East Asian Growth and Japanese Aid Strategy

Collected Essays by

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Foreword

This book collects my recent essays on economic development with the main question of how developing and transition countries of today should face the powerful force of global integration, and how Japan—and other donor countries and organizations—should assist them. In the last few years, I have been drawn increasingly to the realm of practical policy advice from my original habitat of scholarly research and paper writing. The essays included here are addressed mainly to the leaders responsible for policy making as well as those deeply involved in the question noted above. They were written to move those people into action. Some were originally published in Japanese (chapters 1, 2 and 5) while the others were prepared in close cooperation with the Japanese government for a foreign audience (chapters 3, 4 and 6). In either case, I hope this book will be helpful to readers interested in current Japanese thinking on development and aid.

I had the honor of being the first winner of the Osaragi Jiro Award for Critical Works sponsored by the Asahi Newspaper with my book, *Globalization of Developing Countries* (Toyo Keizai Shimposha, 2000). Publication of this booklet was financed in its entirety by the grant that comes with this privilege. I would like to give great thanks to the people of the Asahi Newspaper for making this possible. The book was compiled with high efficiency by my devoted research assistant, Azko Hayashida. The English translation of chapter 5 was prepared by Anjali Patel. My heartfelt gratitude goes to these ladies.

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Chapter 1

Latecomer Countries and the Global Market Economy*

The risk of premature international integration disrupting the development process

The age of international integration

For developing and transitional economies, the 1990s was a decade in which external pressure for liberalization and international integration increased considerably. We now live in a world where acceptance of global—in fact, often American—standards has become the pre-requisite for participating in the world economy. In the economic sphere, these standards include adoption of various market-based systems, privatization of public enterprises and external opening. In non-economic areas, achieving human rights, free election and parliamentary government is now the condition for being recognized as a worthy member of the international community. Latecomers are also told to conform to the models of the more advanced countries in the fields of environmental protection, intellectual property and the like.

Of course, external pressure to conform is not unique to our age. Throughout history, dominant civilizations always towered over neighboring cultures, presenting their local principles as the global standards of the age. However, it is well to recognize that, in our post-Cold War age, disintegration of the Communist bloc permitted the Americans to impose with little restraint their systems based on liberalism and individualism on the rest of the world. Disappearance of the competing ideology means that latecomers irritated by American demands can no longer seek refuge in the other political camp. Also, delays in political and economic liberalization which were quite permissible in developing countries in the past have now become increasingly unacceptable.

Latecomer countries are not always forced to participate in the international society against their own will. Certainly, conditionalities imposed by the international financial institutions and donor countries have played a very important role, but many latecomers also have opened up on their own or under peer pressure from neighboring countries. Many of the countries in systemic transition willingly adopted the big bang strategy. The trade and investment liberalization processes of ASEAN can be considered a natural response to the fierce competition to attract FDI in the Asian region, with China as the most formidable rival.

The key issue I would like to raise in this essay is this: most latecomer countries are unable to properly manage the process of liberalization and integration now engulfing the whole world and, as a result, they have suffered an increasingly large number of severe economic and political hardships

* This is a full translation of the Japanese article published in *Sekai* in January 1999, pp.78-88 ("*Tojokoku sekai to global sijo keizai: hayasugiru kokusaitogo ni yoru kaihatsu senryaku no tsumazuki*"). Translation by the author.

due to ill-managed international integration. The speed and manner with which latecomer countries should integrate with the global market economy is now the central issue in their development strategy. It also provides a new flash point for political tug-of-war between industrialized and developing countries. To realize the nature of difficulties faced by countries in systemic transition or emerging economies beset by recent currency crises, this historical perspective is absolutely essential.

The danger of financial opening without preparation

There are three crucial decisions that latecomer countries must make regarding external economic relations which, if not properly managed, will entail great risks: opening of financial markets, exchange rate management and trade liberalization. Let us consider them in turn.

Asia was the epicenter of the currency and financial crisis that began in 1997 and then spread to Russia and Latin America. By now it is clear that contagious currency crises are not unique to Asia but a problem inherent in the global financial system. Since the Asian crisis was an international phenomenon, detailed analyses of domestic political economy of one crisis country alone will not reveal the true cause of crisis contagion and its severity. The emphasis in policy debate has already shifted from the evaluation of the Asian model of development to the need to reform the international financial system.

To fully understand the Asian crisis, we must first briefly review the history of development finance. From the 1970s to the early 80s, commercial bank loans originating from industrialized countries were the primary source of private funds in developing countries. However, the Mexican debt crisis which broke out in the summer of 1982 and spread to other countries brought this type of capital flows to a sudden halt. During the next ten years or so, international financial institutions and the Paris Club (a group of official bilateral creditors) provided official aid to highly indebted countries in exchange for implementing “structural adjustment”—namely, economic liberalization and external opening.

The debt crisis was finally over by the early 1990s. Thanks to sustained structural adjustment effort, macroeconomic improvements and external economic liberalization were achieved, creating a seemingly favorable investment climate. Large amounts of private capital again began to flow into developing countries as well as those countries which had just begun transition to the market economy. This time, inflows were not in the form of long-term commercial bank loans. Rather, new funds were provided through highly marketable instruments in equity and bond markets and offshore banking facilities. The developing countries and countries in systemic transition that established these financial markets and encouraged foreign investors to invest were called “emerging markets.” These were a relatively recent phenomenon of the 1990s. Latecomer countries which until then had only a minor role in global financial markets now became an integral part of that grand mechanism.

In this way, long-term syndicated loans by commercial banks were replaced by funds in equity markets and short-term borrowings which can leave the country very quickly. What transpired as a result of this shift is enormously increased instability. In the case of long-term bank loans, a debtor country can negotiate a rescheduling if it faces difficulty in repayment. But when one deals with markets, such relaxed and structured negotiations are impossible. A large number of anonymous investors will withdraw funds at the first sign of trouble, causing stock prices to plunge and igniting currency attacks. In financial markets where herd behavior often rules, it is extremely difficult to prevent overborrowing, capital reversal, speculative bubbles and crisis contagion.

In countries which have abolished capital control, enterprises and financial institutions are free to borrow from abroad while the government is unable to effectively monitor the situation. This has led to the accumulation of a vast amount of private-sector external debt not backed by sound business plans or ability to repay. When the currency plunges as confidence in that country evaporates, there is a sharp increase in bad debt leading to system-wide defaults—revealing the fragility of economic growth based on a weak financial system and excessive foreign borrowing.

The Asian crisis was a phenomenon in which countries that had previously achieved high growth suddenly and completely lost the ability to control their macroeconomies due to inadequate speed and sequence of external financial integration. In the developing world, serious currency crisis contagion has already occurred twice in this decade including the 1994-95 Mexican crisis and this one. We must say the pace is rather quick. Crises of this type are likely to occur in the future too, unless the present international system is significantly reformed.

The Asian crisis did not end with just collapsing currencies; it was further aggravated by the poor policy response of the international financial institutions, causing credit crunch, paralysis of the financial system, and immense damage to the real economy. At the height of the crisis, the IMF called for fiscal tightening, higher interest rates, and bold restructuring of corporations and banks. This had the effect of severely hurting relatively sound companies and banks and amplifying panic. The IMF was accustomed to the crisis characterized by budget deficits and a depletion of international reserves, but it had never dealt with financial panic in the private sector.

A crisis of this type requires a skillful combination of short-term rescue measures to calm fears on the one hand and financial and corporate restructuring to improve the system on the other. As markets were shaken, the IMF should have provided a large amount of liquidity immediately. The IMF however got the timing completely wrong. The Asian crisis turned out to be much more persistent and severe than many had initially anticipated. Had the Fund not blundered this way, the crisis would have been much less persistent and severe than it actually was. (Recall that in the 1994-95 Mexican crisis, a $50 billion international bailout package was quickly assembled under American leadership, preceding the Mexican government's announcement of New Economic Policy.)

Some people contend that the Asian crisis was caused by the structural or systemic weaknesses of the countries involved. According to this view, Thailand, Korea and Indonesia each had serious internal problems that made the crisis inevitable. But where can we find a developing country without any structural or systemic problems? Arguing that these three countries were particularly bad performers in the pre-crisis period, without comparing them with other LDCs, is a false hindsight. International comparison would show that the performance of Thailand, Korea and Indonesia was among the best in the developing world. The only mistake committed by all of them was that they opened up too carelessly to global financial markets.

After this unpleasant experience, each country should reflect on its weaknesses inherited from the past. Crisis provides a good opportunity to do so. But it would be unrealistic to expect a developing country to adopt international best practices in information disclosure, transparency, sound banking, fiscal oversight, macroeconomic management etc. in a short period of time. If these were possible at all, we would not need development economics. It is safer to assume that these achievements would take a very long time even with maximum effort, and we need to design policies for international financial integration accordingly, at least in the near future. It is extremely risky to hop on the bandwagon of liberalization without good domestic preparations. The best and most responsible advice that one can give to those countries with undeveloped banking systems and inadequate prudential regulation is "do not rush to external financial opening while these situations persist."

Exchange rate management in the storm

Rigidity of the dollar peg exchange rate system is often cited as one of the causes of the Asian crisis. According to this view, Asian currencies were fixed too tightly to the dollar before the crisis although Japan, US and EU were equally important partners in their trade and investment relations. Therefore, the rise of the dollar during 1995-97 also appreciated their currencies and invited speculative attacks. They argue that post-crisis developing Asia should shift to more diversified currency arrangements reflecting its multifaceted economic relationships.

I do not negate this argument completely. A close examination shows that there is still room for improvement in exchange rate policies in the region. But I must disagree if these authors are to insist that Asia's dollar peg had been utterly inappropriate and these countries should quickly adopt a much superior system of currency baskets. The situation is just not that simple.

The first thing we must realize is that today's developing and transitional countries must manage their currencies in global financial markets that are much more unstable than those in the 1950s and 60s. There is a great deal of volatility among major currencies of yen, dollar and euro, and capital flows originating in the industrialized countries are huge and highly unstable. The best that developing and transitional countries can do is to stay with the *average* of these fluctuating major currencies. Yet, when the yen/dollar exchange rate fluctuates greatly, how much consolation does "average" stability give to a company in Southeast Asia who must import from Japan and export to the US? Average stability does not guarantee stability of currency relations at the micro level. When major exchange rates are highly unstable, there is not much that developing countries can do with their exchange rate policies to offset it. No matter how one uses an umbrella during a storm, one will still get wet.

Though the Asian countries are sometimes criticized for the pre-crisis dollar peg, their currency management was in fact not so inflexible. Considering the dominant role of the dollar in the world economy, the extent of Asia's trade with the US and the dollar bloc, and American price stability since the 1980s, it is not unreasonable for developing countries in Asia to choose the dollar as an anchor currency. Based on the dollar standard, these countries were making additional rate adjustments when domestic and international financial shocks hit occasionally, ensuring that no significant loss would occur in overall competitiveness. A soft dollar bloc established this way has much to recommend it as a system of currency management combining stability with flexibility.

Of the NIEs4 (Korea, Taiwan, Hong Kong and Singapore) and ASEAN4 (Malaysia, Thailand, Indonesia and the Philippines), only Hong Kong and Thailand held their exchange rates consistently stable against the dollar during the pre-crisis period (defined here as from January 1990 to June 1997). Other currencies deviated from the strict dollar peg over the medium to long run through realignments, inflation slide and yielding to market pressure. Calculation of real effective exchange rates (most popular index of a country's inflation-adjusted competitiveness) using consumer prices shows that, in the pre-crisis period, Taiwan, Korea, Thailand, Indonesia and Malaysia maintained their currencies within plus or minus 10 percent of the weighted average of the Japanese, American and European currencies in real terms (of course, greater volatility was recorded against individual currencies, particularly the yen). In Hong Kong, Singapore and the Philippines, a tendency of real appreciation (competitiveness loss) was detected when consumer prices were used as a yardstick, though the Singaporean dollar was stable in real terms when wholesale prices were used. The Thai baht did appreciate prior to the crisis, but the size of real appreciation was only 9 percent relative to the period of stable competitiveness in the first half of the 1990s. By contrast, the Korean won was depreciating in real terms (gaining competitiveness) before the crisis!

In a world of exchange rate volatility among major currencies such as ours, it is highly doubtful if the Asian currencies could have achieved better stability in real terms. Let us make a counter-factual assumption that, during the pre-crisis period, the ten developing economies in Asia (NIEs4, ASEAN4, China and Vietnam) had pegged their currencies to a basket consisting of yen, dollar and ECU with weights reflecting trade amounts. According to my calculation[1], only four

[1] Kenichi Ohno, "Exchange Rate Management in Developing Asia," Asian Development Bank Institute Working Paper No.1 (January 1999), Tokyo (http://www.adbi.org).

economies—Singapore, Hong Kong, Taiwan and Malaysia—would have stabilized their competitiveness (based on consumer prices) relative to the actual, while the other six would have suffered greater instability. This conclusion would be the same whether currency weights were chosen by individual countries or regionally (the latter is called *joint float*). This surprising result—competitiveness is more stable under the dollar peg than with currency baskets—can be explained by two factors. First, each country already had flexible currency management even under the dollar standard. Second, for high-inflation countries such as Vietnam, China and the Philippines, the contents of the currency basket are less important than whether the country devalues as necessary in a timely manner.

Given the unstable global economy, there is no single "international best practice" in currency management applicable to the entire developing world. In fact, any of the exchange rate systems that can combine stability and flexibility—including managed float, currency basket, crawling peg, adjustable dollar peg, etc.—is acceptable. The question is not which system to select, but how to manage the selected system properly. Many of the Asian developing countries were already conducting exchange rate policies sufficiently flexibly even before the crisis. Improvements to their policies are surely possible, but they would be incremental rather than fundamental. If the monetary authorities think that they will enjoy much greater currency stability by adopting a brand new system, they are in for disappointment.

Early commitment to free trade

The current members of the industrialized world (Japan, US, EU) consist of countries that have successfully caught up, since the late 18th century and step by step, with the achievements of the British Industrial Revolution. In the process, it was very common for a latecomer industrializing country to temporary protect their markets in order to promote domestic industries and create new institutions. The Japanese and German systems of official industrial promotion are well known. Even the US, the standard-bearer for free-market economics, adopted protectionist policies against England as it gained political independence. The Americans also imposed stiff tariffs on silk imports towards the end of the 19th century.

In the context of the long and dynamic history of global industrialization, the development problem we face today is "how can we extend the market mechanism and implant modern industries to the next tier of countries waiting for their turn?" Would they succeed by instant trade liberalization, a method that none of their predecessors adopted? We must remember that those countries that have not yet industrialized at present are saddled with certain handicaps. The negative legacy of past colonialism is often pointed out, but a more serious problem is that their societies lack preparations for adopting the market economic principle.

The international community is now pressing these countries to accept free trade, whether or not they are ready for it. In developing Asia, three concentric circles of free trade commitments exist: WTO (global), APEC (Asia-Pacific) and AFTA (within ASEAN). Each country must present an official free trade implementation schedule consistent with these multiple international constraints. Can they really do it? Let us examine Vietnam as an illustration.

Vietnam had suffered many externally- and self-inflicted hardships including a long succession of wars, rigid economic planning and international isolation. The country was excluded from Asian dynamism for many years. In the 1990s, Vietnam's economy at long last emerged from stagnation and began to grow robustly. During 1992-97, an average growth rate of 8.9 percent per annum was recorded. This very impressive performance was made possible by two factors: Doi Moi (renovation), which is the policy of economic liberalization and opening adopted in the mid-1980s, and large capital inflows consisting mainly of ODA and FDI which began in the early 1990s. Trade and investment links quickly integrated Vietnam with the rest of the world. During this process, the Vietnamese economy grew at an unprecedented rate.

Nevertheless, growth based on liberalization and opening to the outside world is a temporary phenomenon; it will not last forever. There were already signs of economic slowdown by early 1997. Now that the Vietnamese investment boom is over and the real estate bubble has burst, the question of whether Vietnam can maintain high growth in the future depends on how it will respond to such long-term development challenges as industrial promotion and institution-building.

Before Vietnam could begin to address these basic issues, however, two external constraints emerged: multiple commitments to free trade and the negative impact of the Asian crisis. This means that Vietnam must now implement their long-term development strategies in a manner consistent with announced free trade commitments while avoiding the risks of currency crisis and financial turmoil. The Vietnamese economy benefitted greatly from rapid international integration in the early 1990s, but more recently the risks and constraints of globalization also became apparent.

Vietnam joined ASEAN in 1995. At the same time and inevitably, Vietnam also began to participate in AFTA, the regional free trade movement already in progress within ASEAN. The primary goal of AFTA was to reduce intra-regional tariffs to 5 percent or less within ten years, and the deadline for Vietnam was set to 2006. Full membership in ASEAN was a great diplomatic achievement for Vietnam. However, from the economic viewpoint, free trade commitments that come with the membership may turn out to be a considerable burden on the Vietnamese economy.

What must be recognized here is that the Vietnamese economy is at a very early stage of development, even by ASEAN standards. Vietnam's per capita income of $320 (World Bank preliminary estimate, 1997) is much lower than that of Malaysia ($4,680), Thailand ($2,800), Philippines ($1,220) or Indonesia ($1,110)—not to speak of Singapore ($32,490) which is already an advanced economy. The export base of these ASEAN neighbors has rapidly shifted towards manufactured goods. Vietnam's major exports, however, are still dominated by primary commodities such as crude oil, rice, marine products and coffee. Its only manufactured exports, garment and footwear on a contract-manufacturing basis, are totally dependent on foreign technology and capital. Inside the domestic economy, many serious problems typically observed in a very latecomer country are evident: absolute poverty, low savings, insufficient infrastructure, a primitive financial sector and an undeveloped market economy.

In Vietnam, a large part of industrial output is attributed to state-owned enterprises (SOEs). This should not be construed as a proof of efficiency of the SOE sector; rather, it points to the extreme weakness of the private sector. Most of the SOEs are protected by import barriers. Except for joint ventures with foreign partners, SOEs are equipped with dilapidated machinery and can only produce products of very low quality. Few of them can compete squarely with the imports of neighboring countries. If regional trade liberalization proceeds as scheduled, Vietnam will surely face massive bankruptcies and unemployment. For private enterprises, the situation is no better. If tariff ceilings are set at as low as 5 percent into the future, there is a concern that new private industries which are expected to support Vietnam's development in the 21st century may not emerge. Free trade does not hurt very much while the country remains at the stage of exporting primary commodities and contract manufacturing. But will free trade not become a binding constraint when Vietnam is ready for the next stage of industrialization?

I would like to add a few words to avoid any misunderstanding. I am not saying that developing countries need not implement free trade policies. It is undeniable that free trade has major benefits. Competition from overseas eliminates inefficient enterprises and forces even surviving enterprises to improve its performance. But I do find it highly problematic that the Vietnamese government has already committed to AFTA's regional trade liberalization and is about to negotiate WTO membership (which is likely to constrain Vietnam's trade policy even more) even though the government does not have any comprehensive and concrete long-term industrial vision, any strategy for restructuring corporations effectively, or any deep understanding of how free trade will impact the country's economy or society.

Although I have discussed this issue intensively with many officials in the Vietnamese government and also analyzed Vietnam's tariff reduction schedule submitted to the ASEAN Secretariat, the role of trade policy in the overall development strategy remains unclear. As it stands, Vietnam's trade liberalization is very different from Japan's trade liberalization in the 1960s which was highly integrated with a scrupulously prepared policy for industrial promotion. Compared to Japan in those days, Vietnam has considerably less time, freedom, and human resources to effectively design and implement development policies while integrating with the global economy. Maybe I worry too much for Vietnam. Despite my pessimism, the Vietnamese economy may continue to grow strongly in the future. But I cannot help wondering if politically committed free trade, without sufficient understanding of its economic and social consequences, will always lead to good results.

Introducing markets to latecomers

For non-Western countries including Japan in the Meiji period (1868-1912) and today's developing and transitional countries, economic development is *not* the process of fostering autonomous growth of productive capacity within the social structure unique and inherent to each country. Rather, it is a process of rushing to be included in the periphery of the pre-existing international system by adapting to foreign values, institutions and technology. In a famous speech in 1911, Soseki Natsume, the famous Japanese novelist, proclaimed that "Western development is endogenous [internally arising] but Japan's development is exogenous [externally imposed]." The concept of economic development can potentially have very broad and diverse meanings, but today it has become synonymous with such terms as introducing markets, Westernization, industrialization, globalization, modernization and catching up with the West. Come to think of it, this is a very odd situation. But that is the reality of our age, for better or for worse.

It is very understandable that latecomer countries wish to actively "import" the market economy; it is because the authorities want to raise national income and people's living standards. Compared with other economic systems, we can hardly say that the market economy is superior culturally, morally or environmentally. It is even likely that the market economy exhibits severe weaknesses in these areas. There is no guarantee that the advent of markets will enrich our spiritual lives. However, from the material aspect of greatly expanding productivity, and from this aspect only, the market economy is superior to any other systems. The market economy can unleash great economic powers, especially when it is accompanied by industrialization and global integration.

The global market economy invades every aspect of our life with irresistible force, and no society can escape its strong hold. Maintaining one's economic independence without becoming a part of this tempest is, for all practical purposes, quite impossible. As seen in Meiji Japan or former socialist economies at present, reform inevitably calls for external integration together with domestic changes. However, for today's latecomer countries, the process of external integration has been strewn with many risks, for the following reasons.

First, if the imported market system and the basic structure of the society are not compatible, the merger of the two systems will not succeed. Even in the case where systemic merger is possible, substantial adjustments of both the domestic society and the imported system are required. The society of any developing country is not a blank canvas on which the market economy can be easily introduced. Each society has a very unique and complex structure with many layers of historical elements painted over one another. We cannot expect that new Western institutions such as business contracts and equity markets will always be assimilated into the existing systemic complex and quickly start to function as intended. The only body that can responsibly manage this complicated blending process is the central government of that country.

Second, the global market economy with which latecomer countries are trying to integrate is a very rough place today. Needless to say, unregulated free markets are inherently unstable. Although the market system does contribute to improving efficiency and accelerating growth, we can hardly neglect its undesirable effects of increasing instability and widening the gap between rich and poor. Markets should always be regulated by appropriate social rules. Unfortunately in today's world economy, the inherent instability of the global economy is unleashed without restraint by the ideological worship of laissez-faire economics. If the global economy is highly unstable, there is not much that helpless latecomer countries can do to completely insulate themselves from external shocks. In fact, in such an environment a small policy mistake will be greatly magnified—rather than offset—and even threaten the very existence of the society.

Third, there is very limited capacity on the government side. On the one hand, the government of a latecomer country is entrusted with many important tasks, including smooth introduction of the market economy and management of the potentially dangerous process of international integration. On the other hand, as is well known, the government itself has many weaknesses to overcome such as poor training, corruption, collusion, inefficiency, political conflict, pressure from interest groups, abuse of power and rigid bureaucracy. This is as if the doctor who must heal the patient is sick himself. Regrettably, it is very common to see the government in a developing or transitional country lacking the capacity to design and implement development policies effectively. Clearly, improvement of government's institutional capacity is the pre-requisite for economic development.

In this context, one vitally important condition for overcoming these difficulties is that the government retain the capacity to safeguard the identity and continuity of the society as it integrates with the world economy. The policy option of non-integration is no longer available. But as a latecomer integrates, the right to determine what foreign systems to import, in what sequence to import them, how to re-interpret them, how the society will adjust to absorb them, how to cope with possible social friction, and the like, should ultimately rest with the home government. Surely external pressure will play a role, but foreign systems should not be unilaterally imposed. The receiving side of these systems should have the will and the responsibility to manage liberalization and external integration. In other words, the government of a latecomer country must "own" its integration process as the international financial institutions would put it. This is the key to the success and the failure of simultaneous systemic transition and international integration.

Keiji Maegawa, economic anthropologist, calls this process of accepting international systems without losing self-identity "translative adaptation"[2]. From outside, systemic transition may appear as the process of a small country being absorbed into the powerful global market economy; but if the country in question can retain self-identity and continuity, the process is not passive submission. The inferior culture which is to be swallowed up by the superior one in fact becomes the master of the process, re-interpreting foreign systems according to its needs and preserving its social identity. The object of systemic merger becomes the subject. Despite Soseki's lamentation that Japan's development was externally imposed, we can still argue that Japan since the Meiji Restoration provides an excellent example of successful translative adaptation by a non-Western country.

What I fear is that the intensification of foreign pressure to liberalize and integrate in the 1990s may have robbed latecomers of the ability to control their own destiny. The authority to determine the contents and timing of crucial policies—such as law-making, political reform, labor policy, environmental protection, privatization, trade liberalization, FDI policy, financial liberalization,

[2] K. Maegawa, "The continuity of cultures and civilization: an introduction to the theory of translative adaptation," *Comparative Civilization*, vol.10, 1994.

exchange rate management and so forth—is gradually shifting from the home government to the international institutions and donor community. Moreover, the reforms demanded by foreign groups tend to be highly uniform, ignoring the stage of development or the institutional capacity of government in each country. As a result, countries not yet prepared to accept foreign systems are plunged into confusion and crisis.

Amid the Asian currency crisis contagion, Malaysia introduced new foreign exchange control and a fixed exchange rate system in September 1998. This was a deviation from the free-market principle and, not surprisingly, Western countries and international organizations sharply criticized the move. However, and the political intention of Prime Minister Mahathir aside, these temporary measures cannot be considered abnormal from the purely economic viewpoint. It is all too natural that countries want to protect themselves from wild markets and regain economic control. It is irresponsible to recommend to unprepared latecomers to jump into the global market economy when it is as volatile as today. What is needed is the reform of the world economy which necessitates such emergency exits. Some call the Asian crisis the "21st century-type crisis," but should we not strive to create rules to avoid the recurrence of similar crises in the remaining time of this century?

Towards integration without crisis

Debate over globalization is often characterized by almost religious belief in the American-type market economy on the one hand and emotional rejection of it on the other. Every time a major event in the global economy—such as systemic transition of the former USSR and the Asian crisis—occurs, these two views diverge even more rather than converge. The first view says that markets must be introduced with full force to overcome the crisis while the second curses externally imposed systemic changes. This is a very unfortunate situation. Common sense tells us that the truth is somewhere between these two extremes. Fruitless debate over ideologies colored with emotions must be replaced by policy-oriented discussions evaluating alternative realistic options.

All I can say to the IMF and the American government which seem to be firmly entrenched in dogmatic market ideals is that they should regain common sense and intellectual flexibility as soon as possible. Understandably, however, it is difficult for players in the center of the world economy to reassess their own systems in a relative light. Intellectual initiative of this kind therefore must come mainly from the group of latecomer countries. With its historically unique position as both an industrialized economy and a non-Western latecomer, Japan should be particularly active in accepting this intellectual challenge.

Every country must adapt to the central values and systems of the age. Development will surely fail if the country refuses to deal with the global market economy. Yet, it is equally improper to force an unprepared country to integrate with the world economy. The problem lies not with globalization itself but with how it is carried out. Compulsory and uniform international integration imposed on all countries irrespective of different positions in the world economy or stages of development must be stopped, especially when the global economy lacks stability.

In the 1990s, the virtues of the market economy and international integration were clearly overplayed. It is time to regain balance, to correct the pendulum that has swung too far. We must formulate concrete policies that promote the merits of the market economy and dampen its demerits. Pressure on latecomer countries to integrate must be accompanied by the reform of the world economy so that countries can integrate without being seriously damaged.

