expanding international trade relations has been facilitated by the confluence of increased capital mobility and easier access to information and technology. Economic success in this coming era will require further separation between the economic and political spheres, greater tolerance of institutional innovation, and increased transparency and accountability on the part of the existing economic and political structures.

These conditions are as important for the mature Western economies as they are for developing economies, in Asia or elsewhere. Regimes that attempt to frustrate this marketplace of ideas will undermine their long-term survival. Just as economic protectionism leads to avoidable economic costs, cultural isolationism involves self-inflicted social and political costs. Neither wishful thinking nor strong-armed authoritarian rule will be able to revive hopes for an 'Asian century', and neither can they hold back the positive forces of a 'Global millennium'.

While the restoration of stability in the East Asian economies will be difficult, the slow pace of institutional changes will make the process of recovery an even longer one. Indeed it may take a generation for some East Asian economies to replicate the necessary institutional infrastructure for sustainable economic growth that will be required by the increasingly efficient global capital market.

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4 Political Foundations of Economic Management: an Interpretation of Economic Development and Economic Crisis in East Asia

Yi Feng

INTRODUCTION

East Asia has witnessed a profound political and economic change in the past few decades. Not only has the region experienced spectacular economic growth until recently, it also has undergone fundamental political change, leading to democracy in South Korea, Taiwan and the Philippines.[1] This chapter discusses a politico-economic model of growth and development. It uncovers some political mechanisms for economic transformation in this region. The general conclusion of this study is that political stability, political consensus and political as well as economic freedom all promote economic growth and development. From a theoretical perspective, this model explains the economic success in East Asia from the 1960s to the 1990s. It also sheds light on political institutions accountable for a series of recent Asian political and economic crises that occurred first in Thailand in July 1997. We argue that while political stability and economic freedom have facilitated economic development in East Asia over the past three decades, political liberalisation and broad-based economic reform are needed to cope with the causes and consequences of the recent financial crisis.

The second section compares economic development in East Asia with that in other regions of the world, exploring the difference in their growth trajectories. The third section posits a theoretical model that explains the anomalies exposed in the preceding section. The fourth section empirically investigates the theoretical implications in the context of East Asian countries. The fifth section uses Indonesia as a template to derive policy implications for the recent financial crisis in Asia. The sixth section concludes the chapter.

A COMPARATIVE FRAMEWORK OF ECONOMIC DEVELOPMENT

In recent years, Feng (1999a), Feng and Zak (1999), Feng and Hsiang (1998) and Feng and Wu (1998) have compared economic development in East Asian developing nations with that in other parts of the world. They find that the former have attained significantly faster growth rates than the latter. Three East Asian newly industrialising countries (NICs) – South Korea, Singapore and Taiwan – and four Eastern Asian newly exporting countries (NECs) – Indonesia, Malaysia, the Philippines and Thailand – have made impressive strides in their economic expansion.

Figure 4.1 is based on real GDP per capita data from Summers and Heston (1995), who have adjusted national income levels according to the purchasing power parity standard, thus overcoming the complications caused by using foreign currency exchange rates. All the East Asian developing countries in Figure 4.1 had lower per capita incomes than Latin American countries in the early 1960s. By 1990 all four East Asian NICs had surpassed their Latin American counterparts (Argentina, Brazil, Chile, Mexico, Colombia, Jamaica, Peru and Venezuela) by a large margin. Among the East Asian NECs, Malaysia had surpassed all Latin American countries except Mexico and Venezuela. Thailand has accelerated its rate of growth since 1986 and led Colombia, Jamaica and Peru in per capita income.

Compared with the growth trends for East Asian countries, most Latin American countries have experienced low or even negative growth. During

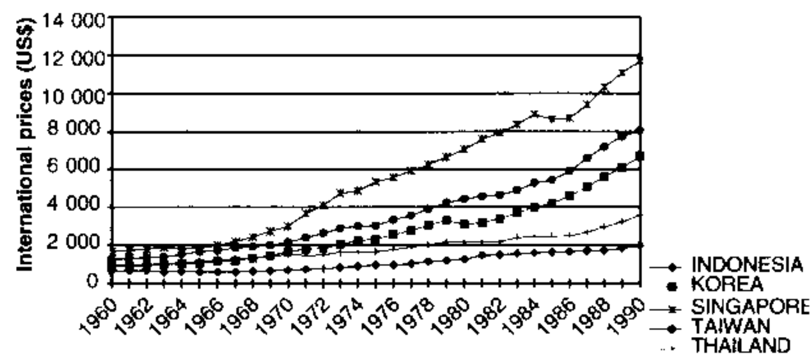

Figure 4.1 Real GDP per capita in East Asian developing nations
Source: Summers and Heston (1995).

the 1980s several high-income Latin American countries (Venezuela, Mexico and Argentina) suffered from substantial negative growth, while Chile and Peru went through massive fluctuations. During the period 1975–90 the average growth rate of real GDP per capita at the international price level was about 5 per cent for the seven East Asian countries, but only 0.04 per cent for the eight Latin American countries mentioned above.

Similarly in 1960 the ten largest Sub-Saharan African economies – Algeria, Congo, Gabon, Ivory Coast, Madagascar, Mauritius, Mozambique, Seychelles, South Africa and Swaziland – on average had higher income levels than East Asia, ranging from US$1 120 for Ivory Coast to US$2 862 for Mauritius in terms of international prices. However the growth rate of real GDP per capita in the ten African countries has been neither high nor stable. Many of these countries experienced periods of negative growth throughout these years, including high-performing Mauritius (with a per capita income of about US$6 000 in 1990). The income levels in Mozambique and Madagascar were even lower in 1990 than in 1960. The average growth rate for the ten countries over the period 1975–90 was only 0.3 per cent.

Though the economies in East Asia grew rapidly until recently, the development experiences of the seven nations discussed here have differed. The NICs (Taiwan, South Korea and Singapore) have performed better than the NECs (Indonesia, Malaysia, the Philippines and Thailand). Figures 4.2 and 4.3 show the growth rates of real GDP per capita for these countries from 1960–99.

