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3 The Institutional Basis of Asia's Economic Crisis

Christopher Lingle

The analysis of the Asian crisis offered in this chapter departs from an understanding of the nature of the interaction of economic and political institutions with market processes. A link is drawn between the underlying political culture and a set of institutional arrangements that it engenders. In turn, this institutional infrastructure defines a set of incentives within which economic decisions are made. Faulty institutions will send misguided signals such that decisions that appear to be rational when judged by internal criteria are proved to be irrational and inefficient when compared with external standards. A number of propositions or observations will be outlined and then explored.

First, the economic crisis afflicting East Asia after July 1997 can be considered as being self-inflicted in that it reflected a general failure of governance. In effect, the turmoil resulted from systematic politicisation of domestic financial markets. Policies of directed development were followed in most of the countries in the region. As such, investments for development were directed through banks while domestic capital markets were suppressed.

Second, it follows, then, that global capital flows were not the cause of the crisis. These footloose flows merely transmitted the message that the institutional framework of the East Asian economies would no longer be considered compatible with the demands of the international marketplace. Overall conditions of competition changed the rules of the game. Political and economic institutions that were once thought to help promote growth in the region began to serve as a drag. Judging from the resignation of former Indonesian President Suharto, global capital can now be seen as a liberating force that displaces dictators and inept rulers.

Third, East Asia's problems are deepseated and arise from elements of political culture and similar development policies that are evident throughout the region. As such, resolution of the crisis requires radical changes that must include the introduction of greater political accountability and increased financial transparency. Participation in the global marketplace will induce reluctant leaders to embrace modernisation of their political and economic institutions.

Fourth, before these economies can recover, they must first stabilise. Stabilisation can only begin after they reach bottom. Japan's state of arrested collapse that began at the end of the 1980s inspires little confidence that its neighbours can act more quickly or more resolutely. There are no good estimates of how much longer Indonesia will experience economic decline. Even though there are some encouraging signs of progress in South Korea and Thailand, the crisis is in the early stages in Malaysia and Singapore.

Fifth, recovery from the crisis involves a long-term structural adjustment. These problems are not merely a brief cyclical downturn. Restoration of confidence in Asia's economic future, and with it the return of foreign capital, will depend on a willingness to abandon culturally imbedded institutions. This may require decades or even generations.

Sixth, there is widespread misunderstanding of the modernising process brought about by the global economy. An oft-repeated confusion is that modernisation is linked to Westernisation or even Americanisation. Such suggestions are misplaced and smack of an inappropriate sense of cultural triumphalism (Lingle, 1998). Modernisation is a universal process and is best interpreted as the implementation and evolution of individualist-based institutions.

WHY (FREE) INSTITUTIONS MATTER

Institutions are systems of rules, conventions, laws or customs that serve as enabling mechanisms discovered through the process of human interaction. Such arrangements emerge and endure inasmuch as they reinforce stability within a community or facilitate change by reducing uncertainty. The rule structure of institutions provides an aspect of predictability in the course of social interplay. This predictability arises from the incentive structures embodied in the institutions that guide individual choices and shape the social impacts of these decisions.

Since institutions define incentives and impact on choice, the overall institutional arrangements have considerable economic import. In particular, markets both depend on and set the stage for the emergence of a contract culture and commercial morality. In turn institutional frameworks will evolve to reinforce and reward or punish actions in reference to the agreements and the legal institutions that support them.

Virtually every country in the world has voluntarily undertaken to participate in the international market economy. Therefore success, as measured by sustainable growth, will require an environment that is compatible with markets.

Countries with institutions that provide strong protection of property rights, along with relatively low costs for innovations, can be expected to have economies that perform better. An effective system of property rights vests the ownership and control of productive properties and means of distribution in private hands. These rights require a firm legal underpinning that includes constitutional guarantees, effective laws and an independent judicial system with the will and ability to ensure enforcement. The qualities of innovation and receptivity to change are not limited to the economic realm and should include politics. In this latter regard, valuable lessons might be learned about political and corporate accountability associated with the rise and decline of the East Asian economies.

Cultural change and economic growth reflect the speed of learning expressed through the learning process. Entrepreneurial action is the search and application of new knowledge that occurs when there are adequate pay-offs from the expense of their quests. As such, institutional arrangements that are based on openness and encourage competition will offer greater opportunities for entrepreneurial innovation. In contrast the presence and enforcement of monopoly, imposed by government mandate, will retard learning and put a brake on economic growth. Consequently a strong case can be made for the linkage between economic liberty, as seen in institutional arrangements that promote free markets and high growth.

