



Capitalism in Asia

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Introduction

A capitalist economy is, of course, a market economy; the exchange of goods and services at freely forming prices in a system that unites production and consumption. This was what Adam Smith meant by a market economy; he also emphasised property rights and “natural liberty”, or what we now call economic freedom – the individual’s freedom to produce and consume, and to use his property rights, as he sees fit.

But capitalism suggests more than “market economy”. I use it in the Schumpeterian sense. For hovering above this essay is Joseph Schumpeter; one the great twentieth-century economists; he was also perhaps the greatest historian of economic thought of all time, and surely one of social science’s most colourful and dazzling performing artists.

Karl Marx wrote about “capital” – the stock of wealth around which production and class relations are structured. Werner Sombart, from the last generation of Germany’s Historical School of economics, was the first to refer to “capitalism”. But Schumpeter had a different vision of capitalism. Vision was one of his favourite words.

“*This innovation – “perennial gales of creative destruction” – “incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one.” It drives material progress.*”



Today the word is debased, for everyone has a “vision”, just as everyone has a “philosophy”. But Schumpeter meant something precise: a vision is a personal conception of how a whole system works, before

filling in its compartments and its nuts and bolts. He laid out his vision of capitalism first in *The Theory of Economic Development*,¹ and later, encompassingly, in *Capitalism, Socialism and Democracy*.

Capitalism is the central nervous system of a market society. It is responsible for the biggest increase in living standards the world has ever seen; it has lifted hundreds of millions, indeed billions, of people out of

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¹ First written in his twenties – the “sacred third decade”, as he called it. Elsewhere he writes of genius as the “preserve of young men in their twenties”. He was referring to David Hume, who wrote his *Treatise of Human Nature* in his twenties. But he could have been thinking of himself.

poverty and enormously improved the lives of ordinary people.

Capitalism also transforms political systems and social relations. It is constantly changing, like cells in a biological organism. It also reminds me of Buddhist psychology: in the Buddha's teaching, nothing is ever the same; everything changes all the time. Capitalism is never in equilibrium; it is always dynamic, never static. In that sense, neoclassical economic models of equilibrium-based perfect competition are irrelevant: they do not apply to real-world markets.

Capitalism's central agent is the entrepreneur – to Schumpeter the “pivot on which everything turns”. His motives are complex in his restless, heroic quest to create wealth; making money is but one of many motives. He is much more than homo economicus, the rational utility-maximiser of neo-classical

economics. And entrepreneurs unleash “creative destruction” – Schumpeter's “essential fact about capitalism”. They swarm around new technological inventions, turn them into marketable products, destroy old, established businesses, and create new, more productive ones of their own. This innovation – “perennial gales of creative destruction” – “incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one.” It drives material progress.

Such is the past and present of capitalism. However, its future is not inevitable. For capitalism to progress, it will need the correct framework conditions, above all to allow entrepreneurs to work their magic. Private property rights and freely forming prices are among the essentials to keep the system open to entrepreneurial activity.

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Without innovations, no entrepreneurs; without entrepreneurial achievement, no capitalist returns and no capitalist propulsion. The atmosphere of industrial revolutions – of “progress” – is the only one in which capitalism can survive.

- Joseph Schumpeter, Business Cycles, 1939

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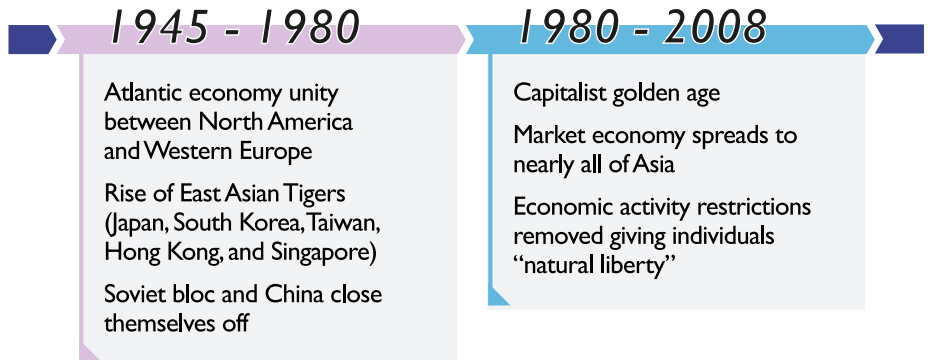
Capitalism Up to and After the Global Financial Crisis (GFC)

Schumpeter dates modern capitalism to the early eighteenth century. At the time, it was centred in North-Western Europe. It really took off with the Industrial Revolution and the liberal nineteenth century. It disintegrated in the first half of the twentieth century, and revived after World War Two. Up to then, it was overwhelmingly a Western phenomenon – Western Europe and British offshoots in the New World, notably the USA.