For this purpose, I propose the following two principles.

First, instead of being uniform, international rules for liberalization and integration must be multiple, reflecting different status, stages of development and institutional capacity of individual countries. In particular, latecomers should be given the freedom to integrate with the world economy gradually and in steps, rather than in a big bang. There should be different criteria for good economic conduct between developed and developing countries, and similarly diverse rules among different types of developing countries. Outsiders should be patient enough to let each country tread its own path of translative adaptation over a long period of time, rather than demanding rapid institutional reforms with unilaterally imposed policy conditionality.

Second, efforts to stabilize the global economy—especially its financial aspects—are absolutely essential. One way to do this is to monitor and regulate private capital movements. We must proceed beyond the abstract argument of whether capital control is desirable or harmful in general; instead, alternative methods of capital control should be evaluated pragmatically as to effectiveness and feasibility. Another critically important issue is the reform of the current international monetary system based on the floating of major currencies since the 1970s. Even partial stability of these currencies would go a long way to improve the world economy. In particular, a more stable yen/dollar exchange rate would be highly beneficial to Japan as well as developing Asia[3]. In the area of trade, abuse of aggressive bilateral trade negotiations and anti-dumping laws must be checked, and resolution of all trade disputes must be delegated to the WTO.

When both of these conditions—multiple rules for integration and stability of the world economy—are fulfilled, and only then, latecomer countries are given the opportunity to accelerate external integration without inviting crisis. My proposal for promoting globalization amounts to creating a better environment for integration rather than beating latecomers into submission. Long-term healthy development of the world economy can be better achieved if we have more patience today, not less. This is the message that I would like to deliver to those people who draft harsh conditionalities for crisis-hit countries.

[3] For more details see R. McKinnon and K. Ohno, *Dollar and yen: resolving economic conflict between the United States and Japan*, MIT Press, 1998.

Chapter 2

A Proposal for Two-Track ODA*

For East Asia and for the World

What position should Japan adopt in the war against terrorism the United States has launched? There is validity in the American claim that terrorism is the enemy of peace and democracy and must be resolutely quashed through global-scale action. Some thus might assert that Japan should support the United States in any way it can within the constraints of its laws. But it is also clear that "eye for eye" retaliatory strikes breed animosity without providing a true solution, which means that efforts must simultaneously be made to deal with the poverty from which terrorism is bred. Here we find a role for economic cooperation to play. We should also critically review the recent tendency to hold the model of American society as the ideal and to impose it on countries with other cultural backgrounds. A true long-term answer to terrorism must surely address this issue.

Having said this much, however, we in Japan find ourselves at a loss as to what to do next. Our country simply has not developed sufficient ideas and communication channels to present alternative intellectual propositions to the rest of the world. At this crucial time of worldwide anger and fear, Japan finds itself incapable of acting as an effective voice based on common sense.

Regrettably, Japanese diplomacy in the postwar era has been characterized by the lack of principles that can be projected to the world and the passivity to external stimuli. While a country that selfishly pushes its agenda is a nuisance to the global community, a country like Japan that continues to mull over how to contribute to whatever the problem the world considers important at any moment attracts no respect. However large amounts of money and human resources such a country may provide, it will forever remain a free rider and never a leader in the world system from the intellectual point of view.

Contribution to global issues is certainly important. But at the same time, as the only major industrial country in Asia, Japan has a duty to offer fresh perspectives to the rest of the world. We cannot expect the global trends that emerge from the West to be perfectly correct all of the time. There will be a greater chance of building a more balanced world if Japan gives voice to a vision from its Asian vantage point.

As a country with strict constraints on what it can do militarily, Japan naturally finds economic cooperation to be an exceedingly important tool in foreign policy. And yet, even in the disbursement of official development assistance (ODA), it has taken the hardly commendable approach of following the crowd. Confronting this reality squarely, I will endeavor in this essay to propose a way to improve our performance.

* This is a full translation of the Japanese article published in *Ronza* in December 2001, pp.54-63 ("*Teigen ODA nibunron: Asia no tameni, sekai no tameni*"). The translated excerpts were published in *Japan Echo* in February 2002 under the title, "Reconfiguring Japan's ODA". Translation by the author.

Mounting Japanese Dissatisfaction

The Japanese government is now under pressure to reassess its ODA programs because of the severe pinch in the budget. In conducting this reassessment, we need to examine the contribution ODA makes to Japan's foreign policy. ODA is no longer a sacred expenditure item as the government aims to cut it by 10% in the next year's budget. It is natural and even desirable to rethink how to use the limited amount of ODA more effectively. But that requires not just reviewing the investment returns and environmental friendliness of individual projects. To review ODA fundamentally, we need to question its effectiveness in achieving Japanese diplomatic objectives.

During the last decade, Japan has occupied the status of the largest ODA donor in the world. But this quantitative contribution has not been accompanied by similarly impressive intellectual leadership. The global debate on development assistance is largely determined by others—specifically, by the World Bank (and in part by the United Nations Development Program) at the international level and, at the level of individual countries, by members of the Anglo-Saxon camp, with the United States and Britain in the lead, and the Nordic group of countries. Every few years they come out with new assistance strategies, which in many cases do not match the sensibilities of the Japanese. We have left the controls to other nations, and Japan's role is no more than that of a timid co-pilot at best.

The policy dialogue between Japan and the World Bank has significantly deepened in recent years. The greater mutual understanding, however, appears not to be narrowing the gap in views but rather to be making the differences even more conspicuous. The development approach taken by Western countries and international organizations features predetermined frameworks, convergence toward a single system, and great attention on macroeconomic and financial issues. Japan, by contrast, starts from concrete experiences, perceives value in diversity, and emphasizes issues of the real economy for the purpose of promoting key industries. It is not easy to fuse two development philosophies when they are based on fundamentally different concerns. Japan's aid administrators are willing to cooperate with and contribute to plans drawn up elsewhere, but they continue to mutter that it does not feel right, that something seems to be missing.

Let me give some examples. When the International Monetary Fund and the World Bank financially supported a number of Latin American and other countries facing debt crises in the 1980s, they made their support conditional on severe fiscal and monetary austerity and radical liberalization and privatization. And when they reached out to help the countries in transition in the former Soviet bloc in the 1990s, they prescribed an even stiffer dose of basically the same medicine. Japan cited the dangers of a uniform imposition of liberalization and belt tightening regardless of the history and social character of each country, and it argued repeatedly that in societies lacking experience with the market economy, markets would not come to life simply by destroying old systems and introducing new policies. The World Bank, in its *East Asian Miracle* report (1993) and *World Development Report* (1997), seemed to come closer to the Japanese position on the need to promote industries. But in the end, these small agreements were hardly sufficient to close the huge gap between the development philosophies of the two parties.

At the 1999 Group of Seven summit in Cologne, the major industrialized countries approved a debt forgiveness scheme for a group of heavily indebted poor countries (the enhanced HIPCs initiative), and again a reform program of the same type was made a precondition. Because Japan is one of the major aid donors to Africa, this means it will not be getting back a considerable portion of the official yen loans it has made to the region. Without doubt it is important to offer a second chance to countries groaning under a massive load of debts. But are the governing institutions and industrial strategies of these countries really sufficiently sound? Might we not discover that merely canceling debts does nothing toward improving the prospects of the poorest countries and only tends to make them permanently dependent on foreign aid? Japan has raised such questions, but no other donor countries seriously listened. Now moves are afoot to create common baskets for African development, with all donors—including Japan—pooling money for joint use.

The latest aid strategy of the World Bank (the comprehensive development framework and the poverty reduction strategy paper) pushes poverty reduction to center stage and proclaims that all aid programs must directly contribute to it. The Bank additionally preaches as follows: the governments of all developing countries must achieve transparency, accountability, good governance and civil society through institutional reforms. Countries without "good policies" should be given advice, not money. Partnership among the government, the private sector, NGOs, donors, and international organizations must be enhanced in each country to greatly improve aid effectiveness.

Certainly a lofty idea. But is this the best strategy in the light of the realities of developing countries? As I see it, the World Bank strategy lacks the perspective of how to enable industries in latecomer countries to catch up in an age of globalization. If industries do not develop, poverty reduction strategies will come to nothing. We must also ask whether it is possible or desirable to have all countries converge to the norms of the West. Here again, the Japanese aid officials are heard murmuring against the World Bank, while contributing money and personnel.

The Asian financial crisis of 1997 greatly accelerated the dissatisfaction in Japan with the existing international approach to aid. As many East Asian economies with which Japan had close trade and investment ties collapsed, the response to the crisis was mapped out by the IMF. Japan's own proposal—that an Asian Monetary Fund be established—was quickly brushed aside. As the crisis worsened because of the conditions the IMF laid down for assistance—which included high interest rates, fiscal austerity, and hasty bank closures—Japanese officials stepped up their criticism of the IMF and began looking for countermeasures without Washington's help. What they came up with was the "New Miyazawa Initiative" for assisting the crisis countries quickly and with much less conditionalities, the "Chiang Mai Initiative" that permitted central banks in the region to help each other in emergencies, and additional infusions of grants and loans to the affected countries.

How pitiful that the country with the largest financial contribution has to defer to other countries on how that money is to be spent, particularly when the policies of the international organizations guiding this effort seem to lack balance. Continuation of this state of affairs will have an ill effect on the psychology of the Japanese government and people. Surely, there have been many attempts to break away from this trap and produce an aid strategy that Japan can be proud of. After the Asian crisis, such moves further accelerated. As part of these efforts, below I will outline a proposal regarding the fundamental principles of Japan's ODA program. My suggestion is to reconfigure it on the basis of a twin set of principles: those deriving from Japan's Asian identity and those arising from its global position.

Reaffirming Japan's Dual Identity

Ever since Japan opened its doors to the world in the second half of the nineteenth century, its foreign policy has been pulled back and forth between the country's identity as an Asian country on the one hand and as a member of the Western community of advanced industrialized countries on the other. Perplexed by its dual identity, the country has sometimes selected the wrong options. Today, a century and a half after U.S. Commodore Matthew Perry's fleet forced a reluctant Japan to open up and just over half a century after its defeat in World War II, our national identity is still torn between Asia and the West and unable to reach maturity. We remain confused about what attitude to take toward both sides as an industrially developed Asian country. Forcing two seemingly incompatible vectors into one without a firm set of guiding principles ends up producing strains, which make us veer to an extreme of either arrogance or servility. Our policies swing toward one side or the other instead of accepting both identities.

In the field of ODA, Japan cannot manifest its true character as long as it is forced to choose from two passive options—toeing the line of the World Bank's strategy or complaining about that line. In his famous lecture in 1911, Soseki Natsume, the popular novelist in the Meiji period, warned us: "Western tides dominate our social development. Since we are not Westerners, every time a new wave arrives from the West we feel uneasy like a person living in someone else's house." This lamentable situation is a reality in today's ODA. What have we all been doing in the last century?

The dual national identity engraved on Japan by its history will not go away with the passing years. It is about time we recognized that it lies at the root of our national character and cannot be eradicated. We should stop turning our back on it or trying to settle on just one of the two alternatives. Would it not be far more preferable to affirm this duality as a historical gift and make constructive use of it in our diplomacy? A skillful combination of the two identities can provide an original character to Japan's foreign relations, adding breadth and depth to them and offering the flexibility needed for dealing with complicated issues. For any non-Western country, this is the key to the successful handling of the dominant systems introduced from abroad without loss of the country's autonomy or continuity.

A dual approach meets a need in all aspects of external relations, and it can be especially helpful in the provision of development assistance. It enables Japan to secure areas where its development strategy will be effective, and present a model for developing countries with strong aspirations to catch up under international integration. But even more important, it can help the Japanese themselves regain pride and confidence in the activities they are undertaking.

Contributing to Asian Dynamism

To concretize our dual identity in the ODA program, we would like to begin with the clear recognition of what we are in the world economy. Japan is an industrial country whose forte is in *monozukuri*—literally "making things," or skilled manufacturing—and it is the chief architect of the Asian production network. The first of our ODA principles should thus be that ODA is to be used as one of the tools for sustaining and developing Asian dynamism.

Regional integration has recently been gaining momentum in a number of places around the world. But in East Asia, strong industrial linkages have already been formed among countries at different stages of development. These linkages, mediated by trade and investment, have sustained the "East Asian miracle" over the past few decades. East Asia has become the factory of the world, especially in the case of electronic products. The structure of production is not one of simple, vertical relationships between advanced and developing countries; instead it is a dynamic and multi-tiered configuration of production bases with Japan as the point of origin. East Asia now has a complex intra-regional division of labor and brisk intra-regional trade and investment. There is no other developing region that boasts such a configuration. As East Asia's economic superpower, Japan bears considerable responsibility for the region's development. At the same time, the vitality of Japanese industries depends on the trends of the production networks extending across the region. Confronted with this reality, we can clearly see the need for a vision that unites Japanese prosperity with the prosperity of the rest of East Asia.

Some may argue that it is anachronistic for Japan to try to implement an Asia-wide industrial policy at a time when it is moving away from its own past reliance on excessive government intervention. Professor Suehiro Akira of Tokyo University terms this perceived inconsistency "the double standard of Japan's Asian involvement." But I believe that such concerns are overstated. There are three points that need to be made in this connection: First, what we are considering here is not bureaucratic direction or the creation of planned economies but complementary policies to support the private sector. Second, it is only natural that the government plays different roles depending on the stage of economic development and the degree of the market's maturity. Rejection of certain industrial policies today does not necessarily negate their effectiveness in the 1960s, when Japan was catching up rapidly. Third, there is obviously considerable room for regional policy cooperation in East Asia, where a dynamic production network operates among countries at all stages from the rich and advanced to the least developed.

It is self-evident that the East Asian economies must be built on the market mechanism. But this does not mean that markets must always operate in a pure, unhindered form. I suspect that it has now become common sense to accept that unrestrained markets have serious defects in preserving stability, equity, environment and cultural diversity. Forceful introduction of market institutions and Western standards in latecomer countries with little experience with the market mechanism often leads to failure and rejection. In addition, the volatility of the world economy at present calls for joint action against adverse contingencies.

Already in East Asia today many issues are being addressed through bilateral schemes as well as in multilateral groups, such as the Asia-Pacific Economic Cooperation (APEC), the Association of Southeast Asian Nations (ASEAN), and the "ASEAN plus Three" in which China, Japan, and South Korea also participate). These issues include infrastructure, institution building, human resource development, trade and investment policies, and visions for invigorating the regional production network. Steps are also taken to promote technology transfer, academic and student exchange, and South-South cooperation. Responses are required in such areas as environmental destruction, trade friction, financial crises, the gap between rich and poor, the ongoing slump in the information-technology sector, and overcapacity generated by excessive investment.

What is important here is not to select and evaluate individual ODA projects in the light of narrowly defined evaluation criteria but rather to reposition the entire ODA program as a key instrument of Japan's foreign policy, broadly defined. Enhancing Asian dynamism requires coordinated marshaling of various policy measures by all the concerned countries, including trade, investment, social program, immigration, financial policy, exchange rates, macroeconomic policy and other areas. Our advice is to use ODA when and where appropriate along with other measures. For instance, foreign aid is of particular relevance in low-income countries in building industrial infrastructure, supporting small businesses, offering policy advice, and improving human resources. ODA may also be used to protect the environment and to provide relief for the vulnerable in times of crisis.

Since Japan obviously cannot determine East Asia's destiny unilaterally, making Asian dynamism one of the central objectives of our foreign policy means creating and strengthening the channels of constructive dialogue with our East Asian neighbors. This challenge is highly welcome and should be met squarely. Japanese diplomacy in East Asia is currently mired in unproductive battles over the Yasukuni Shrine problem, the textbook problem, and the like. To elevate it to a higher level, it will be a good first step for Japan to propose new visions, which must first be thoroughly discussed domestically, to the rest of East Asia for their consideration and constructive criticism.

Furthermore, Japan can convey regional opinions to the rest of the world. East Asia is truly diverse, but on some topics, such as development strategy and currency crisis response, there can emerge a regional view that differs from the global current. It is naturally part of Japan's job as East Asia's leading country to summarize the region's views and make them heard in appropriate forums, such as the World Bank, the IMF, the World Trade Organization, and the G-7 summits.

We need to define East Asia not geographically but functionally, based on its dynamism as a production base for the world. At its core are the countries already linked together in a chain of structural transformation: Japan, the newly industrialized economies (Hong Kong, Singapore, South Korea, and Taiwan), the "ASEAN Four" (Indonesia, Malaysia, Philippines, and Thailand), China, and Vietnam. Outside this core lie a number of countries able or willing to participate in the production network in the future, notably Cambodia, Laos, Myanmar, and North Korea. Beyond them lie other developing countries and countries in transition that, while unable to participate directly in this production network because of geographical distance, are nonetheless keenly interested in the East Asian-style development strategy. It behooves Japan to be generous in cooperation with this group as well.

Elements of Asia's New Vision

At the start of a new century, what should our vision of Asian dynamism be, more specifically? To answer this question, a number of points need to be seriously debated.

The first involves China. Over the past couple of years it has achieved great prominence as an export base for assembly-type manufacturing (though to some extent people's perception of China as a super factory has outstripped the reality). With its abundant labor supply and low wages, China is capable of producing low-priced goods, and recently the quality of its products has also improved considerably. China's competitive power has been felt in Japan, North America, and Europe, not to speak of the ASEAN countries. But simultaneously, China is still struggling with knotty problems from the past, including state enterprise reform, regional inequalities, environmental destruction, and shortage of water and energy. Thought must be given to how long China's advance is likely to continue and how its dynamism can be tied in with the rest of Asia's.

The second—and related—point is the weakening of economic vigor and centripetal force within ASEAN. The ASEAN members are being battered by several problems. In addition to the China shock mentioned above, they face political instability, bad debt, IT slump, the conflict between promoters and gradualists of the ASEAN Free Trade Area (AFTA), and Singapore's keen interest in enhancing bilateral trade relations with developed countries ahead of regional cooperation. From the Japanese vantage point, the relationship with the ASEAN is primarily economic as they provide Japan's overseas production bases, but diplomacy with China calls for a broader range of perspectives. China is simultaneously a large recipient of foreign investment, a formidable rival in manufacturing, and a potential political adversary. To cope with China, we need a diplomatic vision encompassing not only business but also national security and shared regional leadership. How does the ASEAN play in this grand scheme? Can Japan restrain China by bolstering the productive capacity of Southeast Asian nations? Or should we instead focus on deepening interdependence between the Chinese and Japanese economies as the superior path to East Asian stability?

Thirdly, on the long-range agenda, we need to debate whether East Asia should aim for EU type integration with a single currency and free trade and investment among members, or whether it would be better to continue along the present course of open regionalism, without further institutionalization or discrimination against countries outside the region. Such considerations may seem rather grandiose, but the point is that if we wish to use ODA to good advantage, we cannot rely only on the internal rate of return or routine evaluation of each individual project. Various policy instruments (including ODA) of Japan's external policy will be integrated and become mutually consistent only if this sort of all-inclusive vision is established.

One more point we must not overlook is the coherence between external economic policy and domestic structural reform. We will not be able to revitalize Japanese industry by internal measures alone, such as deregulation, administrative and fiscal reforms, supporting venture businesses, etc. We must also allow international competition to guide corporate efforts and to weed out inefficient industries. The mandarins in *Kasumigaseki* and the politicians in *Nagatacho* alone cannot design Japan's industrial structure in the twenty-first century; in the final analysis, it is the world market that will shape it. The government can play no more than an ancillary role in this context, seeking to reduce the degree of uncertainty and offering support where needed. The reform strategy the current government is now pursuing seems too domestically oriented. It is plainly contradictory for the government to introduce safeguards against imports even as it seeks to strengthen the competitiveness of domestic industries. Any vision for Asian dynamism, to be effective, must include a workable principle for resolving the old problem of how to combine foreign competition for industrial dynamism and legitimate temporary protection of domestic industries.

Contributing to Global Issues

Our second principle should be that ODA is to be used as a tool for contributing to the solutions of common issues. This applies to a wide variety of themes with humanitarian and global implications such as poverty reduction, environment, social development, health and nutrition, dispute settlement, refugee and disaster relief, and the preservation of cultural heritages. As an advanced country, Japan bears a natural responsibility to actively contribute to these causes through knowledge, human resources, and finances in cooperation with other donors, institutions, NGOs and the private sector.

A number of points must be borne in mind. First, we should not aim our international contributions at each and every issue, for that would lead to broad but shallow participation. We should rather identify areas where Japan enjoys a comparative advantage and concentrate our efforts on them. This can lead to an efficient use of ODA as well as reduce the "transaction cost" of aid giving. For instance, compared with Western donors, Japan has a relative abundance of funds and scarcity of human resources, so its aid should continue to reflect this feature. Also, Japan has some superlative environmental technologies, which should be spread widely around the world. And in view of the constraints on the military cooperation Japan can extend, I personally feel it should aim at becoming the world's top provider of aid for disaster relief.

The second point is a corollary of the first. There can be no denying that Japan's aid organizations lag behind their counterparts elsewhere in a variety of respects. International organizations and other donor countries have assembled a wealth of human talent, knowledge, and systems, and we should give thought to how we can effectively employ these resources. In specific terms, Japan could contract out some of its aid initiatives to specialized outside agencies and promote personnel exchanges for the training of young Japanese staff members. And where appropriate, it should adopt superior systems and arrangements devised by international organizations.

Third and most important, Japan should try to exercise influence on the policies of international organizations instead of always responding passively to them. Particularly in the case of the World Bank, there is a tendency for each new president to hammer out a new initiative and for all the employees then to fall into line behind it. Each of the elevated objectives of the World Bank—be it structural adjustment, institutional reform or poverty reduction—is a legitimate development concern, but a dogmatic pursuit of just one of them is hardly a balanced approach. Given Japan's adeptness at maintaining policy continuity, it can make a considerable contribution by acting to counter fashionable currents in global opinion and return the attention of international organizations and summit meetings to the fundamental issues of development. And even as it seeks to play this role, it should strive to synthesize the views of Asia and express them to the rest of the world, as I have already noted.

Refining the Japanese Touch

The idea of providing the ODA program with a dualistic design may come across as a radical proposal, but in fact it is a common-sense suggestion. It is a call not for altering the thrust of Japan's economic cooperation but for condensing, elucidating, and amplifying the orientation it has had all along. On the one hand, the main uses to which Japanese ODA has been put in the Asian region include installing infrastructure, promoting small companies, improving human resources, accepting foreign students, and responding to crises. On the other hand, the main axis of Japan's foreign relations will continue to be cooperation with the United States and other industrialized countries, where making contributions to international causes is becoming increasingly crucial.

While in substance my proposal suggests no radical change from past practice, it makes an enormous difference in our psychology and policy impact to positively recognize and affirm this duality. We should sense the pride that comes with the application of a coherent design. My point is that there is nothing inconvenient or otherwise amiss in having a dual identity; on the contrary, it should be turned into an advantage peculiar to Japan. When that is achieved, we can—and should—direct most of our attention to perfecting the way the two apparently inconsistent principles are blended, according to each individual circumstance.

In the recent debate over ODA, some people are in favor of basing Japanese aid entirely on the second principle (global contribution) only. But an attempt to swallow foreign values whole generates dissatisfaction in any country, because the ethnic temperament engrained in the base society is not very easy to replace. The Japanese public will surely become uncomfortable sooner or later with the current international-consensus approach to ODA, in which the focus is limited to reducing poverty and resolving environmental problems. The unique characteristics embodied in Japanese ODA will be lost if such aid is detached from the tradition of skilled manufacturing we cherish so much.

The aid officials want to provide aid *with a Japanese face*, but ultimately this cannot be accomplished just by attaching Japanese government logos to the goods we supply or flying the Japanese flag over our aid facilities in the developing world. If we can manage to provide the policies and projects with a Japanese touch, the recipients will come to appreciate our efforts, and some among them will even call for development strategies drawing on the strengths of the Japanese approach. The way to transform our country's aid into something truly Japanese and not anyone else's lies in adding such depth and appeal to the content of what we provide. Surely, we have our unique development views and partly act on them, but we never clearly articulated them for outsiders. My humble suggestion is that it is time we spoke out.

Since the Japanese have so thoroughly accepted Western rational thinking ever since the Meiji Restoration, they have become intolerant with irrationality and reject things that cannot be analyzed cleanly by a single principle. But no matter what we think, there are always fundamental irrationalities in life. Trying to square them into a simple dualistic framework deprives humans of the ability to think deeply. Science and technology apart, thoughts and philosophies are not expected to progress linearly. While the superpower of the present world may pretend that the world can be divided into good and evil and rally everyone to fight for the good cause, such dualistic ideology is very remote from the traditional Japanese thinking. Can we not even say that intolerance of this kind is the last thing we need for the twenty-first century, in which a multitude of ethnic groups, each shining with its uniqueness, are supposed to live side by side, linked by information technology? What the world needs is not a final battle between grand visions, but the patience to forever live with the friction and tension generated by the coexistence of diverse life principles. Even better if we can relax and enjoy this lively action in play. The idea that affirms such an attitude and counterbalance the predominant dualistic thinking must come from the East.

Chapter 3

Development with Alternative Strategic Options*

A Japanese View
on the Poverty Reduction Drive and Beyond

Development must be achieved on cumulative efforts, not impulsive shifts. The recent global passion for cutting poverty may have gone to extremes. Poverty must be reduced, but in a way that permits pursuing other development goals and strategies reflecting the diversity of poor countries. To supplement the current pro-poor policies, Japan proposes an alternative, more dynamic concept of development assistance for the purpose of helping latecomer countries to be integrated in the world economy as active trading partners. It is up to each developing country, and not donors, to decide whether the ultimate national goal is poverty reduction, industrial dynamism, or otherwise. Japan hopes to continue to use ODA for supporting global causes as well as East Asia's dynamism. Japan is also prepared to transfer East Asian experience to other developing areas where such aspiration is embraced and conditions are right.

Strategic Convergence on Poverty Reduction

Despite intense effort in the last half century, development remains an unresolved problem. Some countries have succeeded brilliantly in catching up with the forerunners, but too many others continue to be trapped in social and economic stagnation. Many strategies were tried to lift them out of poverty, from socialist planning to laissez-faire and from health and educational support to building roads and power plants. But the world has not yet found a single cure that works in all cases. Maybe there is no such panacea in the first place.

But the international economic organizations are constantly in search of one miracle solution. The World Bank's policy focus has shifted from infrastructure and industrial projects in the 1960s to basic human needs in the 1970s, "structural adjustment" in the 1980s, and privatization and institution building in the 1990s.[1] A few years ago, its policy again shifted dramatically to an exclusive attention to poverty reduction. Certainly, poverty is a very legitimate concern in development. Furthermore, adjusting policies to changing reality is not only desirable but necessary. But the transformation of

* Prepared as a background paper for the OECD Forum, Paris, May 13-15, 2002. The author has benefited greatly from the inputs of a large number of Japanese officials and scholars participating in the ongoing discussions for reshaping Japan's development cooperation policy. While this paper reports an emerging consensus among them as the author sees it, it is not an official statement. All responsibility for its contents rests with the author alone.