From 1961 to 1997 Taiwan, South Korea and Singapore enjoyed higher growth rates than Malaysia, Thailand, Indonesia and the Philippines. Although the former nations did experience negative growth in a number of years, the degree of economic shrinkage was significantly lower in the former than the latter. The average growth rates were 6.7 per cent for Taiwan, 6.6 per cent for South Korea and 6.1 per cent for Singapore. By comparison, South Korea was hit hard by the Asian economic crisis. In January 1997 Hanbo Steel collapsed under $6 billion worth of debts; this was the first bankruptcy of a leading conglomerate in a decade. In March 1997 Sammi Steel failed, triggering further concern about the looming debt crisis. In July 1997 Kia, Korea's third largest automobile maker, suffered from a credit crunch and asked for emergency loans; Kia was subsequently nationalised in October 1997 as the result of its failure to acquire loans from banks. Since then the world's eleventh largest economy has suffered a series of setbacks in terms of capital flight, credit downgrading and currency depreciation. Despite all this, South Korea has been able to adjust itself to economic shocks by reforming its banking system, improving its financial

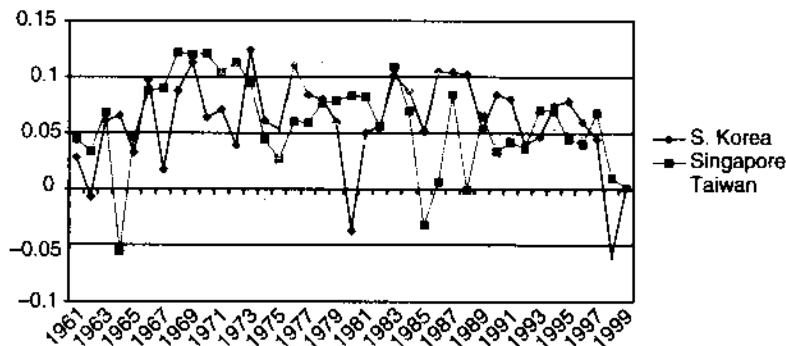

Figure 4.2 Growth rates of GDP per capita (1990 prices) for three Asian NICs, 1961–99 US$

sector and modifying its labour laws and social security programme. As a result the prospect of its recovering from the crisis seems bright.

The other two NICs – Taiwan and Singapore – suffered far less damage from the financial crisis, though their growth rates have slowed down. In contrast to South Korea, both of these countries have had current account surpluses in recent years. In 1997 the current account surpluses as a ratio of GDP were 14 per cent in Singapore and 3 per cent in Taiwan, the only two of the seven East Asian countries to have a positive current account since 1990. The two countries have also had the lowest inflation rates in recent years. In 1997 the inflation rates were about 1 per cent in Taiwan and 2 per cent in Singapore. The macroeconomic fundamentals in these two economies have been relatively solid, which makes them less vulnerable to the financial crisis than others.

The growth rates for the four Asian NECs were lower than for the three NICs. From the 1960s to the 1990s, prior to the Asian economic crisis, the fastest growing economy in this group was Thailand, with an average growth rate of 5.1 per cent, followed by Malaysia (4.5 per cent), Indonesia (3.8 per cent) and the Philippines (1.4 per cent). The economy that has suffered most from the Asian economic crisis has been Indonesia. In contrast to South Korea, the prognosis for its economic and financial problems is nothing but grim. The projected growth rates of GDP for Indonesia are −16.5 per cent for 1998 and −2.8 per cent for 1999. Thailand suffered extensively from the crisis, but seemed to recover steadily. The Philippines and Malaysia were relatively less damaged by the financial turbulence than Indonesia and Thailand, as the levels of economic openness in the former were lower than in the latter.

Since 1998 the consequences of the financial crisis in these nations have been mitigated to different degrees. For instance in Korea and Thailand interest rates declined markedly as currency pressures eased, leading to a drop in interest rates to their precrisis levels. The two nations have also made significant progress in macroeconomic stabilisation and have begun to implement structural reforms. In Indonesia, the modified policy programme introduced in late June 1998 has been implemented broadly as planned, though the recovery is far slower than expected. The causes of the financial crisis have been multifaceted, ranging from 'irrational exuberance' on the part of the global financial market to domestic market imperfections. The purpose of this chapter is not to explore these factors, but to study the constraints of domestic political institutions on economic development and their effect on the recent financial crisis in Asia.

A POLITICO-ECONOMIC THEORY OF GROWTH

The puzzle of uneven growth introduced in the preceding section can be illustrated by what happened in one country in East Asia. In the 1950s the Philippines was considered the best performer in East Asia and the most promising in the long run. Optimism grew following an economic report by the World Bank in November 1957.

> The Philippines has achieved a rapid rate of economic growth in the post-war period (since 1949). Production has continued to grow at an annual rate of 7 percent, despite the disrupting effects of the HUK movement, which hampered economic activity until 1952.... By comparison with most underdeveloped countries, the basic economic position of the Philippines is favorable. It has a generous endowment of arable land, forest resources, minerals, and normal potential. Through a comparatively high level of expenditure on education, transport, communications, and industrial plant over the past 50 years, the Philippines has achieved a position in the Far East second only to Japan, both in respect to its level of literacy, and to per capita production capacity.... The prospects of the Philippines economy for sustained long-term growth are good. [Apart from a] generous endowment of material resources and high level of literacy, other favorable factors are the growth of the labor force, the availability of managerial skills, the high level of savings and investment, rather good prospects for most of the Philippine exports, and considerable possibilities for import substitution.[2]

The Philippines, however, has not lived up to the World Bank's evaluation and forecast. The average growth rate of real GDP per capita in the Philippines from 1960–97 was only 1.4 per cent, the lowest among the three NICs and four NECs in East Asia. By 1990 South Korea, which had compared unfavourably with the Philippines in the report, surpassed it by almost 400 per cent. Taiwan, which had about the same level of GDP per capita as the Philippines in 1960, more than quadrupled the GDP of the latter.[3] How could the Philippines have failed to achieve the high expectations reported with such enthusiasm and optimism by the economists at the World Bank? An understanding of the political institutions in the Philippines provides a key to unravelling the reasons for this.

The data in Figure 4.3 indicate that prior to 1998 the Philippines experienced two periods of negative growth: 1983–86 and 1991–92. The worst period was 1983–86 with the economy shrinking about 10 per cent in 1984. Ironically the most pronounced negative growth occurred after the period of martial law, which lasted from 1972–81. The years between 1983 and 1986 mark one of the most turbulent historical periods in the Philippines, beginning with the assassination of opposition leader Benigno Aquino and ending with the vindication of the 'people power' revolution when Aquino's widow Corazon took office as Marcos fled to Hawaii.

Likewise the other negative growth period preceded a change in political power. Though Aquino won a May 1987 vote of confidence in the legislature, military unrest and slow economic growth continually plagued her government. In December 1989 a military coup was suppressed only with the help of the US Air Force. During Aquino's last two years in office the economy shrank (4 per cent in 1991 and further 1 per cent in 1992).