Capitalism's post-1945 revival can be divided into two phases. The first, roughly from 1945 to 1980, saw the reconstruction and subsequent boom of an Atlantic economy uniting North America and Western Europe; it also saw the rise of the East Asian Tigers (Japan, South Korea, Taiwan, Hong Kong and Singapore). Other "developing" countries closed themselves off, as did Communist countries (notably the Soviet bloc and China).

The second phase, from about 1980 to 2008, was a capitalist golden age. The market economy spread to the Second World and Third World, including Russia, China, India

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and Brazil. Now it covers nearly all of Asia. Before 1980, most Asians lived in command-and-control economies, ranging from Maoist China to India's “Licence Raj”. Since then, economic liberalisation has delivered unprecedented growth, poverty reduction and prosperity. Adam Smith has come to Asia. The removal of restrictions on economic activity has given individuals their “natural liberty”; markets, inside and across borders, have expanded, driving productivity gains and growth.

What has happened since the onset of the GFC in 2008? Initially, output and employment fell steeply worldwide; international trade shrank, as did foreign investment. Advanced economies have had low growth ever since. Western Europe (with the notable exception of Germany) and Japan are stagnant, mired in an expanding swamp of public debt. Households and businesses are also deep in debt, and banks are unwilling to lend. The USA has similar problems but is recovering better.

Most “emerging markets”, particularly in Asia, recovered faster and stronger from the GFC, mainly because they have much lower public, household and corporate debt. They continued their pre-GFC growth spurts. But, since about 2012, they too have had lower growth. Russia and Brazil are deep in recession; India and China have slowed down considerably, as have Thailand, Malaysia and Indonesia. The proximate causes are the end of a decade of cheap money and high commodity prices. Monetary policy is about to get tighter; interest rates will rise, and commodity prices have already crashed.

For all the market economy's gains in the past three decades, it is still severely repressed in Asia and elsewhere outside the West. That makes growth more difficult, especially without the artificial stimulants of easy money and skyhigh commodity prices.

The GFC ended an era of market liberalisation. Since 2008, public policy has been more interventionist; the balance between State and Market has shifted. Keynesianism is back in macroeconomic policy. Fiscal stimulus was common in 2008-9, resulting in higher taxation, public expenditure and public debt. Monetary policy became much looser, and remains loose seven years after the GFC. Central banks have printed unbelievable amounts of money; they have kept interest rates close to zero, and bought government as well as bank debt (what is known as “quantitative easing”). Now macroeconomic policy is more about manipulating aggregate demand and “fine-tuning” the economy; it is less concerned with keeping taxes, public expenditure and inflation low and stable.

Microeconomic interventions have also increased, starting with financial markets. An avalanche of financial regulation descended after the GFC, especially in the USA and Europe. Other markets have also become more regulated, e.g. subsidies for the car industry and renewable energy, and tighter environmental standards to limit carbon emissions and combat global warming.

Asia was not at the centre of the GFC, but it is in the slipstream of post-GFC policy patterns. China had the biggest fiscal and monetary stimulus of them all in 2008-9, equivalent to about 50 per cent of GDP. State largesse went overwhelmingly to local governments (who went on a debt-fuelled construction spree), and behemoth state-owned banks and state-owned enterprises. Japan has “Abenomics”, whose two main “arrows” are fiscal and monetary stimulus. Persistently loose monetary policy led to soaring consumer debt across East and South Asia. Thankfully, trade and foreign-investment liberalisation in the 1980s and ‘90s was not reversed wholesale. But “creeping protectionism” set in, with a gradual increase in nontariff trade barriers. Indonesia is the worst culprit, with a slew of new restrictions on imports and foreign investment.

Overall, the swing of the policy pendulum since the GFC is more akin to what happened in the 1970s than during the Great Depression of the 1930s. The 1930s saw a dramatic swing to a bigger State and a more constrained Market; in the 1970s the swing was smaller, though still significant.

The pendulum of ideas has swung towards market intervention as well. Classical liberalism (“neoliberalism” or “market fundamentalism” to its detractors) is weaker. Intellectual and political giants, led by Friedman and Hayek, Thatcher and Reagan, spread its message up to the 1990s. But since then epigonal figures – mostly bureaucrats in well-funded US think tanks and foundations – have taken over. And the GFC, like the Great Depression of the 1930s, propelled market interventionist ideas. These are a combination of Keynesianism and Pigovianism.

