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Asia's Story of Growing Economic Freedom

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Executive Summary

The global financial crisis reinforced a sense that the world is "shifting East"—to Asia. The essential story of modern Asia is its unprecedented expansion of economic freedom, enabled by market liberalization. Economic freedom, however, remains substantially repressed across the region.

There are three key policy challenges to expanding economic freedom in Asia today. The first is to open up financial markets, which remain backward and repressed by command-economy controls. The second is to renew trade and foreign-investment liberalization, which has stalled since the Asian crisis of the late 1990s. And the third is to open up energy markets, which, even more than financial markets, are throttled by government interventions.

Increasing Asian consumption of fossil fuels will increase carbon emissions. Mainstream advocacy of carbon reduction in Asia should be met with skepticism, given its potential to lower growth substantially. A far better approach is one based on adaptation to global warming through market-based efficiency measures.

Asia's poorer economies should concentrate on "getting the basics right" for "catch-up" growth. These are "first-generation" reforms of macroeconomic stabilization and market liberalization. Asia's middle- and high-income economies need to focus also on "second-generation" reforms—more complex structural and institutional reforms to boost competition and innovation. Diverse political systems can deliver catch-up growth. But autocracies are badly fitted to deliver second-generation reforms for productivity-led growth. The latter demands a tighter link between political and economic freedoms.

The Asian miracle is not the product of superior technocratic minds who concocted successful industrial policies. Rather, freedom and prosperity bloomed on Asian soil because government interventions were curtailed and markets unleashed. Classical liberalism, however partially implemented, has worked in Asia. It is a system to which Asians should aspire.

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Introduction

First there was the "East Asian Miracle"; now comes the "Asian century." The aftermath of the recent global economic crisis has reinforced a sense that the world is "shifting East"—to Asia.

The West suffered a financial crisis, leaving gaping holes in household, corporate, and government balance sheets. Hence an anemic recovery—though with exceptions such as Germany, the Scandinavian countries, Australia, and Canada. The main emerging markets, in contrast, except Russia, went into the crisis with healthy balance sheets. Hence a less severe crisis and a sharper rebound for them. Even accounting for the current global growth slowdown, the International Monetary Fund projects China to grow around 8.2 percent, India 5.9 percent, and developing Asia just under 7.1 percent, in 2013—compared with 1.4 percent growth for advanced economies.[1] Between 2007 and 2012, advanced economies grew 2 percent, China 56 percent, India 43 percent, and developing Asia 50 percent (all at purchasing power parity).[2]

These basic facts tell us two things. First, the crisis has induced sharp divergence of economic growth between the West and emerging markets. And second, this short-term divergence has accelerated the long-term convergence between emerging markets—particularly in Asia—and the West.

Dry numbers, however, mask the essential story of Asia today—its unprecedented expansion of economic freedom. What Adam Smith called "natural liberty"—the individual's ability to exercise choice in daily economic activity—has been on the march in "globalizing Asia" (by which I mean East and South Asia, not less-globalized West and Central Asia). Technological innovation has enabled this transformation, but its crucial enabler has been liberalization of internal and external trade, of domestic and foreign investment, of product and factor (land, labor, and capital) markets. These "negative" acts—removing restrictions that repress economic activity—have unleashed the animal spirits of ordinary people. People now have incentives to exercise their "natural liberty"; they are doing so with gusto and are transforming the world in the process. This is indeed a vast continental awakening.

But there is still a long, long way to go, for most of globalizing Asia remains far behind the West. Asia is still home to two-thirds of the world's poor. And economic freedom, though expanding, remains too repressed across most of the continent. Within this frame, let's look at Asia's key policy and institutional challenges. But first some historical lessons are in order.

Lessons of History

Asia's rise is conditioned by its history, including historical links with the West. Hence the vital importance of looking at Asia's past to inform choices for the present and the future. Here there are positive and negative lessons.