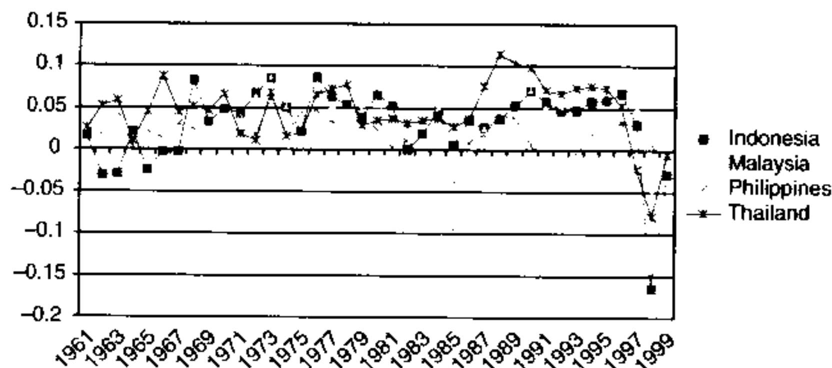

Figure 4.3 Growth rates of GDP per capita (1990 prices) for four Asian NECs, 1991–99

Sources: 1961–97 data from IMF (1999); 1998–99 data from Straszheim (1998).

In 1992 Aquino declined to stand for reelection, instead endorsing the eventual winner, former Defence Secretary Fidel Valdez Ramos. After Ramos assumed office the economy started to stabilise. By 1996 the Philippines had joined the ranks of free nations, with a significant decline in rebel insurgence and a reduction in the political and economic influence of the nation's traditional ruling families.[4]

Political features such as these would be important to the growth trajectory of any country. To understand their effects on growth, we need to construct a theoretical framework of conceptual relations and references in the abstract. Chen and Feng (1996) and Feng and Chen (1996) have developed a mathematical model to study the relationship between politics and growth. Their model isolates three aspects of political institutions as the basic components of the political environment for economic growth and socio-economic development. Political instability, political polarisation and government repression all condition and constrain an individual's economic decision to invest in reproducible capital in the marketplace.[5] Economic growth, a function of the accumulation of reproducible capital, will increase or decrease as a function of these factors. A theoretical discussion of this model is provided below.

An assessment of the political environment is embedded in an investor's reasoning with regard to investment and consumption. When individual economic agents decide how much money they should invest and how many goods they should consume, they examine the current and future political parameters. In particular they are concerned about the likelihood of the current regime being replaced in the future, the degree of polarisation between the opposing political parties and how much political and economic freedom is permitted in the society. Both the likelihood of regime change and the large degree of political polarisation will add to the uncertainty of the economy, thus reducing the agents' incentive to invest. Furthermore, government repression implies that some gains from investment will be expropriated by or lost to the government, decreasing the agents' incentive to invest, thus reducing economic growth.

The probability of political regime change, no matter how minor, always exists. According to the model, an individual born in the current period is assumed to be uncertain of a future government's policy and its implications. Associated with the probability of a new government replacing the current one is the notion that the policy of the future government has not been tested in or experienced by the marketplace. Given that investors are risk averse, they prefer to wait rather than risk their investment today, particularly if there is a strong probability that the current government will be superseded by a new one. Reducing capital inflow and economic growth,

radical political change involving different regimes particularly adds to the uncertainty of investment decision making[6] though it is dramatic to say that one can make money in any policy environment as long as it remains unchanged, investors do appreciate consistent public policy, which comes more easily if the government does not change. By contrast some countries have experienced military coups without concurrent changes in the economic system and policies installed by the previous government. Economic growth should not be seriously affected as a result.

The theoretical model and subsequent empirical discussion in this chapter focus on regime change rather than constitutional government change. While the former occurs outside the constitutional framework, thus creating political uncertainty, the latter represents policy adjustment, usually as the consequence of a political election. In a simultaneous equation model of political stability, democracy and growth, Feng (1997a) distinguishes between unconstitutional government change major constitutional government change and minor constitutional government change. It can be concluded that it is extra-constitutional change (such as a military coup) that has a pronounced negative consequence on economic growth, rather than regular government change (which represents policy adjustments rather than fundamental change to the political system).

Investors will discount the effect of political regime change on growth if political polarisation is low, that is, if the difference between the current and future regimes is negligible. In this chapter, policy polarisation is defined as a disagreement over public policy between the government and its opponents.[7] It stands for a change in the current social policy, or a deviation from the current level of government repression, by a new government in the future. It captures the difference between the new and old regimes in their basic political orientation of running an economy or organising a government.[8] Investors will normally place a high premium on liquidating or consuming assets today, rather than making a commitment to long-term investment, if they perceive that the future government will be very different from the current government in its policy. What is implied in this reasoning is a high level of uncertainty about a potentially large policy shift from the current government. While the future policy could be more or less repressive than the current one, political uncertainty ensues from the concern that the market has not tested the policy of the drastically different government that might be installed in the future.

The effects of five kinds of political actions on growth are compared in Feng and Chen (1996); these are coups *d'état*, revolutions, riots, strikes and assassinations. It should be noted that as indicators for political polarisation, these events reflect the scale and intensity of disagreement about the political management of a country; they are more likely to be the consequence of political polarisation than its cause. The levels of significance of the polarisation variables show a pattern: the most violent or the most extensive political actions (that is, coups and revolutions) tend to be significant, while less violent or less extensive political actions (riots, strikes and assassinations) tend to be less significant. The results from using the standardised coefficient estimates are consistent with the above analysis.[9] As the most organised and most violent political actions, coups and revolutions have the largest negative effect on growth. Riots have a greater negative effect on the economy than assassinations and strikes, and assassinations lead strikes in the degree of adverse impact on economic growth. This pattern is consistent with the theoretical argument that a higher degree of political polarisation is associated with a lower level of economic growth.

Government repression is a third political structural factor that affects economic growth; it implies that the government will forfeit some gains from investment. Compared with political uncertainty and polarisation, where the relevancy lies in the future, government repression is a current choice. Originating in the current government's political and economic orientation, it stands for policies that depress private investment.[10] The government may adopt a policy from a set of options (ranging from the highest to the lowest political, economic and social freedoms), which have an impact on economic agents' investment decisions. Among the examples of government repression affecting investment and growth are infringements of property rights, lack of patent protection, the abuse or misuse of resources to satisfy interest groups, government corruption and violations of human and civil rights.

The government may also initiate and provide public goods such as national defence, infrastructure, education, a framework for property rights and other institutions necessary for growth. For example it may adopt a social policy that reduces income inequality with a view to facilitating continued and sustained growth. The public goods provided by a government can be regarded as negative social costs. In accordance with the level of government repression and the amount of public goods provided by the state, investors formulates their strategy to maximise their utility between consuming today and investing for tomorrow.