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Keynesian ideas prevail once again in macroeconomics. Keynes's distinctive view of "capitalism in crisis" informed his economic theory and policy prescriptions in the 1930s. He argued that a chronic lack of aggregate demand prolonged the debt-deflation of the Great Depression; hence governments should use deficit spending to stimulate demand. But Schumpeter thought that underlying Keynes's short-term diagnosis was a profoundly bleak view of capitalism's long-term prospects. To Keynes, capitalism, if left to its own devices, was doomed to "secular stagnation". Capitalists would sit on their savings rather than turn them into productive investments and employment. Output would be stuck well below its potential, resulting in high unemployment. Only government-induced stimulus could get capitalism out of its rut.

Note the parallels with Keynesian arguments today. Most macroeconomists favour Keynesian demand management to overcome depressed conditions after the GFC. But some go further: Larry Summers has revived talk of secular stagnation. The world economy is set for prolonged anaemic growth, he says; new technology will increase unemployment and inequality

will widen – unless governments pump up demand. This is a post-GFC echo of Keynes's interwar "capitalism in crisis".

The microeconomic complement to Keynesian macroeconomics comes from A.C. Pigou, a leading economist of the generation before Keynes, and indeed Keynes's teacher at Cambridge. Pigou is the father of welfare economics. His basic idea is that the market is beset by "failures". These are departures from perfect competition equilibria in neoclassical models. And this sets up a presumption of government intervention – to remedy market failures. Pigou provided the theoretical foundation for post-1945 market interventions – until the "neoliberal" revival in the 1970s. By then public choice theory was popular. It countered the political innocence of welfare economics, which implies that governments, like Platonic Guardians, are wise and benevolent actors remedying market failures for the public good. But, according to public choice, politicians and bureaucrats are self-interested; they intervene in markets for their own benefit. Markets get distorted and consumers suffer. Welfare economics, in other words, is oblivious to "government failure".

From the 1970s to the GFC, awareness of government failure restrained reflexive interventions in markets. But the GFC shifted the emphasis back to market failures and confidence in governments' ability to correct them – particularly in financial markets. Pigou is back with a vengeance.

Keynesianism and Pigovianism were born in the West and spread outside the West. Asians habitually mimic Western ideas – whatever is the prevailing conventional wisdom. So Keynes and Pigou have been revived in Asia as well after the GFC.

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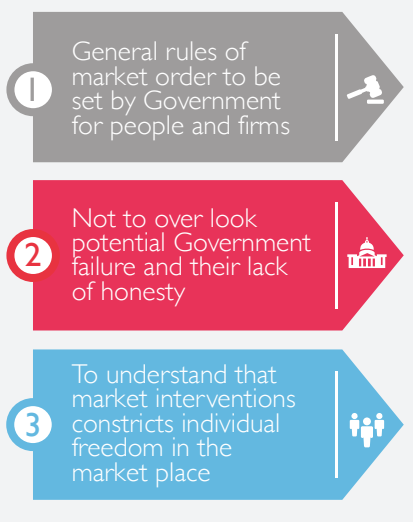
A Critique of Keynes, Pigou and Post-GFC Market Intervention

Both Keynesians and Pigovians believe that a cabal of smart people, acting solely for the public good, should intervene in markets to solve complex social problems. When markets fail, they know best what to do; in such situations, they can do better than individual households and firms. This is the mentality of the social engineer. Adam Smith captures this type well. He is the “man of system” who visualises society as a chessboard; he moves the pieces on the board as he chooses, in line with his strategy to win the game.

As Hayek says, this attitude is a “fatal conceit”. It fails on three counts. First, it assumes a collective authority has sufficient knowledge to plan and execute superior outcomes. But knowledge is fragmented and widely dispersed in a complex market economy: no one person or group, however smart, has such knowledge at its disposal. This is Hayek’s essential insight. He argues the best a government can do is set general rules for a market order; the game itself should be left to the players – individuals and firms – who use their local knowledge to discover their way to an inevitably uncertain future.

Second, “men of system” overlook government failure: they overestimate the honesty and competence of governments and underestimate their potential capture by powerful interest groups. And third, market interventions

Hayak’s essential insight:



constrict “natural liberty” – individual freedom in the marketplace.

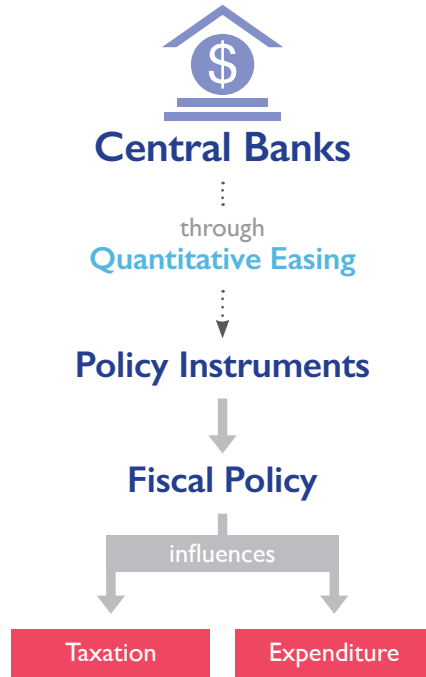
What has this to do with capitalism? Capitalism’s “engine” (another of Schumpeter’s favourite words) is innovation – the process of creative destruction. For the engine to run, the framework conditions must be right; the system must be wide open to entrepreneurial activity. An overload of government regulation however, both macro and micro, represses entrepreneurs and innovation; it makes capitalism’s engine sputter and stall. This is

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the greatest danger to capitalism after the GFC. In Asia, it threatens to slow down, even stall, the astounding catch-up growth of recent decades.