First, for most of the past millennium, Asia had predatory states that suppressed individual freedom and enterprise. They lacked market-supporting institutions, they repressed creative and critical thought, and they were inward-looking. This was true in China, India, Japan, and the Islamic world. It allowed Western Europe to catch up with and overtake Asia, and Asia became vulnerable to Western predation and conquest. Asia's 20th-century experience has been similarly blighted. Think of China under Mao, India's "Licence Raj" from the 1950s to the 1980s, and Indonesia under Sukarno. These gross errors should obviously not be repeated.

Second, Asia should emulate the factors behind the West's ascent during the past millennium: treating merchants, entrepreneurs, and creative individuals more generally as socially useful; enabling such individualism through the enforcement of private property rights and contracts; nurturing a variety of other market institutions to support competition and enterprise; and expanding the market through international commerce. These were the ingredients of successive agricultural, commercial, and industrial revolutions. Indeed it was "Trade and Prometheus"—the interaction of openness to international trade and technological progress—that made the West really take off and outdistance the Rest after the Industrial Revolution.[3]

Third, Asia can reconnect to past golden ages of commerce—China under the Sung dynasty, India under the Mauryas, and the Silk Road during the *Pax Mongolica*, for instance. But what I have especially in mind are Indian Ocean and Southeast Asian trade before western colonialism.

Arab traders rode the monsoon winds to trade in ports all over the Indian Ocean, reaching as far as Chinese ports by the middle of the eighth century. As the *Tales of the One Thousand and One Nights* describes, Sinbad the Sailor, a Baghdadi trader, plied the route from Baghdad to Canton, stopping at entrepôts along the way. Before the Portuguese muscled in during the 16th century, the Indian Ocean was *Mare Liberum*, not controlled by any power and fully open to trade. Coastlines were dotted with "port-polities" such as Aden, Hormuz, Cambay (near Ahmedabad in modern Gujarat); Goa, Canannore, and Calicut on the Malabar coast; Aceh and Malacca (close to Singapore); and Macassar (in the Spice Islands). These were independent towns and cities whose lifeblood was overseas trade. They had a reasonable separation of market and state, with light regulation. Trade tariffs were modest—3–6 percent on imports and zero export duties in Malacca.[4] The latter had a legal structure for trade that prefigured the English common law. According to William Bernstein, the author of *A Splendid Exchange*, this was "a medieval eBay in the tropics, in which good rules attracted good traders, who in turn insisted on better rules."[5]

In essence, freewheeling economic competition went in tandem with decentralized, flexible political institutions. Fractured geography and competing polities combined to promote economic freedom, growth, and prosperity—as it did in medieval and early modern Europe.[6] Moreover, these were religiously tolerant, highly cosmopolitan places.

Fourth, the key lesson of the East Asian Miracle of recent decades is to "get the basics right": prudent monetary and fiscal policies, competitive exchange rates, low domestic distortions (such as price controls), flexible labor markets, openness to international trade, and investments in education and infrastructure. These "horizontal," economy-wide policies provided propitious environments for high levels of savings and investment, and export-oriented industrialization.[7]

But "revisionists" disagree. Robert Wade, Alice Amsden, Ha-Joon Chang, and others have argued that the industrial policies of "developmental states" made a crucial difference.[8] "Vertical" policies of selective intervention promoted targeted industrial sectors, restricted imports, and foreign direct investment (FDI), and directed the financial system to channel cheap credit to favored sectors. According to the revisionists, these policies worked particularly well in Japan, South Korea, and Taiwan. Such policies were flexible, time-limited, and performance-based, and they were administered by strong bureaucracies insulated from short-term political pressures.

However, there is scant hard evidence—only assertion—that industrial policies worked. At best, they altered the sectoral composition of output and exports and did not seriously impair growth. But they had no discernibly positive effect on the productivity of targeted sectors or on aggregate growth—even in Japan, South Korea, and Taiwan.[9] In much of Southeast Asia, and later in China and Vietnam, there were numerous conspicuous industrial-policy failures. Arguably by creating crony-capitalist networks and oligopolies, and by stunting the development of financial systems, they stored up trouble for the 1990s and beyond.

Hence, to repeat, the lesson from the "miracle" economies is for governments to provide for economic stability, to expand economic freedom, and to open up to the world economy—not to "guide the market" with dirigiste policies.