Government repression in the model implies both political freedom and economic freedom, which can be different from each other, if not totally orthogonal. In this section government repression is treated broadly and philosophically: it represents any government policy that imposes a social cost on economic growth. Generally speaking, long-run economic growth requires both political and economic freedom.

The following theoretical conclusions are made. First, *ceteris paribus*, the lower the probability of the survival of the current regime, the lower the growth rate. Second, the more polarised the policy positions of opposing parties, the lower the growth rate. Third, the more repressive the government, the lower the growth rate.

Figure 4.4 presents an illustration of the three variables, using three countries. Political freedom and economic freedom are combined into a single dimension, defined as social freedom, which is obtained by totalling and averaging the political rights score from Freedom House data and the economic freedom score from Gwartney *et al.* (1996), assigning them equal weights.[11] The value on regime stability is derived from subtracting from one the probability of regime change in Feng (1997a). Finally, policy consensus is indexed by one minus the average year of revolutions, the data on which are from Banks (1996).[12] The period in question is 1970–80, for which the average values of the variables are taken to obtain an aggregate environment for economic growth and development. All values range from zero to one, with one indicating the highest value for the most desirable condition for economic performance according to the theoretical model.

Of the three countries in Figure 4.4, the USA and Singapore have the highest levels of regime stability, social freedom and political consensus; they also enjoy the best economic performance in this group of countries. Regarding social freedom, Singapore has the highest level of economic freedom (second only to New Zealand and Hong Kong) but only a modicum of political freedom, reducing its overall social freedom level. By comparison the regimes of the Philippines and Zaire were fairly stable during this period, probably owing to the high-handed authoritarian control of national politics; their levels of political consensus are, however, marred by domestic

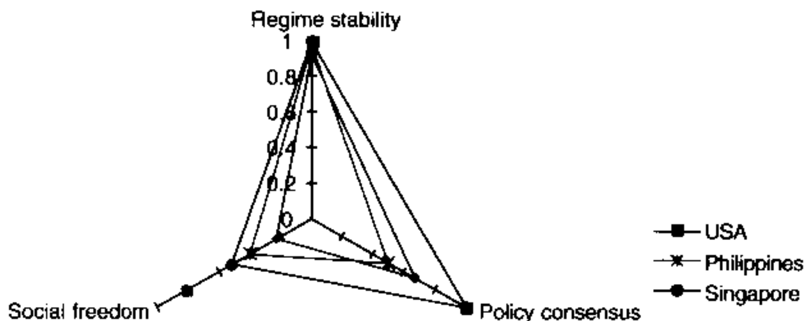

Figure 4.4 Example of the model

revolutions and insurgencies. In addition their social freedom levels are noticeably lower than those of the USA and Singapore. Finally, Bolivia and Peru have unstable regimes, and the probability of irregular government change is higher than in the other countries. Compared with the USA and Singapore, their social freedom is low. Bolivia also has the highest frequency of revolutions.

COMPARATIVE EMPIRICAL ANALYSIS: EAST ASIAN AND OTHER COUNTRIES

This section presents a preliminary empirical look at some political determinants of economic growth. As it stands, the approach used here does not constitute a multivariate test of the model described in the preceding section.[13] We shall focus on the broad implications of the approach exemplified in the model. The framework introduced in the previous section has three implications in terms of how to look at the data and what one should expect to find.

First, the theoretical model introduced in the previous section emphasises the uncertainty associated with a substantial change in government; empirically, we should look at drastic government transfers that are likely to produce high levels of uncertainty. The particular focus is the effect on growth of regime change, which usually causes great uncertainty in the marketplace, rather than government change, which may or may not cause political uncertainty. Regime change is defined as a transfer of the national executive from one leader or group to another, accomplished outside the conventional legal procedures in place at the time.[14]

Additionally, the theoretical approach in the previous section is *ex ante* rather than *ex post*. Though the completion of regime change may bring about certainty about who is currently in power, the likelihood of such a change has already discouraged investors from investing because of the entry and exit costs associated with investment.[15] Even after regime change occurs, investors may still remain uncertain for some time about the new government, whose policies need to be tested in the marketplace. This delay in investment by actors implies a reduction in economic growth.

Second, the model suggests that differences in the views of political groups reduce economic growth. Empirically, we would expect that certain intense political actions would decrease economic growth as they stem from divergence in political views. Third, the model suggests that government repression has a deleterious effect on growth. Empirically, we would

expect to find that policies that seriously repress market conditions and activities have a negative effect on economic growth.

Several groups of countries are further analysed: the OECD group, the G7 group, Latin American countries, Sub-Saharan African countries, the eight Latin American and ten African countries discussed above, and seven East Asian countries (PA7). Both the G7 and PA7 countries have had a very low probability of irregular government change, with the average probability of such change in a given year being 2 per cent for the latter and 0.5 per cent for the former. Latin American countries have had the highest likelihood of regime change for all groups, with the probability of 6.7 per cent, followed by African countries with 5.7 per cent.

The G7 and PA7 countries also have the highest degree of economic freedom, with an average score of 5.6 for the former group and 5.7 for the latter. Economic freedom is essential for economic activities. 'Economic miracles' depend on the protection and promotion of economic incentives, at the centre of which are secure property rights and the ability freely and voluntarily to exchange such rights. Despite its importance in growth and development, economic freedom alone cannot solve the difficulties embedded in the course of development. For instance, in a society of high inequality, economic freedom in favour of the rich that results in greater inequality in the ownership of wealth will not help economic growth. Where it efficiently enriches one section of the society while pauperising others, economic freedom hampers economic growth, as it has been found that inequality is systemically associated with slow growth.[16] Therefore the effect of economic freedom on growth should be controlled by political freedom and income distribution.

Both the OECD and PA7 countries have low-income inequality, as measured by their Gini coefficients, which may serve as another indicator of policy polarisation. The relatively even distribution of wealth in these countries is conducive to growth, especially when – in combination with economic freedom – it enhances wealth acquisition for all or most social groups. Two variables show that PA7 countries differ from OECD countries. First, the incidents of revolution were much higher in the former than in the latter group. Second, political freedom was much lower in the former than in the latter. Domestic revolutionary movements engendered the relatively high frequency in the Asian Pacific Rim countries. For instance two separate forces – the Communist New People's Army and the Moro National Liberation Front – were waging guerrilla wars on the government of the Philippines during the 1970s. In every year from 1975 to 1990, with the exception of 1980, the Philippines was recorded as having at least one revolution.

