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Reshaping of the Global Economy: The Dawn of the Asian Century?¹

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This is a bad time for the world economy and it is an even worse time for the western financial system. However, this is a good time to speculate about the future shape of the global economic system and also how Asia may influence the shape of things to come. Is the current crisis a mere interruption in the process of global economic change that began a decade and a half ago when, with the process of globalisation exerting its force, the structure of production and the structure of international trade began to change? These changes propelled some large emerging markets, most of them in Asia, to the centre of the global economic stage. Or are we seeing, as some analysts have maintained, a change that will inevitably result in directing the global economy towards the direction it was taking before the current crisis began to take its toll? Some analysts have said that the “rise of the rest” – Fareed Zakaria’s phrase³ – may not, after all, actually be a rise but a temporary phase in the evolution of the global economy. They believe that the opportunities offered by globalisation will become constrained as the world’s rich countries make adjustments to the crisis that started in 2007 and is likely to turn the corner in 2010.⁴ I happen to agree with Zakaria.

There are good reasons to believe that the process that began a decade and a half ago will continue to decisively alter the global economic landscape. This change is occurring not just because of globalisation, which is usually defined as the relatively free flow of capital, trade and information, but also because of an extraordinary demographic transformation. With so much adjustment still to take place; it may seem premature to ask, as we do here, what the future of emerging markets will look like. The crisis of 2007-10 notwithstanding, it appears that we are witnessing another epoch of major realignments in the world’s major economies. If that happens, it will be in keeping with the previous patterns in economic history. As on previous occasions, we will see the emergence of new economic powers. The world will have

¹ This paper is a chapter in a forthcoming book by Mr Shahid Javed Burki on the proposed title of “Can Regionalism work for South Asia?”.

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³ Fareed Zakaria, *The Post-American World*, Norton, New York, W. W. & Company, Inc., 2008.

⁴ Among those who argue along these lines is Martin Wolf who writes a widely read weekly column in the *Financial Times*. Also see his recent book, *How to Curb Financial Crisis in the 21st Century*. In an earlier book, Wolf laid a case for the virtues of globalisation to make a case against those who were concerned about the adverse consequences of this development. See *Why Globalization Works*, New Haven, Yale University Press, 2004.

several poles of economic activity, some of them most certainly in Asia. However, in order to think about the future we need to comprehend the past.

Previous ‘Catch-up’ Periods

Some economic historians have identified ‘catch-up’ periods in the world economy when some of the national economies that had lagged behind joined the leader, and sometimes even overtook it. In the eighteenth century, France caught up with Britain, the country that had launched the Industrial Revolution. A quarter century later, Germany joined the two leading economies of Europe and became one of them. Alexander Gerschenkron, a distinguished economic historian, explored the rise of some of the European nations following Britain’s Industrial Revolution. According to him, whereas Britain’s ascent on the ladder of economic power was largely the consequence of private initiative and enterprise, the state, such as it was, helped France and Germany to catch up.⁵

In the late nineteenth century, it was the United States’ turn to ‘catch-up’. It not only joined Europe’s leading economies but, by the start of the First World War, it had overtaken most European economies in terms of the size of its economy and income per head. The twentieth century saw more ‘catch-up’ periods. After the Second World War that saw the defeat and devastation of Germany and Japan, the Americans helped the vanquished “axis powers” to recover. It did this by launching the Marshal Plan, an unusual response by the victor towards the countries it had defeated. Not only did Japan recover, it joined the leading world economies in terms of the structure of its economy and income per capita of its population. The pace and style of Japanese economic development caught the eyes of many academics, including Ezra Vogel, the sociologist at Harvard University who wrote a bestselling book titled *Japan as Number One*.⁶ He was so impressed with the dynamism of the Japanese economy that he thought it could overtake the United States within the foreseeable future. Had that happened, it would have been a spectacular case of ‘catch-up’. Japan, with only one-half of the United States’ population, would have had to double its income per head to overtake America.

The next phase of closing the gap took place in the 20-year period between 1975 and 1995 when a number of East Asian economies – the World Bank called them the “miracle economies” in a celebrated study of East Asia⁷ – achieved rates of economic growth that were without precedence in economic history. Within these two decades, four East Asian states – South Korea, Taiwan, Hong Kong and Singapore – saw a remarkable transformation of their economies. Although they did not approach the income levels of Japan and the western economies, they became industrial powerhouses. Even though there was a brief interruption in their progress by what came to be called the Asian Financial Crisis of 1996-97, they resumed economic development at about the same pace as the pre-crisis period.

Before the start of the global economic crisis in the summer of 2007, there was much speculation that a new group of ‘catch-up’ economies had appeared on the global economic scene. Brazil, Russia, India and China got their own name, the BRICs. They were likely to

⁵ Alexander Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays*, Balknap Press, of Harvard University, 1962.

⁶ Ezra Vogel, *Japan as Number One: Lessons for America*, Cambridge, Massachusetts, Harvard University Press, 1979.

⁷ The World Bank, *The East Asian Economic Miracle: Economic Growth and Public Policy*, New York, Oxford University Press, 1993.

become major economic players. Given the large sizes of their populations, some analysts believed that the centre of global economic activity would move to these countries. There was also a consensus emerging in academic circles that we were witnessing another significant change in the structure of the global economy. “Decoupling” was occurring in the global economy and the BRICs, along with some other large emerging economies, would no longer be affected by the cycles to which the more developed economies were subjected. That was not to be so. In fact, some of the emerging economies were more affected by the crisis than countries in the developed parts of the world. Excluding China and India, the gross domestic product (GDP) of emerging Asia fell by an annualised rate of 15 percent in the last quarter of 2008. In the first quarter of 2009, Singapore’s GDP declined by an annualised rate of 20 percent. In other words, the smaller, more export-driven economies were more affected than those that depended much more on internal demand as the engine of growth. Asia’s two largest economies, China and India, continued to achieve positive rates of growth even during the first few months of the crisis. India was never very dependent on exports to the developed world. While China was more exposed, when measured on a value-added basis, its exports to the United States accounted for less than five percent of its GDP. And it certainly helped that among all the countries, China planned to spend a much larger proportion – an estimated five percent – of its total output than any other country. The United States’ effort was estimated at only two percent of its GDP.

The conclusion I would draw from this is that the large Asian economies will, in spite of the setback in their rates of growth in 2008-09, continue to ‘catch up’, in terms of the size of their GDPs, with the more developed economies. What is even more significant is that the model of economic management they have pursued won a number of new admirers who began to question the wisdom embedded in unconstrained capitalism. This is likely to lead to a redefinition of the role of the state in economic management. The new global economy will be structurally different from the one that was shaped in the half century between the end of the Second World War and the beginning of the sharp economic downturn in 2007.