THROUGH THE PAST, BRIGHTLY

While the pace of material advance in East Asia since the early 1970s has been admirable, the idea of an ascendant 'Asian century' has proven to be fraught with difficulty. One crucial flaw was that it was based on an understanding that expanding international trade is a zero-sum game, with Asia portrayed as a 'winner' at the expense of 'losers'. Second, continued success with high economic growth has proved to be more difficult than predicted by those who assumed that it would arise from a simple extrapolation of past performance.

A fruitful approach to understanding the past and anticipating the future for East Asia lies in an examination of the institutional arrangements and development strategies common to much of East Asia. This requires a long view combined with an understanding of the requirements for market-driven growth to be sustainable. Following this line of reasoning, there is good reason to doubt a rapid return to stability and a recovery in the high growth rates once enjoyed by the economies in the region.

The inherent conservatism and inflexibility of East Asia's economic and political institutions was once widely seen as the basis of high growth in

the region. However it has become clear that the institutional arrangements were incompatible with the demands of an increasingly efficient global market. In particular the boom period for many East Asian economies was coincidental with a form of corporatism as a guiding paradigm for economic development. This framework involved a close cooperative relationship between politicians, technocratic bureaucrats and an established business elite, often with the collusion of trade unions. The German and French economies have operated along these lines, where 'insiders' oversee policies to protect their special interests, which often serves to disadvantage 'outsiders'. In general, outsiders are consumers who pay higher prices and have less choice, workers not covered by the arrangements or small or medium sized firms that are or will be new market entrants.

Asian traditions act upon economic and political structures to create a regional variant, identified here as 'Confucian corporatism', that reflects corporate practices familiar elsewhere. For example key elements of Confucianism such as 'filial piety', 'saving face' and 'society above self' serve to reinforce the hegemony and hierarchical political structures of Asian corporatist arrangements. In Japan this arrangement became known as an 'iron triangle' (Richter, 1999), wherein bureaucrats, businesses and politicians work together in close consultation.

Corporatist arrangements are credited with increasing harmony and cooperation in the workplace, but they might simply have been coincidental with initial high rates of economic growth. Corporatism was also associated with the 'miracle' economy of postwar Germany. However it is likely that the current economic malaise in both countries has arisen from rigidities associated with their institutional arrangements.

Historical experience suggests that corporatist institutions suffer from internal contradictions in that they spawn rigidities in economic relations that retard economic growth rates. Ironically the institutional arrangements previously said to be part of the winning formula for many East Asian regimes are undermining stabilisation and inhibiting recovery of their economies.

For example the growth strategy of most East Asian countries included substantial government involvement. This included government-directed investment, funded through taxes and forced savings. In addition governments often guided bank lending to promote export-oriented industries and offered subsidies and tax incentives to multinationals. This was combined with capital-friendly policies to encourage foreign direct investment and technology transfers.

But most of these policies can only be part of a short-term strategy. In the face of economic fundamentals, subsidies are unnecessary. Indeed they

are economically irrational since they have no positive net impact on jobs. Such attempts to protect employment in one sector generate price distortions and the misallocation of resources in other sectors to offset job losses.

In sum, most governments in the region overlooked the necessary development of their infrastructure for their modernisation. While prudent actions were often undertaken to provide physical infrastructure (roads and railways, communications, seaport and airport facilities), there was a neglect of intangible infrastructure expenditure and human capital investment. In general, this meant that the institutional arrangements were not in place that would make their economies compatible with the changing demands of the global capital market.

The presumed successes of the Asian model provided a cover for the dysfunctional democracy of one-party or one-family regimes. In most East Asian regimes, political longevity was seldom due to the true and unshakable approval of their citizens. More often than not, electoral success reflected a grip on power based on either the carrot of cronyism or the stick of fear. More benign methods involved coopting key elements of the civil society through trade unions, guided by supporters of the regime, filling key university posts with sycophants or concocting laws to tame the media.

An underlying element of the crisis emerged from the politicisation of the domestic financial markets throughout the region. Their policy of directed development involved a purposeful weakening of capital markets so that commercial and industrial investments were directed through the banking system. Bank managers were much easier to control than the millions of individual investors participating in open markets for equities and bonds. Government-directed investments and subsidised interest rates resulted in massive conglomerates such as the Japanese *keiretsu* and Korean *chaebol* diverting vast funds into non-economic activities.

