The Inaugural Hong Kong Monetary Authority Distinguished Lecture: *Asia and the World Economy*

by
William J. McDonough
President
Federal Reserve Bank of New York

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ASIA AND THE WORLD ECONOMY
A Central Banker's Perspective

I am delighted to be here in Hong Kong, and I am greatly honored to have been invited to deliver the inaugural Hong Kong Monetary Authority Distinguished Lecture.

In my remarks today, I will offer a personal perspective on the recent experience of Asia's high-growth economies, with an emphasis on the broad forces underlying the dramatic shift in the region's economic fortunes during the last three decades. It is not my intent here today to provide a detailed analysis of the impressive record of growth that has been achieved. Rather, I would like to examine the Asian experience and focus on the implications for achieving sustained growth in living standards, while being able to maintain low inflation, and general economic and financial stability.

As is well known, much of Asia is going through a rapid economic transformation and modernization, with many economies experiencing exceptionally high growth rates. In recent years, the economic momentum in Asia has strengthened and broadened as the number of high-growth economies in the region has expanded. In fact, most of the world's fastest growing economies in the past decade are located in Asia. Judged in terms of per capita output growth rates, Asia was home for eight of the top ten high-growth economies.

The way to the recent growth miracle in wider Asia was led by Hong Kong and three other East Asian economies—Singapore, South Korea, and Taiwan—sometimes referred to as the four "tigers." Following in Japan's footsteps with a time lag of about ten to fifteen years, these four economies began to grow at historically unprecedented rates in the early or mid-1960s and have sustained the high pace of economic growth since then. With the steep rise in real incomes, all four economies have achieved great success, raising the living standards for the bulk of their populations. Indeed, per capita incomes in Hong Kong and Singapore are now higher than in many industrial countries.

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Over the last twenty years, China, Indonesia, Malaysia, and Thailand have recorded growth rates comparable to those of the four tigers. More recently, many other Asian countries—including India, the Philippines, Cambodia, and Vietnam—have made significant headway in modernizing their economies. Among the new reformers, Vietnam now appears to be showing signs of joining the ranks of high-growth economies. Even India and Sri Lanka—neither of which stands out as a high-growth economy of the region—have enjoyed much more rapid growth than countries in Latin America and elsewhere over the past decade.

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large middle class. Asia's continued strong performance would also provide an example for optimism about the potential for all societies to achieve a comfortable standard of living.

Some twenty-five or thirty years ago, even the most hopeful observer among us would have found it hard, perhaps impossible, to visualize Asia's recent economic achievements and its march to economic prosperity. In the quarter century after the Second World War, a disproportionately large share of the world's misery seemed to be concentrated in Asia. The region, with the notable exception of Japan, did not fare particularly well economically through the early 1960s. Per capita GDP in most Asian countries was 6 percent or less of that in the United States at the start of the 1960s, with the two most populous nations, China and India, having per capita GDP only 2 percent of that of the United States.

Hong Kong did considerably better than other countries, but it, too, had a fairly low per capita income level.

Writing in his book *Asian Drama* against this background, Gunnar Myrdal, a Swedish economist later awarded a Nobel Prize, could find no cause to be optimistic about the region's prospects.

I am sure it will not come as a surprise to this audience that standard economic models are not adequate for explaining the dramatic turnaround in Asia's performance. To be sure, the growth of incomes typically depends most on technological factors and economic policies. But it also depends on a broader set of social, legal, and political institutions and policies that influence the development of economic and technological inputs as well as establish the framework within which the whole economy must operate. Moreover, economic development concerns much more than just increases in incomes—it looks to reduction in poverty, progress in education, health, and nutrition, and protection of the environment. All these things indicate that the huge transformation in so many Asian economies over a relatively short time period can be appropriately examined only in the broader context of both economic and noneconomic forces that underlie the development process.

