu. Thailand's currency depreciated by half, Korea's by 20%, Malaysia's by 30%. Only Hong Kong was able to maintain its exchange rate. The stock markets of the region also came under attack with investors pulling their money out *en masse*. The Thai stock exchange lost 90% of its value by the end of 1997, while Indonesia lost 85%, Korea 80% and Singapore 60%. The collapse was not just confined to the financial world;

real economic activity was hit hard. Indonesia's economy contracted by 13.7% in 1998, Thailand's by 10% and Hong Kong, Korea and Malaysia each saw contractions of between 5 and 7.5%. There was a massive increase in unemployment, the rate more than tripling for Thailand, Indonesia and Korea in the two years from 1996.

There are two competing views on where the fault of the Asian financial crisis lies. The first of these is that the model of Asian development itself was to blame for the crisis. Asian capitalism (or crony capitalism) is based on the symbiotic relationship between government, banks and industry. As Krugman (2000) suggests in his usual cutting fashion, "Many Westerners have turned the story of Asia's crash into a sort of morality play, in which the economies received their inevitable punishment for the sins of crony capitalism." Proponents of this view argue that many of the same factors, which underpinned Asia's extraordinary economic growth, were also the source of its weakness; policy directed lending, the close ties between corporations, governments and financial institutions, fixed exchange rates, and the general control of market forces.

The opposing view is the failure of Western capitalism or a market-failure view. This perspective, vehemently argued in Radelet and Sachs (1998), Wade (1998) and Wade and Veneroso (1998), places the Asian development model in the context of its own tradition. The Asian model of financial intermediation, characterised by close relationships between government, the banking sector and industry, had played a major role in the impressive growth of the Asian economies. While this system had operated effectively in an era of restricted capital movements, supporters of this latter view of the crisis hold that it was the unrestricted inflows of foreign capital following capital liberalisation in this region, prompted by the International Monetary Fund (IMF) and Western powers that upset this symbiotic system and caused it to unsettle the equilibrium in place (Dean, 2000)

While Asian officials proclaimed the soundness of the economic fundamentals on which their systems were based, they failed to recognise that they were assuming that the separation of economics and politics was straightforward. Investment, capital flows and growth are part of the economic sphere and Asia performed well in this sphere. However, regulation supervision, transparency and a sense of balance between dynamic growth and system stability can only be generated in the intertwined political sphere, in which Asian nations failed miserably. This view is reinforced by Sopiee (1996), who observes that, "The tiger economies of East Asia have been first rate in the management of the economic fundamentals in the real economy. They have been second rate in the management of market fundamentals."

Cerra and Saxena (2003) in an IMF survey said "the recovery phase (in Asia) is predominantly characterized by a return to the normal growth rate rather

than a higher-than-normal growth rate". If it is the case that such economies are growing once more, notwithstanding the fact that such growth is from a lower base, a case can be made in line with the market-failure view that it was not the mercantilistic-type policies used by Asian economies in the 1960s through the 1990s that caused the financial crisis of 1997 and consequently such policies have not yet been rendered redundant as effective tools for the facilitation of economic growth and development.

Conclusion

"…Mercantilism… was intended to promote production and commerce of private entrepreneurs who benefited from and contributed to the consolidation, prosperity and power of nation-states, with foreign trade being the most strategic variable."

(Palgrave, 1976)

Palgrave's definition, while it refers to a period of economic thought that 'ended' more than two hundred years ago, could easily describe the economic policies and motivations of twentieth century Asia. Yusuke, chief economist of the Institute of International Finance and former Asia expert at the IMF, noted a "deeply rooted mercantilist instinct" in Asia "with an almost religious attachment to trade and current account surpluses" as well as a tendency much greater than other countries to hold foreign reserves.

Together the Central Banks of Japan, China, Hong Kong, Taiwan and South Korea hold around $1.3 trillion in official reserves (or over half the global total). Their desire to accumulate such a stockpile of dollars is twofold. It is fuelled by their desire to hold enough reserves to insulate them from a financial crisis like that of 1997 and their wish to keep their currencies from appreciating. The dollar has depreciated significantly in 2002 and 2003. Correspondingly, Japan's reserves have increased by 36%, China's by 65% and Taiwan's by 49% over the period (The Economist, 2003).

Another effect of Asian intervention in soaking up excess dollars to support their exchange rates has been that their export prices have been kept down, arguably an orchestrated effect, leading to yet more of the export-led growth it has become renowned for. Exports now account for 64% of the region's GDP, having increased from 55% in the early 1990s, before the crisis (The Economist, 2003). This impressive export performance has concomitantly led to substantial current account surpluses. The combined current account surplus of Japan, China, Eastern and South Eastern economies of Asia was $133 billion in 2002.

It is my view based on the above evidence that mercantilist policies are still being used at present in Asian countries. I believe that the financial crisis in 1997 was a consequence of an amalgamation of financial regimes that were not in sync, a market failure rather than a government failure. Although economic fundamentals were somewhat to blame, the extent of the damage caused by the crisis was probably unjustified by the afflicted economies' crimes. Despite the crisis, the Asian economies have shown signs of a remarkable recovery, suggesting that the economic fundamentals on which their regimes were based were different to those of the Western model but not necessarily unsound. Moreover, their growth since the crisis has taken place within a much more sustainable market framework i.e. in a market where much capital liberalisation has taken place. While markets are not fully liberalised – China, the most notable proponent of market restrictions, still has its currency, the Yuan, fixed to the Dollar.[7] They are now a great deal closer to the norm of industrialised Western countries.

Despite the Asian financial crisis of 1997 and its aftermath, it is clear that many of the tenets of the Asian development model in particular, its mercantilistic policies of a strong nation state, export-led growth, trade and current account surpluses – are valid policy prescriptions for other emerging economies. What it less clear is how countries should proceed, regarding capital account liberalisation and their choice of exchange rate regime.

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[7] China's yuan has been effectively fixed to the dollar since 1994

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