Asia’s financial earthquake is the second biggest international surprise of the past decade. The first (and weightier one) was the demise of the Soviet Union. Like the 1991 Soviet shock, Asia’s financial hemorrhaging has had many contributory causes. Most of these have been acknowledged and discussed, with the debate largely focusing on their relative importance.

However, the primary cause of the Asian crisis has been largely obscured: namely, the legacy of the so-called “Japan development model,” and its perverse consequences. Subsequently relabelled the “Asian development model,” because variants of it were applied elsewhere in the region, this strategy of economic growth has been grandly extolled in the past two decades. Its strongest proponents included Eisuke Sakakibara, presently Japan’s vice minister of finance, Malaysia’s prime minister Mahathir Mohamad, such Western commentators as Karel van Wolferen, Chalmers Johnson, James Fallows, Clyde Prestowitz, and numerous Western academics. What is now being witnessed in Asia’s financial turbulence are the model’s accumulated shortcomings.

This is not to deny the role of other proximate causes, but rather to suggest that many of them are traceable to or abetted by the primary one. The proximate causes, on which most discussion has focussed, include:

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• Short-term foreign borrowing by Asian banks and companies, and long-term lending or investing; and in some instances re-lending to other countries or companies in the region. (The same point can, with equal validity, be reformulated to place the onus not on the Asian borrowers, but on the money center banks in Japan, the United States, and Germany that provided the mounting short-term lending to duly-anointed Asian countries and companies.)

• The assumption (by foreign investors) that exchange rates pegged to the U.S. dollar would be maintained—an unrealistic assumption because the dollar pegs depended on forms of capital inflow to the region (namely, short-term lending and portfolio investment) that are readily reversible, rather than direct investment, which is not.

Once these are acknowledged as proximate causes, how does the formerly-celebrated Japan model figure as the principal underlying explanation for Asia’s financial predicament?

The model began with a conceptual framework largely provided by American and Japanese academic economists. Central to it is the phenomenon of “market failure”: the predictable inability of market mechanisms to achieve maximum efficiency and to encourage growth when confronting “economies of scale” and “path dependence.” These conditions may lead to monopolies in the advanced economies and the extinction of competition from late-starters in the development process. If the objectively-based decisions of the marketplace are recognized to have such predictable shortcomings, so the argument has run, then subjectively-based decisions by government agencies or key individuals could be expected to improve upon market outcomes.

In the original version of the model, these subjective judgments were provided by Japan’s Ministry of International Trade and Industry (MITI) and its Ministry of Finance, in collaboration with particular targeted export industries believed to be associated with economies of scale. These priority “winners” were tagged to receive preferred access to capital, as well as protection in domestic markets through the use of non-tariff or tariff barriers to limit foreign competition.
In the Korean variant of the model, the subjective judgments as to who and what would receive preferment (often the same industries targeted by Japan), were exercised by a combination of the presidential Blue House, the benefitting chaebol conglomerates, and their associated and accommodating banks.

And in the Indonesian variant, the subjective oracular sources have been the presidency and its associated family lineage, in conjunction with the soi disant technological community in the Ministry of Research and Technology, led by its minister H. J. Habibie.

The common characteristic in all three versions is substitution of the objective, if sometimes imperfect, decisions of the market by the subjective judgments of government bureaucracies and influential individuals. These judgments then provided the basis for making allocative decisions as to which industries, firms, and individuals should get access to resources, and under what terms.

To be sure, the Japanese model and its variants produced noteworthy accomplishments. Vast amounts of savings and investment were mobilized for and channeled to the anointed industries and firms. While substantial resources were wasted in the process—for example, MITI’s blunders in the case of steel, shipbuilding, and aircraft—the scale of resource commitments led to world-class performance in other cases—notably, cars, consumer electronics, telecommunications, and semiconductors in Japan, similar heavy industry development in Korea, and light industry development in Indonesia.

But the negative effects of the Asian model were cumulatively enormous, even though often obscured by the apparent successes. The principal negative effects include the following:

- Wasting of resources when mistaken decisions were made by the non-market choice processes. Indonesia’s abortive investments in a national car and in a domestic aircraft industry are examples. These "non-market" failures account for the fact, stressed by several academic economists, that Asia’s economic growth has been mainly due to large inputs of capital and labor, with relatively limited improvement in factor productivity.

- Structural imbalances within the Asian countries due to overemphasis on export industries and neglect of the domestic econ-
omain. As a result, domestic production has been short-changed, and consumption standards held down in favor of aggressive pursuit of export markets.

- Excess capacity has been built up in export industries through the arbitrary processes of picking “winners.” Failure to take adequate account of demand saturation while production continued to expand has contributed to currency depreciation, falling prices, and sharply adverse changes in Asia’s terms of trade.

- Associated with the Asian model has been, until the mid-1997 shocks, a sense of *hubris* among the favored industries, firms, and individuals. When these favored entities confronted market tests that they could not meet, they (and their foreign lenders) expected additional resources to be forthcoming to bail them out. Whether the shortfall was in an old-line major banking house (e.g., Yamaichi in Japan), or an established *chaebol* (e.g., the Halla group in Korea), or the start-up of questionable new ventures (e.g., Indonesia’s “Timor” car), it was expected that some “non-market” (i.e., government) preferment would make up the difference.

- Finally, the Asian model has had a corrosive effect on the societies and polities of the affected countries as a result of the favoritism, exclusivity, and corruption associated with the back-channel and non-transparent processes of decisionmaking underlying the Asian model.

That market-mediated allocations of resources have shortcomings associated with them doesn’t imply that the subjectively-mediated ones of the Asian model will not have still greater shortcomings. In fact, the legacy of the Japan model and its Asian variants suggests that their associated shortcomings are enormously greater because they tend to be protected and concealed. Lacking the corrective, mediating responses that market mechanisms and incentives usually provide, the shortcomings accumulate until a breakdown occurs.

If this lesson is heeded, Asia’s recovery can be rapid and enduring; if it is not, recovery is more likely to be slow and fitful.
Postaudit

This critique of the Japan-centered model of industrial policy and its shortcomings has gained, rather than lost, relevance and validity since it was written in 1998.