The crisis that began in the United States in the summer of 2007 reached other shores – it did not spare the BRICs or other parts of the globe. “The impact of the crisis will be particularly hard on emerging countries: the number of people in extreme poverty will rise, the size of the new middle class will fall and governments of some indebted emerging countries will surely default”, wrote Martin Wolf, chief economics commentator of *Financial Times*, for a special issue of the newspaper dedicated to a discussion of the future of capitalism. “Confidence in local and global elites, in the market and even in the possibility of material progress will weaken, with devastating social and political consequences. Helping emerging economies through a crisis for which most have no responsibility whatsoever is a necessity.”⁸

As already indicated, it is hard to accept this grim conclusion. Some countries in the emerging world are, no doubt, hurt and many of them need the assistance of the international community. Several, however, will emerge stronger from this experience and continue to participate in the reshaping of the global economic structure. Among them is most certainly China but also possibly India. In other words, Asia will soon have at least one or perhaps two economies that will be the centre of new global economic system. The centre of gravity of the global economy may shift from the mid-Atlantic to the mid-Pacific. To make this point it might be useful to briefly visit the changes that have occurred in economic thought in the last few decades, especially after the conclusion of the Second World War.

⁸ Martin Wolf, “Seeds of its own destruction”, *Financial Times: Future of Capitalism*, 12 May 2009, p. 9.

Changes in the Structure of the Global Economy, 1945-2007

The last half century divides itself neatly into two periods – neat in the sense of the attention given by policymakers the world over to certain ideologies concerning economic management. Several influential world leaders did not see the war as a triumph of the United States and its allies in Western Europe and the Pacific. They saw it as the victory of socialism and statism over the market place. The remarkable economic growth of the Soviet Union and the growth of its military might were seen as a vindication of the way it had managed its affairs, in particular its economy. The admirers of the Soviet Union were not confined to the leaders of what came to be called the Third World – leaders such as Jawaharlal Nehru of India, Gamal Nasser of Egypt, Julius Nyrere of Tanzania, Kwame Nkrumah of Ghana and Soekarno of Indonesia. Even in victorious Britain, the voters sent Winston Churchill and his Conservative party home in favour of the Labour party and its leader, Clement Attlee. The model these leaders favoured was that of the mixed economy. In John Maynard Keynes, they had their own philosopher for this approach. The man who gave the clearest substance to this line of thought in the Third World was India's Nehru under whom the state was placed on the "commanding heights" of the economy.

Under Nehru, India's first prime minister who served 17 uninterrupted years in that position, the country adopted the Soviet-style central planning but with some significant differences. The Soviets had totally eliminated the private sector, placing practically all economic activities in the hands of the government. On the other hand, India under Nehru did not disturb private ownership. That happened later when Indira Gandhi, his daughter, nationalised privately-owned banks in 1969. Nehru encouraged large investments by the state in industry. He also ordered his successive administrations to build an elaborate system of licensing that put the private sector under strict government – hence bureaucratic – control. India gradually gave more autonomy to the state governments. Such a development was not envisaged by Nehru and other fathers of the Indian constitution who gave the new state an enormous amount of authority over the federating units. The Soviets, on the other hand, particularly under Joseph Stalin used force – often brutal force – to concentrate power and authority in the hands of Moscow.

The state also played a prominent role in transforming the miracle economies of East Asia. The region had a remarkable record of high and sustained economic growth. From 1965 to 1995, the 23 economies of East Asia grew faster than all other regions of the world. Most of this achievement was attributable to seemingly miraculous growth of the eight economies studied by the World Bank for the preparation of the *Miracle Economies* report.⁹ In most of these economies the government intervened – systematically and through multiple channels – to foster development and, in some cases, encouraging the development of specific industries. Policy interventions took many forms. Policies to bolster savings, build strong financial markets and promote investment with equity included keeping deposit rates low and maintaining ceilings on borrowing rates and retained earnings, establishing and financially supporting government banks and sharing information widely between selected industries, protecting import substitutes, supporting declining industries, and establishing firm- and industry-specific export targets. The state also ensured reasonably equitable distribution of incremental income. The East Asian economies were the only ones that avoided the Kuznets effect – their growth was not accompanied by deteriorations in income distribution. There

⁹ The World Bank's report covered eight countries; not the usual four – Hong Kong, Singapore, South Korea and Taiwan but four additional ones – Indonesia, Japan, Malaysia and Thailand.

were also impressive reductions in the incidence of poverty in the region. It dropped from 37 percent to less than five percent in Malaysia in the 30-year period between 1960 and 1990.

A reaction set in to this approach with the election of Ronald Reagan in the United States in 1980 and Margaret Thatcher's ascent to prime ministership in Britain the year before. The two, who sometimes worked together, ushered in a new economic philosophy. What came to be called 'Reaganism' and 'Thatchersim' redrew the boundary between the state and the market place, pulling back the former in favour of the latter. Reagan proclaimed, "[The] government is not the solution to our problem; [the] government is the problem".

The man who gave real substance to this philosophy was Alan Greenspan, who served 18 years as the Chairman of the United States Federal Reserve Bank, the country's central bank.¹⁰ Greenspan, a careful analyst of the United States' economy, came to two conclusions that were applied to the management of monetary policy. The first concerned the level of the non-accelerating inflation rate of unemployment. He believed that as a result of the remarkable developments in information technology, worker productivity in the United States certainly, but perhaps also in other industrial countries, had increased to the point where a higher growth in national product could be allowed without igniting inflation. This meant that the Federal Reserve could allow an easier monetary policy to stay in place. The second, as important as the first in terms of economic management, was an infinite faith in the ability of the private sector, in particular those operating in finance, to develop products that spread risks across a large number of players. One corollary of this faith was to leave the private sector alone, to let it self-regulate without too much intervention by the institutions of the state. Seeds were thus sown for the crisis that hit the global economy in the first decade of the twenty-first century.

Other events also contributed to the development of the new approach in which private enterprise was to be left alone to its own devices. These included the shift in China from a planned to a market economy under Deng Xiaoping and the dismantling of the "License Raj" in India starting in 1991 under the stewardship of then-Finance Minister, Dr Manmohan Singh. While for the Anglo-Saxon part of the developed world, the shift of emphasis towards allowing private enterprise a free play in the economic system was by choice, for developing countries it was the consequence of the difficult circumstances which some of them had to deal with. This was certainly the case for India which, in 1991, faced its most serious economic crisis since it achieved independence in 1947. That notwithstanding, the men who guided India during this critical phase are trained in Britain and the United States. That is the case with Dr Singh and Montek Ahluwalia, the Finance Minister's Chief Economic Adviser, who are both graduates of Oxford University. Shanker Acharya, the third member of the group, has a PhD from Harvard University. They were familiar with the debate in the Anglo-Saxon economic circles and were attracted to the emerging philosophy that favoured pulling down the state from the commanding heights of the economy. They had studied the damage the prominent presence of the state had done to the Indian economy in the 40-year period between 1957 and the mid-1980s. For them, dismantling the "license raj" was an important part of the reform programme.

