Viksnins, George J.

Article — Digitized Version

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Intereconomics

Suggested Citation: Viksnins, George J. (1998): The East Asian model and the Baltic states, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 33, Iss. 5, pp. 238-244

This Version is available at:
http://hdl.handle.net/10419/40227

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The East Asian Model and the Baltic States

The three Baltic states of Estonia, Latvia and Lithuania had higher national incomes than most of the other states of the USSR. The "Southeast Asian miracle" economies often did not reach comparable levels until the 1980s. Now that the Baltic states have regained independence, are there any lessons to be drawn from the experience of the "tigers"?

In 1997 the world's press devoted an extraordinary amount of space to discussions of the only "reverse transition", when the very wealthy six million inhabitants of the city-state of Hong Kong were merged with the 1.2 billion "red" Chinese in the People's Republic of China. The People's Republic currently is a very poor (GNP per capita in 1995: $620), though rapidly growing (8.3% per annum 1985-95) country, ruled by a single-party government, which continues to be willing to suppress dissent quite brutally. On the other hand, Hong Kong's GNP per capita, at about $23,000, was well ahead of that of its erstwhile colonial master, the United Kingdom (somewhat below $20,000). It is interesting to start the analysis of the East Asian model with the case of Hong Kong. As Thomas Sowell pointed out nearly fifteen years ago,¹ the economic prospects of a densely populated and resource-poor country, which was still a Western colony, must have appeared very bleak: "This country must be doomed unless it receives large external donations."

The situation in Singapore, also a British colony until its independence in 1959, was about the same: today it has a slightly smaller population, but a higher GNP ($26,730), and a considerably more activist government. Two other resource-poor countries, South Korea (around $9,000) and Taiwan (at $12,000) are former Japanese colonies, which have started from a very low level of output and income, and have grown very rapidly indeed. All four of these countries as a special group have earned various nicknames: the "Gang of Four", the "Asian NICs" (for Newly Industrialized Countries), the "Four Dragons", or "the Asian tigers". When a few other Southeast Asian countries are added to this group, along with Japan, they might be called the "capitalist-roaders of Asia". Extensive literature exists about "the East Asian miracle", seeking to explain the extraordinary performance of these countries. As the 1997 Economic Report of the President pointed out, during the last three decades eight of the world's ten fastest-growing economies were in East and Southeast Asia – and they have achieved this very rapid growth without experiencing large income disparities.²

Where do the Baltic states stand? Now that they have regained independence, can they catch up with the "tigers"? Historically, all three were well above the all-Union average income in the Soviet period. As can be seen in Table 1, Latvia's GNP per capita in 1970 was estimated at a little more than one-half of the US level, at a little more than two-thirds of that in West Germany, and even slightly ahead of Japan. In the 1970s, all three Baltic "SSRs" were certainly well ahead of the levels attained by the Asian tigers, which were just beginning their sustained growth process. Both South Korea and Taiwan had "graduated" from USAID economic assistance only around 1965, and were slowly adjusting their policies from import substitution industrialization policies to an outward-looking strategy of promoting foreign trade and investment. Most other Asian countries were still quite reliant on foreign assistance. A further look at Table 1 shows that the USSR by 1980 had already lost some

¹ See Harper's, November 1983.
ground relative to the USA and Western Europe, but that Japan (and by then a number of the “tigers”) had surged ahead mightily. Still, in 1980 the standard of living in the three westernmost republics of the USSR was quite high; in those days, they were the showpieces of a large and rich empire. Visitors from Cuba, Nicaragua, or Vietnam could be taken for a bite of pizza at the prosperous Adazi collective farm not very far from Riga, and would undoubtedly be quickly convinced that life under “advanced socialism” would be just fine.

