

## THE "THIRD WAY" KEEPS COUNTRIES IN THE THIRD WORLD

*By José Piñera*

*Cato Institute*

*and*

*International Center for Pension Reform*

[jose@cato.org](mailto:jose@cato.org)

Prepared for the Cato Institute's 16<sup>th</sup> Annual Monetary Conference cosponsored with *The Economist*, October 22, 1998, Washington, D.C.

The fallout from the current Asian financial crisis has led some people to believe that there was no Asian take off. Yet, even after the sharp recession of this year, GNP per capita at the end of 1998 will be four times that of 1960 in Japan and the Four Tigers (Singapore, South Korea, Taiwan, and Hong Kong). Asia's extraordinary economic growth was not a miracle in the sense that something mysterious or out of this world generated it. It was, on the contrary, the result of introducing, in countries whose potential gross domestic product was much higher than their actual GDP, some degrees of market freedoms. The crisis should not cause us to forget decades of very fast growth that had the Asian Tigers on the verge of abandoning the Third World.

But there was a fatal flaw in the process, and the day of reckoning has arrived. That was the notion that there is a "Third Way" between free-market democratic capitalism and socialist statism. That dangerous and erroneous idea bred the structural problems that erupted in the current crisis. In this case, the Third-Way notion was introduced as the "Asian model," in which a distorted version of free-market democratic capitalism was adopted in a geographic region of the world on the basis of what were called "Asian values." But as Chris Patten, former governor of Hong Kong, has said in his recent book, "Asian values were a shorthand for the justification of authoritarianism, bossiness and closed collusion." The Asian Third Way consisted of two interrelated third ways: one between the free market and socialism; and the other between democracy based on the rule of law and totalitarian dictatorship.

Export-oriented industrial policies were the key element in the definition of the Third Way between free markets and statism in Asia. It is true that the weakness of the banking sector has been the "trigger" of the current Asian crisis. But the real question is, Why was there such a pervasive government intervention in bank lending criteria and such weakness in bank supervision? The opaque and incestuous relations between banks, conglomerates, and governments were a way to evade the discipline of the market and benefit special interests. The so-called industrial policies were a code word for creating wealth through economic dirigisme rather than market competition. The restrictions on foreign investment were designed to protect oligopolistic private-sector structures and direct money toward whichever industries a group of supposedly "visionary" government officials decided had "dynamic" comparative advantages. In Japan, the "visionaries" were in the legendary MITI; in Korea, they were in the planning

ministries and the *chaebols*; in Indonesia, they were technocratic bureaucrats. In each case, the rationale of industrial policies proved a very convenient way to obscure huge malinvestment and, in many instances, outright corruption.

But one cannot permanently have a system of free enterprise coupled with an authoritarian or corporatist political system. If a country lacks the rule of law, a free press, and political accountability, sooner or later vested-interest groups--be they business, trade unions, or political groups--begin to distort the system in their favor. Of course, the rationale of corporatism, so entrenched in Japan and some European countries, was again instrumental in justifying government, business, and trade-union collusion. Substituting dirigisme for the market, whoever was doing the directing, introduced important economic distortions that reduced productivity growth, created or destroyed wealth by government decision, and produced intolerable injustices.

There is here an important lesson for China. I believe that inside China there are strong forces working for economic and political liberalization. Among them are the policies of the late Deng Xiao Ping; huge foreign investments, especially those by the overseas Chinese community; the impact of those 250,000 Chinese students educated in the United States in the last two decades; the increasing media linkages to the free world; and finally the role of the Hong Kong takeover in changing China. But it is a race between those forces and others that are trying to use partial economic freedoms in their favor through manipulation of the state and the political sector. Weaknesses in the banking sector, gross inefficiencies in the state-owned enterprises, and increasing corruption may finally turn China into more of an Indonesia than a Singapore.