The approach that found favour with them was reflected in the development of *The Washington Consensus*, a set of policies advocated to or required of the emerging economies

¹⁰ The best articulation of Alan Greenspan's views is in his autobiography. See Alan Greenspan, *The Age of Turbulence: Adventures in a New World*, New York, The Penguin Press, 2007.

given their circumstances. According to this, emerging economies should pull back the state in order to allow greater space to private enterprise and greater penetration by foreign entities into their economies. These objectives were to be achieved by allowing capital to flow relatively freely across national borders, by lowering the walls of tariff that were erected to protect domestic industry and services from foreign competition, by privatising the assets held by the state, and by removing the constraints on private activity in the economy. The *Consensus* named thus because it was developed by the economists working at such Washington-based institutions as the World Bank, the International Monetary Fund, the Inter-American Development Bank and the Institute of International Economics. Some of these institutions were able to go beyond simple advocacy in terms of selling this approach to emerging countries. They were able to do this by embedding them in the programmes of support that were developed for emerging economies in distress that turned to the international financial institutions for support. India was one such country. However, India, mostly for political reasons, did not go all the way. It did not entirely pull back the state, allowing several important parts of the economy to stay in the government's hands. The reformists also found that they did not have the political muscle to do away with or even dilute the extremely restrictive labour laws that made it difficult for private enterprise managers to fire workers.

Two groups of countries in the emerging world came under the influence of the Washington-based institutions – several Latin American countries that faced serious debt crises in the late 1980s and in the late 1990s, and the “Tiger Economies” of East Asia that found themselves suddenly vulnerable to the changing perceptions about their creditworthiness by private banks in developed countries. Both groups of countries were required to readjust government policies to more fully reflect *The Washington Consensus*.¹¹ However, the large Asian economies were largely spared the need to undertake this massive readjustment in government policies. It is these, I contend in this essay, that will come out stronger once the crisis is over and the world economy returns to a steady state.

The fervour with which this economic ideology was supported has been replaced by an equally fervent condemnation. There is now consensus that the state has a large role to play in the management of the economy. Even if it is not placed on the economy's commanding heights, it must watch over it with great care and diligence. The countries that will do better in this respect are those that did not dismantle the state as an economic overseer and most of those are in the emerging world. For this reason alone I find it hard to accept that the entire emerging world has been thrown back almost to the start of the economic race as a result of the economic crisis of 2007-10. Many countries in this part of the world will recover stronger than the weakened economies of the West. This will particularly be the case for the larger, continental economies of Asia. Why that is likely to be the case will be discussed in the concluding section of the essay.

¹¹ *The Washington Consensus* did not go unchallenged within the institutions that contributed to its development. I was among those who resisted its application first to China for which I had the operational responsibility in 1987-94 and later for the countries of Latin America and the Caribbean. I, along with several other economists, most notably Joseph Stiglitz who was the World Bank's Chief Economist in the late 1990s, resisted the pressure to advocate rapid transformation of public policy in the countries for which we had responsibility. Stiglitz went on to write a scathing criticism of *The Washington Consensus* after he departed from the Bank. See Joseph Stiglitz, *Globalization and its Discontents*, New York, W. W. Norton, 2002.

Is Capitalism *Passé*?

A debate is raging in many circles – among academics, policymakers and policy analysts – about the future of capitalism. At the centre of this debate is the role of the state. This is how George F. Will, a syndicated American columnist, sums up the views of those who believe that we are witnessing a tectonic change in economic thinking as a result of the financial crisis. “Proponents of today’s world-turned-upside economic policies say the policies may be wrong but are really boldly modern in their rejection of markets in favour of the pervasive government intervention in economic life. Hence, New York, which until eight months ago was the financial capital of the world, is no longer even the financial capital of the United States. Washington is.”¹² An opposing view articulated in an article by Ian Bremmer that appeared in early 2009 in *Foreign Affairs*, held that the state interventions that have occurred in recent months should be seen as aberrations. The line between the state and the market may have been blurred but the state will eventually pull back since in economic matters, it is inherently incompetent. Once the crisis abates, the state will begin to look for the exit sign and an exit strategy. The state’s record has not been an impressive one. State capitalism “has introduced massive inefficiencies into global markets and injected populist policies into economic decision-making”, and “deeper state intervention in an economy means that bureaucratic waste, inefficiency and corruption are more likely to hold back growth”.¹³

“Some crises spread hysteria; some clear the mind and focus attention”, wrote the *Financial Times* in an editorial published while the crisis was at its peak.¹⁴ Which of these points of view are correct; which way is the global economy likely to go; and what will be the impact of the crises on the future of the emerging economies? In order to answer these questions, we may want to go to the beginning and start with the definition of capitalism and what Adam Smith, the father of modern economics, thought about the role of the state in a capitalist system. What is capitalism and does its universal adoption as a way of conducting economic exchanges among various participants operating in the market place spell the “end of history”? The term, of course, is from Francis Fukuyama who used it in the title of his bestselling book written and published soon after the collapse of the Soviet Union in 1991.¹⁵ The end of European communism and the seeming triumph of capitalism had brought a history of ideological conflict to an end. There had been much to celebrate.

It would not do to look at Adam Smith’s *The Wealth of Nations*, his best known work, since the word “capitalism” is absent from the long book. Nonetheless, Smith is recognised not only as the father of modern economics but also the man who provided “capitalism” with its intellectual underpinnings. Some reference to his works are a good starting point to develop an understanding of the nature of the present crisis and how it may affect the shape of things to come. Amartya Sen provides as good a definition of capitalism as any in an essay published in early 2009. “The standard definition seems to take reliance on markets for economic transactions as a necessary qualification for an economy to be seen as capitalist. In a similar way, dependence on the profit motive and on individual entitlements based on

¹² George F. Will, “Capitalism goes out of tune”, *The Washington Post*, 10 May 2009, p. A19. I should point out though that Will was sceptical about the wisdom of allowing too prominent a role to the state in economic matters. He and other conservative commentators did not give up on ‘Reaganism’ and became very critical of President Barack Obama’s economic policies that clearly favoured an activist state.

¹³ Ian Bremmer, “State Capitalism Comes of Age: The End of the Free Market?”, *Foreign Affairs*, July-August 2009.

¹⁴ *Financial Times*, “Lessons learnt for capitalism’s future” 12 May 2009, p. 13.

¹⁵ Francis Fukuyama, *The End of History and the Last Man*, New York, Free Press, 1992.

private ownership are seen as archetypal features of capitalism”, he writes.¹⁶ This definition would be accepted by those who believe that the markets should be allowed to operate without too many constraints as well as those who are of the view that the state should play a significant role in taming the wilder forces which unconstrained private initiative invariably unleashes. Where would Adam Smith find himself in this dispute?