Fifth, Asia has benefited enormously from post-1945 globalization. This started with the

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integration of the Northeast and Southeast Asian Tigers into the world economy. But benefits multiplied after 1980 with the opening and global integration of China and India in particular. The liberalization of trade and FDI have been crucial spurs to economic growth and technological progress, as they were in the 19th century. Ratios of trade and FDI to GDP have increased sharply, as have manufactured exports, and East Asia has become the production hub of global manufacturing supply chains. According to the Asian Development Bank, output in developing Asia increased 7.5 fold between 1990 and 2009, per capita GDP increased 6 percent per annum in the same period, and 850 million people were lifted out of absolute poverty between 1990 and 2005.[10]

Three Policy Challenges

Now I turn to key planks of contemporary policy: (1) financial markets and unbalanced growth, (2) trade and investment, and (3) energy and environment. They illustrate how far Asia has come in expanding economic freedom, but also how much economic freedom remains repressed. Its repression constitutes the main economic challenges facing Asia today.

Financial Markets and Unbalanced Growth

Financial markets across Asia remain backward compared with the West, Latin America, and Eastern Europe. They also lag behind dynamic parts of Asian economies, especially export-oriented manufacturing. Liberalization and global integration of trade and FDI have gone much further than financial liberalization in Asia.

The conventional wisdom is that this is not a bad thing. Government controls, it is argued, have insulated Asian financial markets from catastrophic global risks, especially the toxic assets of Western banks. This is true up to a point, and it is an argument against precipitate liberalization. But it addresses neither the huge cost of government controls nor the fundamentally sound case for medium- to long-term financial liberalization. To be clear about what is at stake, present restrictions repress financial freedom; reducing or eliminating them will expand financial freedom.

China retains a command-economy style banking system at the heart of a much-liberalized economy. The "big four" banks are state owned, as are two giant "policy banks" that make huge investments at home and abroad. Their CEOs are appointed by the Communist Party and have vice-ministerial status in the government hierarchy. Bank lending is highly politicized and is skewed heavily toward state-owned enterprises (SOEs). Then there is "financial repression" through government-controlled interest rates: depositors' rates of return are kept very low, while banks make super profits from higher lending rates while still showering SOEs with underpriced capital.[11] India's financial markets are much freer, but state-owned banks still control about 80 percent of household deposits, and there are restrictions on capital-account transactions.[12]

These distortions promote massive capital wastage by unproductive SOEs, who are bunched in capital-intensive heavy industries. In China, SOEs account for over 50 percent of nonagricultural fixed investment despite employing only 13 percent of the workforce. At the same time, the much more productive private sector is starved of capital. That applies particularly to labor-intensive small- and medium-sized enterprises. Financial repression also leads to overdependence on bank lending and cramps equity and bond markets. In essence, a government-directed financial system holds back productivity gains; it is a drag on the whole economy. It retards the transition from catch-up growth, based on maximum mobilization of capital and labor, to more advanced, sustainable growth based on productivity gains.

Enabling the transition to a more prosperous, sophisticated economy demands more financial freedom. That means open-

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ing markets and ushering in greater competition to boost productivity. Specific liberalization measures include the removal of interest rate controls, opening to new entrants, including foreigners; broadening bond and equity markets; and, ultimately, opening the capital account.

Financial liberalization, however, is politically much more difficult than liberalization of goods and some other services. Financial markets are the neuralgic point of national political economy—the junction where government and party politics meet banks, SOEs, and large, well-connected private-sector business houses. They are the epicenter of crony socialism and crony capitalism.

Furthermore, China's government-directed financial system is at the core of "unbalanced growth." It promotes oversaving and overinvestment, while repressing private consumption, real wages, and employment growth. Savings and investment have grown to about 50 percent of GDP while consumption has fallen to about 35 percent of GDP. Corporate savings—overwhelmingly SOE profits from their government-protected markets—account for half of overall national savings.[13] Simply put, SOE profits have come at the expense of jobs, higher wages, and higher disposable incomes for Chinese workers and their families.