Let's delve a little into the right framework conditions for capitalism today. Start with macroeconomic policy. It has swung towards regulatory discretion and away from hard rules: that is the essence of fiscal and monetary stimulus. Most glaringly, central banks, through "quantitative easing", have added to their arsenal of policy instruments. So armed, they have marched onto fiscal-policy turf, making decisions that directly affect taxation and expenditure.

So far, these policies have not worked – or not nearly as well as their proponents anticipated. Fiscal stimulus in the USA and Europe has not had the predicted growth-multiplier effect, while piling up deficits and debt. Loose monetary policy has boosted



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growth a little, though again less than predicted. Massive monetary stimulus has failed to kickstart Japanese growth. China's post-GFC stimulus has created an Everest of local government and corporate debt; its distortions make urgent market reforms to "rebalance" the economy (from fixed investment and exports to domestic consumption) more difficult.

Easy-money policies have enlarged asset bubbles in financial and housing markets – a boon for banks and billionaires, but quite the opposite for small savers facing near-zero interest rates. Worst of all, cheap money is as addictive as heroin: market actors, particularly in finance, cannot wean themselves off it; they importune governments and central banks to keep injecting it into their bloodstream. Finally, macroeconomic policy discretion is infectious: it spills over to other policy areas. Financial market regulation is the most conspicuous example.

These are the ill effects of post-GFC macro-economic policy. The treatment should be constitutional – to return to rules that constrain regulatory discretion. Rules should be simple and clear to protect private property rights and economic freedom. They should be stable and predictable, so that market actors have the confidence to save, invest and be entrepreneurial. Schumpeter was a big fan of Gladstonian public finance, based on low taxation and low expenditure.² Budgets should be balanced, not in deficit, and fiscal measures should interfere as little as possible with market activity. Monetary policy should aim for price stability, which could be achieved through a fixed exchange rate or an inflation target. Central banks should be restricted to a single objective (price stability) and a small set of policy instruments, rather than having multiple objectives and multiple (fiscal and monetary) instruments.

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Now turn to microeconomic policy. There is much unfinished business in Asia, despite market liberalisation in the 1980s and '90s. Economic freedom remains much more repressed than it is in the West – less so in product markets, where most liberalisation has occurred, and more so in factor markets. Property rights for land are undeveloped or unclear in China, India and elsewhere. Labour laws restrict hiring and firing, thereby deterring investment in jobs. India's labour laws are probably the most damaging. China's *hukou* system of household registration restricts labour movement to its cities; it deprives rural migrants of rights to urban housing, schooling and social welfare. Capital markets are rudimentary, often dominated by state-owned banks and insurers. China's financial system is a command-economy Forbidden City, walled off, with a protective moat separating it from the surrounding market economy. Energy markets are even more throttled than financial markets, replete with state-owned monopoly incumbents, subsidies and price controls.

The same principles should apply to both macro and microeconomic policy. Market rules should be simple, clear, stable and predictable. They should protect property rights and economic freedom. They should constrain regulatory discretion. And they should be general rules of conduct rather than specific market interventions. Government should be more an “umpire” and less a market “player” – in Michael Oakeshott's phrase, “an umpire of a civic association, not an estate manager of an enterprise association.”

² W.E. Gladstone was one of Schumpeter's heroes. He writes gushingly of Gladstone's three great reforming budgets when he Chancellor of the Exchequer in the 1850s.

But this classical-liberal ideal collides into raw political realities. It is difficult enough to steer macroeconomic policy away from discretion and towards hard rules. It is even tougher to do this with factor markets, for they are arteries that attach to the heart of political systems. Property rights to land, labour laws, financial systems and energy markets are all bound up with the make-up of the state and, ultimately, ruling parties. Hence sluggish “secondgeneration” market reforms throughout Asia.