If Smith is read at all, it is *The Wealth of Nations* that seems to draw the most attention of economists of many different persuasions. One of his most-often quoted sentences is the one pertaining to the importance of trust in economic transactions. “When the people of any particular country have such confidence in the fortune, probity and prudence of a particular banker, as to believe he is always ready to pay upon demand such of his promissory notes as are likely to be at any time presented to him; those notes come to have the same currency as gold and silver money, from the confidence that such money can any time be had for them.” It is this loss of trust that is one reason for the crisis that erupted suddenly but with great fury in the summer of 2007. The enormous expansion of the financial system by the incorporation of new instruments of such complexity that even experts were not able to comprehend them created opportunities that many people were not able to resist. “Banking is an industry that failed”, wrote *The Economist* in the opening paragraph of its special report on international banking published in May 2009. “Banks are meant to allocate capital to businesses and consumers efficiently; instead they ladled credit to anyone who wanted it. Banks are supposed to make money by skillfully managing the risk of transforming short-term debt into long-term loans; instead they were undone by it. They are supposed to expedite the flow of credit through economies; instead they ended up blocking it. The costs of this failure are massive.”¹⁷ There is also a massive loss of trust in the financial system of which Smith wrote so eloquently more than two centuries ago. The state can help restore confidence by putting in place a regulatory system that will be difficult to flaunt even by the most adventurous entrepreneurs. Had such a system existed, Bernie Madoff¹⁸ would not have happened.

However, the role of the state goes beyond the regulation of the financial sector. All rich countries in the world and even those that are heading towards prosperity have been, for some time, dependent on transactions that occur outside the markets and in the domain of the state. These include unemployment benefits, social security and old-age pensions, public provision of school education and healthcare. Even those that relied more on the markets to supply some of these public goods are now turning to the state to provide them. If United States President Barack Obama succeeds in his designs, he is likely to get the American state involved much more profoundly in providing education and health to the people than was the case in the second half of the twentieth century. If he succeeds, he would have reversed the trend that began with the Reagan presidency and continued under his successors, even the Democrat, Bill Clinton.

According to the historian Paul Kennedy, “most sensible governments since Smith’s time have taken precautions against the citizens’ totally unrestricted pursuit of private advantage. States have invoked the needs of national security (therefore, you must protect certain

¹⁶ Amartya Sen, “Adam Smith’s market never stood alone”, *Financial Times: Future of Capitalism*, 12 May 2009, p. 12.

¹⁷ *The Economist*, “Rebuilding the banks: A special report”, 10 May 2009, p. 3.

¹⁸ The reference here, of course, is to Bernie Madoff who ran a ponzi scheme that defrauded hundreds of high net worth individuals and rich institutions of tens of billions of dollars. Some of those who invested in the funds managed by Madoff claimed to have a considerable amount of financial expertise. Madoff was exposed by his two sons, tried in a United States court and sentenced to jail for several years.

industries, even if that is uneconomic), the desire for social stability (therefore, do not allow one percent of the population to own 99 percent of its wealth and thus provoke a civil riot), and the common sense of spending upon public goods (therefore, invest in highways, schools and fire brigades). In fact, with the exception of the few absurdly communist states such as North Korea, all of today's main political economies lie along a recognisable spectrum of more-free-market versus less-free-market arrangements.”¹⁹

As capitalism came under pressure as the unfolding of the deep financial and economic crisis began in the summer of 2007 in the United States, it was easy to overlook the contribution the system, in its various forms, had made to global prosperity. World GDP grew by 145 percent from 1980 to 2007, or roughly by 3.4 percent a year. Global health, as measured by life expectancy at different ages, also rose sharply, especially in poor countries. There was a closing of the life expectancy gap between the rich and poor nations. Even if global GDP declined by 10 percent in 2008-2010, an unlikely event, “the net growth in world GDP from 1980 to 2010 would amount to 120 percent, or about 2.7 percent a year over this 30-year period. This [would allow] real per capita incomes to rise by almost 40 percent even though the world population grew by roughly 1.6 percent a year over this period”.²⁰ Given what capitalism had accomplished since the Second World War, some economists were of the view that the policymakers were overreacting in America as well as in Western Europe. Two of them, both of them from Chicago University and one of them the winner of the 1993 Nobel prize in Economics, were sceptical of some of the moves that were initiated by the young administration of President Obama. Wrote Gary Becker and Kevin Murphy, “Even though we had well-qualified policymakers, we have gone from error to error since 2007. The policies of George W. Bush and Barack Obama administrations violate the ‘do no harm principle’ [of good economic policymaking] interventions by the United States Treasury in financial markets [since they] have added to uncertainty and slowed market responses that would help to stabilise and recapitalise the system...Therefore, in devising reforms that aim to reduce the likelihood of future severe contractions, the accomplishments of capitalism should be appreciated. Governments should not so hamper markets that they are prevented from bringing rapid growth to the poor economies of Africa, Asia and elsewhere that had limited participation in the global economy.”²¹

This warning from several conservative economists notwithstanding, a consensus has emerged. Accordingly, there has to be some rethinking about the nature of the relationship between the public and the private sectors and the role of the state in economic management. A beginning was made in this direction by G20, a group of large developed and emerging markets. At the group's meeting on 2 April 2009, the second of the series dealing with the recent crisis, Prime Minister Gordon Brown of the United Kingdom, who hosted the event, declared that the world's economic leaders were burying *The Washington Consensus*. This was his shorthand for saying that the moment had arrived to redefine the role of the state. “The economic difficulties of today do not, I would argue, call for some ‘new capitalism’, but they do demand an open-minded understanding of older ideas about the reach and limits of the market economy”, Sen wrote in the article cited earlier. The reference to the “older ideas”, of course, was to Smith whose lesser known work, *The Theory of Moral Sentiments*, investigated in some detail the powerful role of non-profit values. While stating that

¹⁹ Paul Kennedy, “Read the big four to know capitalism's fate”, *Financial Times, The Future of Capitalism: The Big Debate*, 12 May 2009, p. 20.

²⁰ Gary Becker and Kevin Murphy, “Do not let the ‘cure’ destroy capitalism”, *Financial Times, The Future of Capitalism: The Big Debate*, 12 May 2009, p. 13.

²¹ Ibid.

“prudence” was “of all virtues that which is most helpful to the individual”, Smith went on to argue that “humanity, justice, generosity and public spirit are the qualities most useful to others”.²² It is this part of Smith’s work that those who pursued capitalism in its most naked form either did not know or did not fully understand. However, will balance be restored between the state and the market place as the lessons of the crisis get digested? Will one type of capitalism dominate the global system or will there still be many different interpretations, given the differences in the makeup of the societies and differences in historical experiences? Where will Asian capitalism fit into the evolving global system? And, in the context of the last question, is it even appropriate to speak of one Asian capitalism?