The picture differs in other parts of Asia. India's rates of savings and investment have grown—rightly so for a developing economy—but consumption is a much higher share of GDP than it is in China. Southeast Asian countries have seen a big drop in private investment since the Asian crisis. Government investment and consumption have increased across East and South Asia, especially since the global financial crisis.

China's growth is on an investment-powered treadmill. That is normal for catch-up development; it was true of previous generations of East Asian Tigers during their catch-up growth phases. But, inevitably, investment-led growth is subject to diminishing returns—in China's case accelerated by state-owned banks' and SOEs' massive capital wastage. Hence China's economy needs to "rebalance." Savings and investment need to decrease as a proportion of GDP, and the efficiency of investment needs to increase. Private consumption in particular needs to increase. Continuing with the present model will lead to a severe growth slowdown or a crash. On the other hand, reasonably high growth will be more sustainable if it is more productivity- and consumption-led. Rebalancing would also rely more on domestic sources of growth and less on exports.

Rebalancing, however, is not going to happen as a result of macroeconomic "fine-tuning." As Nobel laureate Friedrich Hayek pointed out, it is a conceit that policymakers in the garb of social engineers can manipulate macroeconomic aggregates to achieve desired goals.[14] Rather, genuine rebalancing requires difficult microeconomic—that is, market—reforms. Thus far, China has liberalized most of its product markets while retaining strict controls on factor markets. Factor inputs—land and resources, labor and capital—are underpriced as a result of government distortions such as interest rate controls, a repressed exchange rate, caps on energy prices, and cheap capital and land for SOEs. This is a subsidy equivalent to about 10 percent of GDP.[15] It favors exporters, investors, manufacturers, real estate, construction, state-owned banks, SOEs, and the coastal provinces at the expense of consumers, services sectors, and the inland provinces. Liberalizing factor markets—not least financial-sector reforms—would strike at the behemoth of vested interests at the heart of the Party-State. That is why such structural reforms are so elusive.

China is the biggest and most conspicuous example of the need for factor-market reforms, but they are also needed across Asia. Liberating these markets would unlock domestic and regional sources of growth—all the more important given depressed demand for Asian exports in a crisis-ravaged West. But daunting political obstacles—analogous to those of the Party-State in China—stand in the way.

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Trade and Investment

Asia saw big trade and FDI liberalization in the 1980s and 90s, but it has slowed down since then, and reforms have stalled in some countries. However, there has been no significant reversal of liberalization, either after the Asian crisis in the late 1990s or after the recent global financial crisis. There has been a creeping increase of mainly nontariff protectionism since 2008, but so far it has affected only a small amount of international trade. The fact that a major retreat to protectionism has not occurred despite the largest contraction of international trade since the 1930s is testament to the strength of economic globalization. Notably, global supply chains in both manufacturing and services remain resilient. The benefits they bring, and the costs of disrupting them, are the most powerful deterrents to protectionism today.

But that still leaves large pockets of protectionism, with huge variation across Asia. South Asia is much more protectionist than East Asia. The free ports of Hong Kong and Singapore are the most liberal trading entities in the world. Japan, South Korea, and Taiwan are the next most open, followed by the more advanced Southeast Asian countries (Malaysia, Thailand, Indonesia, and Philippines). Then come China, Vietnam and India, with other poorer South Asian and Southeast Asian countries making up the protectionist rear.

Tariff barriers are still a problem in many countries, but a plethora of nontariff barriers obstructs trade and FDI much more. Most are embedded in complex domestic regulation. Domestic red tape—on property rights, contracts, licensing arrangements, paying taxes, opening and closing businesses, labor laws, and customs procedures—continues to stifle the business climate much more than in the West. This is reflected in the World Bank's *Doing Business* index. Organization for Economic Cooperation and Development (OECD) countries occupy 8 of the top 10 places (Singapore and Hong Kong are in first and second place; and South Korea, which is in the OECD, is in third place). Malaysia, Thailand, and Taiwan are in the top 20. But China is 91st, India 132nd, Indonesia 128th, and Philippines 138th. There is also wide variation in one category of the Index, "Trading Across Borders," a proxy for trade costs. Here Singapore and Hong Kong are 1st and 2nd respectively, South Korea 3rd, Malaysia 11th, Thailand 17th, Japan 19th, Taiwan 23rd, Indonesia 37th, Philippines 53rd, China 68th and India 127th.[16]

