SAE./No.66/October 2016

## *Studies in Applied Economics*

# REVIEW OF "TRADE, DEVELOPMENT, AND POLITICAL ECONOMY IN EAST ASIA"

***Joe Studwell***

Johns Hopkins Institute for Applied Economics,
Global Health, and Study of Business Enterprise

**Review of "Trade, Development, and Political Economy in East Asia"**

by Joe Studwell



**About the Series**

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Co-Director of The Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise (hanke@jhu.edu).

Routledge
Taylor & Francis Group

*Bulletin of Indonesian Economic Studies*, Vol. 52, No. 2, 2016: 251–60

# BOOK REVIEWS

*Trade, Development, and Political Economy in East Asia*. Edited by Premachandra Athukorala, Arianto A. Patunru, and Budy P. Resosudarmo. Singapore: ISEAS Publishing, 2014. Pp. xxv + 278. Hardback: $35.90.

---

This festschrift by colleagues, collaborators, and pupils of Hal Hill reflects the diverse interests of an important scholar whose work spans East, Southeast, and South Asia. Indonesia is at the heart of the collection, as it is in Hill's copious canon, but Malaysia, Vietnam, India, China, Taiwan, and other states play important roles in these 13 chapters. As the title suggests, the book is broken down into three sections: 'Trade', 'Development', and 'Political Economy'.

With respect to Indonesia, the collection neatly captures—whether by design or by accident—the seemingly never-ending struggle over the country's development challenge between analysts adopting a marginalist economic perspective, on the one hand, and those expressing more heterodox concerns about technological progress, on the other. The old Indonesian battle between the marginalist 'Berkeley mafia' and the technocentric Habibie-ites lives on in these pages, albeit, in the best Javanese tradition, without any open declaration of war. Of the book's seven chapters that speak directly to Indonesia's economic progress and rank in the region nearly two decades after the 1997–98 Asian financial crisis, three can be described as sanguine, four as not. The verdict depends very much on which of the two lenses the Indonesian predicament is viewed through.

From a marginalist perspective, there has been much to celebrate following the Asian crisis, the IMF's structural adjustment program, and the taming of Indonesia's more dirigiste impulses. Trade is freer, not least because Indonesia is party to more free-trade agreements (FTAs). Mari Pangestu, in a chapter about Indonesia's place in the world trading system, urges the country's leaders (of whom, of course, she was one throughout the Yudhoyono presidency) to accept Indonesia's position in the global division of labour; concede that 'countries should no longer produce all of their own inputs, intermediate goods, and final goods domestically' (p. 22); and attract more foreign direct investment.

Contra those who suggest that the rise of bilateral trade deals increases the chances that the largest trading nations and blocs will bully weaker states (see, for instance, Sundaram 2016a, 2016b), Pangestu believes that bilateral deals will 'act as a catalyst for completing multilateral negotiations', including the WTO's Doha round. Jayant Menon, in a chapter that addresses the current plethora of bilateral deals in the world trade system, makes the same claim: 'As more and more FTAs are negotiated, preference erosion sets in, reducing the resistance of FTA partners to multilateralism' (pp. 41–42).

ISSN 0007-4918 print/ISSN 1472-7234 online/16/000251-10

Anne Booth contributes an interesting chapter on trade (included, oddly, in the 'Development' section) in which she looks at economic relations between China, India, and Southeast Asia since the 1997–98 crisis. She argues that fears of an export deluge from China when Premier Zhu Rongji proposed a China–ASEAN FTA in 2000, and again with the ending of global textile quotas in the early 2000s, were overblown. The China–ASEAN and China–India FTAs of 2010 have not, she writes, yet led to big increases in either trade or investment flows. Meanwhile, Booth lauds a two-percentage-point increase in intra-ASEAN trade as a share of total ASEAN trade between 2002 and 2012. Her conclusion appears to be one of steady progress on the trade front, during which 'China's growing export power has forced Indonesia, and other ASEAN countries as well, to re-evaluate their longer-term comparative advantage, away from labour-intensive manufactures and towards a range of primary exports, including coal and natural gas, as well as towards more sophisticated manufactures and traded services' (p. 86).