In theory – or at least the theory that came down from such founding fathers as Adam Smith and David Ricardo – capitalism was based on simple and easy to understand truths. Most of these concerned human behaviour. The role of the state was a derivative in the sense that those who defined it looked at how that behaviour helped others in the society. It was inevitable that, based on these simple foundations, several different types of capitalist structures would get built. In the American system, as practiced during the eight years of the Reagan presidency and as it developed after he left office, the state was pushed back to the margins of the national economy. Greed became the main driver. However, even then those who minded the system were not able to dismantle the safety nets that the economy was provided with President Franklin Roosevelt’s New Deal and President Lyndon B. Johnson’s New Society programmes. When President Bush tried to privatise the social security system, he discovered that the constituencies that supported them were far too powerful for him to overcome.

In the European system, minus, to some extent, that of Britain, there was much greater emphasis placed on social justice. This was the other truth Smith had put forward in his lesser known work cited above. Even in Britain, there were some safety nets available in the sector of health that the Americans had tried but failed to establish. Given the size of its economy and its ability to communicate more forcefully and effectively, the Americans were able to export some features of their system across the Atlantic. This was the case particularly in the sector of finance where the American type of risk taking and leveraging became the norm. Open markets led to the ability not only of good things to go across the borders, but also those that were less desirable.

Some aspects of the American system also went across to Asia. For instance, even though the Indian financial system was not well integrated with the structure of global finance, corporate governance allowed some of the more adventurous owners to take the types of risks that had become common in the United States. For instance, the owners and directors of Satyam, the information technology company that had a sterling reputation, were able to undertake the kind of practices and risks that had driven such large corporations as Enron and Worldcom into bankruptcy in the United States. The Satyam crisis was a vivid reminder of the basic truth of capitalism – that unattended and untended human greed can take any entity, anywhere, towards antisocial behaviour. This is why, in the reaction to the economic and financial crisis of the early 2000s, there will be much greater attention given to the redefinition of the role of the state. The state will become more actively involved not only in the management of the domestic economy but also in minding economic interactions among the states.

²² In quoting from Smith, I have not gone to the original works since they are not usually read even by the historians of economic thought. Smith is by far the most quoted but least read in the original of the old masters. Most of my quotations come from the very helpful guide to Smith by O’Rourke.

Is the Asian capitalism really different from the type of economic system advocated by Smith? Is there an Asian exceptionalism akin to the one that the Americans focus on with respect to their country? There are several analysts who believe that this indeed is the case. One of the more notable ones among these is Kishore Mahbubani of Singapore, the author of an influential book on the subject. While “neither China nor India have lost faith in capitalism, because both have elites who remember living with the alternatives”, Mahbubani wrote in an article in May 2009, “the desire for an orderly society is deeply ingrained in the psyche of all Asians, which explains why virtually all Asian states hesitated to copy America in deregulating their financial markets. Instinctively, they felt government supervision remained critical. This was equally true in India’s democratic system and in China’s Communist Party system.” However, a larger and more visible role for the state is not the only difference between the Asian and American interpretation of capitalism. Culture is also important in differentiating the Asian and American systems. “Asian culture has been honed by centuries of hard experience, which explains why Asians save more. All Asian societies have memories of turbulent times. They know from experience the importance of preparing for the bad days that will follow the good.”²³

There cannot be any doubt that, after the near-death of American capitalism, there will be a considerable amount of rethinking about the role of the state. The state will watch both domestic and global economic transactions. How should that be done is a question which will be debated within countries as well as in the numerous international forums that will be convened for this purpose. Some of these, the G20, for instance, have been tasked to come up with suggestions to redefine the role of the state. The two countries that will play important roles in changing the structure of global finance will be both Asian – China and India. However, the role of the state in these two large Asian economies has been very different.

The State’s Role in the Asian Economies

In Asia, there have been not one but at least three models of the role of the state in economic management. There have been variations even within these three models. Starting in the continent’s northeast, we have the model in which the state guided private enterprise while leaving a great deal of initiative in the hands of the private sector. This was done in full recognition of the fact that the private sector was more competent in directing capital to its most productive uses. The capitalist system encouraged risk-taking, rewarding those that succeeded but punishing those that failed. That said, it was a slow process. The Asians in the northeast, starting with Japan, were in a hurry to catch up with the economies of the more developed West. They wanted to compress the period during which this transition could be made. There was also the belief, correct for those times, that the size of the markets needed by the private sector to develop could not be provided by domestic consumers. They were too poor to provide the scale needed by private enterprise to make investments that would produce profit. Such markets would have to be found abroad. Combining the need for guidance by the state and developing markets outside became the distinguishing features of the East Asian model. Its first successful operator was Japan’s Ministry of International Trade and Investment.

Japan’s spectacular success encouraged the countries in its neighbourhood to go in the same direction. They followed Japan and developed an activist state to propel the economies

²³ Kishore Mahbubani, “Lessons for the West from Asian capitalism”, *Financial Times: The Future of Capitalism: The Great Debate*, 12 May 2009, p. 32.

forward. Economic historians called the follow-the-leader approach the “flying geese” model in which the leading bird falls behind, giving the lead to those that are a little behind in the formation. However, even while following Japan, the state in countries such as South Korea, Taiwan, Hong Kong and Singapore had to create the human resource needed by modernising economies. Accordingly, the state invested heavily in education, skill development and healthcare – the types of investments the Japanese had made in the period before the Second World War. This export-led, human development model of accelerating the rate of growth and economic change with the state playing an active role worked for East Asia.

The Chinese had an example to follow when Deng Xiaoping turned his attention towards adopting some elements of capitalism to bring about economic modernisation in his very poor but very large country. However, as the Chinese model evolved through much experimentation, one thing remained constant – the presence of a powerful state that more than directed the economy, it actively participated in the economy as the most important player. In looking at the Chinese approach to economic development and social change, what impresses is the pragmatism of the leaders who followed Mao Zedong. However, it must be recognised that without the contributions made by the much vilified Mao, China would not have achieved its own economic miracle. He forced social change on a very conservative and backward society. Although done at a tremendous cost by the time Mao left the Chinese scene, the country’s population was much more educated and considerably healthier than was the case when the Communists took control of the Chinese state 30 years earlier. There was much experimentation on the way, some of which produced disastrous consequences – especially during the Great Leap Forward, in the late 1950s and the Cultural Revolution in the late 1960s. Leaving ideology aside, Mao, like the leaders who guided East Asia’s miracle economies, also wanted to compress history. Given the size of the country and its relative backwardness, Mao’s task was considerably more difficult.

Deng was also a man in great hurry. He too wished to compress history. His ascent to power, following the chaos during the “Gang of Four” period, resulted in a number of structural changes in the Chinese economy. Initially, the most significant of these was the end of the communalisation of land ownership and the return of land to the peasantry. Unlike the Soviet Union, the Chinese had not destroyed individual farms; their privatisation, therefore, could proceed smoothly. The transfer of land produced a quantum jump in agricultural productivity, in the total output of agriculture and in the income of the peasantry. The next question Deng and his reformist associates faced was channelising the increase in rural incomes. Pragmatism came into play once again. The government allowed the peasantry and rural communities to invest in what came to be known as “town and village enterprises” (TVEs). This was a uniquely Chinese form of asset ownership. The TVEs initially became active in small-scale manufacturing, transport, and warehousing. They developed scale once they were allowed to receive capital sources other than their own. Eventually foreign investment was also allowed. Several large Chinese enterprises of this day have their origins in the TVEs.