Still, the systematic flaws of the Stalinist central planning model were becoming more and more obvious, and the peoples in various nations living under Moscow’s domination were feeling quite restive. A detailed enumeration of the reasons for the collapse of the CMEA in early 1991 and the USSR itself later the same year, is beyond the scope of this paper. Certainly, environmental degradation, waste of natural resources, persistent shortages, and the "soft budget constraint", (discussed by Hungarian economist Janos Kornai at great length), as well as a significant lessening of state terrorism were major factors in the economic disintegration. With greater democratization, the decentralization of decision-making weakened Moscow’s control over revenues, credit and foreign exchange, and greatly strengthened the position of local political leaders. This quickly led to even greater shortages as each unit tried to maximize resource extraction from its trading partners. Political reform, “glašnost” (meaning honesty and openness) in a sense succeeded, while “perestroika” (economic restructuring) did not accomplish much. Still, greater freedom of expression fanned the flames of nationalism in Poland, Czechoslovakia, Hungary and the Baltic states (all wishing to rejoin Western civilization), and the other non-Russian republics quickly spun off as independent entities as well.

### The East Asian Tigers

The economic development and growth of Japan and the other “capitalist-roaders of Asia” has been discussed and analyzed at great length by historians, social scientists and the media. For many people, their success has been explained rather simplistically: it is often alleged that they did so well mainly because of the so-called Cold War. The United States (and its allies) sought to surround the Communist world – the USSR, the People’s Republic of China, North Korea and North Vietnam – with reliable non-Communist clients. The most important such clients were Japan itself (“an unsinkable aircraft carrier in northeast Asia”) as well as Taiwan, across the straits from “red China”, South Korea, as a counter to the “juche” (self-reliance policy) of the North, and South Vietnam, which was eventually lost to leftist public opinion in the USA. Still, the protracted fighting in Vietnam gave a bit of breathing room for Thailand, Malaysia and the Philippines, all potential dominos, who managed to deal successfully with Communist-led insurgency movements. Thus, the United States supported all of these clients by economic assistance and investment flows, but – most importantly – by providing a wide-open and free market for their exports. Furthermore, the USA seemed to be willing to provide political support for even rather unsavoury government leaders (e.g. Marcos in the Philippines), as long as they were decidedly anti-Communist. Thus, economic growth in these countries was mainly dependent upon export expansion: very simply, they were export platforms receiving US geopolitical support. However, the chain of causality running from exports to income/output growth needs to be reversed, although it probably runs in both directions. In other words, export expansion can be possible only if domestic output expands sufficiently: if the local

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2 For 1995, including both Germanies.

3 For 1995, just the Russian Federation.


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### Table 1

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<tbody>
<tr>
<td>USA</td>
<td>4710</td>
<td>11,360</td>
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<td>Canada</td>
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<td>France</td>
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<td>13,590</td>
<td>27,510</td>
</tr>
<tr>
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<td>9890</td>
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<tr>
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<td>4550</td>
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<tr>
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</tr>
<tr>
<td>Lithuania</td>
<td>2208</td>
<td>4600</td>
<td>1900</td>
</tr>
</tbody>
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Interdependence...
economy absorbs everything that is produced, nothing will be left over for export to foreign countries. In turn, output growth in the local economy depends upon a number of factors, among which the roles of money and financial institutions are crucial. The financial factor mobilizes savings and allocates funds for investment projects on the basis of expected rates of return. Of course; sometimes these are estimated very optimistically, and credit expansion becomes too rapid, leading to painful corrections, as in 1997-98 in Asia.

Many analysts emphasize the positive role of government policies and a better understanding of macroeconomic theories. As Lucian Pye has put it, ... the Confucian tradition had to be coupled with advances in economics as an intellectual discipline in order to produce the economic miracles of East Asia. Second, and closely related, is an elitist view of the sociopolitical order ... In recent times the idea of rule by an educated elite has meant the legitimization of technocrats in government ... The third quality is the Confucian stress on harmony ... Rulers are expected to preserve order, prevent social confusion, and thus keep in check any and all who are likely to disrupt the smooth flow of economic social life.