Before turning to the question of what caused the growth miracle in Asia's economies, I want to highlight some basic characteristics of the recent Asian growth experience. From my perspective, four distinguishing features of that experience stand out:

- First, Asia's high-growth economies have managed to bring about major improvements in the quality of life at a much faster pace than other countries had been able to do previously. The United States took nearly half of the nineteenth century (from 1839 to 1886) to double its per capita output, and the United Kingdom took even longer at an earlier stage of the industrial revolution. Over time, some countries advanced at a faster rate as the industrial revolution gained momentum but, through the first half of this century, the time required for doubling per capita output on a sustained basis generally did not shrink below two decades.

In sharp contrast to these earlier experiences, beginning in the early or mid-1960s, Hong Kong, South Korea, Singapore, and Taiwan doubled their per capita output within about eight to twelve years; starting in the late 1970s, the same feat was accomplished by China, Indonesia, Malaysia, and Thailand. (Japan, starting from its war-torn base, had done the same thing in the 1950s.) This exceptional performance is all the more remarkable by historical standards in that these growth rates have been sustained throughout the subsequent period, doubling per capita output about every ten years or so. With such substantial and persistent increases in incomes, Asia's share in the world economy has risen considerably over the years, leaving no doubt that Asia's performance in the past three decades cannot be considered a flash in the pan.

- Second, Asia's high-growth economies have been successful at distributing the gains from economic advances and, unlike the experience of many other developing and developed countries, high growth has gone hand-in-hand with declines in income inequality. While the extent of economic progress differs considerably among these countries, overall human welfare—as reflected in indicators of poverty, health, and education—has improved dramatically in most of them.

I personally regard the widespread sharing of the fruits of growth and the associated improvement in income equality as one of the most heartening features of the recent Asian growth experience. A continuous widening of economic disparities is not conducive to maintaining strong economic performance in the long run. I have no doubt that increases in living standards can be achieved and sustained only if gains from economic growth are shared broadly by the whole society—rich and poor, educated and less educated, urban and rural, factory owners/management and labor, people of all backgrounds.

As an aside, let me mention that I have been greatly concerned that, in my own country, economic disparities between the haves and have-nots have widened over the past two decades. For some time now, I have been involved in efforts to encourage business groups and other private and public sector participants to bring job growth and economic opportunities to poorer segments of our society. I believe this is one of the major challenges facing the United States today.

- Third, the external sector has been a major contributor to Asia's high-growth economies. This fact, by itself, is not surprising in view of the longstanding recognition of the positive relationship between international trade and economic growth. What is less well appreciated, however, is that only part of the external sector contribution to Asia's high-growth

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economies is associated with strong export orientation. In my view, more important and longer lasting benefits to economic growth in these economies stem from their high degree of openness to a variety of external influences, especially developments in technology and business innovation.

The international flows of technology and knowledge into Asia's high-growth economies have taken many different forms—foreign investment, foreign education, technical assistance, the licensing of patented processes, knowledge transfers through labor flows, technology embodied in imports of capital goods, and exposure to foreign goods markets. Some channels, such as foreign education, imports of capital goods, and exposure of exports to competition in foreign markets, have served as the transmission belt for technology and knowledge to all of Asia's high-growth economies, while others have been used in different degrees in each country. I think that most observers would agree that, overall, the region has been very receptive to international influences, although, with the possible exception of Hong Kong, none has shown itself to be completely open to the whole set of those influences.

Without the strong, persistent contributions of external factors, I am convinced that it would not have been possible for Hong Kong and other "tigers" to maintain exceptionally high growth rates throughout the period since the mid-1960s. The same point applies just as forcefully to China, Indonesia, Malaysia, and Thailand, though their high-growth period is about a decade or so shorter. In the long run, a high degree of openness is a key element in the strong economic performance that has been achieved.

- Finally, the recent Asian growth experience has been characterized by low inflation and general macroeconomic stability, even as the economies went through major structural transformations. Annual inflation rates in Asia's high-growth economies have averaged well below 10 percent since the late 1970s, and occasional bursts of higher inflation in individual countries have been brought under control within a relatively short time. Indeed, the recent inflation record of these economies is comparable to that of many low-inflation OECD [Organization for Economic Cooperation and Development] economies. More generally, the Asian growth experience underscores that low inflation and macroeconomic stability are necessary ingredients for economic growth. I will return to this point later on in my remarks.