This picture shows that most Asian countries have not moved significantly from "first-generation" Washington Consensus–type reforms, such as border liberalization of trade and FDI, to "second-generation" structural reforms—more complex, politically sensitive domestic regulatory reforms to unlock competition and boost productivity. These include the factor-market reforms described earlier.

In China, market reforms have stalled in the last six years, alongside an increase in industrial-policy interventions to benefit national SOEs. Export restrictions, China-specific technical standards, subsidies, high-tech and Internet restrictions, services and FDI barriers, government-procurement and intellectual-property restrictions, are all part of the mix. This has led to trade conflicts with the United States and European Union. China's supercharged fiscal and monetary stimulus in 2009, equivalent to almost half of GDP, primarily benefited SOEs; they received an avalanche of credit from state-owned banks. This reinforced the power of the public sector at the expense of the domestic private sector and multinational enterprises.[17]

Much is left to be done in India. Agriculture suffers from high external trade barriers, in addition to high internal trade restrictions, subsidies, price controls, lack of property rights, and poor infrastructure. Manufacturing suffers from draconian labor laws. A company that employs more than 10–20 workers has to apply to its home-state labor department to fire an employee—an example of the much-feared "Inspector Raj." That is why large Indian manufacturers prefer to occupy capital- and skill-intensive niches rather than engage in labor-intensive production. In contrast to China and other parts of East Asia, India performs pathetically in labor-intensive exports and has not yet had its industrial revolution. Finally, despite India's boom in information-technology services exports, domestic services remain largely unreformed, beset by internal restrictions and low productivity.[18]

Asia has had a proliferation of free trade agreements (FTAs) over the past decade. But they are almost all "trade light." The stronger ones eliminate most tariffs, but their discriminatory treatment involves multiple and complex "rules of origin" that increase business costs and delays. Also, these FTAs do very little to tackle nontariff and regulatory barriers. Asia is also awash in regional economic integration initiatives. But these are even more trade-light than bilateral FTAs. Even the strongest, the ASEAN Economic Community, has made paltry progress on nontariff and regulatory barriers.

The reality is that the bulk of trade and FDI liberalization in Asia has come about *unilaterally* and in *nondiscriminatory* fashion. Governments have opened up autonomously—what I like to call the Nike strategy ("Just do it!")—and copied each other rather than liberalize through cumbersome, bureaucratic international negotiations. That is how East Asian countries attracted inward investment in information and communication technology (ICT) manufacturing, from which regional production networks for global supply chains spread.[19]

South Asia, in contrast, is the least integrated region in the world: intraregional trade is only 4 percent of total trade and 2 percent of regional GDP. South Asia accounts for only 5 percent of Asia's total trade and 1.5 percent of world trade.[20] And, with few exceptions, it has not joined up with East Asian manufacturing supply chains.

Top-down trade negotiations are unlikely to deal with unfinished business; unilateral liberalization has to be the motor of new trade, FDI, and domestic structural reforms in both East and South Asia. FTAs, regional initiatives, and World Trade Organization (WTO) agreements can at best play a supporting role.

In sum, opening to trade and FDI has been critical to expanding economic freedom across Asia, but existing barriers continue to restrict economic freedom. The Fraser Institute's *Economic Freedom of the World* index has only two Asian societies—Hong Kong and Singapore—in the top 20; the others are way behind. Generally, Asian economic institutions—public administration, enforcement of property rights, domestic regulatory authorities—are still relatively weak and keep business and trade costs high, repressing entrepreneurship, innovation, and consumption.

Energy and Environment

Over half the world's "energy poor" live in developing Asia, most of them in India. Overwhelmingly, they are the rural poor. They lack access to electricity and use traditional biomass (wood, dung, and crop fuels) for cooking. At the other extreme are the "energy rich"—high consumers of energy in prosperous Japan, South Korea, Taiwan, Hong Kong, and Singapore.