Further elaboration of this point leads one to Chalmers Johnson and his concept of the "developmental state". The Asian nations have found a "third way", claims Johnson, that is different from the market-oriented approach of the Anglo-Saxons and the state-planned path of the Marxist-Leninists. This view would emphasize the role of Asian governments in industrial policy, subsidies to research and development, guided finance (through government-owned commercial banks and special development institutions), favourable tax policies, and the establishment of special export enclaves (Kaohsiung in Taiwan, Shenzhen in the People’s Republic of China and, more recently, Subic Bay in the Philippines). While corruption has historically also been a serious problem in most of these countries, there has been enough participatory democracy and press freedom to keep it in check. Still, in comparison to most of the rest of the so-called Third World, Asian governments have followed policies leading to reasonable macroeconomic stability (as of the autumn of 1996, the worst performers in terms of inflation in this region were experiencing price rises of less than eight per cent) and there was considerable respect for private property rights and contracts. Of special relevance to Eastern Europe, however, may be the observation that most Asian governments tend to be formed by one or a couple of (not thirty) political parties. It may be argued that a moderate authoritarianism may work better in mobilizing resources, but that may depend upon culture. Indeed, the Balts have probably seen enough of Oriental despotism.

Yet another explanatory factor, perhaps the most important of all, is the role of education. Both Taiwan and South Korea, as former Japanese colonies, started their periods of independence with very low levels of educational attainment. Right after World War II, the percentage of Koreans with university degrees was minuscule, and the literacy rate was very low (whereas today it is the highest in the region, except for Japan). A recent research project covering 41 countries (the Third International Maths and Science Study, or TIMSS) shows that a number of Asian countries score very well, while the Balts do poorly. Somewhat surprisingly, both Lithuania and Latvia fall behind Canada and the USA in both areas. Indeed, Russia’s results in maths and science are well above those of both Latvia and Lithuania (Estonia was apparently not included).

The Transition in the Baltic States

Someone has described going from the market economy to Stalinist socialism as making a fish soup from an aquarium – but the way back to a functioning

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market system may be as difficult as reversing the process. As Eastern Europe began to move away from socialism (the Comecon trading system ended in 1991) and the republics of the USSR became independent countries, there was a heady atmosphere of optimism surrounding the process of change. Dismantling socialism was relatively easy; production targets and five-year plans no longer existed. However, the establishment of the institutions of a market economy will take a lot longer and will apparently be more difficult than once thought. These countries are passing from one mode of economic organization to a thoroughly different one; and institutions tend to resist change. In the words of the 1996 World Development Report, "... Paternalistic and restrictive, these institutions delivered goods and services to meet basic needs while setting severe limits on individual choice and indoctrinating citizens with antimarket propaganda. Thus, for the transition to succeed it must transcend economic engineering, restructure the institutional basis of the social system, and develop civil society - an enormous agenda that will take many years to complete."

There is no general theory of the transition, despite the thousands of books, articles, special studies and conferences which have been employing experts, consultants, and academics from both West and East. As the Comecon system of trade and the rules of central planning were abandoned, output fell precipitously and prices rose. Attempts to maintain the status quo and to print money to "paper over" political compromises - as in Ukraine and the "Southern tier" - have led to worse outcomes, although the consequences of armed conflicts (Armenia, Azerbaijan, and Georgia) have been even more disastrous. In Russia itself, the level of GDP in 1996 was estimated at about 50% of its 1989 value, the figure was 25% in Georgia, and the authorities do not yet have a figure for Turkmenistan. It is, of course, true that eliminating activities with a "negative value-added" is a good idea, and the slaughter of cows no longer giving milk is sound policy. Most of the East and Central European transition countries have moved quite resolutely in the direction of setting up, and quite quickly, a "market economy without adjectives".

Following Vaclav Klaus, the hard core of reform measures, all of which must be taken together, without any particular sequencing being needed, includes:

- early, rapid and massive privatization;
- price deregulation;
- foreign trade liberalization and currency convertibility; and
- monetary and fiscal conservatism.