This sounds like a mutually beneficial outcome, but a couple of data points in Booth's comprehensive review create some discomfort. First, a small increase in intra-ASEAN trade over a decade depends entirely on one's picking the right years. Intra-ASEAN trade bounces around somewhat, and if one picks the peak year from the aftermath of the ASEAN crisis, 2003, it turns out to have been just as high as a share of total ASEAN trade as it is today. The old charge that ASEAN fails to function as an effective, integrated trading bloc is rearoused. Second, ASEAN may not have been entirely swamped with Chinese goods in recent years, but as of 2012 the grouping was running a $36 billion trade deficit with China (while running a surplus with the rest of the world). So has ASEAN really 're-evaluated' its comparative advantage in trade with China, or is it simply carried along in a relationship in which China, pursuing a much more proactive industrialisation strategy, makes all the running?

Herein lies the rub. The marginalist perspective tells us that freer trade leads to better use of given factors of production. But what if ASEAN countries, Indonesia included, want to forego their optimal short-run trading status, invest in capital stock and technological learning, and seek to trade in the future in higher-margin activities? This is not, of course, a one-for-one trade-off, but it brings us to the door of industrial policy and to the less sanguine chapters in the 'Development' section.

Perhaps the most striking of these is Ian Coxhead's contribution. Coxhead argues that in post–Asian crisis Indonesia, in the absence of an effective manufacturing strategy, a resource boom created lower-value-adding jobs and in turn reduced returns to young people remaining in education. In 2000, manufacturing accounted for 29% of Indonesian GDP and 57% of merchandise exports; by 2012 it had fallen to 24% and 34%, respectively. Employment in manufacturing in Indonesia as a share of the total never came close to the levels seen in Japan, South Korea, Taiwan, and China, which peaked at over 30%. The Indonesian share was only 18% in 1997 and had fallen to 15% by 2007. Household surveys cited by Coxhead show that almost three-quarters of workers are now informally employed and, as he demonstrates with regressions, the greater the likelihood of informal, low-paid employment, the greater the incentive to quit school early. Coxhead's findings on returns to education may well be of interest to developed countries as well as to developing ones. For Indonesia, his conclusion is simple: the government must re-energise the manufacturing sector.

In a chapter that closely complements Coxhead's, Chris Manning reviews labour-market regulation under the Yudhoyono government, providing a taxonomy of increased labour-market inflexibility since 2000 as unions prevailed on the government to rewrite employment legislation. Indonesia now ranks lowest among the core ASEAN states for Manning's measure of 'total labour efficiency', which reflects flexibility in wage-setting, industrial relations history, redundancy costs, and other factors. The result has been a boom in outsourcing of employment to labour agencies and a fall in in-company training. If Indonesia requires a new emphasis on manufacturing, it also requires a sufficiently flexible labour market to allow formal, better-paid manufacturing employment to increase beyond its presently dismal share of the total. The unions have not always served the workforce well in post-Soeharto Indonesia.

Two other chapters in this collection deserve special mention. The first is Ross McLeod's defence of the advice given by economist Steve Hanke to Soeharto during the Asian crisis to introduce a currency board in Indonesia. This episode may seem to some readers like water long under the bridge. As McLeod notes, however, the currency board controversy was so misleadingly reported in much of the mainstream press, the behaviour of some IMF officers so culpable, and the damage to the Indonesian economy from IMF missteps so egregious, that the affair deserves our full attention.

McLeod begins with the point that Indonesia in July 1997 was not a disaster waiting inevitably to happen. The structure of the financial system, in which every oligarch owned one or more banks and lent to related parties, in defiance of banking regulations, was certainly problematic, and largely a result of Indonesia's having followed advice from the IMF and the World Bank to privatise and deregulate its banking system prematurely. However, the macroeconomic picture was pretty solid. Indonesia was not running the same, gaping current account deficit as Thailand, where the crisis kicked off; foreign-exchange reserves were substantial; and inflation was low by historical standards. The problem was that Thailand, which had sold forward its rapidly diminishing foreign-exchange reserves without admitting the fact, caused regional panic when the Thai government was found out and compelled to float the baht. Indonesia, with no capital controls to insulate it, then became the subject of aggressive speculative attacks against its currency.

The fatal step, as McLeod relates, was the response of Bank Indonesia (BI), the central bank. BI ignored monetary policy considerations and provided the banking system with vast credit, much of which was onlent to oligarchs and converted into foreign exchange—leading both to a blow-out in domestic money supply (and consequent inflation) and to a devastating plunge in the value of the rupiah. In effect, BI had funded speculation against its own currency. It was in this unnecessary and apocalyptic scenario that Soeharto called in Steve Hanke to discuss the introduction of a currency board that would replace a failing central bank and establish a strict link between base money in circulation and the country's foreign-exchange reserves. It was a technical area in which Hanke had long and proven expertise.