Take another issue – inequality. Income inequality has become a leading pre-occupation since the GFC, propelled to the fore by Thomas Piketty’s bestseller *Capital*. Incomes of educated, skilled professionals, and those with substantial capital assets, have increased tremendously, while incomes of the unskilled and low-skilled have stagnated. Median incomes have stagnated. This is true of the USA and UK before and after the

GFC. East Asia has seen widening income inequality since the 1990s. In China, income inequality is back to where it was when the Communist Party grabbed power in 1949. Income gaps have widened markedly in the city-states of Hong Kong and Singapore.

Technology and globalisation are the culprits. Globalisation has brought new competition from low-wage countries, particularly in Asia, squeezing low-wage, low-skilled industries in the West. New technologies – robotics, artificial intelligence, supercomputers, 3D printing, to name a few – are killing jobs, including skilled white-collar jobs. Schumpeter would not be surprised: these are the ‘perennial gales of creative destruction’. But, unlike Schumpeter, today’s ranks of the inequality-obsessed are techno-pessimists and globalisation-pessimists. They see a future of low growth and greater inequality. Their solutions are collectivist. Governments should intervene more to redistribute wealth; markets should be fettered.

There are many counter-arguments. One is that global (rather than in-country) income inequality has decreased substantially – because hundreds of millions of people in developing countries have escaped poverty and had fast-rising real incomes. Asia, especially China, has narrowed the income gap with the West.

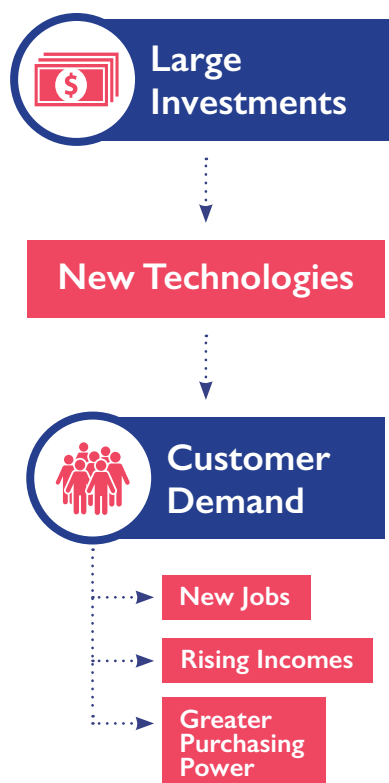
Another counter-argument is that people all over the world have enjoyed huge consumption gains as prices for consumer goods have fallen dramatically. In other words, with a given income, consumers can purchase a greater variety of goods and services at better quality and cheaper cost. A third counter is that better education and opportunities for girls – the fruit of higher economic growth in developing countries – narrows income gaps.

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But let's return to Schumpeter: He would surely attack today's techno-pessimism. To him the problem would be too little innovation, not too much of it. History shows that innovation destroys old industries and jobs, but it creates new and better ones, with rising incomes that spread from entrepreneurs to the middle and bottom of society. That is what happened in the second half of the nineteenth century up to World War One, and again after World War Two.

For all the sexy inventions of the last generation – chiefly the Internet and mobile communications – innovation remains stymied. Corporations sit on trillions of dollars of cash and play around with it in financial markets, rather than investing it in R&D and new products. Capitalism is too cautious and bureaucratic. That is true of the West; it is even truer outside the West, including Asia. Excessive government regulation is mainly to blame. Restrictions on competition obstruct the creative destruction of new entrepreneurs. Governments and Big Business continue in happy collusion; crony socialism elides into crony capitalism.



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Market deregulation would unleash creative destruction. Innovation would spread to wider swathes of economic activity. New industries would replace the old. The application of new technologies would require huge investments, not least on infrastructure. These would stimulate huge demand from consumers. In turn, this would translate into new jobs, rising incomes and greater purchasing power from the top to the middle to the bottom.

Capitalism is inherently unequal. A small band of entrepreneurs drive it; the most successful reap superprofits. But capitalism is also the greatest engine of progress for the world's poor and middle class. It requires the right framework conditions. Obsessive government interventions to reduce inequality undermines them.

An Agenda for Capitalism in Asia

How can capitalism thrive in Asia? Here, one must factor in Asia's diversity, with different countries and regions at different stages of development. Capitalism's regulations and institutions vary enormously across Asia. So do political systems. Asia has only five high-income countries: Japan, South Korea, Taiwan, Hong Kong and Singapore. They have living standards equivalent to those in the West. China, Malaysia and Thailand are in the upper middle-income bracket. Most Asian countries are lower middle-income, including India, Indonesia, Philippines and Vietnam. And some are still very poor: Nepal and Cambodia are still in the low-income bracket; Bangladesh, Laos, Myanmar and East Timor are only slightly above it.³ There is also large variation within countries. China's first-tier cities and coastal provinces have much higher living standards than its lower-tier cities and interior provinces. Similar gaps exist in India.