As mentioned above, the reform process began in a very upbeat fashion. Latvia provides a useful case study of the transition. Centrist political parties did well in the first elections, with programmes designed to move Latvia as quickly as possible toward competitive capitalism and eventual entry into the European Union. Trade was to be reoriented quickly toward the West, the currency would be completely convertible, and prices would be allowed to move toward world market levels within the first year (the inflation rate in 1992 was more than 900 per cent). Subsidies would be phased out, and imports liberalized. The programme was quite successful in some fields. For example, the permanent currency, the Latvian "lats", was re-established in March 1993. It was probably the world's strongest currency over the subsequent twelve months, appreciating steadily against the US dollar, until it was decided to peg it to the SDR in the spring of 1994. The rate that was selected was 1 SDR = 0.7997 lats (in 1998, one US dollar equals approximately 0.58 lats). The Estonians pegged to the D-mark, and the Lithuanians to the US dollar. However, the Baltic countries learned that a strong and stable currency does not in itself assure economic progress. As trade with the East collapsed, output and income fell drastically - indeed it was estimated that average daily caloric intake in Latvia in 1993 was about one thousand calories lower than it had been in 1991. While the main reason for the contraction was the trade crash, many people blamed the reformers - and in all three countries a distinct backlash took place.

In Latvia, it was a two-stage process. The initial centrist coalition failed, and Valdis Birkavs resigned as Prime Minister. A new coalition with a splinter faction of a pro-Russophone group was established, but...
economic policies did not change very much. The second stage of the backlash against the reformers began in the "Saeima VI" (the Saeima is a 100-member unicameral legislature) elections in the autumn of 1995. A new party, the Democratic Party "Saimnieks" (DPS - the word "saimnieks" can be translated, somewhat unkindly, as "boss"), was formed, attracting quite a few KGB and Komsomol types. Another "party of discontent" also emerged - the TKL or "People's Movement for Latvia", controlled by a German adventurer named Zigerists, who does things like handing out boots and bananas to pensioners, and holding fireworks shows in the provinces. Initially, both parties of discontent (DPS and TKL) united to propose a cabinet, which failed to be approved by the Saeima by a single vote. Shortly thereafter, a businessman (and a former deputy minister) named Andris Skele took on the task of assembling a government, which lasted for about a year.

In most of the transition economics, the seven tendencies enumerated by noted Hungarian economist Janos Kornai in his discussion of "highway and byways" seem to apply:

- Marketization. Most of the transition economies, including China and Vietnam, have allowed supply and demand to determine price levels, although we are not seeing a "triumphant advance toward perfect competition". The state often engages in regulation, even when there is no reason to intervene, and fails to intervene when it properly should.

- Evolution of the private sector. Kornai argues that there is no "Third System", which could prove its superiority over Stalinist socialism and modern capitalism. Thus, it is necessary to permit the state sector to shrink significantly – some firms simply close, others are weakened through "decapitalization" and the theft of state property, and some others improve their efficiency under the pressure of the private sector.

- Reproduction of the macro-disequilibria. At the turning point, there are four problems: "chronic shortage, open or repressed inflation, budgetary deficit and foreign debt". All are really interrelated, and both inflation and unemployment may worsen "for a long time to come". It is probably most important to bring inflation under control first, and to establish the credibility of the monetary authorities, but this requires the sort of resolve demonstrated by very few East European leaders.

- Development of a constitutional state. A market economy, based primarily on private ownership, cannot operate in a lawless environment. Why produce more than you can eat, if a man with a gun will take it away from you? Kornai talks about the need for three levels of state activity: legislation, enforcement of the law, and – probably most importantly – the alteration of the mentality of citizens. As Kornai says,"...The previous illegitimate system destroyed people's honest respect for the law; instead they were influenced only by fear of erratic repression... Those who cleverly circumvented some regulation or other...

Franco Ferrari (ed.)