Much has been written that helps to explain the economic successes in Asia. Yet there is no uniform or single model that can be applied to all of the region's economies, with their markedly different economic structures, social institutions, and political systems. There are common themes that do emerge, however, and

I would like to use them to offer a personal perspective and to outline the main implications of the Asian experience for sustaining economic development in the long run and raising living standards more broadly.

Let me start by noting a rather obvious but fundamental prerequisite for economic development. History has shown, time and again, that sustained development cannot occur without peace and political stability. Civil wars, ethnic strife, and international conflicts destroy the base of development and leave little time and resources for normal business activity. The most important cause of famine in the developing world has not been inadequate agricultural output or even poverty, but civil wars and military conflicts associated with political instability. As a matter of arithmetic, output growth in Asia's high-growth economies—just as anywhere else—can be accounted for by the growth of capital and labor and by increases in productivity of those inputs. Not surprisingly, the precise contribution of each source relative to others differs significantly from one country to another. Productivity increases, however, have been the key to sustaining long-run economic growth in all these economies.

There is no obvious or simple explanation of the forces underlying the growth-accounting arithmetic. Capital formation and labor supply are influenced as much by economic factors as they are by social and demographic factors. The driving forces for productivity growth are new technologies, advances in knowledge, and a more educated and better trained labor force.

Technological progress and advances in knowledge are diffused through physical and human capital and international trade. Their contributions to the economic development of a nation, therefore, depend not only on policies for capital formation—physical and human—and international trade, but also on the nation's history, culture, institutions, level of education, and degree of openness. I think all of us would agree that using technology and knowledge effectively over the long run requires supportive economic and social policies capable of dealing with rapid structural shifts in the society—shifts from agriculture to manufacturing and services, shifts in the scale of production and business organization, shifts toward urbanization, shifts in consumer tastes, shifts in international trade practice, and so on. It also requires adaptations and innovations in economic institutions and, at times, in political and social institutions as well.

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The point of all this, from my perspective, is that technological progress and greater knowledge by themselves cannot provide a meaningful explanation of high productivity increases or high economic growth rates in Asia's economies. As noted long ago by Simon Kuznet, a Nobel laureate in economics, "advancing technology is the permissive source of economic growth, but it is only a potential, a necessary condition, in itself not sufficient." This point is perhaps more valid today than ever before: with the globalization of knowledge and capital, new technologies and ideas have become international commodities that potentially are available to all nations.

In my view, the most important lesson from the experience of Asia's high-growth economies concerns the role of government in the development process. The over-arching common theme

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of the Asian experience is that governments have used what the World Bank calls a "market-friendly" approach to economic development. The approach involves heavy reliance on market forces and carefully limited government activism. Intervention is deemed appropriate only when the case for benefits is clear because markets either prove inadequate or fail altogether in carrying out certain critical activities.

To be sure, in most high-growth Asian economies, governments have intervened systematically and through multiple channels to foster economic development and, in some cases, the growth of specific industries. But such interventions have been aimed generally at addressing market inadequacies or outright failures in resource allocation. More important, the industries have been put to the discipline of domestic and international market competition. And usually, when the costs of interventions have become excessive—as, for example, in the case of a heavy chemicals industry drive in South Korea—governments have pulled back. As a consequence, interventions in these economies generally have avoided serious distortions in market price signals and relative prices.

However, the economic role of governments in Asia's high-growth economies has been much larger than just standing in for markets when they fail to work. The governments in these countries have provided effective legal, judicial, and regulatory systems, which are required for proper functioning of markets and for defining and protecting property rights. Just as important, they have crafted policies concerning trade and other international linkages, education, and macroeconomic management—policies that are consistent with the market-friendly approach that has played a fundamental role in the development process.