The challenge in Asia is twofold:

1 Get the basics right

2 Embark on structural reforms

"Getting the basics right" was the essence of the East Asian Miracle – the spectacular catch-up growth of two generations of East Asian Tigers, followed by China and Vietnam. It has the following ingredients. Fiscal policy should aim for balanced budgets, and monetary policy should be geared to price stability. Both help to maintain a stable exchange rate. Taxes should be low and simple; and public expenditure should avoid creating a welfare state with open-ended middle-class entitlements. Such prudent macroeconomic policies create a conducive

environment for savings and investment. Basic domestic distortions such as price controls and wasteful subsidies should be removed to boost competition. International trade and foreign investment should be freed up. The labour market should be flexible. And the government should invest in education and infrastructure.

Structural reforms go deeper into domestic regulation. They are more complicated – technically, administratively and politically. Among them are nitty-gritty measures to

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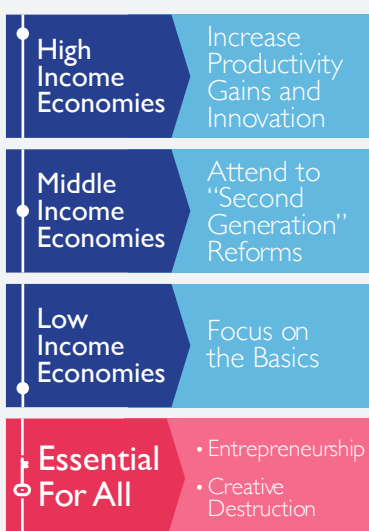
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³ The World Bank classifies low-income countries as having a Gross National Income per capita of USD 1,045 or less. Lower-middle-income countries have a GNI per capita of USD 10,454, 125. Upper-middle-income countries have a GNI per capita of USD 412,512,736, and high-income countries a GNI per capita of more than USD 12,736.

cut red tape and lower the costs of doing business; liberalising labour; energy and financial markets; shrinking the public sector and opening it up to competition; and bringing competition to education, healthcare and other public services. Such reforms dovetail with reforms to state institutions: strengthening private property rights and the enforcement of contracts; building a more sophisticated legal system and entrenching a real – not a sham – rule of law; making public administration leaner and more efficient; and establishing transparent, clean and competent regulatory agencies.

Obviously not all these reforms can be done at once, or indeed quickly. Nor is there an identikit package.

Actions for each income economy to grow:



To repeat, Asia has different countries and regions at vastly different stages of development. Reform priorities – the balance between basics and structural reforms – and reform speeds will differ from place to place. What Asian countries should have is a broad direction of travel: limiting the reach of government and expanding economic freedom for ordinary people.

Asia's poorer economies – those classified as low-income and lower-middle income – should concentrate on the basics. These are "first-generation" reforms of macroeconomic stabilisation and market liberalisation. They provide the right environment for mobilising resources savings and investment, labour and capital for growth. This is "catch-up", "input-led" growth – what Paul Krugman calls "perspiration". Most of South Asia, the poorer Southeast Asian countries, and the poorer

parts of China (its interior provinces) are in this growth phase. These countries, especially in the lower-middle-income bracket, should attend to "second-generation" structural and institutional reforms as well. But, given limited state resources and capacity, getting the basics right should be the overriding priority.

Asia's upper-middle and high-income economies have unfinished and never-ending business with policy basics: it is a constant battle to maintain macroeconomic stability; and there are always plenty of basic market distortions left to tackle. But they should focus also on structural and institutional reforms to boost competition, innovation and productivity gains.

These economies are approaching the end of or have exhausted catchup growth. Hence they depend more on productivity or

“output-led” growth – what Paul Krugman calls “inspiration”. Otherwise countries get stuck in a “middle-income trap”. Entrepreneurship and creative destruction apply to all growth phases, but it is especially relevant to this growth phase. Now capitalism gets more advanced and sophisticated.

Asia’s richest countries – Japan, South Korea, Taiwan, Hong Kong and Singapore – have made the transition from low to middle and now high-income status. Exceptionally, they have escaped the middle-income trap. Their challenge is to drive productivity gains and innovation in established and new global-market niches. Their products need to be more differentiated and their economies

more specialised. China, Malaysia and Thailand, in contrast, risk being stuck in an upper-middle-income trap for lack of structural and institutional reforms.