What is most interesting in McLeod's account is the manner in which the IMF, and its then managing director Michel Camdessus, set out to torpedo the idea of a currency board, despite the fact the IMF had backed such boards in Bulgaria and Bosnia-Herzegovina in 1997 and would go on to support in principle their introduction in Brazil and Russia in late 1998 and 1999 (in these cases, neither was implemented). Media coverage at the time, informed by briefings from the IMF and the US government, indicated that currency boards were eccentric and unworkable, when it was an observable contemporary fact that they were neither. It is difficult not to sympathise with McLeod's conclusion that for the IMF and the Clinton administration, getting rid of Soeharto and forcing state asset sales were higher priorities than stabilising the rupiah. One widely discussed conspiracy theory at the time was that Soeharto would use a currency board to introduce an overvalued exchange rate, allowing his family to move its vast fortune abroad on improved terms; there was never a shred of hard evidence for this.

McLeod's chapter should serve as a warning to other developing countries, even if, thankfully, the most ideologically driven era of IMF activity appears to be well behind it. What is perhaps missing from the chapter is a discussion of other capital control options that were open to Indonesia in 1997–98. It may well be that McLeod believes—as Hanke (2002) certainly did—that any continued role for BI would have undermined stabilisation efforts and that a pure currency board (the padlocked drinks cabinet of monetary management) was essential. A fuller discussion of capital account management would have been helpful.

Finally, James Riedel and Thi Thu Tra Pham take the opportunity of this festschrift to revisit Riedel's (1993) paper suggesting that Vietnam was set to emulate the developmental success of economies like Taiwan, China, and Japan. The authors here find themselves much less optimistic. They cite state-sector wasting of investment capital, an increased allocation of investment funds to non-productive real estate rather than to manufacturing, and slow progress in reducing the state-owned share of industrial output. All this, they argue, has contributed to a secular growth slowdown since 2006.

Riedel and Pham are right to flag the significant fall GDP growth in Vietnam. However, their pessimism may be premature. Vietnam is struggling with the same structural adjustment of a huge legacy state sector that confronted Zhu Rongji, in China, when he became vice-premier in charge of the economy in 1993. China's adjustment was also tortuous and was associated with falling growth in the late 1990s. Yet after a decade of lay-offs, closures of smaller state firms, and the creation of greater competition between remaining state firms, China steamed back from 2002 with a long boom that took its share of global manufacturing from 6% to not much less than 20%. One hesitates to predict such spectacular success in Vietnam, but the basic preconditions are in place: high-yield household farming (and hence broad-based capitalism) and a national industrial strategy, as well as financial-sector policies that support these two key parts of the economy. Although Riedel and Pham include Thailand along with Taiwan and China in their comparisons with Vietnam, Vietnam's structural economic story is very different from what Thailand has had to contend with. Per the arguments of *How Asia Works* (Studwell 2013), Vietnam's long-run capital accumulation should be more sustainable. The most successful economic development strategies in East Asia—and indeed the world—have not just been about export-oriented industrialisation, as Riedel and Pham would have us believe; they have involved a subtle balance between this form of industrialisation and more domestically oriented technological upgrading strategies.

In conclusion, this is a useful collection. It would have been nice to read more on agriculture, the most perennially undervalued aspect of development economics in Southeast Asia. But the range of subject matter is already broad, and a fitting tribute to the contribution to date of Hal Hill.

Joe Studwell
*Cambridge, UK*


http://dx.doi.org/10.1080/00074918.2016.1211078

Hanke, Steve. 2002. 'On Dollarization and Currency Boards: Error and Deception'. *Journal of Policy Reform* 5 (4), 203–22.
Riedel, James. 1993. 'Vietnam: On the Trail of the Tigers'. *World Economy* 16 (4): 401–22.
Studwell, Joe. 2013. *How Asia Works: Success and Failure in the World's Most Dynamic Region*. New York: Grove Press.
Sundaram, Jomo Kwame. 2016a. 'Some Real Costs of the Trans-Pacific Partnership: Lost Jobs, Lower Incomes, Rising Inequality'. GDAE Policy Brief 16-01, Global Development and Environment Institute, Tufts University.
———. 2016b. 'TPP: Winners and Losers'. Mimeo.