[1] World Bank economist Easterly also critically reviews the shifting ideas in development in the last half century (William Easterly, *The Elusive Quest for Growth*, MIT Press, 2001).

what the World Bank considers the key policy ingredient is a bit too fast and too radical; wisdom of the past should not be thrown away so quickly when the Bank staff stampede to a new development credo (especially after the inauguration of a new Bank president).

By now, poverty reduction has captured the hearts of aid officials around the globe, making it synonymous with the entire development process. In 1999, World Bank President James Wolfensohn launched a new initiative called the comprehensive development framework (CDF) and poverty reduction strategy paper (PRSP). Of these, CDF provides the basic ideas and procedure for policy formulation stressing *ownership* (i.e., leadership) of the developing country and *partnership* among various development actors. On the other hand, PRSP is a document that concretizes targets and needed actions and allocates them among actors. Initially, only a small number of poor countries asking for debt reduction were supposed to prepare PRSPs. But the scope of PRSP was subsequently enlarged, and all poor countries are now required to engage in this process. Once agreed, PRSP becomes an overarching framework for budgeting, prioritizing, project selection, evaluation, and donor coordination for that country. This situation reminds us of "structural adjustment" reforms universally applied to countries with balance-of-payments difficulties in the 1980s.

Furthermore, the United Nations Group has linked up with the World Bank in fighting poverty. The UN Millennium Summit in 2000 adopted the Millennium Development Goals (MDGs) that called for concrete social achievements by 2015, including halving the ratio of people in extreme poverty. The World Bank's PRSP is going to be used as the instrument to achieve these goals. The Bank economists estimate that this would require $40-$60 billion in additional external assistance per year, implying roughly doubling the current global ODA.[2]

In the current global excitement over MDGs, the EU and US are to bolster their aid spending to levels unthinkable from their past stinginess. The EU has promised to increase ODA to 0.39 percent of GNP (amounting to an additional $7 billion or so per year) while the US has declared to add $5 billion per year during the next three years for the benefit of poor countries with "good practice." There seem to be two reasons for the outburst of goodwill particularly in 2002. The first is the newly found nexus between terrorism and poverty after the September 11 attack, making some countries more generous. The second is a series of international conferences in 2002 that feature development.[3] With so many opportunities for publicity, it is natural that national and international bureaucracies strive for greatest visibility.

The renewed global interest in development is welcome, but we have some worries. We are not worried too much about the fact that even the superb generosity of the EU and US will fall short of the required ODA targets calculated by the World Bank. Nor do we lament exceedingly that Japan, the top donor until 2000, is unable to participate quantitatively in this humanitarian effort due to its fiscal crisis. Our concern is over the strategic soundness of poverty reduction rather than its finances. With all enthusiasm and determination, the global drive to cut poverty may go off track if the sense of balance and continuity is lost. Poverty has always been a tough problem in human society. We are now confronting the toughest part of it, extreme poverty in the poorest countries, which past efforts failed to eliminate. To succeed, cool heads, not just religious fervor or herd instinct, should be in the driver's

[2] For the contents and costing of MDGs, see S. Devarajan, M.J. Miller and E.V. Swanson, "Goals for Development: History, Prospects and Costs," World Bank Discussion Paper no.2819, April 2002; and "The Costs of Attaining the Millennium Development Goals," World Bank pamphlet at Monterrey, Mexico, March 18-22, 2002. However, it is puzzling that all additional funding for growth or poverty reduction is assumed to come from ODA, not from private or domestic sources. If policies are improved (as the authors assume), even poor countries should be able to mobilize these sources. To deny this is to underestimate their potentiality as well as to contradict many of the World Bank's own programs for private sector development and financial sector reform.

[3] These include the World Economic (Davos) Forum in New York (January-February), UN-hosted International Conference on Financing for Development in Monterrey, Mexico (March), OECD Ministerial Summit in Paris (May), G8 Summit in Kananaskis, Canada (June), and the World Summit on Sustainable Development in Johannesburg, South Africa (August-September), in addition to the regular World Bank-IMF annual and development committee meetings.

seat.

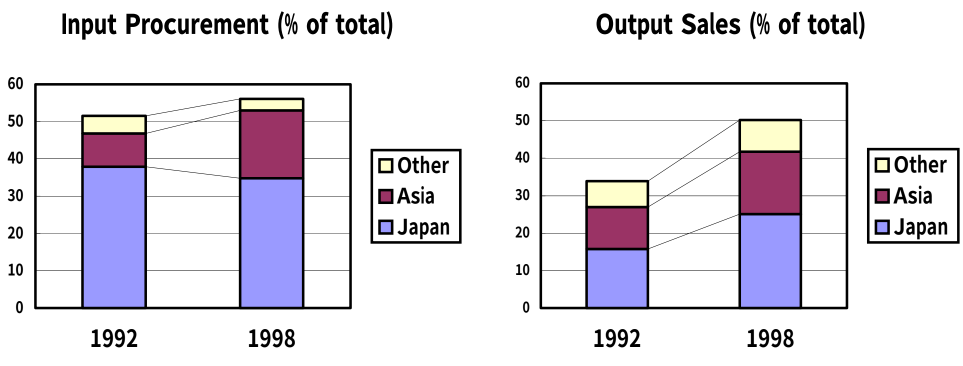
The Japanese government has supported the current poverty reduction initiative, but with caution. First, we do not think jumping from one idea to another every several years is the right way to promote development. Ideas and policies should be more stable and cumulative. Second, strategic convergence is positively harmful. Reflecting the great diversity in the social and economic conditions of poor countries, there should be more than one path to development from which they can choose. Whether or not cutting poverty should be the principal national goal is up to each developing country to decide.

East Asian Development as a Catching up Process

The current approach presupposes developing countries with weak capability. It assumes a world where politics is unstable, growth is low, industrial promotion invariably fails, and foreign debt forgiveness is taken for granted. Such countries cannot hope to relieve mounting social misery by their efforts alone, so external help is requested. Even under the best scenario, it is unrealistic to expect them to surge as "factories of the world" challenging the high-tech industries of advanced countries. Under such circumstances, development must necessarily take a humanitarian turn. The immediate policy goal should properly be to lift as many individuals, families and villages as possible out of the abject and dehumanizing condition of extreme poverty. Though fairly gloomy, this is one legitimate idea of development. Unfortunately, there are many countries that this description largely fits. Among them, failed development in Sub-Saharan Africa is especially striking as a collective, regional phenomenon.

Figure 1. Japanese Firms as Builders of Asian Production Network

International Transactions of Asian Affiliates of Japanese Firms



Note: the remaining procurement and sales are domestic.

Source: Shujiro Urata, "A Shift from Market-led to Institution-led Regional Economic Integration in East Asia," presented at the Conference on Asian Economic Integration, RIETI/UNU, April 2002.

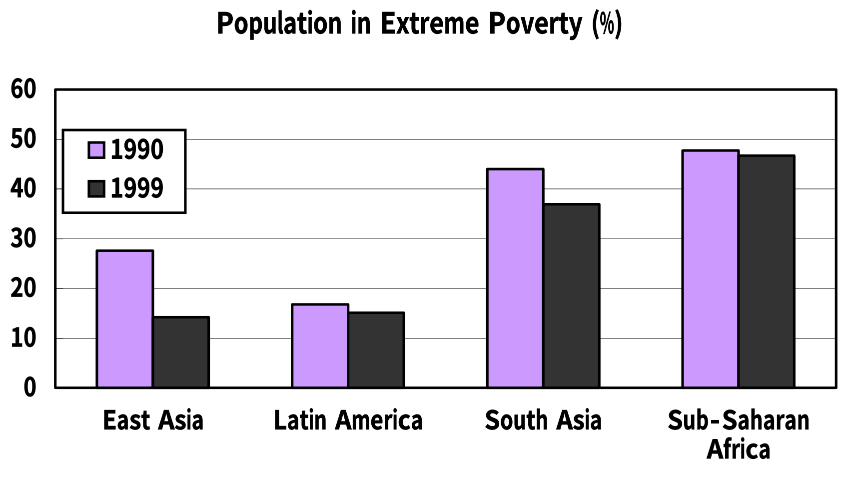
But this is surely not the entire picture. At the other extreme, developing countries in East Asia have emerged from dire poverty and social instability into the state of industrial competitiveness and much higher living standards within a few decades. During the 1950s and early 60s, real income and living conditions in East Asia were similar to—and sometimes below—those of African societies.

East Asia has had its share of crises including hot and cold wars, military coups and threats, economic stagnation and currency attacks. Moreover, there were differences in development stage and growth performance among them. But despite all this, over time and as a region, their socio-economic achievements have been truly outstanding.

Their success was not a matter of sheer luck. East Asian growth was realized by staggered participation in the regional production network through trade and investment. The supply linkage was first formed between Japan and NIEs (Korea, Taiwan, Hong Kong and Singapore), then spread to include ASEAN4 (Malaysia, Thailand, Philippines and Indonesia). Later, China and Vietnam joined. Once captured by this regional dynamism, each country was under constant pressure to master technology, improve human capital and enhance competitiveness for survival. Multinational firms (including Japanese) played a key role as bringers of capital, technology and management as well as agents of economic integration (Figure 1). On the demand side, it is noteworthy that East Asian growth depended heavily on the existence of huge external markets, especially American.

For East Asian countries, development was not poverty reduction but a social process of catching up with the front-runners, driven by national pride and the acute sense of threat and inferiority. Their strategy consisted primarily of generating high economic growth and managing the negative aspects of such growth. In most cases, a strong state, not necessarily democratic by Western standards, orchestrated the entire process. For East Asia, the concept of poverty reduction was too static; instead, more dynamic objectives, such as coping with emerging income gaps and maintaining social equity in the growth process, were preferred. The incident of poverty also fell sharply, but this was the result of their successful development, not the cause (Figure 2). By now, East Asia has already attained the principal target of MDGs, namely,
cutting extreme poverty in half between 1990 and 2015.

Figure 2. East Asia Cuts Poverty Despite Currency Crisis



Source: S. Devarajan, M.J. Miller and E.V. Swanson, "Goals for Development: History, Prospects and Costs," World Bank Working Paper no.2819, April 2002.

Development as poverty reduction and development as a catching up process are two entirely different phenomena, which must be clearly distinguished. East Asian development experience and aspiration can hardly be discussed or interpreted within the framework of poverty reduction, which is too narrow. In addition to the current development approach centered on poverty reduction, we propose an alternative approach consistent with a national desire for industrialization under global integration. It is odd that the lessons of East Asia as a developing region with highest performance have not so far been firmly incorporated in the policies of the international organizations. That will be the first step toward strategic diversity in development. We hope there will be even more approaches in the future reflecting the multiplicity of development experience.

Some may object that the East Asian model is an exception that cannot be easily transferred to other regions. We agree that it presupposes certain conditions which we hope to elucidate on another occasion. It may be more realistic to expect that only a few countries can make a full use of this model at first. But outright denial of transferability is tantamount to discounting the ambition and potentiality of poor countries. We know that many developing countries outside East Asia share an earnest desire to be integrated meaningfully into the world, not as permanent aid receivers but as active players in the global trade game.

Japan's ODA Vision: for Asia and for the World

Japan is in the process of reformulating its economic cooperation policy. This is partly due to ODA budget cuts necessitated by fiscal austerity. But more fundamentally, Japan has reached a point where it can no longer remain a silent partner to the global development trend with which it feels considerable unease. Intense donor coordination and poverty reduction drive in the last few years have made it impossible to ignore what others are doing and pursue its own development agenda. Japan is challenged to cast off passivity and make its position clear, contributing actively to global aid schemes where such support is warranted but speaking out loudly where it thinks improvements are needed. Without such engagement, Japan runs the risk of being marginalized in development cooperation and forced to provide money and personnel for the cause not of its own.[4]

It is not that Japan wants to depreciate the importance of attacking poverty on a global scale. Japan also wishes to contribute positively to environmental protection, education and healthcare, refugee assistance, elimination of epidemics and other common causes of the world. But at the same time, we want to support industrial development and economic integration of developing countries where such goals are entertained and conditions are right. We want to continue to use ODA as one of the tools for such support as we did in the past. We hope that global aid philosophy will not only accommodate but actively embrace this type of ODA.

In Tokyo since last year, a group of economists including myself have advanced a vision of Japanese ODA consistent with the dual aspects of Japan's policy goals noted above. This vision, called the *two-track approach to economic cooperation*, urges the Japanese government to proclaim *contributing to global goals* and *supporting Asian dynamism* as two pillars of development cooperation, and conduct external policies including ODA accordingly (overlapping of the two goals is permissible). We have advocated this in the Study Group on Asian Dynamism of the Ministry of Economy, Trade, and Industry (METI), policy consultation with officials from the Ministry of Foreign Affairs (MOFA) and ODA implementing agencies, as well as through media and conferences. Official reception has been very favorable. Our next step is to present more visually and concretely what the East Asian experience is for external dissemination.[5]

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[4] In the area of financial and exchange rate policies, projection of Japan's own ideas onto the world already began with the New Miyazawa Plan for helping Asian crisis-hit countries (1998) and the Chiang Mai Initiative for regional central bank cooperation (2000). These were triggered by deep dissatisfaction with the IMF's policy response at the time of the Asian crisis. In trade, Japan concluded a free trade agreement (FTA) with Singapore (2001) and proposed FTAs with Korea, Mexico, ASEAN and so on. But similar activism has been slower in coming in the area of ODA policy.

[5] The World Bank's famous *East Asian Miracle* report (1993) did not win full approval of Japanese economists partly because it gave only a hedged nod on what East Asian officials considered as the essence of their development experience, and partly because it failed to analyze the region's production network as an enabling external environment for synergic

The two-track approach to economic cooperation is not really new. It is simply an affirmation of Japan's dual identity, engraved by its history since the mid 19th century, as an Asian nation on the one hand and as a member of the developed West on the other. Our proposal is to turn this dual identity, which plagued the policy makers in the past, into an advantage for active and flexible use in economic diplomacy. It should provide a framework for interpreting, appreciating, and expanding Japan's economic cooperation.

Looking back, Japanese ODA has contributed significantly to building infrastructure, human resource development, technical transfer, growth of small and medium enterprises, crisis response and so on, with East Asia as a main target. Simultaneously, Japan has cooperated constructively with developed countries in Europe and North America to tackle issues of global dimension. Asian dynamism and global concern have long been the two pillars of Japan's external contribution which are unlikely to go away. Affirmation of this situation will enable Japan to do both even better. It also permits Japan to moderate global development trends which sometimes go to extremes. But most important of all, the two-track approach will restore pride and confidence to the Japanese in their conduct of development cooperation.[6]

Industrial Support in the Age of Globalization

To promote industries in East Asia and elsewhere, supporting policies must be the ones suitable for open and market-driven economic environment. The old-style industrial policy of fostering baby industries under the high wall of import protection is no longer available in our age of globalization. Newcomer countries are required to liberalize their trade regimes at much earlier stages of development than Japan and the West in the past, or even Korea and Taiwan in the 1960s and 70s. Policy innovation in industrial promotion is called for.

This hardly means that the government should stand idle. The experience of ASEAN clearly indicates that the key to industrial development in open economies is attracting foreign direct investment (FDI) in both quality and quantity and using its impact to raise domestic capability over time. To accumulate FDI, economic opening is not enough. To offer superior locational advantages and low costs of doing business, additional targeted measures to improve domestic skills, infrastructure and institutions are needed. Efficient government services and good management of industrial and export processing zones also help. Primary education is important, but that alone will not upgrade domestic industries unless engineers and managers are also supplied. Traditional factors such as domestic market size, natural resources and low wages have become relatively less important.

At regional and global levels, policies are also required to supply international public goods, correct externalities and market failures, cope with international income gaps, coordinate macroeconomic and other policies, integrate economies and harmonize procedures, prevent and manage crises, and so on. We believe that the case for collective official action in the international arena is strong, especially when countries with different stages of development are involved.

Surely, these are not top-down, heavy-handed state intervention but much lighter, market-enhancing policies. Nevertheless, they must be executed well in order to take full advantage of foreign impact and build domestic capability. Laissez-faire policy will not do. In this area, too, ODA and other forms of economic cooperation can go a long way to supplement domestic efforts.

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growth; the report evaluated the policies of each country separately.

[6] For more on this approach, see I. Ohno and K. Ohno, "Global Development Strategy and Japan's ODA Policy," GRIPS Development Forum Discussion Paper no.1, March 2002; and K. Ohno, "Reconfiguring Japan's ODA," *Japan Echo*, February 2002 [re-titled and included unabridged as Chapter 2 of this volume].

Vietnam: Does PRSP Work in East Asia?

Vietnam is a country with typical East Asian aspiration. It is located in the heart of dynamic Asia, but its economy has lagged seriously behind its neighbors due to the long period of wars and economic planning. The Vietnamese government is keenly aware of this situation, and hopes to catch up with the ASEAN forerunners as soon as possible. Domestic economic liberalization called *doi moi* began in 1986. From around 1993, Vietnam ended self-imposed isolation and normalized relations with international organizations and Western countries, including the US. It also joined ASEAN in 1995 and APEC in 1998.

A decade of international integration has transformed the Vietnamese society enormously. The economy has grown at an average rate of 7 to 8 percent, despite a mild slowdown in the recent years. Growth is driven mainly by external stimuli including FDI, ODA, tourism, and remittances from overseas Vietnamese and migrant workers. The export base has already shifted significantly from primary commodities (crude oil, rice, fish, coffee) to manufactured products (garments, footwear, electronic components). However, a decade is not enough to escape from backwardness. Vietnam's market economy remains seriously underdeveloped and technology and competitiveness are very low. The per capita GDP in 2000 was still as low as $390 (World Bank data). Vietnam's national goal is *industrialization and modernization* by 2020 and the key official documents for this are the Ten-Year Strategy and the Five-Year Plan. In sum, Vietnam is trying to participate in the East Asian production network as a latecomer—as its neighbors have done in the past.[7]

Since 1999, the World Bank and other donors (led by UNDP, UK, and Nordic countries) have introduced an aid coordination scheme for poverty reduction in Vietnam. Vietnam became a pilot CDF country and produced an interim PRSP (2000) and a full PRSP (2002). It is of great interest to know how PRSP, intended for a country with weak initiative, is received by the Vietnamese policy makers with strong pride and beliefs. Other countries in the region which must draft their own PRSPs (Indonesia, Laos, Cambodia, etc.) as well as some African countries are carefully watching the evolution of Vietnam's PRSP.

On the surface, Vietnam's PRSP is considered a great success by the World Bank and the international community at large. The main reason for this is Vietnam's strong *ownership* of the PRSP process, with a national team drafting the main report and adjusting its contents (it is hardly like that in most poor countries). The process has been even renamed to the Comprehensive Poverty Reduction and Growth Strategy (CPRGS), adding the term *growth* which the Vietnamese side insisted. At first, the authorities and the World Bank were at odds over the prioritization of growth versus direct poverty measures, but both sides exercised restraint so the process proceeded "successfully." All agree that growth and poverty reduction are closely related, but the precise relationship between them is left unclear.

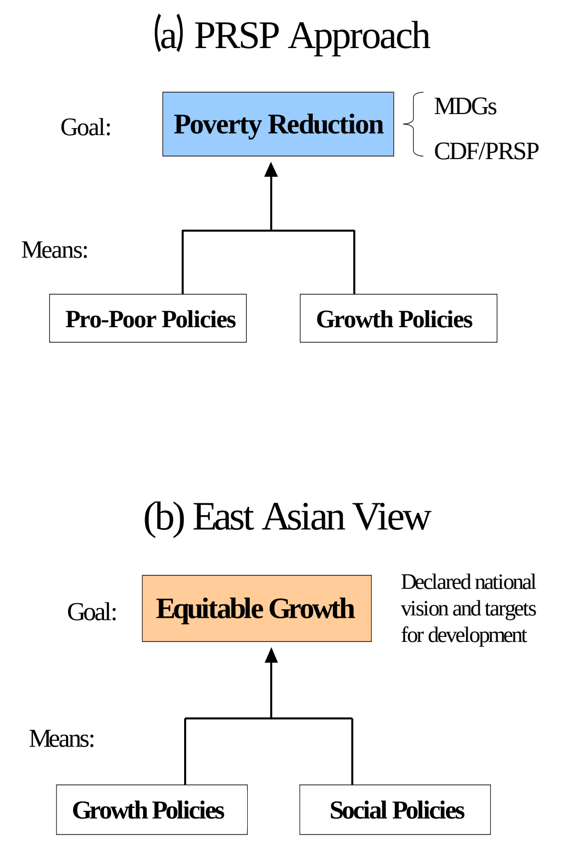
Some aid donors want to influence Vietnam's policies through CPRGS, but whether that will be acceptable to Vietnam is moot. Besides Japan, there are other donors in Vietnam who remain skeptical. My seven years of research experience in Vietnam also tells me it is highly unlikely. Compared with the Ten-Year Strategy and the Five-Year Plan, public recognition of CPRGS is very low. If CPRGS goes beyond simply copying and supplementing the existing official documents and begins to tilt the budget and public investment towards pro-poor policies, it will surely meet stiff resistance. For Vietnam, equitable growth is the declared goal which must be realized by a combination of growth and social policies (Figure 3). Poverty reduction as an exclusive national goal is an alien concept to the Vietnamese who fought long wars for independence and freedom. CPRGS

[7] The Japan International Cooperation Agency is conducting a joint research project with Hanoi's National Economic University on Vietnam's industrialization strategy under globalization. This is a typical Japanese-style intellectual ODA featuring real-sector concern and respecting the individuality of each country and sector. See http://www.neujica.org.vn/ for details.

can survive only as long as neither side rocks the boat by raising this issue.

Vietnam's experience already clearly shows the impossibility of fitting East Asian aspiration into the PRSP framework. The deep conceptual gap may be papered over, but no real gain can be had by such a bureaucratic act. In a country with such strong ownership, we must ask fundamentally: why do we need a PRSP at all?

Figure 3. Different Views on Growth and Poverty



Not Just in East Asia

I have argued—and the Japanese government is beginning to argue—for respecting the multiplicity of development experience. There should be diverse paths to prosperity, from which each developing country can select the right mix with ownership. At present, country ownership is limited to active participation in the common poverty reduction framework laid out by the donors, which is not enough. Furthermore, even goals of development should be many, since it is for each country to decide whether or not individual welfare and self-esteem should be always held above national pride and dynamism. For efficiency, aid procedures can be harmonized. But strategic convergence should be rejected in a world of great diversity. Difficulty emerges when procedure and strategy are not easily separable.

ODA for poverty reduction is charity in its essence, a benevolent transfer of income and knowledge from rich to poor. By contrast, ODA for active participation in global trade is aimed at releasing a young country's potential to become an equal partner or even competitor in the future. This may be too difficult for some of the poor countries to undertake today. But the door should always be open. We have no right to tell them that fighting poverty should be their only dream.

This is true for Sub-Saharan Africa as well. In fact, there are countries in Africa, Central Asia, Middle East, Latin America and elsewhere with high aspiration for excellence as in East Asia. They may not be in the majority yet, but policies should not be designed only for the majority. To help them, conditionality, policy matrices and other bureaucratic micromanagement are often counter-productive. Excellence is contagious. Good performance by a country galvanizes its neighbors. Let them copy good practice, but make sure to fully respect their autonomy and pride. From the sideline, donors can support them with proper encouragement, knowledge transfer and financial assistance. At its best, Japanese ODA in East Asia has had this character. Despite failures and disappointments, we have never lost faith in development assistance based on the principle of self-help. Outside East Asia, however, Japanese effort in this direction has so far been modest. It is time that the demonstration effect of excellence should be extended globally.

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Chapter 4

The East Asian Experience of Economic Development and Cooperation*

Economic development in East Asia has followed a remarkable pattern, unlike any other developing regions in the world. In this paper, we would like to share this experience with the reader, discuss remaining issues, and contribute to the global development strategy debate.

Performance of East Asia

During the last half century, the economic performance of the developing world has been far from uniform. Developing countries were polarized into those that made great progress in catching up and those that were mired in stagnation. The majority of the East Asian countries belong to the first group[1].

The following phenomena have been commonly observed in East Asia. Some of these features are unique to this region.

- Diversity in ecosystem, population, ethnicity, religion, social structure, and political regime.
- Equally great diversity in GDP, per capita income, and economic development.
- High growth sustained over a long period almost throughout the region.
- Associated with this high growth are high savings and investment rates, active but managed external opening, export orientation, industrialization, and general improvements in social indicators.

However, the path trodden by East Asia has not always been smooth. Some countries failed to achieve high growth, and the region was hit by occasional setbacks. East Asia has had its share of hardships in its history, with hot and cold wars, social instabilities and economic crises.

Currently, East Asia faces not only the old problems of poverty and political strife but also the new challenges posed by economic growth such as emerging income gaps, environmental degradation, urbanization and congestion, and various social evils. Furthermore, the countries in the region are under pressure to enhance domestic capabilities in order to avoid crises associated with globalization and to sustain growth into the next stages of development.

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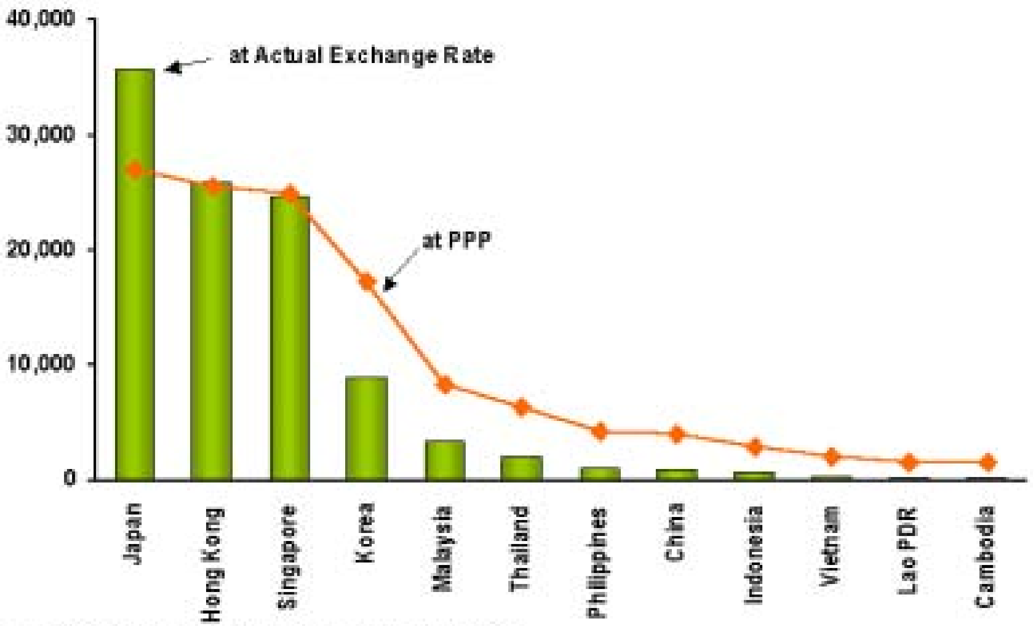
* Prepared as a background paper for the RIETI/METI seminar on September 1, 2002, on the occasion of the World Summit on Sustainable Development in Johannesburg. This paper was drafted after intensive consultations with Japanese experts, officials and researchers in Tokyo and Washington, DC. The author would like to thank them for valuable suggestions and comments. However, all responsibility for the contents remains with the author alone.