The Unification of International Commercial Law

Tilburg Lectures

Since the unification of transnational commercial law promotes certainty of law and, by doing so, the flow of international trade, there is a strong tendency to unify the rules governing situations linked to a plurality of countries. The Tilburg Lectures examine the issue of unification from various points of view (from a scholarly as well as a practitioner's point of view). They show that unification can be pursued on various levels (a regional, European, versus a global level) by using different means (conventions versus model laws) focusing on different methods (unification of substantive law versus unification of private international law and procedural law) and subjects (from the unification of sales law, factoring law, transport law to the unification of procedural law and arbitration law).


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INTERECONOMICS, September/October 1998
were really admired, since that was a way of surviving. It will be a long time before public morality improves in this respect, before a state is reached where a breach of the regulations, betrayal of public trust, tax evasion, business dishonesty or corruption is condemned.”

**Development of democratic institutions.** Kornai presents three observations on this score. The ruling Communist party, with its anti-capitalist ideology and programme, must be destroyed – but this does not guarantee the development of democratic institutions. Second, for arrangements to be stable, the economic system must be based on private property and contracts: “...State ownership inevitably leads to a totalitarian political system.” However, not all market economies are democracies, and the authoritarian temptation is strong. Very few of the post-communist countries had any historical experience with a stable and long-lived democratic system. And yet, those of us who believe in democracy must now be especially vigilant in defending it. A very thought-provoking citation on this score: 12 “...democracy will make the transformation of Soviet-type economies into private enterprise market economies more difficult, but without democracy, it would be altogether impossible. Democracy is primarily a truth-seeking procedure of social praxis. It is the only way to discover the extent of tolerable burden and dislocation that the transition to a new system must cause. It also reveals the adjustments in the pace and scope of changes, and in the distribution of social cost of transition. Most important, without democracy it is impossible to legitimize a society's basic institutions and policies. And without this legitimacy the traumatic but necessary overhaul of Soviet-type economies is unthinkably.”

**The redefinition of a national community.** Kornai notes that in the West, there is a movement toward integration into a larger community. In the East, however, 13 “...Comecon collapsed because it was imposed on the other Eastern European countries by the Soviet Union; the Soviet Union and Yugoslavia have fallen apart because in many respects they were artificial creations thrust with merciless oppression upon smaller communities that yearned for sovereignty.” The newly sovereign states will show considerable resistance to greater integration despite positive official rhetoric on the part of centrist political parties and coalition governments. Influential groups will continue to stir up feelings against “Westernization” (called “bourgeois spiritual pollution” in China) and appeal to nationalism, when the demands of the IMF or other international organizations interfere with their interests.

**An unequal increase in welfare.** Getting back to Kornai, there will be a fairly broad stratum of winners in the transition process, particularly those tied to private business. A much smaller group becomes conspicuously rich very quickly – the BMW, the leather jacket, the Adidas, the mobile phone, and a miniskirted redhead are all the trappings of the successful “free marketeer”. In all of the post-communist countries, the new governments inherited social safety nets featuring free medical care, subsidized education (college students receiving stipends rather than paying for education), enterprise-supported vacation facilities, early retirement with full pensions, and so on. As public sector revenues shrink due to privatization, restructuring, and tax holidays for joint ventures, the governments are hard pressed to deal with these implicit obligations. We conclude, along with Kornai, 14 “For all these reasons, deep dissatisfaction among broad strata of people over the stagnating or falling material standard of living, and the unemployment and social insecurity suddenly falling on them, must be expected for a long time to come. It will be hard under the circumstances to ask people to make further sacrifices. That is another reason why the rectification of the macro-disequilibria will be protracted, not to mention the dangers the discontent poses from the point of view of maintaining democracy.”