The Indian model also evolved over time. The role the state plays today in the Indian economy is very different from the one given to it by Nehru in the period immediately following independence. Today’s state is not as intrusive as it was in the early decades. While it has pulled back from the direct management of the economy, it remains engaged in some of the more important ones. A significant part of commercial finance remains in the hands of the state. While there have been important changes, one element remains strong in the Indian model. The direction the economy should take is determined by an open democratic process. It is not dictated by some leadership groups as is the case in China and East Asia. The leaders

can certainly influence but they cannot direct the extent of change. This is done democratically. India elected its 15th Lok Sabha, the Lower House of the parliament, in May 2009, confirming the direction the Congress Party trinity – Indira Gandhi, her son Rahul Gandhi and Dr Singh – was taking the country. This was not the case in the elections of 2004 when a highly confident Bharatiya Janata Party (BJP), the Hindu nationalist party, was convinced that the “Shining India” it had claimed to have produced will be rewarded by the electorate. The BJP lost, giving way to rule by the Congress, which may well last for more than a decade.

What seemed to have pleased the voters in particular this time is the way the Congress used the state to help the less advantaged people, the vast majority of the Indian population. The National Rural Employment Guarantee Scheme, a huge public works programme from which the government says 44 million families have benefitted, is especially popular. A massive debt write-off scheme for 43 million farmers was also a vote getter. This was an imaginative as well as democratically rewarding use of the state. If the Congress’ election manifesto is any indication about the role of the state, it appears that is unlikely that the public sector will pull back any further. It totally rejected the “policy of blind privatisation followed by the BJP led....government.” Had western capitalism not been so thoroughly discredited by the crisis of 2007-10 and had *The Washington Consensus* not come to be regarded as *passé*, India may have pressed on with more economic realisation. Now, in the current global economic environment, the move in that direction may not be politically feasible.

When some analysts speak or write about the dawn of the Asian century and the attractiveness of the model of capitalism that has worked so well for Asia, it is not clear which of the three models they have in mind. Each, as discussed above, had the state play a very different role in economic matters. That said, one thing is clear – the state in the coming decades will have a much more activist role in the management of both national and global economies. With the experience the Asians have gained in using the state, they have much to teach the world and there is much the policymakers around the globe could learn. To discuss this as well as the failure of the state in some of the large countries of Asia, we will undertake a detour into politics.

The State in China and India – the Two Rising Stars of the Global Economy

There is debate in development circles, in economics as well as political science, as to which of the two systems operating in the world’s most populous countries with billion plus populations will succeed in producing the next economic superpower. The Indians are confident that they have the better system based on democracy and an increasingly decentralised system of governance. Former United States President Clinton seems to agree. In 1997, he told Jiang Zemin, then President of China, that his country’s authoritarian and highly centralised system “was on the wrong side of history”. The Chinese seem not to have been persuaded and their confidence increased as the country’s economy began to bounce back from the severe economic crisis of 2007-10 much more quickly than the world’s other major economies. Even the loss of jobs by 20 million workers, most of them immigrants from the countryside, did not produce the kind of discontent the country saw in 1989 with the eruption in Tiananmen Square.

The apologetic tone that leaders once adopted on political issues was replaced by more confident claims about the benefits of the Chinese model. Zhou Xiaochuan, head of the central bank, said in May 2009, that given the indications that the country was recovering

from the crisis faster than other large economies, China has demonstrated its ‘superior system’ when it comes to making important decisions. In fact, some analysts believe that the “fate of the Communist party – whether it maintains its tight grip on power or is forced to give way to more democratic forms of government – will be the defining moment of the century.”²⁴ The Chinese, unlike the Communist party of the Soviet Union, have gone in for a significant amount of political engineering to keep their party current with the developments taking place in the country. “The lesson from the Soviet experience is clear: adapt and change or atrophy and die. The Chinese Communist Party (CCP) has clearly chosen the former option,” wrote David Shambaugh, the American scholar of modern China in his most recent book.²⁵ In adapting and remaining relevant, the party leaders borrowed freely from modern and western management practices. “Training of officials has been improved, including the opening of MBA-style colleges for party members. The CCP’s all powerful personnel department has imposed rotation of officials to reduce the scope for corruption and broaden experience, as well as enforcing retirement for older officials. In 2007 alone, about 200,000 local government officials changed positions.”²⁶ The main idea behind all this is to make the one-party system more effective.

Another lesson the Chinese have learnt from the experience of the Soviet Union is not to leave senior leaders in place for indeterminate time. Since Deng, they have strictly followed the party’s and country’s constitution by not allowing the top leadership to serve for more than 10 years and to carefully plan for transition. Hu Jintao was identified as the leader several years before he took office. Similarly his and his prime minister’s successors seem to have been identified. In 2012, Xi Jinping is expected to take over as president and Li Keqiang as prime minister, succeeding Wen Jiabao. The real challenge may lie ahead. A prosperous population may seek greater political participation. There is a belief among some political scientists who have studied political modernisation in developing countries that pressure for democracy begins to build up when per capita incomes approach the level of US\$5,000-US\$6,000. This is where China is now in terms of purchasing power parity although in conventional accounting terms, its income is still half of that. The succession in 2002 was relatively smooth and free of acrimony but its institutional base, unlike the one that brings about leadership change smoothly in India, was weak.

The Indian system, being truly democratic, shows all the chaotic manifestations typical of the system of governance. That said, what the nation has achieved is unique in developing countries with large populations. It has not only maintained a democratic system but also developed it to accommodate the changes that the society has experienced since the adoption of the constitution in 1950. As discussed in a previous section, the Indians have used the state in economic matters in ways very different from China and East Asia. Also different is the development of regional politics in India, which has been able to accommodate differences within the established, but malleable, political framework. This has been a dominant theme in the analysis of Indian politics. Some pundits see an end to this trend. “They argue that Indian voters, showing unsuspected perspicacity, have recognised the need for stable central governments.”²⁷

²⁴ Geoff Dyer, “Little leaps forward”, *Financial Times*, 28 May 2009, p. 7.

²⁵ David Shambaugh, *China’s Communist Party: Atrophy and Adaptation*, University of California Press, 2009.

²⁶ Geoff Dyer, op. cit., p. 7.

²⁷ *The Economist*, “Briefing: India’s election”, 23 May 2009, p. 25.