Economic reforms to expand economic freedom beg the question of political reforms to expand civic freedom and representative democracy. The record in Asia and elsewhere shows that catch-up growth is compatible with various political systems, ranging from authoritarianism to democracy. Liberal-democratic institutions and open societies, with their contested elections, plural ideas and checks and balances, are not a prerequisite for catch-up growth. It is possible for governments to get



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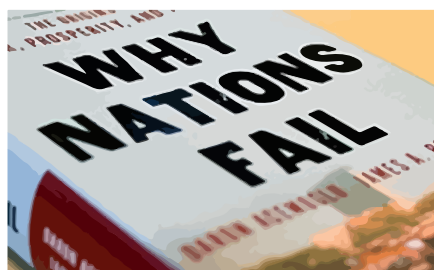


some policy basics right and enjoy catch-up growth in the midst of authoritarian politics, a largely unreformed state and corruption. The East Asian Tigers from the 1950s to ‘80s, China from 1978, and Vietnam from the mid-1980s, prove the point. Democratic India lagged way behind with “License-Raj” policies, but the same democratic India boosted growth and lifted more than 200 million people out of extreme poverty with market reforms from the early 1990s.

But it gets more complicated as countries approach upper-middle-income levels. Now the link between political and economic reforms becomes stronger. Today, China, Malaysia and Thailand need to shift from “perspiration” to “inspiration”, from mobilising resources maximally to using them more efficiently. They need Schumpeterian creative destruction. And for that they need structural and institutional reforms. Unreformed autocracies, or even shambolic semi-democracies, with unchecked vested interests at their core, are badly fitted to undertake such reforms.

In their book *Why Nations Fail*, Daron Acemoglu and James Robinson argue that countries like China, Malaysia and Thailand, and those lower down the income scale, have “exclusive and extractive” institutions. Institutional insiders extract rents from markets rigged in their favour; they use enormous power within an unreformed state to block market reforms. This is the recipe for staying stuck in the middle-income trap. Getting out of it requires a shift to “inclusive” institutions that are open and transparent, with built-in checks and balances. In other words: liberal-democratic institutions in an open society. These have their own problems, of course: vested interests block market reforms in mature liberal democracies as well. But their openness and plurality equip them to better challenge entrenched interests, and their liberal atmosphere encourages individual expression and creative ideas – the fuel for innovation. This, then, is the playbook of Hamilton and Madison’s *Federalist Papers*, not that of Lee Kuan Yew and Deng Xiaoping.

China’s “market Leninism” graphically illustrates the tension between a static political system and a fast-changing, globally integrated market economy. Under Xi Jinping, China has a combination of “Mao and markets”. At the Communist Party’s Third Plenum in 1978, the Beijing leadership signalled new reforms for a “decisive shift” to the market economy. It recognised the urgency of second-generation reforms to transform China’s growth model from mobilising inputs to generating productivity gains, from perspiration to inspiration. But, concurrently, President Xi has centralised power and clamped down on dissent; China’s political atmosphere is less, not more liberal. There is no sign that institutions will become more inclusive. So far, only minor market reforms have materialised – mere baby steps. There remains a basic contradiction between China’s closed, extractive institutions and fundamental market reforms. Will China’s Party-State adapt? Is it capable of introducing sufficient *liberal* and *democratic* political reforms to enable further economic reforms? Or will China stagnate and get stuck in the middle-in-come trap? The auguries are not good.

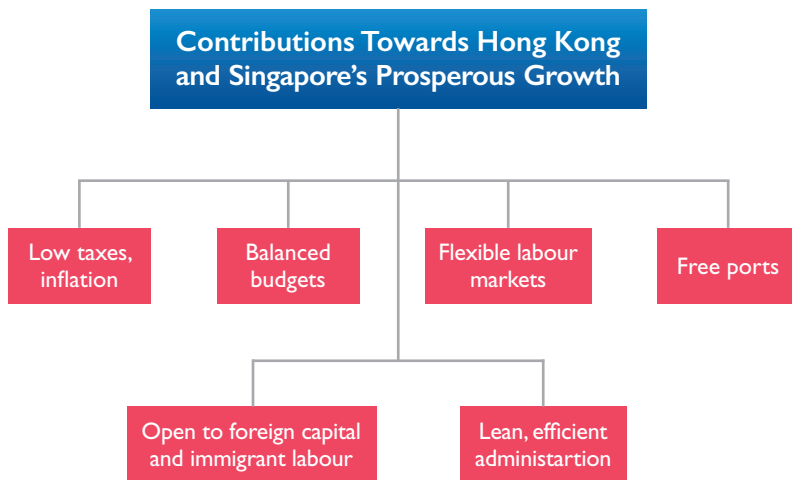


“Why Nations Fail”

by Daron Acemoglu & James Robinson

“*China, Malaysia, & Thailand, in contrast, risk being stuck in an upper-middle-income trap for lack of structural and institutional reforms.*”

India, unlike China, has a historically weak state. Since independence, its political system has combined illiberal, overextended government with messy, rambunctious democracy. This compound has blocked market reforms. That continues under Congress and BJP governments, despite the opening of the economy from the early 1990s. However, India has British-endowed liberal institutions (at least in outline), and a more decentralised and diverse society than China's. That is the context for its economic silver lining: bottom-up market reforms in some Indian states that set good-practice examples to emulate elsewhere in India.