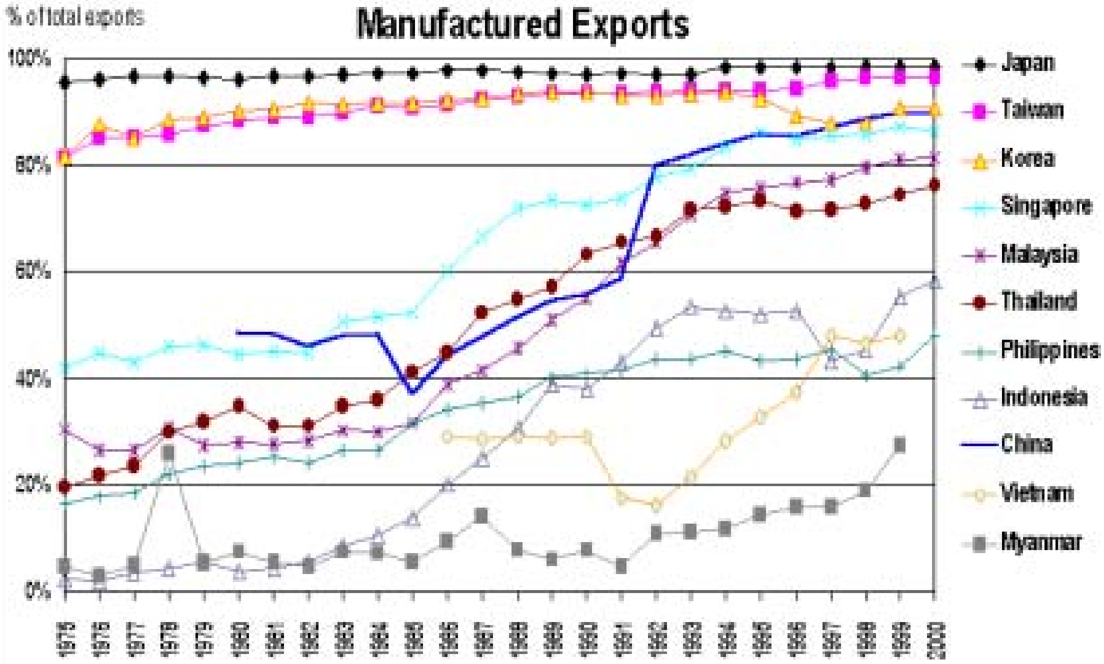
[1] We define East Asia functionally, as those economies that are already taking part in *Asian dynamism*, or the regional production network linked by trade and investment, as discussed below. This includes Japan, China (including Hong Kong), Taiwan, Korea (ROK), Singapore, Malaysia, Thailand, Philippines, Indonesia, and Vietnam. Some countries such as Laos, Cambodia, and Myanmar are preparing to join this regional network.

Figure 1
Per Capita Income (2000)



Source: World Bank, *World Development Indicators 2002*.

Figure 2
Manufactured Exports



Source: ADB, *Key Indicators of Developing Asian and Pacific Countries*, 2001/1993; IMF, *International Financial Statistics Yearbook 1990*. For Japan, *Japan Statistical Yearbook 2002/1999*, Statistics Bureau/Statistical Research and Training Institute, Ministry of Public Management, Home Affairs, Posts and Telecommunications, Japan.

Growth Driven by Trade and Investment

For each country in East Asia, the long-term growth path and the achievement of industrialization can be tracked by income trends and structural shifts in GDP and exports. However, the unique feature of East Asian growth is that it has been attained through the very existence of East Asia as a powerful arena of economic interaction among its members, and not merely by "market-friendly" policies or good governance of individual countries alone[2].

One by one, countries in different development stages realized economic growth by participating in the dynamic production network created by private firms. Linked by trade and investment, a system of international division of labor with clear order and structure exists in the region. Under this system, industrialization has proceeded through geographic widening on the one hand and structural deepening within each country on the other. Terms like the *flying geese pattern*, *structural transformation chain*, and *Asian dynamism* refer to these supply-side developments[3]. To understand this mechanism, we must go beyond individual countries to analyze the production structure, intra-regional trade, and investment flows of East Asia as a whole.

For developing countries in East Asia, economic development was tantamount to becoming one crucial link in this production network under competitive pressure from and cooperative relations with neighboring countries and, through it, upgrading their industrial capabilities from low-tech to high-tech. To initiate development, they had no choice but to undertake international integration via trade and investment. However, the integration strategies of latecomers like the ASEAN4 and latest comers like Vietnam are different from those of the early developers such as Japan, Taiwan and Korea.

East Asia as a region has offered a political, economic and social model and an enabling environment for the catching up of latecomer countries. Every country was under strong market pressure from above and below to constantly improve capabilities and climb the ladders of development. What drove them were national desire for material well-being and the demonstration of excellence from neighboring countries, not conditionalities or policy matrices introduced by international organizations. No other developing region has formed such an organic and dynamic interdependence as East Asia.

For the Japanese economy, East Asia is the most important developing region. For East Asia, too, Japan is a particularly important country as the largest donor and the principal partner in trade and investment. Moreover, Japanese corporations are the chief architects of the East Asian production network. Asian dynamism has also been supported by the trade and investment relationship with the EU and the US, as well as the extensive business network of Taiwan, Hong Kong, and the overseas Chinese.

As the dominant ODA provider in East Asia, Japan has mobilized its extensive tools for economic cooperation mainly to spur and complement the market-based economic linkage. The majority of Japan's ODA projects placed high priority on assisting the self-help efforts of the East Asian developing countries to attain a suitable status in the region's production network and, through it, catch up with the forerunners and overcome social problems. Japan's ODA in infrastructure, human resource development, technical assistance and intellectual support for policy formulation and institution building has greatly contributed to reinforcing Asian dynamism by removing obstacles and

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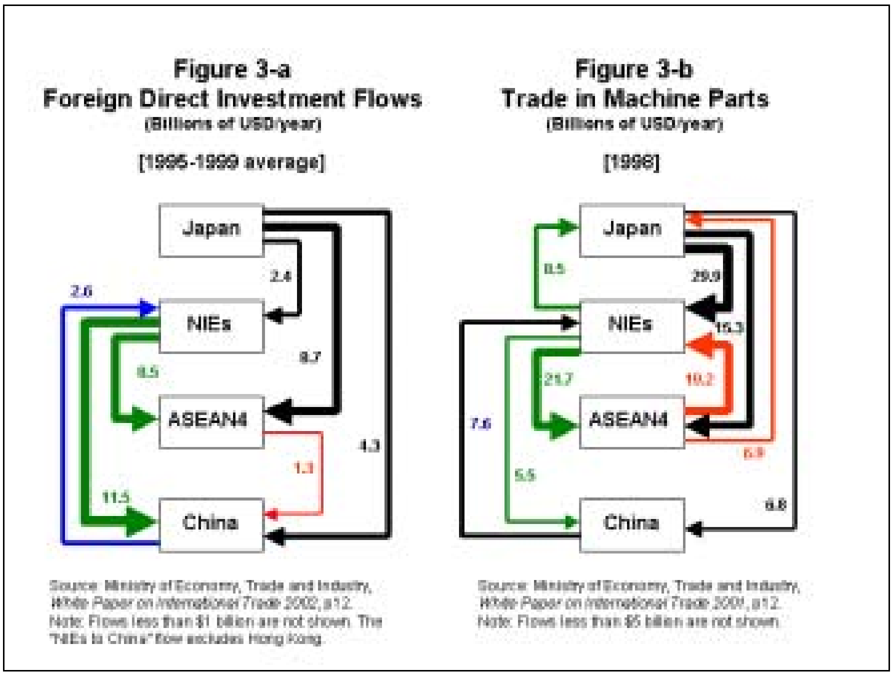
[2] The World Bank's *Miracle* report cited macroeconomic stability, human resource development, export orientation, and benign government-business relationship as the causes of high performance in East Asia [World Bank 1993]. Later, in the aftermath of the Asian financial crisis, the Bank warned that growth would not return to East Asia unless institutions and policies are improved in each country [World Bank 2000]. However, evaluation of policies of individual countries is not enough to understand the sources of dynamism in this region. The future of East Asia critically depends on the sustained vitality of the region as well.

[3] These terms carry different nuances. There is a debate as to whether the flying geese formation is still in shape despite the recent emergence of China, but we are not concerned with this issue. In order to avoid such largely semantic questions, we prefer a more flexible term, *Asian dynamism*, to describe the dynamic production network in East Asia.



generating new trade and investment flows. In fact, Japanese ODA projects have often been formulated in response to the needs of the private sector in Japan or the East Asian developing countries. The resulting economic prosperity and social stability in East Asia have in turn brought significant benefits to Japan.

The Roles of Government

To actively respond to the challenges from the regional and global networks as described above, the developing countries in East Asia must undergo a great transformation. While the main players of economic development are undoubtedly private firms, simply deregulating and opening up the private sector does not generate sufficient impetus for growth if the country is saddled with underdeveloped markets, lack of human resources and technology, and low productivity. In order to kick start an economy trapped in the vicious circle of low income, low savings, and low technology, the role of government is crucial as an external agent imparting order and direction to the national economy.

The role of government envisaged by the World Bank has shifted dramatically, from the unwarranted optimism in the early postwar period to the advocacy of small government in the 1980s, the call for institution building in the 1990s, and the more balanced view at present. But we must remember that the discipline and activism of the East Asian governments were stipulated by their development stages and the region's needs. If the government fails to take certain required actions, the country will remain stagnant as it cannot join the regional production network. In the reality of East Asia, it is all too clear that isolation leads to economic backwardness and that inability to cope with the problems generated by growth destabilizes the society. The unproductiveness of laissez-faire, as well as rigid control, is proven not theoretically but by the actual examples of neighboring countries.

Good governance must also be redefined in the East Asian context. The usual components of good governance, such as macroeconomic stability, structural reform, administrative efficiency and transparency, social participation and the like, do not necessarily coincide with the conditions needed for growth driven by trade and investment. Among these, macroeconomic stability is certainly a must.

But for the other components, East Asia has achieved high growth without them. It is probable that different and more sharply defined components of good governance are required to initiate growth under international integration.

The most basic task of the East Asian governments is to establish a stable political regime and social unity which are the preconditions of economic development. For this purpose, most countries in East Asia have chosen *authoritarian developmentalism* [Watanabe 1995], or authoritarianism with capability[4]. This regime, which is quite different from simple dictatorship, features (i) economic nationalism in pursuit of material prosperity; (ii) obsession with external competitiveness under industrialization and export orientation; and (iii) top-down decision making under a powerful and economically literate leader and a supporting elite group. Such a regime often emerged after a military coup and under a severe threat to national security from within or without. Its management is not necessarily "democratic" by Western standards. Evaluation of this regime varies. However, it is clear that the adoption of this regime was motivated by the external and temporary need to initiate growth in the regional environment. Since its value is historically conditioned, the very success of economic development will in time deprive its legitimacy, forcing its exit and an introduction of a more democratic regime. Such transition has already occurred in the forerunner societies, including Korea and Taiwan.

Once social stability and policy consistency are attained as basic conditions, the East Asian governments have three important roles to play.

First, *the government must create a market economy.* In the poorest or transition countries, domestic markets are extremely primitive. In terms of productivity, organization and human resources, such countries have not reached a stage where mere deregulation can unleash the latent market power to sound development [Ishikawa 1990]. Each country must constantly and flexibly mix market and government according to its development stage. Naturally, this mixing must be done by the government. To create a market economy, rules and frameworks such as laws, deregulation, privatization and free trade are important but not enough. The government must also pay attention to and take action on the real sector concerns, such as trade, investment, technology and industrial structure. Competitiveness must be given pragmatic support and concrete contents.

Second, *the government must actively promote international integration while managing its risks*. In East Asia, as noted above, economic development and external integration are two sides of the same coin and must proceed in tandem. Of these, integration is the primary action since it initiates growth by internalizing Asian dynamism. The timing, sequencing and scope of opening up is extremely important. Developing countries must design an integration timetable which gives sufficient incentive for enterprise efforts while avoiding economic crisis and social instability. Here again, a delicate balance between liberalization and protection is required, which cannot be guided by the general theory alone.

Third, *the government must mitigate the negative aspects of growth*. In addition to the long-standing problems of poverty and income gaps, economic growth creates a set of new problems. Foremost among them are emerging income gaps among individuals, ethnic groups and regions. Environmental pollution, issues associated with urbanization such as rural-urban migration, traffic congestion and housing shortages, and social evils such as crime, corruption, drugs and prostitution, tend to arise. Economic growth is sustainable only when the opportunities and fruits of growth are perceived to be shared equitably by the standards of that society. When that is secured, the virtuous circle of economic growth and social stability can begin.

We cannot say that the governments of the high-performing East Asian countries fulfilled these three roles perfectly. But at least they did not make a fatal error in any of these areas that could

[4] The exceptions include Hong Kong which remained a free economy and the Philippines under President Ferdinand Marcos which was a different type of authoritarianism without developmentalism.

put them off the track of economic development.

Many factors have been cited to explain East Asian growth, including the high levels of education and motivation, good government-business relationship, export promotion, income equality, and so on. But these should be regarded as the concrete achievements by individual governments for the purpose of executing these roles well, not the causes of success. It is important to understand the totality of historical and regional environment of East Asia and the basic problems of development that it poses. Evaluation of individual policies in isolation or an attempt to directly transplant them on different soils is not very useful.

The Roles of Regional Cooperation

The maintenance of Asian dynamism requires regional cooperation in addition to policy efforts by individual countries. Free markets do not always guarantee the healthy development of private trade, investment and production. Problems and crises which are beyond private solutions will occur. Regional cooperation to avoid or remove difficulties, support industries from the sidelines, and present visions to reduce uncertainties have greatly contributed to East Asian development, and will certainly continue to do so in the future. This can be construed as the supplying of broadly defined international public goods.

Up to now, economic cooperation in East Asia has emphasized human resource development, building infrastructure, promoting small and medium enterprises and "supporting industries," creating various institutions for industrialization, coping with negative aspects of growth, and intellectual aid on policy formulation. These overlap with the priority areas of assistance by Japan, the top donor in East Asia. Regional cooperation in East Asia has been characterized by *open regionalism* in the sense that it did not discriminate against countries outside the region. Cooperation has been promoted through voluntary action and peer pressure, not by forced conditionalities or uniform deadlines.

Economic integration in East Asia has been market-driven, with private activities as primary and public policies as supplementary. This is very different from institution-driven integration such as the EU, NAFTA and MERCOSUR. In this sense, East Asia has already achieved the private linkages that other integration schemes aim to create. Recently, however, new efforts in institution-driven integration are being initiated to further accelerate or complement the market-driven integration in East Asia. The Japanese government also shifted its external policies from nondiscriminatory multilateralism to institution-driven regionalism a few years ago [METI 2001, Urata 2002].

At present, the most important framework in East Asia is *ASEAN plus Three* (ASEAN+3)[5]. Other regional schemes, such as the ASEAN Free Trade Area (AFTA), the Chiang Mai Initiative for central bank cooperation, the ASEAN Regional Forum (ARF), the Asia-Europe Meeting (ASEM) are related to ASEAN+3. Additionally, bilateral free trade agreements (FTAs) between Japan-Singapore, Japan-Korea, and so on are being concluded or negotiated. Regional FTAs are also proposed between Japan-ASEAN and China-ASEAN.

In the future, the following topics are expected to be crucial for regional cooperation (many of them are continued problems from the past):

- Regional peace and security as the precondition of prosperity
- Narrowing the gap in income and development stages between the earlycomers and the latecomers
- Promotion of globalization together with the reduction of its negative influences (economic

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5 The members of the Association of South-East Asian Nations (ASEAN) include Singapore, Malaysia, Thailand, Philippines, Indonesia, Brunei, Vietnam, Cambodia, Laos, and Myanmar. ASEAN+3 consists of these countries plus Japan, China, and Korea.

crises, emerging income gaps, and so on)

- Human resource development, institution building, and improving governance in order to sustain growth

East Asian regionalism can also serve as a vehicle for transmitting the East Asian vision to the rest of the world. Although East Asia is extremely diverse, something close to consensus occasionally emerges which is different from the views of the Western countries or international organizations. For instance, many East Asian countries are uncomfortable with the idea of unrestrained markets, the IMF's response to the Asian financial crisis, and the World Bank's development framework where poverty reduction is the only goal. Institutionalized East Asia can be the framework for translating such uneasiness into constructive proposals, to be projected to the rest of the world and influence the policies of the international organizations.

In the age of globalization which began to accelerate in the 1990s, the policy tools for Asian dynamism must be amended to reflect the new reality. Several decades ago when Japan—and later, Taiwan and Korea—were rapidly industrializing, *infant industry protection* was adopted, in which local enterprises were strengthened under temporary protection. However, this policy is no longer feasible because (i) early trade liberalization is required for all countries; and (ii) local firms in the remaining developing countries lack capability. But full and immediate liberalization and external opening will not lead to the catching up of these latecomers. We need to come up with practical policy advice as to how industrialization of these countries should be supported by public policies as well as regional cooperation in the age of globalization. East Asia is an ideal place to initiate this intellectual quest.

Economic Development and Poverty Reduction

Since 1999, the World Bank has promoted cutting poverty as the ultimate goal of development and required all poor countries to draft a *poverty reduction strategy paper* (PRSP) as its principal tool. The United Nations Millennium Summit in September 2000 adopted the *Millennium Development Goals* (MDGs), a set of numerical social goals to be achieved by 2015. At present, poverty reduction dominates the global development debate.

In East Asia, no country has adopted poverty reduction as the only goal in national economic development. A more balanced approach is favored, where economic growth is pursued strongly while serious concern for social equity is also emphasized. It may be argued that this approach, rather than concentrating on the narrowly defined poverty reduction, produced more remarkable results in social development over the long run (though we do not deny that problems did arise in environment, congestion, income gaps and so on, and many East Asian governments were slow to act on them). It is generally agreed that there is no ultimate solution to social problems (including poverty) without sustained economic growth. This fact is also well understood in East Asia.

The United Nations' MDGs and the World Bank's PRSP, if applied uniformly, will be inconsistent with the development strategies in East Asia. Strain is already visible in the PRSP of Vietnam, the first country to embrace this approach in East Asia[6]. For those developing countries in East Asia which possess clear national development visions and are striving to implement concrete

[6] For details, see GRIPS Development Forum's *information module*, "Diversifying PRSP: The Vietnamese Model for Growth-Oriented Poverty Reduction." In the drafting process of Vietnam's PRSP, a friction arose between the Vietnamese government who considered this document subordinate to the existing national development plans and some donors who tried to elevate the PRSP to the central instrument for budgeting and policy making. In the completed PRSP, this issue was left ambiguous. The World Bank highly evaluated the strong ownership of the Vietnamese government and lauded this PRSP as "best practice."

policies to realize them, economic cooperation should be provided to supplement and strengthen the nationally owned policy framework, rather than bringing in an entirely new program.

More generally, application of PRSP must be flexible enough to reflect the different conditions of each poor country. For some countries, including Vietnam, we can even ask whether PRSP is needed at all. The criteria for localizing PRSP should include (i) the degree of dependency on aid and debt reduction, (ii) the existence and quality of a national development plan (including whether it effectively guides the budget and public investment); and (iii) causes of poverty. According to these criteria, PRSP should be diversified flexibly and pragmatically.

Implications for Countries outside East Asia

Most people interested in East Asia are tempted to ask the question: are these lessons transferable to other regions, including Sub Saharan Africa? The answer to this question must take a somewhat complex form, instead of a simple Yes-or-No. Since situations in each country and region are different, it is easy to understand that direct replication of the East Asian model is unlikely to succeed. In our opinion, the East Asian development experience and the Japanese experience of economic cooperation in the region can offer the following suggestions for countries outside East Asia.

In the current development strategy featuring MDGs and PRSP, the close relationship between economic growth and poverty reduction is widely recognized *as a general principle*. At the operational level, however, budgeting and aid modality discussions over pro-poor policies are quite active, while the formulation and implementation of growth strategies which are concrete, feasible and specific to individual poor countries have hardly begun. This imbalance should be corrected by strengthening the support for concretizing the growth strategy for each poor country.

To realize growth through trade and investment, the criteria for *good governance* must be redefined, as noted earlier. Similarly for donor countries, the *selectivity* criteria for allocating aid resources across different developing countries need to be revised as we shift the purpose of economic cooperation from improving health, education and environment to initiating growth under international integration. For growth, political stability and social integration are absolutely necessary. Beyond that, we need a strongly committed and economically literate leadership, a technocrat group to support it, an administrative mechanism to execute economic policies consistently, and popular support for growth-oriented development strategy.

At the level of individual policies, experiences are not transferable from East Asia to Sub Saharan Africa, since these regions differ in degrees of social stability, human resources and knowledge, and regional economic dynamism. However, the *methodology* of industrial research and policy formulation should be transferable[7]. Japanese economic cooperation is characterized by the totality of vision, long-term orientation, and real sector concerns. Respecting the uniqueness of each developing country, Japanese experts are interested in supporting the real sector efforts, including industrialization, trade promotion, and improving skills and technology, by combining different aid tools and from a total and long-term perspective. They want to work with the developing countries as lasting partners in good times as well as bad. This approach can complement short-term contract orientation, frequent performance reviews, and globally common frameworks favored by the international organizations. It can supply patience and the respect for individuality which are desperately lacking in the current global development strategy. The ultimate goal of Japanese

[7] The Japan International Cooperation Agency implemented a large-scale and comprehensive policy support program to Vietnam from 1995 to 2001. This program analyzed and advised on macroeconomic balance, fiscal and monetary policies, agriculture and rural development, trade and industrial policy, state-owned enterprise reform, promotion of small and medium enterprises, and response to the Asian crisis. Similar programs have been implemented in Mongolia, Laos, and Myanmar.

economic cooperation is to help discover—and implement—the most suitable growth strategy for that particular developing country, irrespective of whether it has an East Asian origin or not. This idea can be applied to Sub Saharan Africa or any other region. We believe that one-time help and partial advice are of little use.

However, much preparation will be required if Japan decides to commit itself to such long-term assistance in Sub Saharan Africa, where it has had little intellectual engagement in the past. Domestic consensus for channeling aid to regions other than East Asia must also be formed. This is a challenging learning process for Japan. If such aid is to be extended to other regions, Japan should first select a very small number of target countries with highest potential for growth by the revised criteria for selectivity as discussed above. Strong national ownership of the growth policy is a particularly important condition for selection. Aid resources should be concentrated on these few countries rather than diffused widely and thinly. A permanent policy research team should be established in each selected country to engage in (i) constant policy dialogue with the authorities; (ii) partnership with international organizations, other donors and NGOs; and (iii) policy inputs to Tokyo. Only after such a system is installed, Japan can start to offer development assistance to other regions that is truly characteristic of Japan, as described above.

Since other developing regions lack a regional production network as found in East Asia, growth policies in the context of such regional dynamism must be adjusted accordingly. We firmly believe that a single developing country without regional advantages can also activate growth through trade and investment. For example, strategies for primary commodity processing or light industries can be designed and supported comprehensively, including marketing, distribution, organization, training, technology, and finance. Concrete entry points will differ from country to country, and thus cannot be generally stated. Such assistance must be provided not only bilaterally by Japan, but through multilateral channels in cooperation with international organizations and other donors.

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Chapter 5

The Industrialization and Global Integration of Meiji Japan*

Prologue

For the past several years, I have taught the economic history of Japan, in English, to foreign students comprising mostly of junior civil servants from developing and transition countries in a newly-established graduate school in Japan. The students' greatest interest naturally lies in understanding how Japan was able to catch up to the West from so early on, and what the policy and systemic sources for this feat were. Strictly speaking, this topic is outside my specialty. However, as I wanted to re-examine Japan's modernization process from the perspective of economic development and systemic transition, I happily took on the lectures. Owing to this, I had to dedicate rather a long time to preparing my notes and handouts for the course in the first year[1]. The experience, however, proved to be intellectually challenging and perhaps I learned more than my students. What for Japanese are merely historical facts seem fresh and surprising to students from transition economies like China, Mongolia, or those in Central Asia. Comparison of Japan's modernization process with that of other countries over space and time, contrasts common aspects with those that are peculiar to Japan.

In the very first lecture of every year, I say the following to my students:

> "All of you have come here to learn lessons from Japan's experience that you can apply once you return to your countries. This can be achieved on several different levels. First of all, you can learn facts about what Japan did in the past. Whether this be its support of industry or the financial policies it implemented, absorbing these facts is easy. And no doubt, my lectures will provide numerous examples of this kind. Second, in carefully comparing conditions in Japan at the time of its modernization to those that your countries now experience, you should be able to judge what lessons are transferable to your home-country setting. This exercise is an important one, but not sufficient. Lastly, from studying the development experiences of a broad selection of countries, including Japan, you will acquire the general skill of knowing what kind of questions to ask in response to the problems your countries are grappling with, and how best to answer them. This is the most difficult yet most essential ability for you to

*This is a full translation of Chapter Three of the book, *Tojokoku no Globalization: Jiritsuteki Hatten wa Kanoka* (Globalization of Developing Countries: Is Autonomous Development Possible?), Toyo Keizai Shimposha, 2000. Explanations have been occasionally added for the benefit of non-Japanese readers. The book won the Suntory Prize for Social Sciences and Humanities and the Osaragi Jiro Award for Critical Works in 2001.

[1] In preparing my lectures, *Nihon Keizaishi* (The Economic History of Japan, 8 volumes, Iwanami Shoten, 1988-89), a collection of academic papers that cover events from the Edo Period to the recent past, was particularly helpful. Also, Tetsuji Okazaki's *Kogyoka no Kiseki* (The Path of Industrialization, Yomiuri Shimbunsha, 1997) which argues from the perspective of comparative institutional analysis is very interesting. I believe that if more of this type of literature were translated into other languages, it would contribute greatly to a better academic understanding of Japan.

> develop here. Merely implementing the policies formerly adopted by Japan in your homelands will not achieve much."

Once I was lecturing about the absorption of industrial technology by Japan during the Meiji Period (1868-1912) when a student asked me, "From which countries did Japan receive foreign direct investment and how much did it receive?" This is a natural question to ask in today's world where industrialization and attracting direct investment mean much the same thing to latecomer countries and each country vies aggressively to lure foreign companies. I paused for a little while and replied:

> "Japan at the time did not receive any direct investment in the sense that you all are familiar with. Factory construction in the early Meiji Period was mainly achieved through public works or financed from domestic savings, private capital or joint stock companies. Japan adopted technology from abroad enthusiastically, but funding for the most part was self-generated. The absence of direct investment from abroad is not only characteristic of this period; it is in fact a salient feature of Japan's whole industrialization process – with the exception of certain sectors such as the auto or electrical machinery industries during specific periods."

My students, although looking somewhat puzzled, seemed to accept my explanation.

Most of these students, having completed their Masters, will return to posts in their respective governments. Depending on the country, they will either return to the same junior positions as before, leaving them unable to make use of their training abroad, or conversely, they will immediately be singled out to work in positions of responsibility. In the latter case, I sometimes wonder if it is indeed appropriate to entrust such important policy making to some of the graduates who did not show much distinction in my classes. Whichever the case may be, I strongly believe that the serious time I spent with these young men and women in the classroom will have some positive effect on the development of their societies, however indirectly or even with much delay.