In Indonesia, a crisis arose in December 1975 with that nation's invasion of the former Portuguese colony of East Timor. United Nations human-rights organisations claim that during the subsequent Indonesian annexation of East Timor the Indonesian army may have killed more than 100 000 people. Ongoing political tensions in the region eventually led to the death of pro-independence demonstrators at the hands of Indonesian soldiers in November 1991. Revolutions aimed either at independence or the overthrow of the government also occurred in Thailand, Korea and Malaysia. Figure 4.5 shows the frequency of revolutions in the seven East Asian countries.

Clearly, the relatively high average frequency of revolutions in East Asia was caused by one country, the Philippines, which recorded 24 revolutions during the period. By comparison Thailand had five revolutions, South Korea four and Indonesia three. There were none in Singapore and Taiwan.[17] Without the Philippines, the average number of revolutions per year in the region would have been 0.14 (compared with 0.33 when the Philippines is included). This would compare East Asia favourably to Latin America (0.30) and Sub-Saharan Africa (0.29). It does not seem coincidental that the two countries with the best economic performance, Singapore and Taiwan, had no revolutions during this period while the Philippines and Indonesia, the two East Asian countries where revolutionary movements were, for a while, most threatening, have had the lowest growth in the region.

The other political variable that separates the East Asian countries from the OECD countries is the degree of political rights. It should be understood that even though the average level of political freedom in East Asia is not as high as it is in OECD countries, or even in Latin American countries, it is not extremely low. The average political freedom level during 1975–90 was 0.454 for East Asia compared with 0.215 for Sub Saharan Africa, 0.50

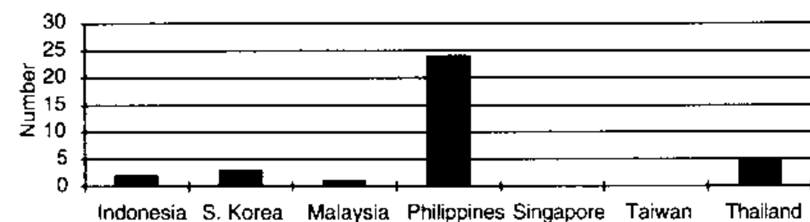

Figure 4.5 Revolutions in East Asia, 1975–90
Source: Adapted from Banks (1996).

for Latin America and 0.946 for the OECD countries. The role of democracy in economic growth should be understood in a broad and complex context. Democracy affects economic growth mostly through the indirect channels of reducing irregular government change, promoting private investment, improving human capital formation, alleviating income inequality and safeguarding economic freedom (Feng, 1999b). Democracy is likely to promote economic growth by relaxing these political and economic constraints where the accumulation of physical and human capital is slow, the probability of a military coup is high, income distribution is markedly unequal and economic freedom is lacking.[18] The role democracy can play in promoting growth is limited where economic freedom is emerging (for example Singapore), the chance of irregular government change is infinitesimal (for example Taiwan), savings and investment are abundant (for example Malaysia) and human resources have been vastly improved (for example South Korea). In the long run, however, these facilitating conditions for growth tend to erode if there is no transition to political freedom. The indirect effects of political freedom on economic development imply that the conditions favourable for marketplace and social environment will improve with political decentralisation and franchise, which will lay the political foundation for social and economic development. Political stability, economic freedom and policy cohesiveness have been contributory factors in the economic growth of some East Asian countries in the past three decades, which makes a difference between these countries and others, accounting for the varying growth trajectories uncovered in the second section of this chapter.

It should be understood that on their own none of the three conditions – political stability, policy consensus and freedom – are sufficient or necessary conditions for economic growth. If the government is very strong and the probability of its demise is extremely low, then political polarisation will not matter a great deal in terms of constraining the behaviour of people when reaching their political and economic decisions. Similarly, if there is no substantial difference between the government and its opposition, then the party in power may not be a crucial factor in economic decision making. Only when all three conditions are violated will the economy surely head towards a crisis.

The recent financial crisis provides an opportunity to examine the difference in policies and, more importantly, their outcomes given the shocks on the financial market. The next section provides a case study of Indonesia in the light of the theoretical discussion in this chapter.

THE ASIAN CRISIS AND THE INDONESIAN EXPERIENCE

East Asia's rapid growth came to an end in the early hours of 2 July, 1997.

> Bangkok's top bankers were awakened before dawn and summoned to a 6:30 a.m. meeting in a low-rise building facing Bankhumpron Palace, as the ornate Bank of Thailand headquarters is known. The nervous group was told the government was abandoning the baht's peg to the US dollar. When the market opened a few hours later, the baht plunged 15% against the greenback, creating a vortex that quickly sucked in the rest of East Asia.
>
> (Chanda, 1998, p. 8)

In the following months, currencies collapsed in Indonesia, the Philippines and Malaysia, causing massive business failures. Currency depreciation in these countries also created pressures in Hong Kong, China, Taiwan and Singapore, threatening the expansion of their economies.

The proximate cause of the Asian crisis can be found in the foreign capital flows into these economies from the USA, Europe and Japan in the early 1990s. According to the International Monetary Fund, by the end of 1996, East Asian countries had borrowed $318 billion from European banks, $260 billion from Japanese banks and $46 billion from US banks. Much of this was in the form of short-term loans. Next to Hong Kong and Singapore, the two main financial centres, the highest international borrowing was by South Korea ($100 billion), followed by Thailand ($70.2 billion), Indonesia ($55.5 billion), Taiwan ($22.4 billion) and Malaysia ($22.2 billion).[19]

The losses in the banking and composite sectors as a result of the financial crisis were substantial. The financial markets in all these nations suffered a massive setback. Speculative forces in globalisation and the lack of financial market rules and regulations in these countries caused the problems associated with the current crisis. The factors discussed in the preceding sections helped the rapid growth in East Asia, which attracted an undue amount of capital from the rest of the world. Meanwhile the domestic financial markets in these countries were still backward, partly due to imperfect political conditions and particularly due to the deficiency of political rights and civil liberties. The lack of a franchised political system or in experience in democratic rule meant that these countries were unfamiliar with or unprepared for a modern market system associated with political decentralisation and sound macroeconomic regulation independent of political motivation.

For the previous three decades the Indonesian economy had grown at an average annual rate of 7 per cent. In this broad-based growth period, the percentage of the population living below the poverty line dropped from over 60 per cent in the early 1970s to around 11 per cent in 1996 (Radelet, 1999). The Asian financial crisis of 1997 caught the world by surprise. In a period of months it wrecked the economies of the fastest growing region in the world. Among the Asian nations, Indonesia suffered the most damaging blow and its subsequent recovery has been the slowest. From July 1997 to October 1998 the equity market in Indonesia declined sharply, with a 90 per cent loss in its banking sector and 56 per cent damage to its composite index. In comparison Taiwan, Hong Kong and Japan sustained relatively light damage.