Cases of State Failure in Asia

The previous three examples – East Asia, China and India – are that of the successful development of political institutions that created a functioning and effective state. Without a reasonably efficient state, these three parts of Asia would not have written the narratives of economic success. But right next to these successful examples of statecraft are those of the failure or near-failure of the state. The most glaring example of state failure is Afghanistan, which has not been able to put together a political system that can help the state perform some of its basic functions. These include ensuring security of life and property of citizens, protecting the territory from foreign intrusion, and meeting the people's basic needs. Some of those who have studied the country suggest that it has never really been a functioning state but a collection of autonomous regions in which the central authority is allowed only a very limited amount of authority. Some external powers tried to impose order on this highly fragmented political system. The British tried it in the second half of the nineteenth century. The Soviet Union attempted it in the 1980s but ended up suffering a major military defeat and withdrawing from the country. This was also the intention of the United States after it invaded the country in 2001. However, President Obama, after assuming the American presidency in January 2009, indicated that his administration will follow a very limited agenda in Afghanistan. It will not attempt nation-building but will only go for the total defeat of Al-Qaeda.

While the failure of the state is complete in Afghanistan, in a number of other places in South Asia, the state is trying to find a firm footing. Across the border in Pakistan, both the nation and the state are struggling to be born. Pakistan's failure in creating a nation based on religion out of a number of diverse people has not worked. I explored this theme in some of my earlier writings.²⁸ Muhammad Ali Jinnah's two nations theory on the basis of which Pakistan was created as a separate homeland for the Muslim community of British India, was tested within a few years of the founding of the state. In January 1972, less than a quarter century after the birth of the original Pakistan, the country's eastern wing parted company and became the independent state of Bangladesh. What was left of Pakistan was at least geographically contiguous but even then a nation and a state were not created. This was in part because the Pakistani people have found it difficult to find a basis for nationhood. This is an interesting phenomenon deserving of both deep analysis and explanation. If Pakistan was founded on the basis of an unworkable proposition, it is not unique among the world's two hundred or so states. Many of them exist as a result of colonial legacy; for them the colonial rulers simply drew lines on the map which cut across well-defined ethnic communities and cultures. One reason why Pakistan still cannot be declared a success is that having been created on the basis of an idea – that the people belonging to one religious identity should have their own political space – it was required to demonstrate that the idea was workable. Israel, the only other country created on a similar idea, is also going through a similar struggle.

A strong Pakistani state could have brought stability to the country. Pakistan could have followed the East Asian model of creating a nation on the basis of a fulfilled promise to deliver economic benefits to the citizenry. This was done not only in the miracle economies of East Asia but also China. The Chinese leadership is always anxious to keep the economy expanding at a rapid rate so that the rewards of growth are available to at least most, if not all,

²⁸ See, for instance, Shahid Javed Burki, *Pakistan: A Nation in the Making*, Boulder, Colo., Westview Press, 1988.

segments of the population. The pursuit of economic growth as a nation-building objective was pursued explicitly by President Ayub Khan in the 1960s and Pervez Musharraf implicitly in the early 2000s. In his autobiography, published after a decade of rule, Pakistan's first military ruler indicated that his main reason for throwing out the civilians was their failure to adequately develop the economy.²⁹ This conclusion was also reached by several prominent development economists of the day, in particular Gunar Myrdal of Sweden. In his seminal work, *The Asian Drama*, Myrdal developed the concept of the "soft state". This, he thought, was the state that did not have the will or the political muscle to bring about the structural changes in the economy and the society without which sustained economic development could not take place. The countries in South Asia had such soft states under the influence of vested interests that did not permit the structural transformation of these countries.³⁰ President Khan drew comfort from such findings by prominent academicians. They gave him and his form of government – he called it "basic democracy" – legitimacy.

President Musharraf also wrote his biography when he was confident that his rule had brought economic growth and stability to the country.³¹ Both Khan and Musharraf lost power two years after the publication of their autobiographies. The obvious conclusion is not that military rulers should not write their memoirs. What their separate experiences demonstrate is that high rates of economic growth cannot be sustained unless two requirements are met. One, the working of the state must draw strength from institutions that will remain in place over time. These institutions need not be based in democratic structures. They can be part of the semi-democratic (or semi-authoritarian) structures as was the case in all the four miracle economies of Asia or as is the case in China. However, they must have a reasonable amount of political longevity. Two, the system must permit the citizenry a voice. As the economist Albert O. Hirschman pointed out in one of his important works on development, not allowed a voice, those who are unhappy will either exit the system or bring it down.³² Popular discontent brought down the two leaders, the first by street agitation and the second by the electorate process.

Bangladesh is the third example of the weakness of the state and its consequences for sustainable economic progress. Although the country has done reasonably well – the rate of GDP growth has averaged five percent a year over the last decade and income per head of the population has increased at a respectable rate of 3.5 percent per annum – there is considerable uncertainty about the future. Some Bangladeshi analysts suggest that the country has still to come to terms with its identity – is it a state created on the basis of ethnicity and culture or on the basis of religion? There are obvious problems with both suggestions. If the common element is ethnicity, then there are a lot of Bengalis living outside the country, especially in the Indian state of West Bengal. If religion is the common element, then why did the country seek separation from Pakistan? It is the resolution of this tension (or the lack thereof) that has kept the country from developing a viable system of governance. The military has intervened occasionally as it has in Pakistan, ostensibly to help with the process of nation-building. Its most recent intervention was in 2007 when, working largely behind the scenes, it put the country in the hands of a caretaker administration that governed for two years before supervising another general election. Before opting for the electoral route, the caretakers

²⁹ Muhammad Ayub Khan, *Friends Not Masters: A Political Autobiography*, New York, Oxford University Press, 1967.

³⁰ Gunar Myrdal. 1967. *The Asian Drama*. New York. Twentieth Century Fund.

³¹ Pervez Musharraf, *In the Line of Fire; A Biography*, New York, Free Press, 2006.

³² Albert O. Hirschman, *Exit, Voice and Loyalty: Response to Decline in Firms, Organizations and States*, Cambridge, Mass. Harvard University Press, 2004.

attempted some political engineering of their own. They tried to put forward the “minus-two” formula which would have taken out the two previous prime ministers, Sheikh Hasina Wazed and Khaleda Zia, as political contenders. Musharraf had tried a similar approach in his own country by having the parliament adopt the seventeenth amendment to the constitution to effectively barred the two prime ministers that had dominated the 1990s, the decade that saw a great deal of political uncertainty.

The conclusion to be drawn from this brief analysis of the failure to create a functioning and effective state is that for South Asia, to carve out a reasonable amount of economic space for itself in the emerging global order, it must first create within all countries in the region political systems that work. India may be tempted to go it alone but I would suggest this will not be possible as it will get constantly distracted by instability somewhere around its periphery. Also, as suggested in a later chapter of my book, India has contributed to perpetuating some instability in the region. It must actively participate in creating the conditions that will address these issues.