The International Energy Agency estimates that energy consumption in developing Asia will double over the next two decades. That translates into much more demand for fossil fuels—oil, natural gas, and coal. Three-fifths of additional demand for oil will come from developing Asia, driven by a transport revolution—a massive increase in passenger vehicles and aviation. Developing Asia will import four-fifths of its oil by 2035. It will become more dependent on natural gas imports. Almost all additional demand for coal will come from developing Asia. Asian coal producers, especially China, India, Indonesia, and Australia, will meet some of that demand, but increasing amounts of coal will have to be imported from extra-Asian sources. Large-scale hydroelectric projects will likely dominate renewable energy production. And production of nuclear energy is likely to increase too.[21]

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Asian energy markets, even more than finance, are throttled by government intervention and SOEs. Price controls, subsidies, export restrictions, and inward-investment restrictions are the norm. Energy is hardly covered by WTO rules. China and India are attempting to secure energy supplies through command-economy rather than market instruments—sending out highly subsidized national oil companies, striking long-term contracts with foreign governments, and pledging loans for oil. These measures make energy markets pricier and more volatile, they do not guarantee long-term security of supply, and they exacerbate geopolitical tensions.

More energy freedom will allow for rising consumption; make supplies more stable, secure, and cost-effective; and preserve peaceful international relations. That can only happen with more private-sector investment—domestic investment plus FDI—and freer cross-border energy trade. That demands a combination of domestic and external market reforms: removing price controls and subsidies; privatization; "unbundling" generation, transmission, and distribution in the power sector; and freeing international trade and FDI (preferably underpinned by WTO rules).

Asia needs to take a leaf out of the U.S. energy playbook. The United States is in the early stages of an energy revolution, with a massive increase in domestic production of shale oil and gas, and even of crude oil. This is lessening the United States' dependence on oil and gas from the volatile Middle East and, through lower input costs, boosting high-value domestic manufacturing.

This transformation is no accident; it springs from the foundation of secure private property rights and free enterprise. In contrast, Europe is missing out because environmental regulations prevent the exploitation of shale deposits. So is China, despite having shale deposits potentially larger than those that exist in the United States. Administered pricing, SOEs, inward-investment restrictions and highly insecure property rights characterize Chinese energy markets. If Asian countries freed their energy markets, they too could enjoy the benefits now flowing to the United States, including less dependence on oil and gas from the Middle East and lower carbon emissions (shale gas being much less carbon-intensive than oil or coal).

Increasing Asian consumption of fossil fuels to power industrializing growth nonetheless translates into rising carbon emissions. This will have a bigger impact on the world and on Asia itself. Climate researchers predict freak weather disasters, water scarcity in China, desertification in Central and West Asia, melting of glaciers in the Himalayas, storms, floods and rising sea levels devastating coastlines and low-lying islands, and much else besides.

China, now the world's biggest carbon emitter, is committed to improving energy efficiency by reducing its "energy intensity"—the amount of energy used per unit of GDP—while absolute carbon emissions continue to increase. The government says it is on track to meet its ambitious targets. However, were they to meet conventional global targets for reducing greenhouse gas emissions, Asia, and particularly China and India, would need to impose binding targets to cap and then reduce *overall* carbon emissions sooner or later. The United Kingdom's *Stern Review* advocates a reduction of global emissions to 50–80 percent of 1990 levels by 2050.[22] It is difficult to see how that can be met without significant contributions from China and India. This is not merely a matter of energy efficiency; serious "carbon mitigation," that is, reducing emissions, will likely lower industrializing growth. That is the inescapable trade-off for China, India, and other Asian countries. It has extremely worrying implications for employment prospects, poverty reduction, the expansion of the middle class, and other improvements to human welfare that come with economic growth.