The Indonesian currency, the rupiah, lost nearly 80 per cent of its value. Many banks and corporations went bankrupt. Unemployment rose rapidly. For a time inflation ran at an annual rate of 50–60 per cent and several million people lost their jobs. The economy was severely disrupted. Some areas experienced serious food shortages. The value of real estate in the metropolitan areas dropped by 50 per cent. Riots erupted across the country, most of which were directed at ethnic Chinese, who made up 3 per cent of the population but controlled approximately 75 per cent of the nation's wealth. The world's fourth most populous nation with over 200 million people, experienced a major crisis. In 1997 it became the recipient of US$10.1 billion, the third largest bailout ever by the International Monetary Fund.[20]

The fundamental cause of the economic problems in Indonesia was a political one. The deeply divided society belied the appearance of political stability imposed by the government. In addition, economic liberalisation had provided only precarious and temporary relief to the ordinary people in Indonesia while tremendously enriching the families of the political elite. As discussed below, the narrowly based economic freedom in Indonesia hampered long-term and sustainable development, a process that was accentuated by the lack of political freedom and a polarised society.

Economic freedom in Indonesia was greater before the financial crisis than in the early years of its economic development. The measure of economic freedom had been on the rise and then stalled before the outbreak of the financial crisis in 1997. Even though the level of economic freedom in Indonesia ranks low in terms of the selected countries in the region, it is higher than in Denmark, France, Italy, Spain, Sweden, Greece, India, Bangladesh and Nepal, and about the same as in Belgium, Germany, Peru, Uruguay and Oman.

From the 1980s Indonesia made significant progress towards economic liberalisation. The government intended to activate its economy through a series of economic reforms. In the mid 1980 it introduced a series of trade and industrial deregulations to encourage producers to export labour-intensive manufactured products to the world market. Such products included textiles, garments, footwear, toys, furniture and electronics, 'creating millions of jobs in the late 1980s and early 1990s and lifting many Indonesians out of poverty' (Radelet, 1999).

Over the years, taxes were cut, barriers to trade were lowered and the economy was opened to foreign investment. Protectionism in Indonesia was considered low, with an average tariff rate of 6 per cent, though strict licensing was applied to a number of products such as rice. The dramatic rise in Indonesia's export industries had been an engine for economic growth in the past.

Indonesia reformed its foreign investment code to allow 100 per cent foreign ownership and to open many sectors that were formerly closed to foreign investment, such as electricity, telecommunications, shipping, airlines, railways, roads and water supplies. From 1969 no foreign banks were granted a license, but this restriction was relaxed in the late 1980s. Though foreign banks are still regulated in Indonesia, they are allowed to participate in the market through a joint venture with Indonesian domestic banks, which tend to gain independence from the government (Johnson and Sheehy, 1996).

Along with the relatively open and free structure of the Indonesian economy, 'Indonesia's regulatory environment is characterized by bribery, kickbacks and corruption. Many regulations are applied arbitrarily, and bribes may be necessary to receive an 'exemption' from a government regulation' (ibid., p. 169). Although the market is supposed to determine prices, government regulation has remained high. The government regulates the price of certain 'strategic' items (for example rice), setting price ceilings or floors. The government also uses subsidies to promote the agricultural sector. Government enterprises are often protected from market competition.

Moreover Indonesia does not have a modern commercial code system that is compatible with economic activities. 'The legal structure provides public officials with too much arbitrary authority. When the discretion of government officials replaces the rule of law, the security of property rights is undermined and corruption (for example, bribes, selective enforcement of regulations and favoritism) becomes a way of life' (Gwartney and Lawson, 1997, p. 117). Court rulings leave much room for inconsistency and arbitrariness. Finally, Indonesia has a very large black market (Johnson and Sheehy, 1996).

Indonesia opened its domestic capital market without first establishing a set of competitive and efficient mechanisms. Capital liberalisation before the establishment of sound domestic financial markets leads to inefficient

resource allocation. Capital inflows can cause serious consequences for the recipient country because of the market failures in the movement of factors and goods, as well as policy failures in achieving a consistent and credible domestic macroeconomic policy.

There has been a healthy debate on the sequence of opening capital and current accounts (see Feng, 1999c). Some countries (for example Chile and Taiwan) liberalised the current account first, followed by the opening or gradual opening of the capital account, while others (for example Uruguay and Argentina) prioritised the liberalisation of the capital account over that of the current account. In Indonesia the liberalisation of the two accounts seemed to be simultaneous. As certain sectors benefit from state protection or regulation, the inflow of foreign capital tends to be allocated to these protected yet inefficient sectors, causing distortion of the economy.

In Indonesia the inflow of foreign capital created financial instability, underlined by the lack of sound market mechanisms, despite the appearance of an open economy. The liberalisation of the capital market was premature and out of pace with the country's development. The capital market was opened too fast and too early, particularly in light of the absence of sound regulatory and supervisory institutions and the rampant corruption associated with the Suharto family.

From the 1980s domestic credit began to rise and a series of financial reforms aimed at liberalisation were launched in the late 1980s. The number of banks more than doubled from 108 to 232 between 1988 and 1993 (Radelet, 1999). The ill-regulated and ill-supervised expansion of the financial sector resulted in a tremendous increase in non-performing loans. Until the financial crisis, the increase in lending was dramatic. Taking into consideration the lack of sound market mechanisms, as discussed above, such huge amounts of lending implies that the degree of inefficiency and distortion in the market worsened in the 1990s. The seeds of financial disaster were sown.

When the financial crisis started in 1997, countries that had relatively open economies but lacked sound economic policies were hit hardest. Creditors quickly withdrew their lending and borrowers with huge foreign debts tried to cover their positions. The value of the US dollar against the rupiah increased from 2450 rupiah per dollar in the second quarter of 1997 to 3275 in the third quarter. By the second quarter of 1998 it had reached 14000. The Indonesian currency had fallen faster than the dollar had in the Great Depression (Lamb, 1998).

Prior to the crisis the families of the political elite had benefited from the liberalisation reforms. The Suharto family and their close circle of friends had controlled a large proportion of the country's economic activities.

The cronyism and favouritism associated with the first family had expanded as the ruler's children came of age in the late 1980s and early 1990s, when economic reforms had increased lucrative opportunities and imposed few constraints on their greedy enterprises.