On the one hand, stunting the growth of long-term debt markets supported the policy objectives of the government but encouraged domestic capital to be used inefficiently. On the other hand, in absence of an active domestic bond market, foreign portfolio funds went into the stock market. But the heavy reliance of corporate enterprises upon bank financing meant that equities were thinly traded and proved to be vulnerable to fickle foreign capital flows.

ECONOMIC GROWTH: INSPIRATION, PERSPIRATION, LUCK...?

A key element of the catch-up process in much of East Asia was the shift of labour and other resources from agrarian production towards

industrial output, especially in Japan, Korea and Taiwan. As these economies modernised, labour resources were released from farming and were combined with increasing numbers of women seeking employment. This massive mobilisation of the overall labour force allowed a substantial boost in production when combined with new capital investment.

The consequence of this input-driven approach to growth became the object of an interesting and lively debate, stimulated by Paul Krugman in an article in *Foreign Affairs* (Krugman, 1994). Krugman pointed out similarities between the East Asian experience and the early stages of development in the USSR. Although many of the East Asian economies have made large expenditures on physical and human capital, these actions are non-repeatable.

In this context, economic growth in much of East Asia has arisen from massive increases in inputs that will inevitably boost output, at least initially. Growth may continue, but it will increase at a decreasing rate. Without gains in productivity, the rates of growth will eventually decline. An economy with high rates of investment will eventually attain a higher level of income than one with lower rates of investment, but income gains will experience diminishing returns. Furthermore, since investment involves the sacrifice of current consumption, excessive levels of saving and investment will reduce economic welfare.

Maintaining increases in productivity became more difficult as operating costs rose rapidly in most of the high-growth regions of East Asia. With rising costs exceeding productivity gains, production facilities began to migrate to areas with lower costs and greater profit opportunities. This problem may become more acute in China. In early 1996 the Beijing regime rescinded the tax breaks that were previously offered as a lure for new foreign investment. Meanwhile the costs of housing for expatriates in controlled property markets have soared, and there is continued interference and financial impositions by corrupt officials. There is also a scarcity of skilled labour and management talent, and delivery costs are rising due to regulations in the transport industry. There will have to be substantial increases in productivity gains or growth will begin to slow dramatically.

While the economic logic in the Krugman logic is intact, the crisis afflicting East Asia did not stem from this process. In this sense, Krugman was right about the fact that growth would slow in East Asia, but for the wrong reason. Problems with returns to scale would probably not have arisen until well into the next millennium.

Indeed the 'miracle' growth of the East and Southeast Asian economies may be no different from the high-growth record exhibited by other countries

during the early stages of development (Witley, 1992). Most East Asian economies relied heavily on off-the-shelf technology and access to markets in the mature economies to fuel their growth. If they fail to develop their own domestic entrepreneurial talent and promote self-generated technological advance, the East Asian economies will be followers instead of world-class leaders. Like Germany and America prior to the First World War, the East Asian economies have benefited as much from expanding product and resource markets as they have from their own development strategies.

The sustainability of economic growth has also been undermined in those countries which depend heavily on the exploitation of non-renewable resources. The limit of this was reached in the Philippines during the 1970s and it is now becoming apparent in Indonesia and Thailand. The obsessive drive for adding to material wealth in the short run may lead to a serious deterioration of the environment in many of the Asian countries. In many cases, such problems have arisen out of the type of government action that leads to overzealous exploitation as politicians and bureaucrats scramble to cut themselves in on sweetheart deals.

AUTHORITARIANISM, COLLECTIVISM AND ECONOMIC GROWTH?

The East Asian crisis has caused a number of casualties in respect of views on the role of governments in economic development. The first is the myth that authoritarianism is good for growth. A corollary to this view stressed the importance of political connections as a necessary and sufficient condition for business success in the region. Another mistaken view was that collective decision making would provide superior results than reliance on individualist-based institutions.

Many Asian cultures rely on methodical deliberation to reach a voluntary or enforced consensus. This reflects a belief that the imposition of order provides better results than the messiness associated with the open discourse of competitive processes. However a good case can be made for encouraging the involvement of a large number of free thinkers when issues become increasingly complex. My own experience as a professor has revealed that uninitiated students ask the most interesting questions and answers because they do not know better!