Here skepticism is in order. Climate science is not "settled," contrary to the conventional wisdom. Long-range forecasts of the impact of emissions on the global climate are inevitably uncertain. Differences abound among scientists from diverse disciplines. And, as "Climategate"—the scandals surrounding prominent climate scientists and the Intergovernmental Panel on Climate Change (IPCC)—recently revealed, scientific input into public policy has been politicized in order to arrive at alarmist conclusions.[23]

Prominent economists who take positions on climate change have not done much better. The two best-known studies on the economics and policy implications of climate change, the United Kingdom's *Stern Review* and Australia's *Garnaut Review*, take climate science as "settled." Their modeling, and the long-range forecasts that issue from it, do not take adequate account of an inevitably uncertain future. And many of their proposals—on binding emissions targets, taxation, carbon quotas, subsidies, and massive aid transfers—owe more to soft central planning than anything else. They entail a massive expansion of government intervention in markets at national, regional, and global levels.

The mind boggles at the monetary sums and the bureaucracy involved. It triggers collective salivation in the "international community"—international organizations and the aid business. And it is already becoming reality in the European Union. The latter and some of its member states have the most comprehensive and intrusive regulations in the world to combat global warming. Measures include carbon taxes, cap-and-trade schemes, price controls, large subsidies, legally binding targets for renewable energy use, all sorts of detailed standards and requirements, and extraterritorial application of EU regulations. The consequences are higher taxes and utilities bills, trade protectionism, and an expanding political market in which companies and other vested interests lobby politicians and officials for "rents."

All this constitutes a huge threat to economic freedom—probably the biggest threat to economic freedom in the early 21st century. Asia should not repeat Europe's follies, nor should it uncritically accept the conclusions of the IPCC and the *Stern* and *Garnaut* reviews. Adaptation to global warming through market-based energy efficiency measures is advisable, but so is skepticism regarding mainstream advocacy of carbon mitigation. This "mainstream" threatens Asia's freedom and prosperity.

Conclusion

The main story of "globalizing Asia"—habitually overlooked—is the expansion of economic freedom. All over Asia, space is opening up for Smithian natural liberty. Policy, technology, and markets have unleashed animal spirits, particularly among the hungry, aspiring, hard-working younger generation. Their commitment to education, work, and self-improvement is everywhere in view. These are the most uplifting sights in Asia. What a contrast with much of the West today, particularly in Europe.

Yet the journey has much, much farther to go; there is enormous unfinished business to expand economic freedom. The public policy challenge is twofold: get the basics right and embark on structural reforms.

Getting the basics right entails, inter alia, prudent fiscal and monetary policies to ensure macroeconomic stability, removing basic domestic distortions such as price controls and wasteful subsidies, and freeing up international trade and FDI. Structural reforms go deeper into the domestic regulatory fabric. Among them are nitty-gritty measures to cut red tape and improve the business climate; liberalizing labor, energy, and financial markets; shrinking the public sector and opening it up to competition; and bringing competition to education, health care, and other public services. Structural reforms also dovetail with institutional reforms: strengthening private property rights and the enforcement of contracts; building a more sophisticated legal system and entrenching a real—not a sham—rule of law; making public administration leaner and more efficient; and establishing transpar-

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ent, clean, and competent regulatory agencies. In essence, institutional reforms are all about the reform of the state itself.

Obviously not all these reforms can be done at once, or indeed in quick time. Nor is there an identikit package. Asia has different countries and regions at different stages of development. Reform priorities—the balance between basics and structural reforms—and reform speeds will differ from place to place. What all Asian countries should have in common is a broad direction of travel: limiting the reach of government and expanding economic freedom for ordinary people.

Asia's poorer economies—those in the low-income and least-developed brackets—should concentrate on the basics. These are the first-generation reforms of macroeconomic stabilization and market liberalization. They provide the right environment for mobilizing resources—savings and investment, labor and capital—for growth. This is "catch-up," "input-led" growth—what Paul Krugman calls "perspiration."[24] Most of South Asia, the poorer Southeast Asian countries, and the poorer parts of China (its interior provinces) are in this growth phase.