Hong Kong and Singapore come closest to the classical-liberal ideal in Asia. They have grown prosperous with their low taxes, balanced budgets, low inflation, flexible labour markets, free ports, their openness to foreign capital and immigrant labour, lean, efficient administration, and excellent infrastructure. They maintain secure private property rights, the freedom of enterprise, and are wide open to the world. So far, they have avoided the horrors of a Big Government welfare state. They have got the basics right better than other places, and have high-quality regulations and institutions. They are worthy successors to the old port-

polities, such as Cambay, Calicut, Malacca and Macassar, that were hubs of Indian Ocean and Southeast Asian archipelago trade – the last golden age of Asian commerce before Western colonialism.

Capitalism is more advanced in Hong Kong and Singapore than anywhere else in Asia. But even there it lacks something. It is too safe and bureaucratic – not freewheeling enough. Both are still high-end copying cities, not really innovative cities like London, New York and several other cities in the USA. They lack Schumpeterian creative destruction.

Multinational companies and the public sector dominate Singapore's economy. They squeeze the domestic private sector; whose companies, with very few exceptions, are small and medium-sized. SMEs employ about half the workforce, but most have low productivity. Their main obstacle to growth is the public sector – GLCs (government-linked companies) and three huge sovereign funds that dominate the

local land and capital markets, and account for a big chunk of the labour market. They suck oxygen from private-sector SMEs. In addition, Singapore's political system is not exactly a Western-style liberal democracy, though it is more liberal and democratic than it used to be. A small coterie of insiders dominates both politics and business. The result is a bureaucratic capitalism that lacks entrepreneurs and creative destruction.



In Singapore, a small coterie of insiders dominates both politics and business. The result is a bureaucratic capitalism that lacks entrepreneurs and creative direction.



Hong Kong has more vibrant SMEs and no history of state-owned enterprises. Under the British, it was certainly not a democracy, but it had liberal institutions and an open society; it never had the nanny-state, social-engineering proclivities of Lee Kuan Yew's Singapore. But it still lacks the entrepreneurial buzz of London and New York. Its SMEs are not that productive. They are crowded out by Hong Kong's tycoons, whose conglomerates dominate the property market and many other sectors of the local economy – aided by their political connections at home and in Beijing. Moreover, Hong Kong, since its handover to China, has a defective political system that produces a mediocre governing elite – one that constantly kowtows to Beijing masters and is incapable of making strategic decisions. Political uncertainty – from Beijing's encroachment on Hong Kong's autonomy and divisions in local society – makes Hong Kong's future as one of Asia's "global cities" ever more uncertain.

Asia's three other rich societies – Japan, South Korea and Taiwan – have even bigger capitalist shortcomings. This highlights what a huge agenda there is for capitalism all over Asia.

Pros

- More vibrant SMEs
- No state owned enterprises
- Liberal institutions
- Open society

Cons

- Unproductive SMEs
- Lacks entrepreneurial buzz
- Controlled by tycoons



Conclusion

To sum up the state of capitalism in Asia: there is good news and bad news. Start with the good news. Compared with a century ago, or even twenty or thirty years ago, Asia and the world are much better off. Their population has increased enormously, but people are still better housed, clothed and fed, with much-improved life-chances. Markets and economic freedom have spread far and wide. On the eve of the Great War, ideological collectivism – a noxious mix of nationalism and socialism – was gathering pace, and great-power conflict was about to destroy a century of relative peace and unprecedented material progress. Now anti-market ideologies are far less noxious, markets and globalisation intertwine nations and peoples as never before, geopolitical tensions are not as threatening, and international institutions (however faulty) enable governments to cooperate – to “jaw, jaw” not “war, war”.

The bad news is that since the late 1990s, and especially since the GFC, classical liberalism has retreated. Collectivist ideas and policies are advancing again – this time not unregenerate socialism and communism, but the social engineering of Keynesian macroeconomics and Pigovian microeconomics. Like classical liberalism, these are Western exports. Mimicry has embedded them in Asia and elsewhere outside the West. Their advance obstructs capitalism’s entrepreneurial engine, as Schumpeter feared. The right oil for that engine is simple, clear rules; rules that focus government on its vital functions, limit regulatory discretion and keep the system open to innovation. These insights go back to Adam Smith and David Hume. In Asia, the twin challenge is to get the basics of economic policy right, and, especially in upper-middle and high-income Asia, to shift from well-worn imitation to genuine innovation. The latter is the biggest challenge, for it demands major changes to rules and institutions, including political systems. Those changes are all about freedom in open societies.

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