> Foreign financiers, fully aware of the growing weakness of the financial sector and the corruption associated with the Suharto family businesses, were more than happy to finance these activities. After all, they earned high profits on these loans, and presumed (along with everyone else) that these protected enterprises could not fail and would be able to make all their debt payments.
>
> (Radelet, 1999)

With the end of Suharto's 32-year rule, most Indonesians feel robbed – they are suffering from the economic catastrophe but Suharto and his family are believed to have enriched themselves tremendously. The Indonesia Business Data Centre, a consulting firm in Jakarta, estimates that the family assets amount to 200 trillion rupiah – about $17.5 billion at the June 1998 exchange rate, or $80 billion at the 1997 rate (*The Economist*, 6 June 1998). The richest families in Indonesia benefited from an economic 'liberalisation' that was fraught with corruption. 'Corruption allowed elite business interests to trample on the rights of rural society and thereby exploit the forest

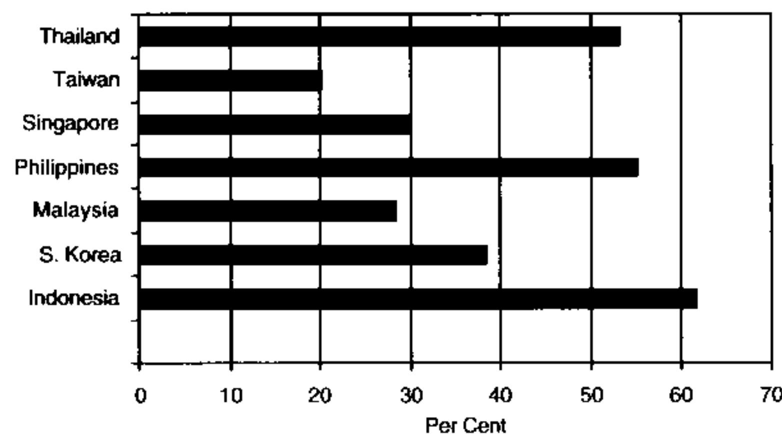

Figure 4.6 Percentage of total market capitalisation controlled by the 15 richest families
Source: Adapted from Claessens *et al.* (1998).

and mineral wealth without having to succumb to the niceties of the law or due process' (Root, 1999, p. 45).

Under such circumstances, economic liberalisation does not necessarily contribute to economic growth because there is no broad base of support for the national policy of economic development. Income inequality also implies that in the presence of economic difficulties the poor will suffer more than the rich, thus breeding political instability and violence, as demonstrated by the series of riots in Indonesia in the late 1990s. Figure 4.6 shows the percentage of total market capitalisation controlled by the 15 richest families. Indonesia ranked number one in this category, with the 15 wealthiest families possessing 61.7 per cent of total market capitalisation, followed by the Philippines (55.1 per cent) and Thailand (53.3 per cent).

It should be noted that after the financial crisis hit Thailand in July 1997, Indonesia seemed to adopt a classic liberalisation policy. It floated the rupiah, eased foreign investment regulations and refrained from spending its foreign reserves. None of this prevented the onset of the same crisis in Indonesia. What many fail to understand is that investors who had taken advantage of the weak economic system and strong political clout now started to exit the market because they anticipated that the worst was about to emerge.

A fundamental answer to the deterioration of Indonesia's economy lies in the contradiction between the country's economic liberalisation policy and its fossilised political system. Indonesia had been enmeshed in an incongruity of rapid economic liberalisation and slow political democratisation. Economic liberalisation had favoured the *nouveau riche* and the families of the political elite. Helped by speculative investors at home and abroad, they had been able to take advantage of the absence of a democratic legal system in order to get rich fast, thus contributing to the bubble economy that finally burst in 1997.

As Figure 4.7 demonstrates, Indonesia's economic freedom stalled in the mid 1990s, following its ascendance in the preceding decade. As time passed, political repression increased and Indonesia was left as the only fully autocratic country among the nations with which it is normally associated – the four newly industrialising countries (Hong Kong, Singapore, South Korea and Taiwan) and the four newly exporting countries (Indonesia, Malaysia, the Philippines and Thailand). The rest of this section explains the rise of political autocracy in Indonesia and its implications for economic development. It is argued that distorted economic liberalisation and rising political repression were responsible for Indonesia's crisis today.

The monopoly of politics by the political party Golkar in Indonesia severely retarded political freedom and civil liberty in the country; it also facilitated the influence of the political elite in business and economic affairs.

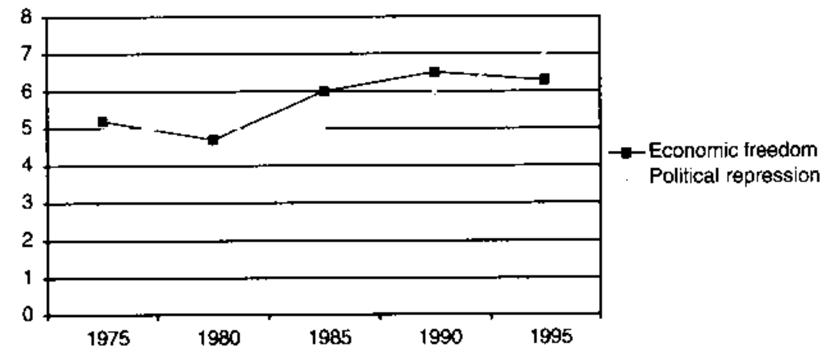

Figure 4.7 Political repression and economic freedom in Indonesia
Sources: Freedom House, 'Tables of Independent States: Comparative Measures of Freedom' (various years); Gwartney and Lawson (1997).

During Suharto's 32-year rule repressive measure were applied intensively in order to silence and neutralise the opposition. Interethnic, interreligious or interclass issues were prohibited from public discussion. Political parties with religious motivations were suppressed. The goal was to force cohesion among Indonesia's ethnic and religious groups. Despite this effort, polarisation in Indonesia underscored the political and economic crises in the country for years to come.

Emphasising authority, the political system reinforced Suharto's personal power, making him comparable to a traditional Javanese king (Demaine with Cribb, 1998). Suharto also enjoyed the support of the military, which occupied half of the provincial governorships (Mydans, 1998). Concurrent with the ascendance of statism, political influence in the economic sphere intensified, which thwarted the deepening of economic liberalisation.

> When the forces of reform hit up against the immovable object of political interests, reform makes a detour … the reason for the foot-dragging is that reform has reached the point where the only interests left unchallenged are those close to the hearts of some very powerful people … the business activities of the Suharto family blanket everything from cars, telecoms, petrochemicals, and toll roads to power plants, airlines, taxi cabs – and even birds' nests.
>
> (McBeth, 1998, pp. 128–9)

Political monopoly prevented true economic liberalisation designed to benefit the whole country, rather than a handful of the most powerful people and their families.