Since the beginning of its high-growth period, Hong Kong chose a less interventionist path to economic development—its government has eschewed extensive intervention in markets to guide private-sector resource allocation. To a somewhat lesser extent, Malaysia has followed a similar path. Moreover, over time, the increased liberalization of markets and international competition have obliged most high-growth Asian economies to be less interventionist than in their early stages of development.

China is a special case. Economic reforms in the 1980s greatly increased the role of market forces, international competition, and technology in the development process. But in my view, further structural changes will be required in both institutions and policies to firmly establish and maintain a market-friendly environment and to provide a sustainable, stable path for economic development in the long run. China's recent experiences with inflation reflect, at least in part, institutional rigidities and the lack of a sufficiently market-oriented framework to conduct macroeconomic policies that will maximize the country's potential.

External sector policies in Asia's high-growth economies have been critical to establishing and supporting the high degree of openness to international influences that is so necessary. In particular, by allowing international market competition and the inflows of new technologies, those policies have played an important role in encouraging domestic producers to make more efficient use of resources and to develop new and better products.

While all of Asia's high-growth economies have welcomed transfers of technology and ideas through various channels, their record is mixed on international trade. All except Hong Kong began with a period of import substitution and a bias against exports. But each moved, within a few years, to promoting exports, albeit using different approaches. In time, the harmful effects of import substitution became apparent and, by the early or mid-1980s, protection against imports had been reduced substantially, reflecting a growing recognition of the benefits of openness and international competition, as well as a response to the increasingly greater international integration of goods and financial markets.

The benefits of openness, technology, and market competition for economic growth depend greatly on education and skill levels. Asia's high-growth economies have excelled in implementing successful human capital policies that have played a critical role in creating and supporting rapid economic growth in the long run.

The Asian growth experience leaves no doubt in my mind that investing in people, if done right, provides the firmest foundation for lasting development. Markets in developing countries generally need some help from governments in providing adequate education, health care, and family planning services. Education makes the economy more productive by speeding the adoption of new technologies, helps in slowing population growth, and, more generally, makes family planning and health care services more effective.

To build human capital, the governments in Asia's high-growth economies focused their education spending initially on providing universal primary education and then on increasing the availability of secondary education. Demographic transitions facilitated these efforts by slowing the growth in the number of school-age children—a slowing that reflected, in part, the effects of universal education, which increased opportunities for women to work. Meanwhile, limited public funding for postsecondary education focused on technical skills and vocational training; higher education at university and college levels was largely, though not entirely, allowed to be met by self-financed private systems.

The result of these education policies has been a broad, technically oriented human capital base, well suited to rapid economic development. These policies also have contributed to more equitable income distributions.

Let me turn now briefly to the role of macroeconomic policies in the development of Asia's high-growth economies. In my view, one of the most—if not the single most—important implications of the Asian experience is that good macroeconomic management policies are necessary for maximizing and sustaining economic growth in the long run.

Macroeconomic policies in most high-growth Asian economies have been successful in maintaining low inflation and keeping away from inflationary financing of public sector activities. By limiting fiscal deficits to prudent levels, the governments in these economies generally have avoided excessive borrowing or monetary expansion and problems in the financial sector.

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Good macroeconomic management deserves much of the credit for general economic and financial stability in Asia's high-growth economies. By keeping inflation low, macroeconomic policies have enabled these economies to perform at, or at least near, long-run potential output and productivity levels, helping to bring about rapid increases in living standards.

Inflation is a serious impediment to efficient resource allocation and economic development. It reduces the effectiveness of the price mechanism and the contribution of market forces to economic growth through a variety of channels: by obscuring the signaling role of relative price changes, the major guide for making efficient resource allocation decisions; by increasing uncertainty about the outcome of business decisions and profitability; by causing adverse effects on the cost of capital through its interaction with the tax system; by hampering the application of new technologies and ideas; and by diverting resources away from productive activities. It is clear to me that low inflation, or price stability, is essential for achieving maximum long-run economic growth.