Much of the now dormant debate revolved around claims that the Asian version of democracy combined the 'positive' features of authoritarianism

with popular rule. Authoritarian regimes invoked the notion of 'Asian democracy' to provide a legitimising veil while they restrained all modernisation and change that threatened to disrupt the political *status quo*.

One serious side effect of the institutionalised collectivism that is common in parts of East Asia will be an accelerated 'entrepreneurial brain drain'. The discouragement of institutions that promote individualism frustrates native entrepreneurs, who are likely to seek a more hospitable environment outside the region. An entrepreneur does more than buy low and sell high. It is unlikely that ersatz entrepreneurs will have the innovative spark of those true entrepreneurs who improve market efficiency by exploiting market share opportunities or instigating changes to the rigidified policy framework. The subsequent shortage of domestic entrepreneurial talent will eviscerate one of the most important internal sources of innovation-based development. Consequently these countries are likely to remain dependent on foreigners for access to markets and creative invention.

Despite its potentially disruptive impact on one-party politics, the high-growth Asian economies must allow increased flexibility and efficiency in information flows as a precondition for future production. Just as continued world economic growth depends on a regime of expanding free trade in goods and services, the modern global economy requires access to and production of knowledge-based commodities. Social progress also depends on open competition among political and cultural institutions, regardless of their geographic origin. Unfortunately many Asian authoritarian regimes have imposed a form of 'cultural protectionism' that is designed to inoculate their citizens against modernising influences that might encourage the liberalisation of individual rights and freedoms. However impediments to cultural and intellectual exchanges are likely to be as self-defeating as politically inspired trade protectionism.

The daunting challenges of the ongoing crisis are especially problematic for the authoritarian regimes in the region. This is because successful resolution will involve choices that are antithetical to one-party regimes. On the one hand, an inability or refusal to adapt to the constantly changing realities of the globalised economy will postpone the process of stabilisation and push recovery further into the future. This undoes the claim of delivering prosperity in return for popular support. On the other hand, relaxation of government economic controls will, *per se*, undermine the basis of political dominance. Furthermore the increasingly complicated political relationships that inevitably accompany economic modernisation will undermine the management and control capacity of authoritarian leaderships. In the long run, East Asian authoritarian regimes must either adapt or die, a choice faced by all economies.

GOVERNMENT FAILURES AND CURRENCY CRISES IN EAST ASIA: OVERINVESTMENT OR MALINVESTMENT?

If Krugman was wrong about what went wrong, what is the explanation of the business failures in East Asia? The surprise and confusion over the currency and financial crises sweeping through the region in late 1997 and early 1998 reflected the belief that the fundamentals were intact to promote economic growth. A report by the World Bank in 1994 praised the East Asia leadership for getting the 'basics rights' (World Bank, 1994). This notion must have been in part wishful thinking, since there would be no discussion of a long-term crisis if the fundamentals had been in place.

Following conventional wisdom, observers have interpreted the turmoil sweeping through the Asian economies as evidence that markets are irrational and unstable. A common notion is that the East Asian economies were victims because they went too far and too fast in liberalising their markets. It seems as if the discussion of the East Asian development has been locked into ideological confrontations between left and right in the West – with an ensuing loss of clarity and logic.

Most East Asian governments pursued a policy that provided government guarantees of subsidised loans to specific producers for an expansion of their operations that exceeded market rationality. But it is not easy to see how these guarantees could lead to *most* companies overinvesting even when they had access to foreign savings. Government subsidy costs would simply be very high. Massive and unpopular conversions of domestic savings into taxes to pay the subsidies would then follow.

The problems confronting East Asia have arisen from a concentrated mass of distorted investments because government guarantees distorted incentives that encouraged investment based on technocratic or political considerations instead of commercial viability and profitability. In the absence of properly functioning domestic capital markets, funds were squandered on ill-conceived projects that exposed their economies to the non-compromising market logic of global capital.

Such malinvestment occurred directly through public spending or the promotion of government-favoured businesses, such as South Korea's *chaebol*. However, such misdirected investments were principally inspired by monetary or credit policies. In turn, illusory signals arose so that consumers and the business community misinterpret increased money and credit flows as real, permanent changes in the economy instead of mere monetary changes.

Unfortunately, government-guaranteed investments divert funds that might be placed elsewhere in more economically rational applications.

As rates of interest are forced down through credit expansion, there is an illusion that certain activities will be more profitable, especially in higher stages of production. In effect production is misdirected by artificial changes in relative prices.