The contradiction between political freedom and economic liberalisation in Indonesia has been a source of economic crisis. We argue that one fundamental source of Indonesia's current economic crisis is the incompatibility of liberalisation programmes and the repressive political system. The double goals of political stability and economic growth were short-lived and crisis-ridden in Indonesia because of the incongruity and incompatibility of the two kinds of freedom discussed in this chapter. Without political liberalisation, economic liberalisation can lead to premature development and economic stillbirth. Indonesia's real challenge and opportunity lie in the institutionalisation of a liberal-democratic government that will deprive the ruling class of their political and economic prerogatives and restore the basic human value of equality and justice for all. Such a political system will foster the economic freedom that once existed but was stunted by a repressive government, and it will promote social and economic development in the long run.

CONCLUDING REMARKS

Political stability, policy consensus and social freedom (the latter including political rights and economic liberties) are the core of the political foundation for economic management. Their effects on economic growth have been deduced in a mathematical model and statistically tested on cross-country data (Feng, 1997; Chen and Feng, 1996). The case studies of the development experience in East Asia, and in particular the financial crisis of late 1997, have further supported our argument.

Those East Asian countries that have been able to maintain high growth trajectories in the past several decades have had stable political regimes and pursued economic policies that enjoyed broad-based support. In tandem with economic prosperity, some of these nations have made the political transition to liberal democracy while others are still struggling with their political identity and destiny.

Economic and financial globalisation has embraced these nations as a consequence of their export-oriented development strategies. Despite all the benefits associated with integration into the world economy, globalisation presents risks for developing economies, particularly in the case of those which lack a sound political foundation for the modern marketplace. Indonesia is one example of this point. Despite its high growth rates, the nation collapsed during the financial crisis. It can be argued that other nations in the region, including democracies (for example South Korea), also suffered from the recent crisis. However their political foundation (that is, political stability, consensus and freedom) and economic conditions

(for example the extent to which the country was integrated in to the world economy) determined the degree of damage they suffered in the crisis and the likelihood of a speedy recovery.

Democracy provides a stable political environment that reduces unconstitutional government change at the macro level; yet along with regime stability, democracy also offers flexibility and the opportunity for substantial change to the political system. This juxtaposition of macropolitical certainty and micropolitical adjustability should be regarded as the ultimate basis for sustainable economic growth and expansion. Such an argument forecasts a faster recovery in South Korea than in Indonesia and may serve as a theoretical insight into economic activities in East Asia and the rest of the world.

Acknowledgement

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Notes

1. Singapore became the first East Asian developing country to be classified as a developed country by the World Bank (January 1996), and Taiwan was classified as a free country for the first time by the Freedom House survey following its first direct presidential election in April 1996.
2. Quoted in World Bank (1993), p. 14. Note that this section uses GDP data from Summers and Heston (1995), which may differ somewhat from World Bank data.
3. Summers and Heston (1995).
4. Karatnycky (1997).
5. The theory of reproducible capital focuses on the fact that the way in which individuals allocate their time between various activities in the current period affects their productivity in future periods (Romer, 1986; Lucas, 1988).
6. Even if the policy remains the same, investment is still negatively affected by changes in the government's ability to carry out the policy. See Feng and Chen (1997).
7. See Cukierman *et al.* (1992).
8. Roemer (1995) uses a deductive model to show that potential government change in a democratic political system creates uncertainty because of the difference in policy between political parties. The difference in policy between opposition parties regarding unconstitutional government change should be even larger, thus creating a higher level of uncertainty.
9. The standardised coefficient estimates the predictive importance of the independent variables. Feng and Chen (1996) take into account the variation of the independent variable in the sample by multiplying the parameter esti-

mate by the ratio of the standard deviation of the independent variable over the standard deviation of the dependent variable.
10. See Ozler and Rodrik of (1992).
11. The sources are Gastil (1989) and Gwartney *et al.* (1996).
12. Revolutions are defined as any illegal or forced change in the top government elite, any attempts to bring about such a change, and any successful or unsuccessful armed rebellion whose aim is independence from the central government.
13. See Chen and Feng (1996) and Feng and Chen (1996) for the multivariate statistical results.
14. For similar definitions, see Easton (1965) and Sanders (1981).
15. See Feng and Chen (1996); Chen and Feng (1996).
16. See Persson and Tabellini (1994); Alesina and Perotti (1996).
17. The following are the years in which revolutions occurred in these countries. Indonesia: 1979 and 1990; South Korea: 1977 and 1979; Malaysia: 1977; The Philippines: 1975–79 and 1981–90; Singapore: none; Taiwan: none; Thailand: 1976, 1977, 1981, 1984 and 1985. Note that multiple revolutions occurred in some of the years. Source of data: Banks (1996).
18. Feng (1995, 1997b) has found that democracy promotes growth in Latin America and Sub-Saharan Africa where the structural constraints on growth leave a lot of room for improvement in respect of the relaxation of political freedom. See Feng (1995, 1997b).
19. See Chanda (1998), p. 10.
20. South Korea received an IMF bailout package of US$21 billion in 1997 and Mexico was rescued by an IMF package of US$17.6 billion in 1996.

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5 The Asian Economic Crisis: Three Perspectives on the Unfolding of the Crisis in the Global Economy

Hock-Beng Cheah

> There is a single set of events that dominates the world economic scene today as it has for more than a year: the global economic crisis that began in Thailand on July 2, 1997, spread from there to Indonesia and Korea, then to Russia, then to Latin America. Few countries have not been touched by the global forces that this crisis – by some accounts the worst since the 1980s debt crisis – has unleashed. Some countries have gone, in the space of a few short months, from robust growth to deep recession. The social consequences of this economic downturn are already manifest, with interrupted education, increased poverty, poorer health.
>
> (World Bank, 1999, p. ix)

INTRODUCTION

This chapter examines three perspectives on the so-called Asian crisis: (a) the perspective of international financial and development organisations, which emphasise deficiencies in the practices of firms and of financial and governmental institutions in Asia; (b) the perspective of Soros (1998) and Strange (1986), who perceive it as part of a broader crisis of the global financial system; and (c) an even broader perspective of the process and consequences of catching up and slowing down in the global system.

The International Monetary Fund (IMF) and others have promoted the term 'the Asian crisis' (IMF Staff, 1998) and initially treated the issue as predominantly an Asian problem, focusing narrowly on economic (and, more specifically, financial) difficulties. More recently the Asian crisis has become known as the Asian 'contagion', which has infected other parts of the globe such as Russia and Brazil (Walker, 1998). However it can be argued that the crisis is not only an Asian crisis but also a fundamentally global one. From this perspective, the principal reason why other locations