1. The Salient Features of Japan as a Developing Economy

Lessons from the Meiji Period

For a long time after the Edo government opened its ports (1854), Japan remained a developing country. This fact is deeply imprinted in the consciousness of our close forebears who lived during the Meiji (1868-1912), Taisho (1912-26) and Showa (1926-89) Periods. At the beginning, Japan's productivity, technology and industrial infrastructure were clearly inferior to that of the West. However, while receiving strong impetus and pressure from abroad, Japan made earnest efforts to mobilize its civil service and people to catch up. This process not only raised income, but also proved to be a dynamic force of change that produced countrywide and continuous social transformation. Japan became the first non-Western country to succeed at industrializing and was the first to rank equal with Western Powers. Historically, this kind of catch-up effort is not guaranteed to bear fruit; more countries have failed at economic development than succeeded. Even today, few non-Western countries can compete with Europe and North America equally in the global market. In this sense, Japan's great achievement over the past century and a half is worth wondering at afresh.

When policy makers from developing and transition economies refer to learning from Japan's experience, topics like the priority production system, industrial policy, small and medium enterprise (SME) development, policy loans and the public-private partnership of the postwar and high-growth periods are popular subjects for study. Indeed, these are important policy issues and this was an important time. However, to understand the circumstances in which latecomer countries are currently placed, the political and economic history upstream of the postwar period, especially that of the Edo (1603-1868) and the Meiji Periods, furnishes more useful information. This is not because Japan then and latecomer economies now bear some resemblance. On the contrary, the Japan that experienced the tremendous external shock of opening up was very different from the latecomer economies of today. The domestic and external conditions of Meiji Japan, when viewed from today's standards, are distinctive in the extreme. Appreciating this fact helps to explain Japan's precocious catch up — a full century earlier than other countries — and at the same time provides a key to understanding why many countries, despite financial and technical assistance, still cannot free themselves from the poverty trap.

Strong Institutional Capacity from Early On

In comparing Meiji Japan to latecomer economies of today, two major differences are discernible. One of these relates to Japan itself, while the other is concerned with the country's external relations. Both of these differences are substantial and form the basic reason why latecomer economies of today cannot pursue the same path to development as Japan did in the past.

Let us first turn to the country itself. In comparing Meiji Japan to modern latecomer countries, we find that its domestic institutional capacity to respond to external shock was clearly superior. On reading the history of the period, what immediately strikes everyone is that not only the urban elite, but the whole of Japan — including the rural population — was ready to respond strongly to stimuli from the West[2]. Japan at the time was a seed waiting for beneficial rains, or a solution waiting only for a catalyst to propel the chemical reaction. In the social confusion that followed the opening of the ports in the late Edo Period and that continued into the early Meiji Period, individuals with ability — irrespective of their former position in the feudal society — introduced new institutions or technology from abroad or adapted these imports to suit the needs and conditions of Japan. This was true of government officials, intellectuals, businessmen, engineers, rural landlords and civil rights activists. Especially important to note is that private entrepreneurs continued to emerge and start new businesses. Entrepreneurship was not limited to wealthy merchants or samurai families, but rather included many newcomers who did not readily fit into the social hierarchy that had existed until then. Moreover, shifts and reversals in fortune among them were fierce[3].

Shokusan Kougyou (industrial promotion) in Meiji Japan did not stop simply at being a government slogan; it was the national goal of both the people and those in civil service. This led to interaction between the dynamic private sector and the public support of industry[4]. Again, this situation is

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[2] This compliment on systemic capability does not extend to the policy of the Bakufu (Edo government) on its collision with foreign diplomacy. In this instance the Bakufu forced open the country without sufficient domestic debate or obtaining Imperial sanction, while suppressing any opposition against it. Even if Japan clearly had no other option than to open up to the outside world given its military inferiority, the clumsy way in which the Bakufu acted stirred up distrust and criticism. Moreover, the unequal treaties that it concluded further undermined its authority. This foreign policy error and the inflation that accompanied Japan's opening up formed the major trigger for the movement to overthrow the Bakufu.

[3] Matao Miyamoto, *Nihon no Kindai 11: Kigyokatachi no Chosen* (A History of Modern Japan, Vol.11: Challenges of Entrepreneurs), Chuo Koron Shinsha, 1999.

[4] While there is no doubt that government policy in general did promote industrialization, some initiatives were harmful to private sector development. During Meiji, being on friendly terms with high-ranking officials was indispensable for wealthy businessmen. In addition to drawing out assistance, it enabled them to obtain prior knowledge of capricious and unreasonable policies and to seek measures against them. For example, in 1874, the government suddenly notified merchants entrusted with official deposits that the collateral required had increased from one-third of the deposit to the total amount, and, demanded that the difference be paid in less than two months (keepers of official deposits made huge profits because they did not have to pay interest on these deposits). Mitsui, which was able to obtain this information in advance,

not unique to the Meiji Period but is a major characteristic throughout Japan's modern history, including the wartime, postwar and high economic growth periods. Clearly, much capability is required of both the public and private sectors. But if we were to ask which sector contributed more to the country's economic development, the answer must be the dynamism of the private sector. Schumpeter-type entrepreneurs, who continually carry out innovation as the Japanese ones did, are not to be found everywhere. There are few developing countries today that possess a vibrant private sector, even with the assistance of the government or international organizations in setting the playing field[5]. If Japanese-style industrial policies were implemented in an environment where the market economy is underdeveloped, all that would be visible is scrambling for official protection rather than a dynamic entrepreneurial response.

Another prominent feature of Japan is that as well as having commerce and service industries that aim at short-term profits, it is successful at launching manufacturing enterprises that call for the cumulative learning of technology and substantial initial investment. This feature, which can consistently be observed from the Meiji Period to the present, is attributed to Japan's fascination with *monotsukuri* (making things). Although overseas Chinese are active in Asia's economic scene today in the fields of commerce, finance, property development and low-skill assembly, they do not possess significant strength to be leaders in high-level manufacturing. Other than Japan, the only non-Western countries that have managed to develop domestic manufacturing capability of international standing are Taiwan and Korea. The industrial development of ASEAN member countries is remarkable too, but their production is highly dependent on foreign investors rather than domestic technology, human resources and production linkages. Where does Japan's dynamism supported by a *monotsukuri* culture not evident in today's latecomer economies come from? To find out we must study the period that preceded industrialization, that is, the Edo Period (Section 2).

A World that Discriminates Against Latecomer Societies

Secondly, with reference to the external circumstances, the global environment surrounding latecomer countries during the latter half of the nineteenth century was completely different from that of today. Under the imperialism of the nineteenth and the first half of the twentieth century, the relationship between Western and non-Western countries was that of the "ruler" and the "ruled," and the major powers did not expect nor desire that latecomer countries adopt the same standards as the West. A blatant discrimination existed between developed and latecomer countries. The absence of international organizations and development assistance at the time meant that the importing of technology and funding of investments all had to be conducted by the latecomer countries themselves. Added to this, it was a harsh period where countries that were not vigilant were in danger of ending up as colonies.

In 1881 the Meiji government declared that a constitutional government would be established within ten years. In the following year, Hirobumi Ito, a leading statesman, traveled to Europe to study the contents of the proposed constitution. He was surprised to hear Wilhelm I, the German emperor, and Rudolf von Gneist, a professor of law at Berlin University, declare that a constitution and a parliament

was able to prepare the funds and survived, but the Ono Group and the Shimada Group, which could not procure the capital required, went bankrupt.

[5] Bazaars traders, stall-owners, or black marketeers often observed in developing and transition countries do not indicate the existence of a modern, sound market economy; rather they are evidence of its underdevelopment and imperfect functioning (recollect the post-World War II black market in Japan). That high-level officials from international organizations take the existence of the informal sector in developing countries as proof of the universality of the market mechanism is a point that I am totally unable to comprehend.

would be of no use to Japan and that a dictatorship would suit it better. Ito later indignantly wrote that their advice, which was totally unexpected, was too soft on despotism[6].

Reacting strongly against this type of contempt thrown at Asia from the West, Japan used its sense of inferiority as a springboard to aim for national unity and become a first-class power. Japan accomplished this in half a century if we, for the moment, assume Japan's opening (1854) and the Russo-Japan War (1904-05) as the starting and ending points. In the period between the two World Wars that followed, Japan was accepted as a member of the 'Big Five' (together with USA, Great Britain, France and Italy) at international conferences and grew to be a power to be reckoned with, even in economic and military terms.

In contrast, latecomer countries of the present day are required to quickly adopt institutions that are the same as or similar to those in the developed countries. Regardless of their stage of development or social structure, international organizations urge all countries to liberalize and open up their economies in order to converge into a single economic system. This seems to have become prerequisite for being accepted as a member of the international community. Furthermore, the number of areas that ought to be integrated internationally is considerable, while the period allowed for this process is extremely short. To overcome this difficulty, latecomer countries actively attract foreign direct investment, while making use of technical and financial assistance from the donor community. Multilateral organizations such as the United Nations, the International Monetary Fund, the World Bank, the World Trade Organization and the Asian Development Bank offer the carrot (aid) and the stick (conditionality) to draw lagging countries into the existing international framework. Because democracy and the market mechanism are now regarded as universal values, the excuse that a country is poor or has a unique social structure is no longer acceptable for avoiding this integration. However underdeveloped a country is, the argument goes that it must be receptive to democracy and the market economy. This is how much the situation has changed in just over a century.

The world that attempted to fix latecomer countries in a subordinate position to exploit them has changed to a world that forces the system of developed countries onto latecomer ones. It is hard to tell which situation is more arduous for a latecomer country. However, the difference between Meiji Japan, which was able to successfully complete an industrial revolution despite the conditions of the former age, and latecomer countries today, which are unable to make a start at economic development despite the modern day world, must be sought mainly in the extent to which a country is endowed with a domestic capability to respond to external pressures. Japan's success in the latter half of the nineteenth century and the failure of most latecomer countries today naturally reflect their different abilities. If this is the case, we need to elucidate what forms the essence of this capability. Clearly, this cannot be achieved by merely listing the concrete policy measures Japan implemented at each point. Such a superficial imitation of Japanese policies would not be productive.

2 The Edo Period: A History of Pre-Industrial Japan

The Endogenous Growth of Commerce

Without doubt the technology and machinery of Edo, the period that preceded Meiji, was antiquated. However, in terms of economic systems, conditions were ripe for the active import of the

[6] Letter from Hirobumi Ito to Masayoshi Matsukata (September 6, 1882), as quoted in Yasushi Toriumi, *Nihon no Kindai* (Modern Japan), University of the Air Press, 1996.

industrial revolution. In recent historical research, the largely negative view of Edo Japan as a stagnant feudal society isolated from the rest of the world no longer holds sway. Heita Kawakatsu has developed a unique theory that proposes that the islands of Britain and Japan, located on either side of the Eurasian continent, each carried out their domestic development independently until the nineteenth century, and claims that the industrial successes of both were autonomous and not due to external stimulus[7]. Placing Japan and Britain of the nineteenth century on the same level, at least in terms of technology and economic power, may be going a little too far. We cannot ignore what was blatantly clear in international relations at the time; that Britain was the world's leading industrial economy and Japan was no more than a backward agrarian society of the Far East. Nor can we put aside the shared perceptions of the Japanese people at that time (see Soseki Natsume's lament at the end of this chapter). However, if we focus exclusively on the systemic potential of the Edo economy, then even Kawakatsu's bold theory which sets Japan and Britain on equal pegging is not totally off the mark.

Below is a list of characteristics that enabled Edo Japan to catch up rapidly with the West in the periods that followed. It is given to my students as a near-consensus view among Japanese economists.

1. Political stability and unity under the Tokugawa administration
2. Agricultural growth (expansion of farmable land in the pre-Edo and early Edo period and rising productivity in the late Edo Period)
3. Establishment of a communications and transportation network and the integration of the national economy
4. Increased commodity production, including a large number of local specialties
5. Development of commerce and finance and the emergence of an affluent merchant class
6. Official promotion of industries, especially at the level of han (local) governments
7. The spread of education through Bakufu and han schools, private academies and *terakoya* (private schools for children)

These items may strike Japanese as nothing out of the ordinary. However, we must realize that these conditions are still rare in latecomer countries of today. A few exceptional countries like Taiwan, Korea and Singapore have achieved a high level of industrialization and now fulfill the above seven points. On the other hand, as for transition economies and the poorest countries of today, none of them boast *all* the conditions that Japan of the late Edo Period enjoyed, and only a few of them can provide even some of them.

Of the seven points listed above, 3, 4 and 5 are closely connected and can be summarized into a single phrase: the endogenous growth of commerce. From my experience in working with developing and transition countries over the past several years, I have come to consider this as the key factor desperately lacking in countries that do not grow despite economic liberalization. In societies where private-sector business activity is lethargic and a nationally integrated market does not exist, bold liberalization measures, the privatization of state-owned enterprises, the support of small and medium enterprises, free trade and the establishment of a legal system are unlikely to ignite private sector dynamism. The optimistic view that the removal of bad policies and the leveling of the playing field for private as well as state-owned enterprises will automatically release hitherto suppressed economic dynamism does not hold for the latest comers that are attempting to jump-start production in the twenty-first century. The sound growth of a market economy requires several conditions to be fulfilled. Naturally, not every country is equipped with all of them. This is

[7] Heita Kawakatsu, *Nihon Bunmei to Kindai Seiyo: Sakoku Saiko* (Japanese Civilization and the Modern West: Rethinking the Closed Door Policy), NHK Books, 1991.

the point that Japanese development economists repeatedly emphasized to international development organizations throughout the 1990s.

Two Distortions that Stunt the Development of a Market Economy

What are the prerequisite conditions for creating a market economy? Shigeru Ishikawa, an authority on Japanese development economics, offers the following three: (1) a division of labor in production associated with an increase in productivity, (2) the development of a merchandise distribution system, and (3) the adherence to the rules of market transaction, including the strict observance of business contracts[8]. Taking the example of China in the 1980s, he indicates several incidents where economic liberalization did not bear the intended results, and argues that this occurred in large part because of the enormous gap between the level of systemic maturity required for such policies to be effective and the underdeveloped systems that China actually possessed. Ishikawa stresses that the mission of development economics, as a policy-oriented science, is to correctly identify the gap between policy and reality, and to work out the appropriate next step for a given stage of development in the context of a particular country. That is to say, it must formulate a delicate policy mix that promotes the development of a market economy without perpetuating the present situation or throwing the society into crisis.

What is vital here is the ability to discriminate between the *innate* and *artificial* distortions that disrupt the formation of a market economy[9]. On the one hand, every society is stamped with unique features that are historically formed and are not easy to erase. These include the existence and nature of certain characteristics such as social unity, mutual trust, morality, long-term vision, entrepreneurial spirit, the observance of law and attitudes towards outsiders. Some of these innate features are barriers that must be overcome in order to form a market economy. Imagine, for example, a society that does not trust newcomers because of a history of continual warfare, or a society where food is so plentiful that there is no thought to invest for the morrow, or even a society where all wealth is equally redistributed among villagers and thus the desire to work and save is absent. These features arise from the unique ecological background of a particular society and originate well before colonialism, and thus cannot be attributed to the past few centuries of foreign rule.

On the other hand, the suppression of private sector activity through artificial constraints imposed by the government is certainly possible. These include various types of control, monopolies, exclusive cartels, excessive and unpredictable taxation, and misappropriation of the nation's wealth by those in power. An extreme example of such economic suppression was the adoption of a command economy by socialist states. If economic stagnation is caused by this kind of policy distortion, but the fundamental structure of society itself is compatible with a market economic system, then removing bad government or bad policies alone will suffice as a development strategy. After a bold liberalization drive, economic activity can be left to the private sector, and the government and international organizations would not have to worry about institution building or fostering production. However, if the cause of a lackluster economy derives from innate distortions, which reflect the social structure at a deeper level, then it is clear that laissez-faire policy will not succeed. We cannot decide *a priori* which cause is holding back a given country. But if the private sector does not respond to bold and repeated liberalization initiatives, we can suspect that it is due to innate distortions.

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8 Shigeru Ishikawa, "Underdevelopment of the Market Economy and the Limits of Economic Liberalization," Chapter 7, *Kaihatsu Keizaigaku no Kihon Mondai* (Basic Issues in Development Economics), Iwanami Shoten, 1990. Translated in K. Ohno and I. Ohno, eds., *Japanese Views on Economic Development*, Routledge, 1998.

9 Shigeru Ishikawa, "*Shijokeizai Hattensokushinteki Approach: Rironteki Ichizuke to Oyou*" (Approach to Promote the Development of a Market Economy: Theoretical Underpinnings and Applications), *Kaihatsu Enjo Kenkyu,* Vol.4, No.1, Overseas Economic Cooperation Fund, 1997.

The Edo Period: A Mercantile Perspective

John Hicks developed an economic growth theory based on the strength and scope of mercantile activity, and Yonosuke Hara further expanded the thesis to the Asian context[10]. What they propose is an extremely interesting and useful idea for our purpose. Their argument can be summarized as follows: A market economy is not a system that can be created through socio-economic engineering and quick policy switches. Rather, it is a product of a long historical evolution, which is realized only in societies that satisfy specific conditions. If we look back at the history of civilization, we see that market economies first emerged from the groups of free-trading city ports that surrounded the richly islanded seas of the Mediterranean and Southeast Asia, where the activity of itinerant traders formed ties among them (it is worth noting that market economies were not born of continental empires with relatively closed economic activity). The traders gradually extended their trading network based on mutual trust, just as a plant slowly spreads its roots, to overcome the uncertainties of long-distance transportation and reneging on contracts. Essential for the growth of this network was the development of financial services that offered account settlement, foreign exchange, and insurance, as well as a government that took on the role of protecting traders from physical harm or fraud. However, while such financial services tend to emerge spontaneously from a market economic system, there is no guarantee that government protection will. If a government takes predatory action on international traders, economic activity is likely to wither.

The rise and fall of this type of long-distance trade has been observed throughout history, depending on the ecological and geographical conditions of the region and the kind of government that existed. The Industrial Revolution of the latter half of the nineteenth century associated with technological innovation was an event that grew out of the successful development of a mercantile economy. However, a new problem arose with the advent of the Industrial Revolution: commerce and finance are activities that are naturally arising within the market mechanism, but labor, on which the success of industrialization critically depends, is not dealt with well by the market. To handle it better, institutional innovations such as the firm in the private sector and industrial policies by the government were required.

This mercantile theory highlights the following three points: (1) the market economy exhibits a natural tendency to evolve from commerce to manufacturing, however, (2) the success of this evolution is not guaranteed, and (3) traders and merchants are the key players in this evolution while the government must also play an important supplementary role. But if the government fails to fulfill this responsibility or even engages in harmful activity, it will hinder the expansion of the market economy. To consider the economic development from Edo to Meiji in light of this theory is extremely interesting. In Edo Japan, the use of sea routes allowed nationally integrated markets to be established and thanks to vibrant commercial activity a class of wealthy merchants with considerable capital came into existence. Furthermore, a distribution system for goods along with a financial system developed with Osaka at its center. These systemic developments were geographically limited to within Japan, but they constituted the very ingredients needed to fire an industrial revolution.

Meanwhile, despite many mistakes made along the way, central and local governments in the Edo Period continued their support of trade and industry. For a revenue source, the governments at both levels relied heavily on a tax-in-kind levied on rice, which was collected and then redirected for sale to consuming regions. When the Tokugawa administration was established in the early 17th century, in addition to Osaka and Kyoto, which were already major cities with significant production capacity, a large

[10] J. R. Hicks, *A Theory of Economic History*, Oxford University Press, 1969; Yonosuke Hara, *Asia Dynamism* (Asian Dynamism), NTT Press, 1996; and Yonosuke Hara, *Area Economics: Asia Keizai no Topology* (Area Economics: Topology of Asian Economies), NTT Press, 1999.

urban area for consumption was created artificially in Edo by resettling samurai who by nature were not engaged in production. This means that the functioning of the Edo economy presupposed the existence of a nationally integrated distribution network. To support this system, the Edo government introduced policies for sea routes, the provision of highways, the alternate attendance system (requiring all daimyo to reside in Edo every other year) and the courier system.

However, with regard to the promotion of private commercial activity, the policies of the central government remained highly inconsistent throughout the Edo Period. Just as soon as it had officially recognized and even enforced *kabunakama* (trade cartels) to tighten its control, it would ban them and return to an economy with free entry and competition. As for the taxation of commerce, it was extremely arbitrary and unpredictable. As the production base steadily shifted from rice production to commercial crops and handicrafts industries, and then onto commerce based on them, the inability of the government to create a stable tax base from these new sources became the basic cause of fiscal difficulty. Furthermore, the debasement of gold and silver coins to finance the fiscal deficit gave rise to inflation. However, even with the government firing out policies that were of no help to the private sector, it was not inept or destructive enough to quash commercial activity entirely. In other words, the vitality of the private sector was strong enough to survive this level of inexpedient policy. Turning our attention to the local governments, due to the fiscal crisis they too were pressed by the need to enlarge their annual revenue. Thus, efforts to encourage industry by the various han administrations at the regional level intensified, and some even succeeded brilliantly and cleared the deficits.

However, if we visit the transition countries of Indochina or Central Asia today, there are few signs of a nationally integrated economy, the growth of private commercial capital, or the autonomous development of a financial system. Nor do these countries have a civil service or governing structure that is able to effectively design and implement policies for industrial promotion. In Vietnam, for example, family-run subsistence agriculture is dominant and a large part of rice production is for domestic consumption only. Any surplus rice from the Mekong Delta region in the South of the country is transferred to the North by state-owned enterprises, not private ones. Through trade and investment, the large urban centers of Hanoi and Ho Chi Minh City continue to integrate into the world economy, but the economic links between the cities of Vietnam and the countryside where 80% of the population lives are still weak. In Central Asia, the bazaars are crammed full with Chinese goods brought over by peddlers, yet a formal distribution system is not yet in place. Because enterprises are unable to borrow working capital, let alone investment capital, from banks, they are forced to resort to barter or accumulate arrears to one another. In the great plains of Central Asia, transportation costs have rocketed because of the large number of illegal police checkpoints demanding bribes from passing long-distance truck drivers.

The Edo Period is often viewed in a negative light. Compared with earlier periods, Japan's closed door policy (1639-1854) during the Edo Period significantly reduced stimulus from abroad. It cannot be denied that its feudal hierarchy also contributed to the rigid social structure. However, with regard to the economic system, considerable achievements were made: thanks to peace and stability, the agricultural sector generated a surplus, commercial and handicraft businesses developed, trade among adjacent regions was activated, and the sea routes connecting these regions created a nationally integrated market. In other words, the *national economy* steadily grew, tracing the natural order outlined by Hisao Otsuka[11]. This remarkable economic development spanned more than two centuries, but by the end of the Edo Period, a systemic gap had emerged between the rigid form of the Tokugawa system with a revenue base totally dependent on rice farming and the dynamic reality of commodity production backed by a nationwide

[11] Hisao Otsuka, *Kokumin Keizai: Sono Rekishiteki Kosatsu* (The National Economy: A Historical Study), Kodansha Gakujutsu Bunko, 1994. Otsuka's idea is discussed in Chapter 1 of the original book.

distribution system. To overcome this contradiction and propel the Japanese economy to the next stage of development, Japan needed more liberal, open and industry-friendly policy. In this sense, the great shock of opening the country up was fortuitously timed. If Commodore Perry's black ships had visited Japan much earlier in the first half of Edo period, Japan's economy would probably have been unprepared to respond successfully. On the other hand, if Japan had not been forced open in the middle of the nineteenth century, the country would have had to invent new systems to resolve the inconsistencies by itself.

3 Catching Up as a National Goal: The Joint Efforts of Government and Business

The Policy Goals of the Meiji Government

It may be difficult to imagine from the ineptitude of the Japanese government today, but the policy goals of the Meiji Japan that sprang into the international community were remarkably clear and deadly earnest. Furthermore, the goals were not only proposed by the government but shared by the whole nation, including the political opposition. Immediately after the opening of Japan to the rest of the world, the national priority was security-oriented and defensive, namely, to avoid colonization and to protect sovereignty. However, with time and as the threat of being subjugated by the Great Powers diminished, the national goals took on the more positive aim of making Japan a "first-class" power to rank equal with the West. These goals were summarized in the famous phrase, *fukoku kyohei* or enriching the country, strengthening the military. It is important to understand the acute inferiority Japan must have felt as it encountered countries clearly more powerful than itself as well as grasp the simultaneous surge of pride that urged it on to overcome its backwardness. Nationalism grew as a result of Japan's contact with the outside world following its long seclusion and at the shock of discovering that it was merely a backward country in the world system. This desire to catch up backed by a fierce national pride was to strongly color the history of Japan for the following half a century or more, ending with the Pacific War.

However, let us now return to the early part of the story. In the early years of Meiji, conflicting policy lines on how to become a first-class power were already apparent within the government. There were three major issues which concerned the high officials of the Meiji Government[12]:

1. Industrialization on the economic front (*shokusan kougyou,* or industrial promotion)
2. Expansionist policy on the international front (for example, *seikanron* or the argument for the "Korean Expedition")
3. The establishment of a constitutional government on the political front (which called for a constitution and a parliament)

However, for a Meiji government that had just come into being and whose power and financial basis were fragile, pursuing all of these goals at once was impossible, and the question of sequencing set off fierce confrontation within the leadership. The complicated political development of the early Meiji Period can be understood fairly well if we keep the debate over these policy priorities in mind[13].

[12] Apart from these three issues, the revision of the unequal treaties with the West was an important diplomatic goal remaining from the Edo Period.
[13] Takuji Shibahara, *Sekaishi no Naka no Meiji Ishin* (The Meiji Restoration in World History), Iwanami Shinsho, 1977; and Junji Banno, *Nihon Seijishi: Meiji, Taisho, Senzen Showa* (The Political History of Japan: Meiji, Taisho, and Prewar Showa), University of the Air Press, 1993.

The first policy (industrialization) was advocated and implemented by Toshimichi Okubo, who was successively in office as minister of finance and then as home secretary. After his assassination in 1878, Shigenobu Okuma and Kiyotaka Kuroda inherited this policy line.

The second policy was proposed by Takamori Saigo and Taisuke Itagaki, and behind it lay the strong sense of danger that if the dissatisfaction of disaffected samurai was not deflected externally, the new government would not last long. However, because of stern opposition from Okubo and Takayoshi Kido to the military expedition, the councilors who made up the Korea Expedition Faction were forced to leave the government in 1876. After this event, Saigo was exalted as the leader of the disaffected samurai groups and led an uprising against the government (Satsuma Rebellion). Meanwhile Itagaki and his followers started an anti-government offensive as the self-proclaimed leaders of the civil rights movement.

The third policy (political reform) was prepared by Kaoru Inoue and Hirobumi Ito from within the government. Their plan stressed gradualism and aimed at the Prussian model of a constitutional monarchy, as opposed to the more advanced British-type of democracy with a party government. Shigenobu Okuma, who proposed the latter model, was forced from power during the Crisis of 1881. From outside the government, Itagaki, who had left public office, and other civil rights campaigners like Kenkichi Kataoka and Emori Ueki called for radicalism. The popular movement which called for the immediate introduction of a parliament and prepared private drafts of a constitution spread like wildfire through the country, politicizing wealthy farmers and poor peasants alike, and at times turned quite violent.