The Asian State and Economic Management

The point of this detour into politics is to suggest that for the Asian model of economic governance to work for other parts of the developing world, Asia will have to first deal with some of the countries that have lagged behind in nation-building. There are a number of countries in the region that have to first demonstrate that the near state failure experienced by them was an aberration from the course taken by the continent’s more successful members. This is needed not only to indicate that the various models of statecraft can work for some of the sick nations in the continent as well, but also two other reasons. One, the success of an approach is contingent upon its ability to deal with aberrant behaviour. Two, even more important, what Smith said a couple of centuries ago still holds true. He laid emphasis on trade as an engine of economic growth as well as in bringing about social transformation. However, trade will only play this role if Asians are able to resolve a number of outstanding intra-state as well as inter-state disputes.

Smith also said that prudence is “of all virtues that which is most useful to the individual” and, by extension, to the society of which he is a part. This is where culture enters the picture. Although some Asians like to gamble, Macau now houses the world’s largest casino and Singapore is building two, they seem to indulge in this activity with some restraint. This restraint gets reflected in the making of public policy. In the United States, speculation has entered economics, adding another element to the inventory cycle that was supposed to be the main reason for the ups and downs in the capitalist economies that appeared at almost predictable frequency. This was noted by a chastened Alan Greenspan as he reflected on the most recent economic and financial crisis. “Free market capitalism has emerged from the battle of ideas as the most effective means to maximise material well-being but it has also been periodically derailed by asset-price bubbles and rare but devastating economic collapse that engendered widespread misery. Bubbles seem to require prolonged periods of prosperity, damped inflation and low long-term interest rates. Euphoria-driven bubbles do not arise in inflation-racked or unsuccessful economies...Once a bubble emerges out of an exceptionally positive economic environment, an inbred propensity of human nature fosters speculative fever that builds on itself, seeking new unexplored, leveraged areas of profit.”³³ The Asian

³³ Alan Greenspan, “We need a better cushion against risk”, *Financial Times: The Future of Capitalism: the Great Debate*, 12 May 2009, p. 38.

cultures and, therefore, the Asian economies seem less prone to these kinds of speculative bubbles. Even if there was a tendency to go in that direction, the state seems to have the will to correct the move. The only time the state failed to do that produced the Asian Financial Crisis of 1996-97. However, this crisis was largely the result of exposure to western financial institutions that suddenly withdrew from countries such as South Korea, Indonesia and Malaysia.

Where the Asian state works – as it does in the miracle economies of East Asia and China – it has demonstrated its ability to deliver economic growth, human development and better distribution of incomes among different segments of the population and different regions of the concerned country. Where the state has not been fully effective, it has still delivered growth but has not been able to ensure equality and human development for the entire population. This is the situation in India. And where the state has failed, is failing, or has done poorly in delivering to the people what is expected of the state – which is the case in much of South Asia, not including India – the state's poor performance is the result of poor political development. Therefore, much work remains to be done in South Asia before the state becomes an effective instrument for bringing about economic and social change.

The state has done particularly well in East Asia in one area of political and two areas of economic activity. In politics, various institutions of cooperation the countries have put in place have minimised inter-state disputes. In the area of economics, the East Asians have done well in handling financial crises that went beyond national boundaries and in creating the framework within which inter-regional trade can be promoted. Both functions are critically important for the future of the global economy. For the current century to become the Asian century, the countries of the region will have to show to the rest of the world that what they have done with the state in these two areas can also be done globally with the right choice of public policies and with the establishment and development of the right set of institutions. For several months and years ahead, as the debate on the restructuring of the global economic system proceeds, the large countries of Asia which have been invited to participate in it in various international forums, will be called upon to show why some of the Asian policies and practices have worked within the broad capitalist framework. In most areas of regional cooperation, much of the advance occurred in moments of crises. This was the case with the launch and evolution of the Association of Southeast Asian Nations and with the adoption of economic policies which, by creating large national foreign exchange reserves, were able to protect the region from *some* shocks in the global financial system. While this debate occurs, the Asians will need to keep on moving in the area on inter-state cooperation, particularly in trade. As will be discussed in a later chapter of my book, there is still a great deal of hard work to be done to develop a regional trading system in South Asia and also to link the systems in East Asia and South Asia into one pan-Asian enterprise. As Mahbubani wrote in the article cited earlier, “recent history has taught Asians a valuable lesson: more trade leads to greater prosperity. In the Asian way – two steps forward, one step back – trade barriers will gradually come down. By the middle of the twenty-first century, intra-Asian trade will far surpass that of any other region.”³⁴

What, then, is the Asian model of the state for managing the national economy? Can this model be used to improve the structures of cooperation among economies? Could the Asian model be exported to the rest of the world as it deals with the worst economic and financial crisis since the Great Depression of the 1930s? The model has many features, some of which

³⁴ Mahbubani, “Lessons for the West from Asian capitalism”, op. cit., p. 45.

are also relevant for the economies of the West. The first is that the state remains activist no matter what the level of development is. The state's functions continue to evolve with the evolution of the economy. In the initial stages of development, the state guides private enterprise in the use of capital. Not only that, it also helps with the distribution of capital by directing, but not, owning the banks. For more mature economies, although the allocation of capital is left to the market, the state keeps a sharp eye on its use and distribution. For this, it needs a regulatory system that is transparent and works according to a well-defined system of law.

Second, recognising that cultures play an important role in the accumulation of capital and its use, the state inculcates – through the education system in particular but also through the systems of communication and entertainment – habits of prudence and thrift. This has been done to a limited extent in Europe but has been largely ignored in America. Third, the state helps to expand the market by taking an active role in international trade. Given the layering of the international trading system with the evolution of regional arrangements, the state must simultaneously work on regional agreements as well as in fine-tuning the multilateral trading structure. This role is particularly important in South Asia, one of the regions that have lagged behind in integrating itself in the global trading system. Much of the responsibility for the creation of regional arrangements rests on the largest economy of the area. In that context, India will have to be an active player in developing a workable, stable and effective regional trading arrangement in South Asia.

Fourth, the state must take an active interest in human development, a role played well by the governments in East Asia even when they were pursuing different ideologies. There is now a growing recognition in the United States – this was an important plank in the manifesto of President Obama – that the American state has underinvested in educating the population and giving it the skills it needs to participate in a modern economy. Fifth, the state must protect and provide for the poor. This not only needs safety nets that come into play during periods of economic stress, but a permanent set of institutions are needed to provide basic needs to all segments of the population. This function cannot be left to the markets. This is what distinguishes the European capitalism from the American variety.

Sixth, and finally, the state must develop the skills and aptitude to work with other states in the region and in the world. At the same time, the global community has to develop institutions that allow full participation to all parts of the world. A United Nations-type of one-state-one-vote system is not practical to oversee the working of the global economy. Equally, the system that has kept policymaking power with the economies that were once large and dominant is not practical either. With the “rise of the rest”, there has to be much greater accommodation for several emerging economies. The system that worked well for a few decades after the end of the Second World War needs to be reformed in a fundamental way. Tinkering with the established order will not work to deal with the economic and financial crisis the world faces in the first decade of the twenty-first century.

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