Asia's middle- and high-income economies have unfinished and never-ending business with policy basics: it is always a struggle to maintain macroeconomic stability, and there are plenty of basic market distortions left to tackle. But these economies should focus also on second-generation structural reforms to boost competition, innovation, and productivity gains. These economies are approaching the end of or have exhausted catch-up growth. Hence they depend more on "output-led" growth—what Paul Krugman calls "inspiration."[25] This growth phase also demands deeper institutional reforms. Otherwise countries get stuck in a "middle-income trap."

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Asia's richest countries—Japan, South Korea, Taiwan, Hong Kong, and Singapore—have made the transition to middle- and now high-income status. Exceptionally, they have avoided the middle-income trap. Their challenge is to drive specialization, product differentiation, and innovation in established and new global-market niches. Malaysia and Thailand, in contrast, risk being stuck in the middle-income trap for lack of structural reforms. So do the relatively wealthy coastal provinces of China—and indeed China as a whole as it grows closer to middle-income status over the next decade. And the same applies to the wealthier parts of India.

Economic reforms to expand economic freedom beg the question of political reforms to expand civic and political freedoms. The track record in Asia and elsewhere shows that catch-up growth is compatible with a variety of political systems, ranging from authoritarianism to democracy. Liberal institutions and open societies, with their plural ideas and their checks and balances, are not a prerequisite for catch-up growth. But unreformed autocracies, with unchecked vested interests at their core, are badly fitted to undertake structural and institutional reforms. Expanding economic freedom, embodied in the rising expectations of a burgeoning middle class, comes into conflict with straightjacketed, neanderthalic politics. Now the link between political and economic reforms becomes stronger.

China's "market Leninism" graphically illustrates the tensions between a static political system and a market-oriented, globalizing economy. Will China's Party-State adapt? Is it capable of introducing sufficient *liberal* and *democratic* political reforms to enable further economic reforms? India, on the other hand, has a historically weak state. Since independence, its political system has been characterized by overextended, illiberal government and messy, rambunctious democracy. This cocktail has often blocked market reforms—not least under the present Congress-led government. But India has British-endowed liberal institutions (at least in outline) and an open society. That is the context for its economic silver lining: bottom-up market reforms in some Indian states that set good-practice examples to emulate elsewhere in India.

Finally, my message for Asia is a classical-liberal one in the spirit of Adam Smith and David Hume. Freedom and prosperity have bloomed on Asian soil because government interventions have been curtailed and markets unleashed. *Pace* fans of the "developmental state," the Asian miracle is not the product of social engineering—the belief that superior technocratic minds can "guide" markets and solve complex social and economic problems with targeted interventions. Limited government—a "strong but small" state that performs its core functions well but does not intervene left, right, and center—free markets at home, and free trade abroad: that is the "system of economic liberalism," as Joseph Schumpeter called it, to which Asians should aspire.[26]

Hong Kong and Singapore come closest to this classical-liberal ideal—in Asia and the world. They have grown prosperous with their free ports; their openness to foreign capital and immigrant labor; and their lean, efficient administration. They have their differences and blemishes: Hong Kong is more liberal and less democratic (though, at the margin, becoming less liberal in the economic sense); Singapore is the other way around (though becoming more democratic in the political sense). But, overall, they maintain secure private property rights and the freedom of enterprise, and are wide open to the world. So far, they have avoided the horrors of a Big Government welfare state.

Hong Kong and Singapore are also the successors to the old port-polities of Cambay, Calicut, Malacca, and Macassar. These days they are connected not only with far-flung markets in the West, but also with the fastest-globalizing parts of China and India: the Chinese coastal provinces with their coastal hubs of Shanghai, Xiamen (the old Amoy), and Guangzhou (the old Canton); and the most advanced Indian states in an arc from Tamil Nadu to Gujarat. It is in these mostly coastal strips and cities that liberalization of markets, property rights, a burgeoning middle class and other features of commercial society are blossoming most. These are the spots where the best policy innovation takes place. They recreate the Golden Age of Indian Ocean commerce. Only this time its networks are complex manufacturing and services supply chains linking them to global markets. They form the core of liberty outside the West today; they point the way to its future expansion. That is why we can be confident that the future of liberty is shifting East.

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