This type of political wrangling among the political elites was not confrontation over fundamentally incompatible goals. It was persistent argument over how to set priorities and the sequence in which the country should realize what were mutually agreed upon as common goals. Therefore, a confusing process came into being where the same person drove forward opposing policies in quick succession, and political alliance would form and dissolve depending on the issue at hand. For example, Okubo, who opposed Saigo's expansionism and ousted the Korea Expedition Faction in 1876, dispatched troops to Taiwan in the following year, and in the year after that, sent a battle ship to Korea in provocation. Itagaki, who had resigned from public office and was supposed to be on the side of criticizing the Meiji government, later returned to the government only to leave it again before long. However, ferocious conflict among politicians over how to realize commonly held goals is not unique to the Meiji Period, it is a universal phenomenon throughout world history.

Constitutional Government and Nationalism

Do the latecomer countries of today embrace policy goals similar to those of Meiji Japan? In our age, the option of invading other countries no longer exists[14]. However, as for the other two goals, the question of how economic and political development should be sequenced remains unanswered even today. The ongoing debate over whether economic development should precede democracy, whether these two goals are compatible, or how the authoritarian developmentalism of East Asia should be evaluated are all variations of the same question. However, unlike the passive adoption or rejection of a single Western model recommended (or enforced) by the IMF and America, which many developing countries are driven to today, Japan's policies were the product of a pro-active attitude that selected the appropriate model in

[14] The colonization of other countries through overt military action has definitely become a feature of the past. However, the use of hard-line foreign policy as a centripetal force to unite the government and mobilize national sentiment is still alive. Consider the launching of missiles by North Korea, the competition over nuclear capability between India and Pakistan, the anti-U.S. policy of Iraq and Iran, the tension between Mainland China and Taiwan, as well as the criticism of foreign private investors in Malaysia.

light of the historical circumstances in which the country was placed. Moreover, Japan was not only able but permitted by the international turn of events, to take this course.

From 1871, a high-level mission headed by Tomomi Iwakura and including about half the government ministers was sent to America and Europe for nearly two years. Its purpose was to (1) conduct preliminary negotiations for the revision of the unequal treaties, and (2) study Western technology and systems. The mission failed in its first objective because the West would not treat Japan equally as long as its institutions were considered backward. However, it did succeed in gaining insights with regard to its second objective. The mission was warmly welcomed wherever it went.

Upon the return of the Iwakura Mission, Toshimichi Okubo, one of the principal mission members, wrote “Proposal for a Constitutional Government.” His views can be summarized as follows[15]: Democratic government and monarchy both have their advantages and disadvantages. Obviously, democracy in its ideal form is superior to monarchy. But in reality it often disintegrates into factionalism and in the worst case may descend into a tyranny of numbers which brutally suppresses political opponents (Okubo had in mind the reign of terror after the French Revolution). On the other hand, a monarchy functions well where the ruler is wise and the people are unenlightened. But if the ruler is tyrannical and the officials corrupt, the misery and the resentment of the ordinary people will be limitless. Compared to England, Japan is only semi-civilized and cannot rid itself of the customs of feudalism. For us, monarchy is already a thing of the past, but preparations to install a democratic system immediately are incomplete. Thus, to carry the various reforms through with resolve, the central government should maintain a strong position as the mainstay of a policy-making. The realistic path for Japan is to introduce a constitutional monarchy based on the principle of the gradual installment of a constitutional government adjusted to the speed of social change. This, for the moment, means joint governing by the Emperor and the people under a constitution.

Let us contrast Okubo’s argument with that of Yukichi Fukuzawa, another intellectual leader of the Meiji Period. In his main work, *An Outline of the Theory of Civilization* (1875), Fukuzawa categorizes each country as civilized, partially civilized or uncivilized, and ranks Japan as semi-civilized. He also states that the relative merits and demerits of democracy as opposed to monarchy cannot be generally ascertained. Up to this point, his argument is in line with Okubo’s. Moreover, his emphasis on Japan’s need to avoid the threat of Western imperialism and preserve political independence is not especially original. He advocates that Japan should cast away its traditions and customs and adopt Western civilization to its advantage. Fukuzawa notes that civilization has a spiritual and material aspect. Imitating the material is easy, but imitating the spiritual is hard. To those who desire civilization, he advises that they “tackle the difficult first and then the easy: first change the hearts and minds of the people who will have an affect on the laws made by the government, then finally move onto the material issues.” This advice vividly contrasts with that of Okubo. Fukuzawa, the enlightened thinker, gives precedence to the disposition of free and broad-minded people in the private sector, while Okubo, the high official with a grand vision, endeavors to accelerate the pace of “material” civilization by applying the strong hand of the central government.

How did history actually progress along the three policy lines? From the earliest years of Meiji, economic development was actively pursued through the policies of the Ministry of Industry, the Ministry of Finance and the Home Ministry, and we can say that their efforts met with a great deal of success. As for the expansionist campaign, it was at first set back because of the expulsion of the Korea Expedition

[15] Yasushi Toriumi, *Nihon no Kindai: Kokumin Kokka no Keisai, Hatten to Zasetsu* (Modern Japan: The Formation, Development and Collapse of the Nation State), University of the Air Press, 1996.

Faction in 1876. But militarism subsequently gained in force gradually right up to the middle of the twentieth century as Japan repeatedly waged war to secure its interests abroad and add to its colonies. As for the establishment of a constitution, this proceeded in line with the gradualist approach of the government. In response to the growing civil rights movement, in 1881, the Meiji government announced, in the form of an Imperial Order, that a parliament would be inaugurated within ten years. Thereafter, Hirobumi Ito and Kaoru Inoue conducted research on constitutional systems and prepared a draft constitution, which was deliberated by the Privy Council. In 1889 the leadership enacted a constitution as promised, and in the following year the first Imperial Parliament opened. This happened twenty-two years after the Meiji Restoration.

An interesting point here is that not only the public at large, but even the political opposition (known as the *jiyu minken ha*), which severely criticized the government previously and was in turn suppressed by it, warmly welcomed the promulgation of the Meiji Constitution. For example, Yukio Ozaki, who was ordered to leave Tokyo under the Preservation of the Peace Acts, praised the Constitution as "wonderfully made," and Sanae Takada, the education specialist, added strong support with "I think that the Constitution of the Empire of Japan is a good constitution, it exceeds our expectations." To our modern day sensibilities, the fact that opposition leaders applauded the establishment of the Meiji Constitution that featured a strong emperor and led the country down the path to militarism is very strange. However, we should remember that at the time Japan was the only country outside the West to have a constitution. Even if opponents were somewhat dissatisfied with the content or wording, it is still easy to imagine that the constitution was a source of enormous national pride for them. Furthermore, the Meiji Constitution was fairly ambiguous in its prescription for the form of government, and depending on its interpretation and application, it could even accord with a party cabinet system. At least on the political front, with a constitution Japan had furnished itself with the condition it needed to be accepted among the Western powers. Nationalism, it seems, was stronger than the enmity between political opponents.

Eiichi Shibusawa: Builder of the Market Economy

I always introduce Eiichi Shibusawa as a "super businessman" in my lectures. Unlike Okubo, Shibusawa did not like being a bureaucrat very much. Invited to the Ministry of Finance shortly after its inception, his task was to lay the foundations for a market economy through the introduction of a joint-stock company system, a monetary system, new weights and measures, a railway line, nationally chartered banks, the Tomioka Textile Factory and so on, all of which he achieved with tremendous results. Furthermore, he managed this in the four years between 1869 and 1873, while he was between the ages of 29 and 33. On leaving the Ministry, he became the head of the First National Bank, which he had established, and reigned supreme in the business world until his death at the age of 91. He spent all his efforts creating a myriad of enterprises, economic organizations and social bodies.

Shibusawa was cast in a completely different mold from another great business leader of Meiji: Yataro Iwasaki. Iwasaki, who founded the Mitsubishi *zaibatsu* (business group) from scratch, was a capitalist through and through. He relentlessly pursued his own interests using his enterprising spirit and government connections to the maximum while engaging rival businesses in repeated and fierce battles. Shibusawa, on the other hand, did not form his own *zaibatsu* and had no interest in expanding his business empire. He was not so much a player on the market, but one step removed from it, he acted as a business promoter and dedicated his whole life to forming Japan into a modern economy. When he called for the establishment of a new organization, his motive was not profit or market share, but the fact that Japan needed such an activity. Shibusawa's business philosophy was neither that of the self-seeking individual nor the utilitarian, but one that unites economics and ethics, the latter of which was based firmly on the Analects of Confucianism.

Shibusawa was quick to perceive the needs of the Japanese economy, and was the type to instantly act to fulfill them. In setting up a business, his usual practice was to proclaim himself as an investor in a newly established joint-stock company and urge other men of substance to invest with him until ~~a~~ sufficient funds were collected. In this manner, Shibusawa was involved in the establishment of more than 500 companies[16]. He was also largely involved in the establishment of other economic organizations, universities, and welfare institutions[17]. Furthermore, as a private emissary, he made strenuous efforts to improve Japan-US relations as dark clouds began to gather. Of course, for a single man to be involved personally in so many activities is physically impossible, and in fact in many cases it was just his name that was lent to the project. He did not intervene deeply in day-to-day management. Only when a problem arose did he offer necessary support and dispatch advice.

Well before he became a super businessman, Shibusawa's youth was already unique. Those who have read his autobiography[18] cannot help but be overwhelmed by his energy and the speed at which he adapted to change. He was born in 1840 in what is now Fukaya City in Saitama Prefecture. He was the oldest son of a wealthy farmer who traded indigo. From his youth, he was a shrewd businessman and also stood up to local officials that tried to collect funds "for official purposes." Before long, the young Shibusawa became resentful of the absurdity of the feudal system and burned with the desire to overthrow the Tokugawa administration and to expel foreigners. He planned to attack Takasaki Castle and from there storm the foreign settlement in Yokohama to set alight the mansions of the foreign residents. However, this ridiculous plan fell through and the twenty-three-year old Shibusawa fled with his companions to Kyoto. In Kyoto he made the acquaintance of and then served Yoshinobu Hitotsubashi, one of the most illustrious relatives of the ruling Tokugawa family. Even here Shibusawa was quick to reform the military system for the Hitotsubashi family, encourage industry in the territory, and issue local money that circulated with much confidence. Shortly afterwards, in a strange turn of events, Yoshinobu was promoted to Shogun and before Shibusawa knew it he had been transformed from an anti-Tokugawa campaigner into a retainer of the Tokugawa family. But Shibusawa knew that the Tokugawa administration was doomed to collapse before long. This being the case, not only was he a traitor, but it was certain that he would end up on the losing side. Despondent with his lot in life, for a while, Shibusawa spent his days "dissatisfied and enjoying nothing."

Soon however, the prospect of going to France arose. It was as an attendant for the official delegation to the Paris International Exposition and to serve the fourteen-year-old Akitake Tokugawa who was to study abroad. Shibusawa departed for Europe with joy, and while working as treasurer, he was entrusted with solving a number of problems that arose. Finally, however, the Tokugawa government did collapse. Rushing back home, Shibusawa decided to live a quiet life in Shizuoka near the unfortunate Yoshinobu who had been forced to retreat there. However, he was not the type to sit still for long. He proposed that the local government of Shizuoka use funds provided by the new government to develop the regional economy by establishing joint stock companies, and the proposal was instantly adopted. However, just as his new project was taking off, an order to come to Tokyo was sent down from the new government: Shibusawa was to join the Ministry of Finance and participate in the construction of a new economic

[16] The following companies were among those established with Shibusawa's assistance: First National Bank, Oji Paper, Japan Railway, Kyodo Transportation, Osaka Spinning Mill, Tokyo Gas, Japan Mail Shipping, Imperial Hotel, Sapporo Beer, Japan Sugar Refining, Oriental Shipping, Keihan Electric Railway, Tokyo Electric Power, and NKK.

[17] Shibusawa helped to create the following institutions: Tokyo Commercial School (later to become Hitotsubashi University), Tokyo Bankers' Association, Tokyo Chamber of Commerce, Tokyo Stock Exchange, Japan Women's College, Tokyo Clearing House, Tokyo Municipal Orphanage, Imperial Theater, Japan Anti-Tuberculosis Association, and Tokyo Women's University.

[18] *The Autobiography of Shibusawa Eiichi: from Peasant to Entrepreneur*, translated by Teruko Craig, University of Tokyo Press, 1994. The book combines a complete translation of *Amayo-gatari* and excerpts from *Kosei Nikki*.

system. Shibusawa stiffly declined the offer at first, however, the earnest entreaties of Shigenobu Okuma (a leading statesman of the Meiji Period who later served as a prime minister) moved him, and he finally accepted. His activities from this point are as I described earlier.

Shibusawa cannot be classified as a farmer, merchant or samurai. He was the unique product of a tumultuous period in Japan's history. He was a keen observer and was highly sensitive to irrationalities and inefficiencies. If he noticed any such problems, he would immediately suggest a solution, and would take the lead in transforming it into action. Where obstacles existed, he did not relent until he overcame them. He was able to respond to any change in circumstances. He could not bear emotional attachment to the past, undue formalism, or red-tape bureaucracy. Besides that, Shibusawa was a womanizer. With a man packed solid with such energy reigning in the business world, the Japanese economy had no choice but to develop!

Is there an Eiichi Shibusawa in any of the latecomer countries of today? How about other types of business leaders such as Yataro Iwasaki (the founder of the Mitsubishi *zaibatsu*), Tomoatsu Godai (a business promoter in Western Japan), Rizaemon Minomura (the reformer of the Mitsui *zabatsu*), Soichiro Asano (the founder of Asano Cement Company and the Asano *zaibatsu*), and Ichibei Furukawa (the founder of Furukawa *zaibatsu*)? A market economy does not arise out of laws and policies only. Nor can everything be decided simply by supply and demand. The true heroes in a market economy are entrepreneurs of strong character, like Shibusawa and the others. To produce such heroes continuously, a society must be equipped with mechanisms to encourage and support them.

4 The Establishment of New Industries

Silk, Cotton and Machines

In its early years Meiji Japan was an agrarian society in which farming, forestry and fishing employed more than seventy percent of the working population and supplied over sixty percent of national output. This situation was also reflected in the trade structure. Throughout Meiji (1868-1912), Taisho (1912-26) and pre-war Showa (1926-36), Japan's top exports were raw silk yarn, tea, and marine products. The main market for these commodities was America. Along with the opening up of Japanese ports, demand for these primary commodities suddenly ballooned and domestic producers greatly profited from it. Virtually unseen in Japan nowadays, during Meiji all villages that could cultivate mulberries to rear silkworms, and many earned a good income from this activity. In this sense, silk was not only a traditional product that brought wealth to rural areas, but it also made an important contribution to Japan's industrialization by earning much coveted foreign exchange. Moreover, mining, which had continued from the Edo Period, was largely requisitioned by the new government and later sold off to the private sector to become one of Japan's principal industries.

However, from another perspective, trade structure in Meiji accomplished a dramatic change. The greatest transformation came from the success of import substitution in the cotton industry and the shift to export-oriented production. In the early part of Meiji, nearly half of all imports came from Great Britain in the form of cotton and woolen goods and cotton yarn. Japan exported primary commodities and imported manufactured goods — the typical vertical trade pattern of latecomer countries. However, as Japan's cotton industry grew, the import of textile products fell steadily and around the 1900's it was close to nothing. Furthermore, from the latter part of the 1890s, Japan began to export cotton yarn and clothes to neighboring Asian countries, and at the same time it started to import raw cotton in large quantities mainly from India. In other words, the industrialization of the Meiji Period was a *light* industrial revolution, which made its way from importing to domestic production and then onto exporting. Within this transition, cotton production played a central role.

What about Japan's heavy industry? The iron and steel, shipbuilding and chemical industries, as well as the manufacture of electrical machinery and appliances were in their infancy and the country was still in the process of learning by imitating the West. These industries were not yet in any condition to be called the main forces of production; they were not internationally competitive and importing the necessary machinery from the West was the norm. Moreover, the scant production of machinery and tools that did exist was mainly in the hands of state-owned enterprises, especially munitions plants like the Tokyo Artillery Factory, the Yokosuka Naval Arsenal, the Osaka Artillery Factory and the Kure Naval Arsenal, all of which used technology and machinery solely from the West. However, by late Meiji, private-sector production in the areas of shipbuilding, railway carriages and machine instruments had slowly emerged. Meanwhile, engineers and workers who had handled new technology in the state-owned munitions plants began to transfer to private-sector businesses or set up their own. In this manner, the production technology of the West propagated widely and small businesses and subcontractors began to form in Tokyo and Osaka. Thus, while heavy industry was in its infancy during the Meiji period, it was preparing itself for a rapid leap in the period after the First World War.

Because of the unequal treaties that had been signed by the previous government, Meiji Japan did not have autonomy over its tariff regime and import duties on all goods were set at the low rate of around five percent (according to the World Bank today, low and universally applied tariff rates are ideal). Surely, this constraint must have had an enormous effect on Japan's industrialization? In my opinion, it did not. Japan at the time did not have industries that needed to be cocooned with protective tariffs. Setting aside the diplomatic issue of the loss of autonomy and the financial issue of insufficient tariff revenue, the fact that Japan could import manufactured goods and machinery from the West at low tariffs under these circumstances worked in favor of its industrialization. At this stage, where the light industrial revolution was in progress, free trade worked well for Japan[19]. However, before long industrialization was to progress a stage further to foster heavy industry. Here, technology accumulation and large investment in capital equipment were of great importance, and new industries would not have been able to gain a foothold without government support or protection from imports. Around the same time that Japan reached this stage (end of Meiji), tariff autonomy had been restored — first partially in 1899 and then completely in 1911 — and the government happily began to raise tariffs on industrial products. The timing was more than fortuitous. After this point, Japan was able to achieve industrialization based on heavy, chemical and manufacturing industries, which were protected by the interruption of trade during the First World War and high tariffs during the period between the two world wars. However, it is questionable if latecomer countries of today would be permitted to use this strategy of increasing tariffs which were previously low, as industrial development progresses.

The Role of Engineers

For the past several years, the development strategy of the international organizations, including the World Bank, has strongly emphasized the early establishment of Western values such as rule of law,

[19] In his article, "Hogozei o Hi to Suru Setsu" (Why Protective Tariffs Are Undesirable) in *Meiroku Zasshi* (Journal of the Sixth Year of Meiji), Volume 5, 1874), Mamichi Tsuda put forward the following reasons against protectionist tariffs aimed at relieving the trade deficit: (1) they are impossible within trade agreements, (2) foreign goods such as iron and steel are much cheaper than domestic production and the latter cannot be protected by tariffs alone, (3) no factories that can produce Western-style manufactured goods exist in Japan as yet, (4) it is inconsistent to cut off imports when the nation's desire for imported goods is strong, and (5) the fact that Japan is backward and needs a large volume of Western products cannot be helped. Incidentally, in 1878 tariff revenues amounted to 9 percent of the total fiscal revenue. This ratio is fairly small when considered from the perspective of Japan's development stage at the time.

transparency, partnership, good governance, accountability, and civil society. International organizations assert these values as if they form the core of all development issues, and assume that just with their provision, the economy and society of a latecomer country should be able climb onto a steady track to development. However, does this intoning of fine but abstract phrases while ignoring the individual character and history of a country really amount to a development strategy?

What supported the startling industrialization of Meiji Japan was not the direct import of vain invocations from the West. It was individual businessmen of strong character who burned with zeal and the proud engineers who absorbed new learning like a sponge absorbs water and raced around the machines that equipped the factory floors. Japan during the period of its industrial revolution was very much like a living museum packed with energetic industrialists.

Twenty-six-year-old Takeo Yamanobe was a foreign student in England who studied Economics and Insurance at London University. In 1877, he unexpectedly received a letter from Eiichi Shibusawa. The letter read something like this: "I heard about you from a friend. In Japan, state-owned spinning mills are in a poor state and the import of cotton yarn is huge. For the good of our country, it is imperative that we establish high-performing spinning mills under Japanese control. For this to be possible, people familiar with technology and operations are indispensable. I plan to set up a spinning mill and I ask you to forget economics and start studying the technology of Britain's cotton industry." Enclosed with this letter were entreaties from his father and friends. How bewildered Yamanobe must have been at such an audacious proposition! Nevertheless, after some consideration Yamanobe decided to accept Shibusawa's request.

Yamanobe transfered to Kings College and began to study Mechanical Engineering. However, he noticed that his course focused on theory and was not linked to practice. He moved to Manchester, which was the center of the world's cotton production at the time, and there he visited factories and advertised in the newspapers requesting "employment as a trainee who was willing to pay tuition." He suffered countless rejections. At long last he met Mr. Braggs, the owner of a cotton textile factory, and for the next eight months he learned the ins and outs of cotton spinning — from ginning, spinning, and finishing to the purchase of raw cotton, the sales and marketing of finished goods, packaging and shipping. The cost of the traineeship was covered by research funds of 1,500 yen that Shibusawa sent to him. Regarding this large sum, Shibusawa remarked: "It was a leap of faith, like jumping down from the stage at Kiyomizu temple and hoping to land well!" Yamanobe was the first Japanese to learn the latest theory and practice of cotton production, and before he set off for home he purchased spinning machines and steam engines from Pratt & Co. and Hargreaves & Co..

On his return, Yamanobe, together with Shibusawa, set about locating a site for the mill. Moreover, Shibusawa had raised 250,000 yen in capital from businessmen and nobility, and had arranged for the operating costs to be financed by the First National Bank, of which he was president. In this manner, the Osaka Spinning Company was born in 1882. From the very beginning, the performance of the company was startling. Both on the technology and management fronts, ideas of the past had been thrown out completely. Innovations featured a five-fold increase in output capacity, the use of steam power, locating the mill in a large urban area and not in the backwoods, round the clock production, the selection of goods that would not compete with Britain, and a shift to using cotton from China as opposed to the domestically-grown cotton as the raw material. Stimulated by the rapid success of Osaka Spinning, Mie Spinning, Kanegafuchi Spinning, Settsu Spinning, Amagasaki Spinning and a host of other mills modeled on it sprang up all over Japan. Thus, cotton spinning grew into the key industry of the Meiji Period.

However, in the stock companies of Meiji Japan, including the cotton industry, the voice of shareholders who had little knowledge of industry was powerful, and they severely criticized the management if investment returns fell short. In contrast to this, technical experts like Yamanobe, who had a deep understanding of industry, bore the long-term development of the business in mind rather than focusing solely on short-term profit when working out production and investment plans. This was the archetypal clash between the owners and management. Particularly during the recession around the 1900s, this confrontation between the owners and management heated up at Osaka Spinning, and the president and shareholders alike criticized Yamanobe, its chief engineer. Discouraged, Yamanobe went to Shibusawa to tender his resignation. Instead, Shibusawa firmly supported him and advised him to remain in his post. Finally, as the economy recovered, Yamanobe was appointed president of Osaka Spinning as a specialist who combined technical knowledge and management experience[20].

What if Shibusawa had not sent that first letter, or what if Yamanobe had persisted with his study of economics? Or, what if Shibusawa had not supported Yamanobe in his time of difficulties? It is possible that the cotton industry of Meiji Japan would not have emerged. The source of the vitality of the Meiji economy was the social environment which produced men of caliber such as Shibusawa and Yamanobe one after another, and that is the secret of the country's phenomenal catch up.

Policy Assistance and Macroeconomic Management

What about the contribution of the government? Meiji Japan adopted the following policies with the aim of adopting technology. As mentioned before, this list does not include attracting foreign direct investment, which is the most popular method today.

1. Hiring of foreign specialists
2. Nurture of Japanese specialists through study and training abroad, at engineering schools and universities, and on-site at state-owned factories
3. Investment in munitions plants, railways, mining, shipbuilding, and agriculture
4. Transfer of state-owned enterprises in the areas listed above to the private sector
5. Establishment of indigenous Japanese *zaibatsu* by assisting *seisho* (influential businessmen) and the easing out of foreign interests
6. Encouraging invention and domestic production through industrial expositions

Some comments and notes on the above list are in order. First, state-owned enterprises had experienced little commercial success, as Shibusawa had mentioned in his letter. Moreover, the general consensus is that they contributed little towards the "suppression of imports," which is what the government had hoped for. However, even with this record, the state-owned enterprises of Meiji cannot be wholly dismissed as only a drain on the national budget. These enterprises, through the strong demonstration effect of modernization, the employment of foreign specialists and the latest machinery, and by using the latter to train Japanese technical specialists established the groundwork for the rapid growth of private-sector industry.

Furthermore, because all public works, with the exception of munitions plants, were eventually sold off to the private sector, they in fact became part of its capital stock. The process of privatization was not transparent and criticized as only benefiting *seisho*, who paid almost nothing for the factories in comparison with the capital that had been invested in them (a similar criticism arose in the privatization processes of the countries in the former Soviet Union in the 1990s). However, as mentioned before, a large

[20] Matao Miyamoto, *Nihon no Kindai 11: Kigyokatachi no Chosen* (A History of Modern Japan Vol.11: Challenges of Entrepreneurs), Chuo Koron Shinsha, 1999.

number of these businesses were in the red and many of them needed large amounts of fresh investment to survive. We have to give just credit to the businessmen who willingly took on these loss-making businesses and successfully turned them around. Also, the role of the government, which took on the risk of modernization and bore its initial costs through establishing state-owned enterprises, should be duly acknowledged. All in all, we can call the state-owned enterprise strategy of the Meiji government a success. This is a considerably different opinion to that prevalent today in the development community, which flatly denies any role to state-owned production.

Turning our attention to technology transfer, this was achieved through three channels[21]. First, the employment of foreign specialists: Here, the cost of employing these professionals was so high that it became a major pressure on the national budget. To ease this, the government attempted to replace foreign specialists with Japanese, and this effort bore fruit around the 1900s when the number of foreign nationals employed dropped dramatically.

Second, the training of Japanese specialists: This was achieved through study and training abroad, the founding of *Kobu Daigakko* (an engineering university that later became the Faculty of Engineering of Tokyo University), and the creation of a multitude of technical vocational schools. The Japanese who studied abroad at the time attended the best universities in America and Europe to learn about the latest technologies, and it was not unusual when they replaced the foreign specialists on their return to Japan. At *Kobu Daigakko*, located in what is now Kasumigaseki in Tokyo, the teaching materials were all foreign texts and many of the lectures were conducted in either German or English.

Third, the importing and imitation of machinery: Here, Japanese engineers demonstrated an amazing capacity for selecting technology appropriate for the country and then absorbing and adjusting it. For example, when it was time to introduce a telephone service, Saitaro Oi of the Ministry of Communication and his fellow graduates from *Kobu Daigakko* collected publicly available information, conducted research in the West, and after negotiations with telephone makers there, decided on a system to adopt.

From around the 1900s, in an attempt to start up its own machinery production, Japan initiated a new method for adopting technology through collaboration between domestic and foreign businesses. Some examples of this cooperation included Japan Steel Manufacturing (a warship outfitter), a joint venture of the Mitsui Group and the British firms of Armstrong & Co. and Vicars & Co.; Nippon Electric Company (telephones) established with technical assistance from America's Western Electric; Tokyo Electric Company (light bulbs), which had a similar relationship with the US firm General Electric; and Shibaura Manufacturers (heavy electrical machinery, later to become Toshiba), which also received technical assistance from General Electric. Even in these cases, Japan quickly digested the new technology and was also able to adjust it for its needs. Behind all of this activity was a large number of Japan's elite who avidly studied engineering (not finance, law or management!). They advanced into every branch of industry and formed a rich pool of human resources for Japan's industrialization process. (A more recent example of this phenomenon was visible in the construction of the Pohang Steel & Iron Co. (POSCO) in Korea where Korean engineers, having received wide-ranging technical assistance from Japan, were quickly able to make the technology they worked with their own).