**Conclusion**

As we have noted above, Japan was well behind the Baltic states in terms of official GNP statistics in 1970, and most of the East Asian miracle economies did not reach comparable levels even in 1980. Now that the Baltic states are in a position to select strategies and models on their own, without following the dictates of the Gosplan in Moscow, the lessons of East Asia should be studied carefully – as mentioned, eight out of the ten fastest growing countries in the period since 1960 have been in East and Southeast Asia. Certainly, these countries have been expanding

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14 Ibid., p. 225.
exports quite successfully, but the ultimate causes of both export expansion and output growth may be less obvious. Monetary and fiscal policies leading to a rise in savings and investment as well as stable exchange rates should certainly be mentioned. Stable governments committed to economic progress are another factor - which would bring in Johnson's developmental state concept, first developed in connection with Japan. Human development generally is very crucial. (Latvia ranks 55th, Estonia 68th and Lithuania 81st out of 174 countries in the UNDP's 1996 Human Development Report) with particular emphasis on education. Unfortunately, the educational systems left over from the previous regime are being modernized very slowly. Confucianism and similar philosophical systems emphasize values which seemed prevalent in Baltic cultures sixty years ago, but which may not be easily accepted by the majority of Balts today.

In October 1997, The Economist posed the interesting question - will the "Asian flu" spread to Eastern Europe? The short answer is: "Yes, it has, just look at Russia", but more can be said. The experts at that London-based publication had devised an index of currency vulnerability, ranging from zero (no problem) to twelve (collapse is impending), and awarded both Estonia and Latvia scores of 9, while Lithuania earned a 10. One of the main determinants of a poor score is the size of the current account deficit, which is admittedly quite high in all three Baltic states (nearing 10% of GDP in the case of Latvia). It is also true that the ratio of foreign exchange reserves to imports is presently quite low - though another relevant ratio, of foreign exchange reserves to domestic money, is quite high.

Indeed, there are many significant differences between the relatively well-developed financial markets of the "Asian tigers" and those of the "Baltic kittens". The Asian countries have experienced three to four decades of rapid growth, compared to a couple of decades of stagnation followed by a collapse during the five years after regained independence in the Baltic region. The stock markets of Southeast Asia had all experienced significant inflows of foreign portfolio investment. When the Thai baht began to fall in the summer of 1997, large sums of money were pulled out of Bangkok - and the SET index was down by more than 60% by early November. The stock markets in the other Southeast Asian capitals also fell by about 50% in 1997; moreover, in the first eight months of 1998, the decline has continued. In fact, Korea has been hit the hardest this year - with stocks down 54% since last September. The Baltic bourses have not done well, but their relative importance to these economies is truly miniscule.

In addition to the stock market disasters, many Asian currencies have been in a "free fall". All three of the Asian countries currently receiving IMF assistance - Indonesia, Korea, and Thailand - are rather significant debtors by international standards. Their commercial banks engaged in profitable arbitrage operations, borrowing in London, New York and Tokyo, and lending domestically at much higher rates. Those Asian nations with little debt and high foreign reserves - China itself, Hongkong, Taiwan and Singapore - have experienced a much smaller decline in currency values. Just as the stock markets in the Baltic region are just beginning to develop, and have not attracted much foreign money to date, there has also been relatively little foreign investment in local banks and fixed-value securities. Apparently Nomura took a successful flier in Latvian government bills, and a couple of foreign banks have shown an interest in Riga, but there is relatively little scope for "hot money" to flee the Baltic capitals, because there is very little there presently. Both Estonia and Lithuania have allegedly been following "currency board" regimes, while Latvia has held ample foreign reserves relative to the quantity of lats circulating (as of mid-April 1998, the cover is at around 107%, up from 104% a year ago - check out the home page of the Bank of Latvia at www.bank.lv). Foreign investments in the Baltic region have been growing, but they have generally taken the form of physical assets (hotels, food, services, and gas stations) rather than liquid assets. It is not likely that the Raddison hotel or the McDonald's outlets will be liquidated in the near future.

The main concluding idea seems obvious. There is much to learn from the East Asian miracle in the context of looking at the past forty years. An important footnote on that is a cautionary one - do not become complacent, do not expect continuous double-digit growth, and avoid irrational exuberance. Latvia, for one, already went through a serious banking crisis in 1995, and it is to be hoped that financial regulations are already more alert than those in the worst cases of "crony capitalism" in Asia. Probably the best way to conclude this is to cite my good friend and colleague, Gundar King, "You can't cheat the market."