The way out of the Asian crisis is to abandon the Third Way--in both its economic and its political dimensions--and introduce more free markets, more civil liberties, and more democratic accountability. Introducing capital controls is not the answer. The world (including the emerging countries of Asia) needs the integration of capital markets to channel savings from mature economies to those with projects that might provide a greater rate of return. The Asian economies need to open more to direct foreign investment, discard ill-conceived limits on the ownership of corporations, and remove restrictions on the entry of foreign banks and other financial institutions. As *The Economist* has rightly emphasized, Chile, supposedly the model country for capital controls, has no restrictions on the entry of foreign banks. Foreign participation in the banking industry stands at around 20 percent there. Meanwhile, in the mid-1990s foreign-owned banks accounted for roughly 5 percent of bank lending in South Korea, Thailand, and Indonesia. The real issue is proper banking supervision, especially of short-term debt in currencies different from those of the lenders. Strict supervision and well-designed rules are needed. But that is not an argument for so-called capital controls. Portfolio investment is necessary, even of the short-term kind.

Protectionism is also the wrong answer and one that deepened the depression of the 1930s. Only a week ago the Chilean Congress approved a reduction of the 11 percent flat tariff (already a key reform because its flatness prevents the distortionary effects of varying rates and

especially the political lobbying for differential tariffs) to a 6 percent flat tariff in five years. From there to zero, it should be a small step for legislators, but a great leap for free trade.

In Asia, Central Provident Funds with individual accounts were an advance with respect to pay-as-you-go social security systems. But the allocation of the accumulated capital has been done by government bodies rather than competitive private enterprises in a transparent capital market. More than overinvestment, Asia has had a crisis of malinvestment, as will always be the case when you substitute the political committee for the market. It is now time to decentralize the management of the individual pension accounts. And, of course, you cannot have a Third Way in exchange-rate policy: you must choose either a full currency board or a totally flexible exchange-rate regime.

For Latin American countries, the Asian crisis should confirm the importance of a coherent free-market strategy and the need to uphold the rule of law, honest government, and democratic freedoms. Those Latin American countries that have most followed such a path--especially Chile, Argentina, Peru, and, to a lesser but important extent, Mexico--will weather the crisis and rebound strongly in the next two years. The fate of Brazil, important as it is, rests in the leadership of recently reelected President Fernando Henrique Cardoso, not on the International Monetary Fund or the U.S. Treasury. Even though he has taken great steps forward in privatizing huge state-owned companies, Brazil urgently needs radical fiscal and pension reform. In time Latin America should go even further and join a dollar area, probably as part of a hemispheric free-trade area. In the 21<sup>st</sup> century we could see a whole hemisphere committed as never before in its history to economic, civil, and political liberties.

I believe that there are many megatrends that will lead Asia, sooner rather than later, to follow the freedom path. Let me emphasize only two. First, the communications revolution, especially the Internet phenomenon, is spreading a real "freedom virus" all over the world. And second, the outstanding success of the United States, a model that in a post-Cold War world will be emulated without the ideological and historic prejudices that obscured the vision in the past. Once this happens, the enormous strengths of Asian economies—human capital, high savings rates, low taxes, entrepreneurial spirit—will manifest themselves and produce a lasting period of prosperity.

From this perspective, the Asian crisis may turn out to be the fall of a second Berlin Wall, that of a supposedly Third Way to development and freedom. And this could not only bring enormous benefits to the rest of the emerging world--especially to African countries that are tempted to follow the Asian model--but also give impetus to the necessary restructuring of Europe's faltering welfare state. Monetary unification and the coming pension crisis will reveal the entrenched rigidities and corporativism of the Old World's own brand of the Third Way.

Let's face it. The Third Way will keep emerging countries permanently in the Third World, and maybe produce an historical anomaly, the descent of a European country to Third World status in a few decades. There are two big truths being revealed by the current world

situation, especially by the contrast between Asia and the United States: first, freedom is indivisible, and second, "indivisible freedom" works.

If this is well understood and there are leaders who dare to do what is correct rather than what short-term political considerations dictate, the pain being inflicted by this crisis, rather than marking the agony of global democratic capitalism, may well signal the birth of an era of global freedom.