Empirical work finds a significant long-run relationship between lower inflation and higher levels of output and productivity, but the statistical evidence has not yet fully established that the correlation represents a causal link running from inflation to output and productivity. Notwithstanding the lack of definitive proof, I have been convinced for a long time that low inflation is good for long-run economic growth. I cannot help but note that the Asian experience of high growth with low inflation is fully consistent with my long-standing view.

Without low inflation, Asia's high-growth economies would not have been able to sustain continuous economic development for such a long period. Experience shows that inflation above certain relatively low levels has a tendency to accelerate and gain momentum, and also to become entrenched in the economic process, making its elimination difficult and progressively more costly. Keeping inflation low, therefore, requires vigilance on an ongoing basis. The only way to sustain long-run economic development is to control inflation from the outset—to nip it in the bud, so to speak. If inflation is allowed to build up, even for a short while, attempts to control it can make economic growth falter and destabilize the economy. It does not take long for inflation to cause serious damage to the financial structure and the economy.

In assessing the development of Asia's high-growth economies, one has to be impressed with the high levels of business investment and the associated accumulation of physical capital—machinery and equipment, buildings and bridges. During the last fifteen years or so, most high-growth Asian economies have invested 30 to 40 percent of GDP in physical capital, significantly more than in the earlier period. These investment levels are much higher than in other developing or industrial economies. Moreover, the private share of investment in most high-growth Asian economies is about two-thirds, which is much greater than the private share in other countries with comparable income levels.

Such high rates of capital formation obviously have made important contributions to economic development in Asia's high-growth economies. From my perspective, however, the exceptional rates of capital accumulation in these economies are best seen as an outgrowth of the policies and conditions that I have discussed. To a large extent, high levels of investment have reflected the combined influence of a range of sound fundamentals—good macroeconomic management, appropriate human capital development policies, the receptive attitude toward foreign investment, the welcoming of technology and knowledge, and the market-friendly role of government.

Low inflation and macroeconomic stability have played an important role in inducing strong capital formation by reducing uncertainty about the outcome of investment decisions, by improving the resource allocation process, and by helping to create a stable and secure financial environment that has encouraged high saving rates. Similarly, rapid advances in human capital and flows of foreign investment and technology have made major contributions to spurring investment in physical capital.

Asia's high-growth economies have wisely used specific initiatives to clear away obstacles to the efficient allocation of capital and create an investment-friendly environment: tax policies generally have favored investment, and other policies have been aimed at keeping the relative prices of capital goods low, largely by avoiding high tariffs on imports of capital goods. The fact that these governments have been particularly good at creating infrastructure that has been complementary to private investment has further enhanced the hospitality of the investment environment.

In recognizing that the fast pace of physical capital accumulation in the high-growth Asian economies has been driven by a variety of strong fundamentals, my point is not to downgrade the usefulness of physical capital for economic growth. Instead, I wish to emphasize that policies that get the basics right deserve much of the credit for high levels of capital formation and their contributions to economic growth.

Let me reiterate my main theme. The most compelling lesson of the recent Asian experience is that economic development must rely heavily on competitive market forces, but that markets do not operate in a vacuum and cannot do everything. The government has a substantial and irreplaceable role in the development process. The popular dichotomy of state intervention versus laissez-faire is a false one. Indeed, from my reading, the experience of Asia's high-growth economies tells us that when markets and governments work in harness, the results can be spectacular.

In the long run, all successful governments need to retain a measure of popular support for their actions, as well as a growing degree of openness and accountability, which cannot be fully separated from economic progress. It is clear, for example, that the free flow of information is essential to the proper functioning of markets. With ongoing advances in communication technologies and the globalization of information flows and knowledge, the linkages between the growth of incomes and economic development are bound to strengthen in the future.

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These issues are not unique to Asian economies, of course. But as major transitions take place, both here in Hong Kong and elsewhere, the balancing of social and economic considerations will be one of the key questions facing policymakers. The stakes could not be higher. Maintaining national and international confidence in institutions and policies will determine whether the goal we all seek—the continuous improvement of living standards—will be achieved.

Thank you for giving me the honor of delivering the inaugural Hong Kong Monetary Authority Distinguished Lecture.