A point that we should not forget is that native craftsmen and artisans from the Edo Period did not just molder away upon the introduction of Western technology. Certainly, new industries such as the

[21] Hoshimi Uchida, "Gijutsu Iten" (Technology Transfer) in S. Nishikawa and T. Abe, eds., *Sangyoka no Jidai 1: Nihon Keizaishi 4* (The Age of Industrialization 1: Japanese Economic History) Vol.4, Iwanami Shoten, 1990.

railways and telegraph and wire communications had to be adopted as completely novel forms. However, as regards construction, sake-making and brewing, printing and the making of hand tools and instruments, traditional production technologies managed to survive for a long time. They went through an evolution, sometimes merging with Western technology, sometimes existing alongside modern equipment that had been introduced on a small scale, or by finding a niche market. Takafusa Nakamura calls this coexistence of traditional and modern technologies "new indigenous industries," while Konosuke Odaka describes it as "the parallel development of the indigenous and the modern."

This tendency is most vividly depicted by the development of the cotton industry. As mentioned before, this was the star industry of Meiji Japan. However, along with the modern spinning mills with hundreds of young female workers standing in rows operating cutting-edge machinery, a completely different traditional workplace for cotton goods production —through the *putting out system* or the small-scale household production coordinated by a broker — existed for a long time in parallel. In the beginning, modern mills were devoted entirely to spinning and traditional production for the most part took on the task of weaving. Modern factories first wove cloth from domestically produced yarn as Japan entered the twentieth century. Also around that time, powered looms were adopted into traditional production and the mechanization of the textile industry advanced. Thus, Japan's light industrial revolution was a process where traditional and new technologies worked together and complemented each other.

In addition to the policy of technology absorption, macroeconomic management also strongly affected the ups and downs of the private sector. The monetary and financial systems of early Meiji were in turmoil. Moreover, the reckless printing of unconvertible paper money to cover the cost of quelling the Satsuma Rebellion in 1877 caused inflation. This inflation enriched farmers but impoverished the samurai class whose rice salaries had been changed into the one-time receipt of government bonds (whose value was nominally fixed). This situation of monetary confusion was terminated by the deflation policy adopted by finance minister Masayoshi Matsukata in the early 1880s. During the Crisis of 1881, as noted earlier, Shigenobu Okuma and his faction which advocated political radicalism were ousted from the government. Okuma was also a fiscal activist and once he was gone, Matsukata assumed the councillorship for finance and the government was ready to pursue a policy of tight money and fiscal austerity. The price deflation that followed plunged Japan into recession. The price of rice fell especially hard.

When viewed from the perspective of long-term industrial development, the Matsukata deflation was significant in two ways. First, it caused the farmer class, which had grown rich until now, to fracture and accelerated the differentiation of the class into landless farmers and absentee landlords. It also brought the civil rights movement that had been financially supported by wealthy farmers to a standstill. Secondly, Matsukata built the financial foundation for industrial growth by establishing the Bank of Japan as the sole authority to issue money, thus ending the state of monetary confusion. Using slightly outdated terminology, we can say that the Matsukata deflation, by creating a proletariat class and providing financial capital, built the basis for capitalism in Japan.

Once the Matsukata deflation was over, the Japanese economy entered the so-called *kigyo bokko* (company boom) period. This period, beginning in 1886, released the energy of the young private sector and the country rushed into an unprecedented boom of setting up joint stock companies. Railway construction and textile production occupied the core of this activity. Moreover, the government underpinned the boom by providing easy money and permitting the yen to depreciate in foreign exchange. A succession of waves to establish stock companies again surged in the late 1890s, at the end of the 1900s, and during the First World War. Besides this, after both the Sino-Japan War (1894-95) and Russo-Japan War (1904-05), the central and local governments adopted the policy of "post-war management," namely, active fiscal spending for military buildup, railways, telecoms, steel production, waterworks, road-building, education, and the administration of Taiwan (Japan's newly acquired colony). The small government by degrees transformed into a big government and brought about a widening of the balance-of-payments deficit, a reduction in gold reserves, an increase in the outstanding balance of government bonds, and the external borrowing of local governments. The policy disputes between fiscal activists and the *minryoku kyuyo* (easing the popular burden) faction, which advocated tax and spending cuts and a free economy, persisted from the first Imperial Parliament in 1890 to the eve of the Pacific War and formed the biggest economic issue for the whole of pre-war Japan.

Akira Hara, an economic historian, summarizes the industrialization of the Meiji Period as follows:

> "The industrial revolution that started with the *kigyo bokko* period progressed rapidly during the Sino- and Russo-Japan Wars, and was almost over by the end of the Russian conflict [1904-05]. Cotton spinning, the silk industry and textile production alike developed rapidly, while shipbuilding and machinery production, and the steel industry on which they were based, also formed a foundation for future progress. The coal-mining industry secured a source of energy, while the silk industry earned the foreign exchange that supported the frail machinery industry. Munitions plants also became autonomous by relying less on imports"[22].

There is a great deal more that can be said about Meiji industrialization. But even with the limited description in this chapter, I hope the reader is able to sense the atmosphere that abounded in the extraordinary period known as Meiji. It possessed a strangely fluid and dynamic society which nurtured groups of people with outstanding ability while allowing an inventive private sector and government support for industry to mesh. The agents of change during Meiji lamented the country's hopeless backwardness. However, knowing what we do of latecomer countries today, we can say in hindsight that Japan of that time fared pretty well. I wonder if there is a way to transmit the atmosphere of Meiji society and its dynamism to latecomer countries of today.

5 Japan, the First-Class Power

The Words of Soseki Natsume

With Japan's military, economic and political catch up to the West for the most part complete, when was it that Japan became aware of itself as a first-class power? Even if the exact point cannot be clearly identified, the Russo-Japan War (1904-05) was without doubt an important milestone for the country. The nation, drunk on its victory against white Imperialist Russia, criticized a government unable to win indemnity payments as part of the Portsmouth Treaty. The mass media in unison raised the slogan of "Down with the shameful peace, on with the war!" The National Anti-Peace Conference, a rally against the signing of the treaty held in Tokyo, broke down into a mob that burned and looted (Hibiya Riots).

The life of Soseki Natsume (1867-1916), perhaps the most popular novelist in Japan then and now, largely coincided with the Meiji Period. He was well acquainted with both English and ancient Chinese literature. His early novels were sometimes comical (*I am a Cat* and *Bocchan*), sometimes romantic (*Sanshiro*) and even aesthetic (*Kusamakura*). But his later novels exposed the dark side of modern Japan, featuring individuals who struggled within human limitations and feudal constraints in modernized life without success (*Sorekara* and *Mon*). In his lecture, "The Development of Modern Japan," delivered in

[22] Akira Hara, *Nihon Keizaishi* (The Economic History of Japan), University of the Air Press, 1994.

Wakayama in 1911, Soseki cast the following words at his compatriots around the time they had begun to swell up with self-confidence and conceit at Japan becoming a civilized nation that ranked equal with the West (this was the year in which Japan's autonomy over its tariff system was fully restored).

> The development of the West was an endogenous process, while that of Japan today is exogenous. Here, "endogenous" means to come naturally from within, just like a flower opens from a bud in an outward motion of its own accord, while by "exogenous" I mean being forced to take a certain form under an external influence... Japan's development since that time [the opening of the country in the late Edo Period] started to take a completely new course, due to the enormous shock we sustained that made change unavoidable. To use the term I introduced earlier, our nation, which until now had evolved endogenously, suddenly lost control and found itself coerced to take whatever action that was forced upon it, whether willing or not.

I sense that this is a problem shared widely by the latecomer countries of today. If I were to call Meiji Japan a transition economy and liken its opening to the West to the collapse of the Soviet Union, then would it be too bold an analogy to liken the WTO and IMF to Commodore Perry's black ships? A nation having global integration forced on it is unsettled because the change is not of its own making.

> The waves that direct Japan's development come from the West. Because, we Japanese who ride these waves are not Westerners, as each new wave approaches we feel uneasy, like a person living in someone else's house… Instead of being able to enjoy the many delicacies offered to our heart's content, it is as if they are cleared away and the table is set again with new dishes before we have a chance to clearly see what was on offer. A nation that experiences this kind of development process must be left with a feeling of emptiness and insecurity. We should not pretend that this type of development is somehow endogenous. Such an attitude is make-believe. It is insincere, shallow, and not acceptable.

So, what should we do? Soseki has no good answer.

> However much we flatter ourselves, one part or even a large part, of our development process can only be evaluated as superficial. That does not mean we should put a stop to it because it is no good. We must accept reality. After swallowing our tears, we have to continue sliding along on our superficial course... I have no brilliant solution to offer. All I can say, just for the record and without much substance, is that we should try to evolve as endogenously as possible while avoiding a nervous breakdown.

The discomfort of the Japanese that Soseki witnessed stemmed from the feeling of loss of autonomy and self-esteem. This is an experience common to all latecomer countries that have to integrate into the periphery of an existing world system. Not only Japan, but all societies placed in this position must endure it. Despite Soseki's lamentations, Japan thereafter accomplished a spectacular catch up to the West on the material as well as institutional front (even with the enormous tragedy of the war that intervened). However, who have we ourselves become, the "we" who are so successful at imitating others? After all these years, we have neither resolved nor eliminated the issues Soseki raised. We have swept them under the rug but they still remain in the depth of our consciousness. Whenever we are ready to face them, these problems will immediately surface and challenge us. Since the end of Meiji, this important question concerning the Japanese identity has been neither deepened nor dealt with squarely. Even in today's latecomer countries, the impact of global integration on their societies and spiritual life has escaped proper attention and analysis, leading only to a repulsion of and dissatisfaction with external pressure at the emotional level. The investigation of this issue as a legitimate branch of social science is an important task in economic development — a task becoming of a Japan that succeeded in catching up with the West while maintaining its non-Western traditions.

Industrial and Trade Policies of Vietnam under International Integration

MINUTES OF MEETING

The National Economic University (NEU), Hanoi, and the Japan International Cooperation Agency (JICA) held a joint symposium on Vietnam's trade and industrial policy in Hanoi on March 29 and 30, 2002. This was part of intellectual ODA provided by the Government of Japan to Vietnam. The research project is headed by Le Du Phong, Vice Rector of NEU, on the Vietnamese side, and Kenichi Ohno, Professor at the National Graduate Institute for Policy Studies, on the Japanese side. Additionally, seven Japanese and twenty Vietnamese experts (including those from the Ministry of Planning and Investment, Ministry of Trade, Ministry of Industry, and Vietnam Steel Corporation) participate in the project.

Opening remarks by His Excellency Mr. Ryuichiro Yamazaki, Japanese Ambassador to Vietnam, and Professor Dr. Vu Ngoc Nhung, Vice Minister of Education and Training

SESSION 1 : OVERVIEW AND MAJOR RECOMMENDATIONS

(March 29, 2002, morning)

Presentation by Prof. Kenichi Ohno, *National Graduate Institute for Policy Studies (GRIPS)*

This research project between National Economic University (NEU) and Japan International Cooperation Agency (JICA) was organized to produce concrete policy advice for Vietnam's industrialization under integration. We conduct in-depth studies respecting the individuality of each industry. Twenty-nine researchers from Vietnam and Japan participate in this project. We disseminate output through various channels including a web site and seminars like this. My role is to summarize our current views and recommendations.

The market must be the main engine of growth. But where the private sector is weak, the government has important roles in fostering markets and managing integration. We reject both full control and full liberalization. Liberalization must be strong enough to provide incentives for reform, but it should not be too drastic to cause social problems. This delicate role of government in a developing country is what we want to convey. There is much room for improvement in Vietnamese policies.

Integration for a latecomer country is a process of great self-transformation under foreign pressure. This tends to create dual structure according to the degree of foreign penetration. Vietnam's manufacturing sector is also split into two parts: the protected domestic sector and the open export sector. They operate independently now, and Vietnam's challenge is to link them by improving domestic capability.

The key to Vietnam's industrialization is foreign direct investment (FDI) policy. FDI dynamics is a very complex one in which two forces of *agglomeration* and *fragmentation* interact. Vietnam should first accumulate a critical mass of assembly-type FDI. This will open up the possibility of creation of supporting industries and, later, technology transfer. Do not try to jump to the last stage without sufficient FDI accumulation. To attract FDI, the government must actively build good environment and reduce the cost of doing business. The policy of free trade and investment is not enough.

By contrast, industries producing for domestic markets are now protected. Foreign and Vietnamese firms in these industries must be given clear timetables for the removal of protection. For industries with realistic restructuring plans, the government may temporarily support them in exchange for such efforts.

We also have specific advice for individual industries. In textile and garment as well as in steel, for example, the Japanese advice is different from the current government policies. The details will be presented in later sessions, today and tomorrow.

Mr. Tran Dinh Thien, *Institute of Economic Studies*

We appreciate very much the presentation of Prof. Ohno. May I ask some questions? First, does the essence of your proposal contradict with Vietnam's commitment to free trade? Is there not a dilemma between industrialization under protection on the one hand and globalization on the other? I wonder if your project is also considering the issues of institutional reforms and incentive policies as well. Second, Prof. Ohno mentioned the sequencing from assembly to parts production, and finally to technology absorption. But we need clear criteria for moving from one stage to the next. We have to specify the timing from the viewpoint of technology.

Prof. Ohno

In theory, there seems to exist a dilemma between globalization and protection. But in practice, there is no such dichotomy; the two policies must always be combined properly. We can say that a country with good preparation should be able to go far in globalization. The problem is that, for many countries, globalization proceeds too quickly without preparation. The preparation includes not just new laws and institutions but also industrial competitiveness. How to combine globalization and protection in each individual case is more important than trying to choose between 100% globalization and 100% protection. When we study specific industries and products, we will see that both are needed but with different proportions. On the second point, I agree completely. That is exactly what we are studying. At present we do not have concrete proposal for timing (except steel, below). But in the rest of this year, we will continue to prepare such schedules for key industries. To present concrete timetables for integration, we need to study hard to understand deeply the local industries as well as global market trends.

Mr. Nguyen Quy Son, *General Secretary of Vietnam Electronic Industries Association (VEIA)*

Vietnam's electronics industry is assembly-concentrated and foreign-dominated. Foreign firms produce hardware, but the government emphasizes software. However, we have only a few small and medium enterprises (SMEs) and state owned enterprises (SOEs) in the software industry. Prof. Ohno suggested that Vietnam should identify its proper position in the global electronics industry to design appropriate policies. According to Japan's experience, what is the current position of Vietnam's electronics industry in the world?

Mr. Nguyen Xuan Hoa, *Vice General Secretary of the Vietnam Association of Textile and Garment*

Prof. Ohno suggested that the textile and garment production in Vietnam should focus on downstream processing. What is the basis of this recommendation? In deciding the development path of the textile and garment industry, we need to consider many factors. And the most important among them is the internalization of production and the increase of domestic content.

Prof. Yumiko Okamoto, *Nagoya University*

For electronics, there will be a detailed presentation this afternoon. It is true that the major driving force of Vietnam's electronics industry at present is multinational companies. Vietnamese experts may be worried that the industry is dominated by foreigners. But we need to look at the experiences of other Association of Southeast Asian Nations (ASEAN) members. At first, they invited as many multinational corporations (MNCs) as possible.

Secondly, they tried to establish linkage between local SMEs and large MNCs. What Vietnam should do is first to attract foreign firms and next to improve domestic capability. We cannot do everything at once, and the sequence is very important. For this, Vietnam needs to have a good development strategy for the electronics industry.

Prof. Ohno

I would like to add that all our recommendations for electronics, textile and garment, and other industries are based on international experience and the analysis of global and regional forces, not just domestic factors.

Let me give you an example. For textiles, we do not support “internalization,” or investing upstream, for the following reasons: Vietnam is rich in human resources and poor in capital, but upstream investment requires a lot of capital. There are already many countries that produce good textile, and it is very hard to compete with them in price and quality. Moreover, if you sink your money into big capital equipment and if the global condition changes, you cannot switch to another strategy. Before investing so much, Vietnam can do many things to improve competitiveness in garment manufacture. The productivity of Vietnamese garment workers is low compared with China. To improve this, better production management is needed, not large capital investment. At present, Vietnam depends entirely on foreign partners for marketing and input procurement. Why not start to learn these from them, step by step, which will raise domestic content, reduce foreign partners’ operation cost and attract more FDI? The Vietnamese side can also take up designing, accessories, dyeing, and factory management in proper speed and sequence.

In the age of globalization, raising value-added does not necessarily mean investing upstream. You should not try to internalize the whole industry. Even for one product, there are many stages of production with different labor and capital requirements. Concentrate on the process you can perform well, and do it even better. If Vietnam focuses on the processes requiring a lot of high skilled labor, it should do very well in the future.

SESSION 2 : WTO, AFTA AND FDI

(March 29, 2002, morning)

Presentation by Prof. Mai Ngoc Cuong, *National Economic University*

Integration is an urgent requirement for Vietnam. Despite the recent efforts of both government and enterprises, their preparation still cannot meet the challenges of integration adequately. Therefore, the preparation for economic integration should be accelerated. This requires continued endeavors by both government and enterprises.

For the government, appropriate strategies for economic restructuring under ASEAN Free Trade Area (AFTA) and World Trade Organization (WTO) should include: (1) building a long-term comprehensive plan for regional integration; (2) regulating the direction of investment for systemic transition and development of potential advantages of the economy; (3) upgrading business environment including credit access by non-state enterprises and tax rate adjustment; and (4) trade related measures such as removal of Non-Tariff Barriers (NTBs), shift from positive to negative lists, transparency in trade laws, etc.

For enterprises, appropriate strategies should be: (1) enhancing enterprises' quality and effectiveness; (2) designing business strategies for most effective targeting in the long run; (3) renovation and modernization of technology and achievement of low cost; and (4) enhancing quality and management of labor resources at enterprises.

Presentation by Prof. Okamoto (on behalf of Kimura)

Let me present the paper on FDI strategy by Prof. Fukunari Kimura, who is absent. My own presentation on the electronics industry is scheduled this afternoon, but the first half of my presentation is related to Kimura's ideas. The difference between the ASEAN model on the one hand and the Japanese or Korean ones on the other is that the latter separated export and domestic markets in industrialization strategy. To promote exports, instead of waiting for local firms to grow up and penetrate the world market, the ASEAN countries established export processing zones (EPZs) to attract FDI and let foreign firms produce for the world market. Then they tried to strengthen the linkage between the domestic and international sectors. Vietnam should follow the ASEAN model for industrialization.

The question is what type of industrial policies Vietnam should adopt today. The most important recommendation by Prof. Kimura is to design new industrial promotion policies centered on FDI accumulation. Vietnam is facing new challenges which were not experienced by the other East Asian countries in the past. The forces driving FDI are changing: there is more competition for FDI attraction among developing countries; unskilled labor alone is no longer enough to attract FDI. To attract export-oriented FDI, Vietnam must become the best (or second best) location in the world. For this, the key is to provide good infrastructure services and good policy environment. Additionally, supplying more skilled and educated workers as well as development of intermediate inputs will attract more FDI into Vietnam.

Mr. Peter Sturm, Ph.D, *German Development Service and Central Institute of Economic Management*

Let me raise two questions. First, Prof. Ohno advises that Vietnam should concentrate on assembly now and not parts. Does this mean that Vietnam should refuse investment projects in parts? It is for private firms, not government bureaucrats, to decide what investment they will make. There should be no selectivity in attracting FDI. Second, if you permit protection in import-substitution industries, this tends to attract uncompetitive projects, leading to a waste of capital.

Prof. Okamoto

There should be a clarification of terms. Vietnam has both assembly of final products and assembly of parts. The distinction between assembly and parts, therefore, is not really correct. What I am saying is that the Vietnamese government should try to attract as many FDI projects as possible. Of course the business sector is in the best position to decide the type of FDI. But the government has also to play the role by preparing good environment and infrastructure.

Ms. Karolyn L. Gates, PhD, *Multilateral Trade Policy Assistance Program (MUTRAP), EU*

Prof. Kimura's paper says that Vietnam should be the No.1 or No.2 location for FDI. But locational advantages shift dynamically and specific measures required may differ from one industry to another. Telecom may be the key for one industry, but a good road system may be more important for another. I feel that policy to target particular industries in this way is difficult to realize.

Prof. Okamoto

Perhaps the way I presented Prof. Kimura's ideas was somewhat misleading. In the new competition for FDI, how you attract FDI depends very much on the type on industries and, even within an industry, on the particular production process. I am not saying that Vietnam's government should prepare everything.

Dr. Nguyen Duc Kien, *Economic Research Agency of the Vietnam Communist Party*

I would like to raise a point of clarification. It is proposed to let the private sector decide what kind of investment they should make. But I want to refer to a situation in Vietnam and ask for your advice. The very first group to oppose the tariff reduction under AFTA framework was FDI firms in Vietnam. They asked the government to raise import tariffs to protect their production. Chemicals and motorbikes were examples of these. In the current transition process, where is the boundary between government and private decisions, and to what extent should the government intervene in the market?

Prof. Ohno

We are not asking the Vietnamese government to screen FDI. On the contrary, we are complaining that the government is screening too much, especially in imposing local contents. Our main argument is that Vietnam should first establish an FDI attraction policy without selectivity. Under import protection, as noted by Dr. Kien, some FDI firms come to enjoy high protection, and they often lobby against trade liberalization. This type of protected FDI should be clearly distinguished with export-oriented FDI which operate under open and competitive environment. For protected FDI, a clear timetable for reducing protection including both tariffs and NTBs should be announced. The government should respect international commitments.

Mr. Thien

Prof. Kimura's paper suggests that Vietnam should follow the ASEAN model for attracting FDI and achieving industrialization. But this may not be the right model for Vietnam. The Asian financial crisis revealed the risk of adopting the model which may have succeeded in other countries. First, in the earlier period, the East Asian countries industrialized under high tariffs. But now, Vietnam has to reduce protection within a short time, so the same model cannot be used. Second, capital mobility has increased dramatically. Third, this is the age of the knowledge economy, but Vietnam lags far behind in this area. To catch up, Vietnam needs a medium-term strategy for moving from simple assembly to high-tech. As the world changes, the model for attracting FDI in particular, and the development strategy in general, must also change. Therefore, with respect to the Kimura paper, I would like to ask: can Vietnam really apply the ASEAN model? If not, what model should developing countries adopt in the age of globalization and knowledge economy?

Vietnamese participant

I agree fully with Mr. Thien. We have relied too much on past experiences, but what Vietnam needs is new creativity for its development. FDI attraction must be balanced with the government's own vision about Vietnam's development. Even under WTO, the government should give directions so that our path will be knowledge- and technology-based and inputs and upstream processes are internalized.

Prof. Ohno

The two previous speakers hope to maintain Vietnam's autonomy in the process of industrialization. I can understand that, but policy independence must be realized in a way consistent with FDI dynamics. The oriental saying teaches that, to control the flow of water, we need to work with the nature of water, not against. Vietnam's autonomy must be realized by guiding FDI, not dictating it.

Prof. Okamoto

Let me stress three things in clarification of the ASEAN model. First, the other ASEAN countries did not lift protection immediately. Second, strategies for export-oriented industries and import-substitution industries must be clearly distinguished. Third, Vietnam has much less time to implement free trade than the other ASEAN countries.

SESSION 3 : ELECTRONICS INDUSTRY

(March 29, 2002, afternoon)

Presentation by Dr. Nguyen Ngoc Huyen, *National Economic University*

The electronics industry has grown strongly since 1990, in terms of both production capacity and number of enterprises. To date, there are approximately 200 enterprises, of which state enterprises account for a half. Most enterprises are small-scale assemblers. Enterprises in the South account for 75% of total electronics output. Foreign-invested enterprises dominate, while state enterprises and domestic private enterprises account for a small proportion of output.

In terms of technology, it remains a labor-intensive industry in which complete knock down (CKD) assembly accounts for 80% of total. Simple labor is Vietnam's largest input. While the government desires to promote the industry, the strategy is formed at national or ministerial level with very general directions. The government has revised its policy orientation from import substitution to export promotion.

Despite the advantages of cheap labor and the government's promotion, Vietnam's electronics industry faces many challenges: (1) market imbalance; (2) inherent disadvantages of a late starter; (3) unskilled labor with little discipline; (4) poor infrastructure; (5) weak macroeconomic management; and (6) the weakness of state electronics enterprises.

From the current situation, taking into account the potential and the targets of the industry, we would like to propose some measures. The government needs to stimulate FDI in original parts production, promote technology transfer, build necessary infrastructure, and support trade in the electronics industry. Additionally, domestic investment should be promoted. For copyright protection, the legal environment must be improved by strengthening the legal protection institutions and the fight against smugglings and counterfeits. Finally, the development of human resources must be accelerated.

Presentation by Prof. Okamoto

Global electronics production is entering a new stage with (1) globalization of production; (2) new factors dictating the location of MNCs; and (3) emergence of China as an industrial power. The driving forces of this industry are MNCs. In Vietnam, the share of MNCs in total manufacturing rose from 1.3% in 1996 to 4.4% at present. Even so, Vietnam's share in East Asian electronics production is very small. Although electronics appears to be one of the leading industries in Vietnam, its size is minuscule by the Asian standard. New opportunities generated by both international and regional changes have not been fully captured by Vietnam. Development of the electronics industry in Vietnam is constrained by (1) high cost of doing business; (2) lack of promotion; (3) underdeveloped infrastructure; (4) strict local contents requirement; and (5) bureaucracy.

In Vietnam, office rents are about the average of ASEAN but higher than in ASEAN4. Phone charges are the second highest in the region. Electricity is also expensive. Local transportation costs more than transoceanic shipping. All these offset the advantage of cheap and skilled labor.

My suggestions for Vietnam's electronics industry are as follows: up to 2006, Vietnam should attract as much electronics FDI as possible. This should be done by cutting the cost of doing business, improving the quality of government services and removing various disincentives in production. In the medium to long term, Vietnam should gradually introduce selectivity and support the development of SMEs.

Mr. Sadanori Watanabe, *JICA expert and VCCI*

Let me say a few words from the private sector's viewpoint. Vietnam's electronics production is only in assembly. Further development requires parts industries. To build such industries, the government must clarify its policy and offer good incentives. But not much time is left for Vietnam to do this. It is very important to distinguish electronics for exports and electronics for domestic sales.

Prof. Nguyen Ke Tuan, *National Economic University*

Let me ask some questions. First, I understand that the electronics industry is characterized by rapid change and short product cycles. How do you assess the competitiveness of Vietnam's electronics in the globalization age, in the domestic as well as foreign markets? Vietnam currently does only assembling, which is old technology. Second, Dr. Huyen's presentation seems to emphasize the closed circuit of production from A to Z. In the mean time, Prof. Okamoto suggests that Vietnam must become one link in the international division of labor. Third, Dr. Huyen's forecast is too optimistic, especially the export demand of USD 2 billion by 2005. Fourth, research and development (R&D) should be included in the development strategy since this is very important. How do you assess its possibility in the Vietnamese context?

Mr. Tran Dinh Thien

I agree that the electronics industry must be given priority. Concerning Dr. Huyen's presentation, the strategy should be more specific. For instance, what are the conditions for successful implementation of the measures proposed, what is the technology needed for the proposed development, and this question leads to the market selection. Given that Thailand, Korea, Taiwan and others have attained high levels of electronics development, at which market should Vietnam aim? The electronics industry is also highly volatile, as seen by the recent IT recession. So our strategy must also be flexible. Could the Japanese experts suggest international experiences useful for Vietnam, especially the Malaysian experience?

Prof. Hoang Duc Than, *National Economic University*

Prof. Okamoto mentioned the problem of Vietnam's high costs. I do not think it is a major problem. Currently, the government is promoting decentralization so provinces can offer rent exemption, like the case of the Nomura Industrial Zone. According to the government's plans, the electricity tariff will come down and the telecom cost will be equivalent to the regional level by 2006. Second, the most important issue for the electronics industry is to increase the domestic content, to produce parts locally. The lesson from the motorbike industry is highly suggestive. The increase in local contents from 18% to 33% led to a large fall in the price. The IMF/World Bank study of Vietnamese production finds that the cost of imported inputs accounts for 42-60% while the labor cost is only 7-9%. Domestic production of inputs is very important. So can you tell us whether Vietnam should invest upstream for stable development or continue to do only assembling?

Mr. Nguyen Quy Son, *Vietnam Electronic Industries Association (VEIA)*

The government has no strategy for the electronics industry at present. We have clear targets for telecommunication and a plan has been submitted for software. But we have no strategy for electronics hardware. With the cooperation of the Vietnamese government and Japanese experts, I sincerely hope that a formal strategy will be drafted for hardware. As to the localization of parts, reality is moving faster than the government can think. To promote localization, tax incentives will be necessary. When AFTA tariffs begin to come down from 50% to 30% in 2003, there will be a severe problem of survival among TV producers. Technology must come from abroad, but we must upgrade infrastructure.

Prof. Okamoto

Thank you for your comments. I have visited many foreign electronics companies in Vietnam and they have a lot to say about high domestic contents requirement and high tariffs on imported components. In order to make them more competitive, they must procure cheaper inputs. There are two ways to do this. One is to import the best and cheapest parts from neighboring countries. The other is to attract FDI in parts. However, with the current production volume in Vietnam, it is very difficult to attract FDI in components that require large scale for efficiency.

In conclusion, I would like to make three remarks. First, Vietnam has a big potential in electronics, and whether that will be realized depends on policy. Second, as to the question of remaining in assembly or going upstream, let me say that the current global business model is concentrating on *core competence* and outsourcing the rest. And third, let me repeat that the government must have a good strategy for electronics to guide investors. At present, there is none.

SESSION 4 : TEXTILE AND GARMENT INDUSTRY

(March 29, 2002, afternoon)

Presentation by Prof. Nguyen Ke Tuan, *National Economic University*

With the comparative advantages of Vietnam, the textile and garment industry is very important in the national industrial structure. The cut-make-trim (CMT) mode is currently most suitable with Vietnam's textile and garment industry because of abundant labor, lack of capital and complicated technology, geographical location, etc. In the last few years, Vietnam's textile and garment production expanded considerably but the country still remains in a backward position. Exports also rose rapidly, reaching USD 2.15 billion in 2001, of which 70% was export processing. The CMT mode not only dominates, but also it is the main reason for foreign companies to choose Vietnam. The industry faces many constraints, including the limited access to foreign markets, weak competitiveness, and mismatches in institutional environment.

Despite these challenges, the industry's opportunities for development are great. The development strategy for the industry up to 2010 has been approved by the government, in which exports are targeted to USD 4 billion by 2005 and USD 7 billion by 2010. The bilateral trade agreement (BTA) with the United States has been ratified, giving the industry a chance to enter the American market in the future. We offer the following recommendations for textile and garment companies exporting through CMT.

(1) Manage well the quality of material and accessories provided by foreign partners as well as the quality of each stage of production, improve the professionals and labor, and build and apply advanced quality management systems.

(2) CMT partners should be diversified over different markets.

(3) Promote investment for technological innovation.

(4) Renovate production organization and management.

(5) Follow the strategic direction of gradually shifting from CMT to FOB.[1]

On the government side, the main tasks are two: promoting investment in material development for the garment sector, and improving the legal environment.

Presentation by Mr. Kenta Goto and Prof. Yasuhiro Ota, *Kyoto University* and *Tokuyama University*

The Textile and garment industry plays important roles in Vietnam. However, Vietnam is competitive only in the exports of a narrow range of garments and contributes to very limited stages of production and distribution. The main mode of garment production for export is CMT. This is suitable for Vietnamese garment manufacturers as it provides small risk and stable margins. Some factories export in the FOB mode, but even this is the simplest FOB (type I), not more advanced FOB (types II and III).

[1] The FOB, or free-on-board, mode refers to a production contract where the Vietnamese garment factory, not the foreign partner, procures inputs. It has no relation with FOB in international trade business.

Our survey of factories and outlets in the North and South shows the lack of a modern merchandise distribution system. The Vietnamese textile markets are very primitive and cannot handle inter-firm business risks. If FOB is forced under such circumstances, each factory will have to bear all business risks and may end up losing money compared with CMT. This problem is more serious than the lack of modern production equipment.

The Vietnamese government has approved a "speed up" strategy for 2000-2010 aiming at (i) building a backward linkage through investment in the upstream sector (textiles); and (ii) early realization of garment export under "type III FOB." However, we suggest that Vietnam should concentrate on the CMT mode for the moment, improving its quality and quantity and achieving its full potential.

After that, the next step will be the development of the upstream sector. But this should be supported indirectly, not by hasty investment but as a natural evolution of expanded garment production in the downstream. The upstream sector is highly capital intensive and requires high-level management and production skills. Its development takes time and money, and FDI should play an important role in it.

The following measures are additionally recommended: (1) clarify the causes of poor quality and low productivity and take appropriate measures; (2) expand the domestic market of ready-made clothes and materials; (3) encourage independent SMEs to link textile producers and garment makers (such SMEs already exist in Ho Chi Minh City (HCMC)). The government should introduce measures to develop core competence and increase the availability of education, training and technical services.

Presentation by Prof. Yoshiaki Ueda, *University of Marketing and Distribution Sciences (UMDS)*

The leather and footwear industry has contributed to Vietnam's economic growth. In 2001, it was the fourth largest export industry. The industry has a good prospect of future development, including the US market under the newly ratified US BTA. It has also benefited from the policy of private sector development as well as low cost and high quality labor. However, Vietnam has to overcome a few obstacles: keen competition from other countries (especially China), high dependence on imported raw materials, etc. To strengthen the competitive edge, the government should integrate its industrial policies with the activities of enterprises in both global and domestic areas.

Seven policy actions are proposed: (1) set up "hybrid" vocational schools; (2) establish research and development centers for design; (3) receive foreign experts for technology transfer; (4) promote supply of low cost raw materials; (5) convert weak companies into other industries; (6) promote SMEs; and (7) promote exports for the entire industry.

Mr. Tran Manh Thu, *Ministry of Industry*

I was very interested in all the presentations. I have some comments. First, Prof. Tuan did not mention the quota issue for garment exports, but that is an important factor. Second, Mr. Goto advises indirect development of the upstream sector. Here I want more explanation. You are trying to demonstrate that the CMT mode has the comparative advantage in Vietnam today, and maybe you are correct. But the real question is how to get from here to more value-added: by promoting CMT or investing upstream? Can you, instead of describing advantages of CMT, prove that upstream investment is more costly for Vietnam than CMT in achieving this goal? China has a three-year strategy to upgrade textiles under WTO. Thailand is renewing technology. Technology changes fast, and we must find a short cut for development. I do not see why Vietnam should promote only CMT.

Mr. Truong Huynh Cam, *Vietnam Textile and Garment Corporation (VINATEX)*

We appreciate all of your presentations and agree with many of your points. Your assessment of CMT has been comprehensive. Of course we should aim at FOB as a long-term goal. VINATEX is also trying and some enterprises have reached high FOB ratios. To increase domestic content, the government has approved the 2000-2010 strategy. CMT has low risk but its productivity is low. It is prone to the same crises as FOB. Another important consideration is that the US market only accepts FOB exports. So CMT will not do.

As for the risk-sharing distribution mechanism mentioned by Prof. Ota, I think the Japanese model is not directly applicable to Vietnam. Regarding the quotas mentioned by Mr. Thu, garment exports depend on quotas only in EU and Canadian markets. To date, these quotas have been distributed to only garment manufacturers, not trading firms. So the Japanese experience may apply in future, but not today.

Vietnam has other difficulties, especially competition with Chinese exports. China has more material supplies than we do. Regarding FDI attraction, the current accumulation of FDI in the garment sector is relatively large, but the efficiency of these JVs is still low. I wonder why. So attraction of FDI is good, but it may not be the highest priority.

Vietnamese participant

I agree with Prof. Tuan's recommendations, especially government actions to support education and management, provide stable legal environment, etc. I also concur with Prof. Ueda that the roles of government and enterprises should be more clearly separated. The government's role is to negotiate integration and draft a road map for guidance. This is extremely important in the current globalization trends. But all recommendations should be made more concrete.

Second, we should let the market decide how to go from CMT to FOB. We cannot deny FOB entirely since it is important and some markets require FOB. We should concentrate more on marketing and trade promotion.

Third, the suggestion to develop relations between producers and trading firms will encounter a problem in Vietnam. Currently, foreign sales are dominated by foreign companies which are profit-oriented. We need to diversify partnership.

Mr. Goto

We have discussed whether and how fast Vietnam should go upstream. This question is similar to that in electronics. As a current strategy, I believe Vietnam should focus on CMT, namely downstream, not upstream investment. I do not think "short cut" solutions are possible, and buying modern machines will not guarantee success. Vietnam can hardly afford the luxury of spending so much money on capital equipment.

However, this does not mean that Vietnam will forever remain at this level. Doing CMT well not only generates more value-added, but you will realize technology transfer through foreign partners and can move to the next stage.

Vietnamese participant

The government's roadmap for the textile and garment industry already exists. But it is certainly true that realizing full potential will take much time.

SESSION 5 : STEEL INDUSTRY

(March 30, 2002, morning)

Presentation by Prof. Nozomu Kawabata, *Tohoku University*

Our study discusses the policy options for the Vietnamese steel industry. The iron and steel industry includes many production processes. In Vietnam, the production structure is not only limited in scope but is also imbalanced. There are many rolling mills for long products, while there is too little steel-making capacity and no rolling mill for flat products.

The feasibility of constructing a large-scale integrated steel works (ISW) has been hotly debated among Vietnam's policy makers. In my opinion, however, the ISW is not an urgent problem. It is too large in capital requirement and cannot be built in a short time. Instead, the government should focus on the two immediate challenges that will determine the future of Vietnam's steel industry: (i) coping with the overcapacity in long product rolling; and (ii) successful operation of the nation's first flat steel mills.

First, with long products, steel-making capacity is lacking while rolling capacity is excessive. This resulted from mutually inconsistent trade and competition policies. The Vietnam Steel Corporation (VSC) should avoid over-investment in rolling mills.

While Vietnam should liberalize its steel trade, its timing is important. I present two tariff reduction scenarios in concrete numbers and three policy options for your consideration. The first option gives top priority to liberalization. The second option makes partial modification to AFTA commitments for temporary protection of long products. The third option tries to strike a balance between temporal protection and the commitment of liberalization. In the first option, rolling mills will face difficulty because product margin for rolling mill will diminish rapidly. In the second option, relatively thick margin is predicted. In the third option, which combines strict AFTA implementation with slower liberalization with non-AFTA countries, the margin for rolling mill will be somewhere between the first two options.

Second, with flat products, the first cold rolling mill (CRM) will be built by 2003-04 to produce sheets. For viability of this mill, market research and development is crucial. The main target for the new flat products should be customers in the middle-range market. There is also an issue of speed of capacity expansion. If it expands too vigorously, it will create overcapacity in that market segment.

As in the case of long products, I have two tariff reduction scenarios and three policy options. If Vietnam adopts the first option (fastest liberalization), building a hot strip mill (HSM) in the future will become virtually impossible because the margin is too thin. On the other hand, CRM and HSM can secure thick margins in the start-up periods in the second option (late liberalization). In the third option, the margin will be somewhere between the two options.

Overall, I recommend the step-by-step approach for developing the steel industry in Vietnam.

Pham Chi Cuong, *Vice President, Vietnam Steel Corporation (VSC)*

As for the past developments and current issues, Prof. Kawabata's observations are similar to mine. With respect to the overall speed of steel industry development, JICA cautions us since an ISW will require huge capital to build ($5-7 billion) and face fierce competition. But some want an ISW as soon as possible. I agree with JICA experts that the step-by-step approach is superior. VSC's view is that Vietnam should not build an ISW early.

In building flat steel mills, we do not want to raise protection against Russia's cheap but low-quality sheets. These cheap products are needed in Vietnam. We will target other market segments to avoid direct competition with Russia.

As for boosting billet production, the pre-feasibility study (F/S) of an electric arc furnace (EAF) with a capacity of 500,000 tons was approved two days ago.

As for domestic raw materials, the pre F/S of Thach khe ore is being conducted by the Russian team. After we receive its results, we will decide whether to proceed with the full F/S.

Regarding Thai Nguyen Steel Corporation, JICA advises us not to expand any further (second phase), but there are different views in Vietnam. My personal view is that Thai Nguyen should not be expanded any more; it is not competitive and cannot survive under AFTA due to import requirements and inappropriate location. Because of needed land transportation, its steel is $10 higher per ton than other mills. Under AFTA, many mills must be closed or consolidated, and only those with good technology will survive.

Presentation by Prof. Hoang Duc Than, *National Economic University*

The steel industry has an important role in Vietnam's industrialization. Since 1986, it has been performing well in terms of capacity and product diversification. However, the industry also faces some drawbacks: the monotonous and simple product structure (only low and medium quality long products); the low capacity of billet production; out-of-date technology; and inconsistency between targets and capacity. Competitiveness is weak with respect to production cost, human resources and infrastructure. The regional and international integration process has posed many challenges for the steel industry, and the survival of enterprises operating in Vietnam is being threatened. We have the following suggestions to reform the industry in the integration process.

Regarding the government policy, various resources should be mobilized including budget, official development assistance (ODA) and FDI to train staff, build infrastructure and promote R&D. These indirect measures are better than directly subsidizing steel enterprises. The protection policy should be reasonable with proper selection of products based on the situation of the domestic market and AFTA commitments.

Regarding enterprise efforts, competitiveness comes from cost advantage as well as differentiation. Production cost can be reduced by organization, technology and the efficiency in input use. We propose the scheme for cutting cost in the medium and long run as described in the table in our paper. Product differentiation requires enterprises to reform distribution to create more value for customers. We have concrete data for the profitability of state-owned steel distributors in the paper. VSC should reorganize its structure and activities, and the steel association should play more roles.

Dr. Do Huu Hao, *Director General, Institute of Industrial Policy and Strategy*

All presentations have described the steel industry well and given good recommendations for our policy design. I have the following comments. Our steel industry is imbalanced. Although there is overcapacity in rolling, more manufacturers are entering into this market. The VSC and the Ministry of Planning and Investment (MPI) must curb investment in steel rolling.

There are two opposing views on the development of the steel industry: go upstream fast, or step-by-step. The government takes the second position. As to Thai Nguyen, we are only talking about expansion to the maximum capacity of 0.5 million tons of billet, and not more. Quy xa ore is inefficient. The new investments should be on the coastal area, near Ha Tinh ores. We will use gas for billet production.

We are facing many challenges, especially the difficulty in capital mobilization. Soft loans with 3% interest rate are available but amounts are limited. ODA loans are no longer usable for steel. Please also note that domestic steel demand is rising strongly. CRM and HSM must be built soon.

Mrs. Nguyen Thi Bich, *Deputy Director, International Relations, Ministry of Finance*

We highly appreciate all presentations; they have provided valuable information and mentioned issues of our interests. Regarding policy options offered by Prof. Kawabata, I have some questions. First, you have proposed scenarios for tariff reduction in the steel sector. In my opinion, AFTA commitments are fixed and should not be changed. If we want to renegotiate the AFTA commitments, we have to offer new concessions in other products. Is such a strategy profitable for the whole economy? And if we choose to renegotiate, what should be the proper length of protection for the steel industry? Second, in your tables you start the projections from the 20% tariffs, but the current AFTA tariffs for steel are already less than 20% [Note: there is however a dispute as to whether that has really been implemented]. Third, Prof. Kawabata mentioned Russia and Ukraine as big competitors, but what about neighboring countries like Thailand and China? I fear they will be even bigger competitors for Vietnam.

Prof. Ohno

Concerning the renegotiation of AFTA commitments, I think that the message conveyed by Prof. Kawabata is that it should not be renegotiated. His third policy option, which is most reasonable, combines full AFTA implementation with temporary higher tariffs against non-AFTA countries. This avoids the political mess associated with AFTA renegotiation.

The grave problem with Vietnam's industrial policy is that it is not integrated with trade policy. In the opinion of the ministries responsible for international integration, free trade commitments should be surely honored. But from the viewpoint of building industrial strength, part of the Vietnamese government still considers deviation from AFTA as a serious option. And investors, both domestic and international, are perplexed as to which policy will be followed in each industry.

Another problem with AFTA is that it is not certain whether other members like Indonesia and Malaysia will fully implement AFTA. Particularly in steel, with globally depressed prices and US anti-dumping disputes, it is very unlikely that AFTA will proceed as scheduled. If so, we cannot expect Vietnam to stick to AFTA when most other members are not implementing it, at least in steel.

Prof. Kawabata

Thank you for your questions and comments. My second policy of postponing AFTA commitments is only one option among many, for the Vietnamese government to consider and choose from. Personally, I do not recommend it to you. But the reality of the steel industry is such that, as Prof. Ohno noted, not only Vietnam but other ASEAN countries face difficulty in keeping the AFTA deadlines. Thailand imposed a 25% surcharge on flat steel this January, on top of the 10% tariff. Malaysia is doing the same. My prediction is that ASEAN as a whole will be forced to renegotiate tariff reduction in steel products.

But apart from this, if Vietnam decides to respect the AFTA commitments, I believe the third option is most realistic. Differential tariffs between ASEAN and non-ASEAN does not violate the non- discrimination principle of WTO, since AFTA is considered to be regional integration.

On the question of Asian rivals, I have checked their potentiality already. My overall conclusion is that neighboring countries are not the largest threat to Vietnam's steel makers. In long products, ASEAN producers are not competitive at all. In flat products, producers in Thailand are competitive, especially Japanese affiliated cold rolling mills. They tried to export during the Asian crisis, but they supply domestically under more normal circumstances. Russian and Ukrainian producers are serious rivals, so relatively high tariffs should be imposed on their exports. China is a big steel producer but does not export much. But by 2010, this situation may change.

SESSION 6 : SOFTWARE INDUSTRY

(March 30, 2002, morning)

Presentation by Dr. Truong Dinh Chien, *National Economic University*

The Vietnamese software industry is new, with about 200 enterprises operating in the market. The domestic market is also new with low demand. The product structure is simple and monotonous. On the export side, Vietnam's access to international market is limited; only a few companies export to a limited number of countries. Total export value is USD 5 million, or 5% of the industry's total revenue. The industry's competitiveness is weak and the production scale is small.

Despite these points, the industry has a good potential in terms of human resources, low labor costs and government support. Considering all the strengths, weaknesses, opportunities and threats, we would like to propose the following development strategy. By the year 2005, the software industry should attain the domestic sales of USD 80-90 million and the export revenue of USD 200 million. The attraction of FDI and enhancement of the reputation of Vietnam's software industry are also important targets. To achieve these goals, we need to carry out a set of comprehensive measures. These include implementing a mixed marketing strategy, improving supporting policies like training of human resources, developing domestic and international markets, building good IT infrastructure and improving the legal environment.

Mr. Nguyen Quy Son, *Vietnam Electronic Industries Association (VEIA)*

Your presentation has covered almost all issues in Vietnam's software industry. We greatly appreciate recommendations in your presentation and will use some of them in developing the program for the software industry in the period 2001-2005. However, it would be better if you concentrate on fewer issues and provide deeper analysis. In my opinion, the software industry in Vietnam has a good potential to develop. However, to find suitable promotion steps, an appropriate strategy is needed. The Vietnam's software products are facing many obstacles, including the lack of English capability and low commercial value. The NEU study has suggested many measures, and we hope JICA will assist us to concretize major ones.

Mr. Nguyen Huu Thang, *Vietnam Electronic Industries Association (VEIA)*

This is a complete study with appropriate approaches. The study has provided many valuable findings that even industry insiders could not recognize. The first part of the study has provided us with a comprehensive assessment of the industry's current status. Regarding the domestic market of software, I think it is growing strongly, with rising demand for internet and telecommunication, the e-government program worth VND 1000 billion, the Edunet program worth USD 450 million, etc. In my opinion, we also need to analyze the software industry in close relation with the hardware industry.

However, I wonder if your forecast of exports of USD 200 million is based on sound ground.

The study mentions many good strategies. I want to add that we need to focus on a few crucial products to design appropriate exporting policies. The idea of software parks remains unclear. The current policies are good in general terms, but we need concrete measures to implement these policies.

Mr. Long, *Information Technology Center, Vietnam Bank for Agriculture and Rural Development*

Let me say a few things as a user of software. I find the NEU study reasonable with high practicability. But we need to set clear goals and orientations, including targeted markets. Concrete measures should include good training for software writers. At our center, it takes two years to train new staff for our own programs, and five years to work efficiently in the banking sector. The software industry lacks consultants, managers and other well-trained professionals. The client-provider relationship, which is less than ideal, must be improved. Public awareness campaign is also needed, as some top managers do not have enough knowledge about computer software.

Mr. Huynh Duc Thang, *Ministry of Planning and Investment*

The study is comprehensive and logically presented. I have some comments. First, in assessing the strengths and weaknesses of the sector, you are relying on the general perception like the Vietnamese are intelligent, but more training is necessary, etc. This is not concrete enough. As to training, for example, the question is where we should start. Software writers need a few more years of training, it is said, but who will teach them? And where are the curriculums? We need deeper studies on these two issues of teachers and methodology. Second, regarding the telecom sector, I do not think slow speed is a problem. The reason why the Quang Trung IT Park does not function well is not related to the problem of infrastructure. Its failure is due to high service cost and inherent localism of the Vietnamese people. Each ministry and province wants to have its own IT department and programs, causing dispersion of limited resources. This issue should be taken up in the policy formulation process.

Prof. Ohno

I would like to question if the NEU's export target is really realistic. Vietnam's software is a baby industry with very limited capabilities. The paper presenter proposed two development directions: domestic sales and international marketing. But I think Vietnam should concentrate on the domestic market, which is growing fast and also protected by the language barrier. The international market is very hard to penetrate for such an infant industry with low English proficiency. Separately, I was surprised to hear that local fights over IT industries are so fierce in Vietnam. Do Hanoi and HCMC fight to have their own IT parks and projects?

Mr. Alain Chevalier, *Senior Technical Advisor, VIETRADE, Ministry of Trade*

I agree with Prof. Ohno that in Vietnam, we need to focus on the domestic market. I note that the present export value of the industry is only USD 3 million, and as targeted, it should reach USD 200 million by 2005. This is impossible. However, the potential for Vietnam's software industry is good, especially with respect to speed of growth. The computer literacy of the young Vietnamese is picking up quickly. Internet is still slow, but it takes time to improve the infrastructure. Many talk about e-commerce, but Vietnam should do other things first, including upgrading of the contents of web sites.

I would like to emphasize the importance of marketing. Production must follow the market, not vice versa. This is true for both domestic and foreign markets. Government should help those who help themselves. Let government follow and support them. Instead of big targets for the whole industry, there should be an accumulation of concrete strategies, each not too ambitious, to improve "how to" capabilities. To improve the image of Vietnamese software, what is needed is action. Regarding human resources, exporting programmers is not a good idea because they will not come back! At any rate, there are very few Vietnamese software companies abroad. My final point is that we should look at ASEAN experience and draw lessons for Vietnam.

Mr. Pham Hong Chuong, *National Economic University*

Let me comment on and review the arguments of the last two days. First, whether upstream or downstream, we should focus on the stages of production where Vietnam has efficiency and comparative advantage. We are in the globalization age, and risk is acceptable and necessary in order to become part of the international production network. However, not everything is acceptable. Second, we should shift from the production-oriented planning method with quantitative targets to the market-driven approach where production is for the sake of the satisfaction of users.

Regarding software, Vietnam need not have a complete software industry. Let us focus on applications if that is our comparative advantage. If that succeeds, we can move to network software with greater labor skills and capital later. If we want to export, we must find a market niche.

Dr. Do Huu Hao, *Director General, Institute of Industrial Policy and Strategy*

There are four points we should consider seriously for the Vietnamese software industry. First, we need to pay more attention to the copyright issue. Second, the salary of software engineers is too low which is causing brain drain. The industry is too small and weak to offer high salaries to attract good people. Third, there is a supply imbalance: we have a lot of application and accounting software but very few industrial applications. And finally, we need to have a training strategy. We should establish special schools for IT skills. Education of young Vietnamese is needed with assistance of foreign experts. India provides a good example for Vietnam.

Mr. Vu Huy Thong, *National Economic University*

Thank you for all of your comments and suggestions, especially the opinions about IT education. This issue draws much attention from the government as well as the industry. Regarding the telecom environment in Vietnam, I think the slow speed of internet access is a problem for the software companies. Also, I agree with Dr. Hao on the issue of the copyright. It is the responsibility of the government to solve this problem. If this project continues into the third stage, we should focus on the IT education issue.

CLOSING SESSION

Prof. Ohno

After two days of lively discussion, I want to say three things in summary.

First, the common thread of our debate across many industries was how to increase the value-added of the Vietnamese industry. Right now, Vietnam performs only a small link in the production process, and the rest is done by foreigners. The two conflicting considerations always come up: (i) in the age of globalization Vietnam must accept free trade and take advantage of FDI dynamics as much as possible; and (ii) Vietnam should take a strong initiative in national industrialization, not just passively receiving foreign influences. These two ideas must be combined wisely and realistically.

Second, from now on, all studies must go into much greater detail, proposing policies that are concrete and operational. This is also what we wish to do in the third stage.

Third, to discuss each industry more deeply, we should have smaller and more targeted seminars with relevant government officials and enterprise managers.

Closing remark by Professor Nguyen Dinh Phan, ***Vice rector, National Economic University***

About the Author

Kenichi Ohno is a Professor of Economics at the National Graduate Institute for Policy Studies (GRIPS) in Tokyo. He was born in Kobe in 1957. Having received his Ph.D. in Economics from Stanford University (1987), he worked at the International Monetary Fund (1987-91) and taught at Tsukuba University (1991-97) and Saitama University (1996-1997) before taking up his present position. His books include *International Monetary Systems and Economic Stability* (Japanese, 1991), *The IMF and the World Bank* (Japanese, with Izumi Ohno, 1993), *Strategy for Transition to Market* (Japanese, 1996), *Dollar and Yen* (with Ronald McKinnon, 1997), *Development Economics of East Asia* (Japanese, with Kojiro Sakurai, 1997), *Japanese Views on Economic Development* (co-edited with Izumi Ohno, 1998), and *Globalization of Developing Countries* (Japanese, 2000). He regularly advises the Japanese government.