The extent of malinvestments depends on the vigour of the induced expansion. The vigorously manipulated expansion in East Asia simply ran into a financial wall, which was the cause of the abrupt decline in production in the region. As investors began to understand that the boom was unsustainable, speculative pressures were brought to bear. Although condemned by governments in the region, the motivations behind the speculative actions were homegrown. Speculators were acting as countervailing forces to the counterfeit expansion and provided a force that burst speculative bubbles throughout the region.

Every speculative bubble eventually bursts when consumers and producers realise that changes in activity are based on an inflationary surge. Governments must then choose whether to curb the inflationary consequences of their loose credit policies, or succumb to self-correcting forces triggered by inflation. Inflation will expose and restore the actual relations in the economy – prices will rise, relative prices will change and exchange rates will fall until a balance between the different parts of the economy has been reached.

Asia's problems have been heavily compounded by industry policies that have created their own malinvestments and added to those created by inflation. Even in the absence of inflation such policy-created malinvestments have the effect of slowing down productivity growth. The logic of market economics suggests that when politicians and bureaucrats rather than the market allocate resources, there will be a decline in the rates of return on capital and productivity. Only markets allocate to generate conditions of the highest efficiency.

Much attention has been given to the degree of corruption in Asia and its role in the recent financial events. While corruption added to the turmoil, it did not create it. Even in the total absence of corruption the meltdown would still have happened. Interventionist policies that politicised financial markets made it inevitable. The blame for East Asia's crisis lies with a failure of governance, not speculators or irrational investors or market imperfections.

TRUTH HURTS: WHY THE EAST ASIAN CRISES SURPRISED SO MANY

It is interesting to consider why the economic turmoil in the region was not better anticipated. There was no conspiracy of silence; however there

was a pattern of slinking away from the truth. Many Asia watchers who were unable to anticipate what lay ahead apparently chose not to see. While some were bereft of an understanding of the economic fundamentals behind the operations of markets, others suffered from conflicts of interests that kept them from offering an honest appraisal. Rating agencies were of little help. As in the case of the Mexican peso crisis, their warnings lagged behind newspaper reports that were themselves both tardy and too often uncritical.

In fairness, few journalists have the training to sniff out theoretical or practical inconsistencies in economic policies. And custom or legal restraints thwart even those with the ability or inclination to ask the sort of tough questions that might reveal such disharmonies. Many Asian countries require questions to be submitted in advance. In many other countries press restrictions or the rough handling of 'uncooperative' journalists runs the gamut from assassination to blatant censorship to limiting the circulation of periodicals to expulsion. Local media often face similar or even heavier constraints, plus a lower level of investigative initiative based partially on social conventions. For example it was nosy foreign journalists who uncovered most of Japan's big political scandals and local coverage followed the presentation in the international press.

Foreign diplomats assigned to the region or visiting politicians are congenitally loath to criticise or challenge conventional wisdom. Indeed many people assigned to the region bought into the idea that the Asian model represented a third way between free market capitalism and socialism (Arogyaswamy, 1999). Consequently they were incapable of seeing the rot beneath the surface, arising from fatal contradictions with the demands of the global economy.

International bureaucrats at the IMF and the World Bank were no better than foreign service personnel, even though they had or could have had access that would have alerted them to impending problems, for example the IMF and the governments of the affected countries were aware of the imbalances in the financial sectors of the crisis economies. In particular the excessive accumulation of short-term debt was public knowledge, but no steps were taken to rectify this problem.

Then there were investment houses and brokers who were mostly mute or irredeemably bullish on East Asia, especially those trying to sell the junk paper offered by many of the regimes. There was also the characteristic lack of independent analysis among the region's academics that was combined with weak political opposition. The tendency for persistent dominance by a particular political party, often leading to a single-party state, meant that parliamentary challenges were unheard of and inquiries into potential economic disorder were few and uncritical.

Behind much of the unwillingness to see was an abiding belief that political connections were sufficient to ensure profitability. At the same time there was a presumption that authoritarian regimes were inherently stable and would contribute to economic growth. Based on these myths, political risks were underestimated and financial risk was simply set aside, because with political support losses could be passed on to local taxpayers.

East Asia's economies exhibited a series of flaws that led to an avoidable doom. Unfortunately there were few rewards for telling the truth and punishment was often excessive for those who were willing to be critical.

GLOBAL CAPITAL AS LIBERATOR OF THE MASSES

Global capital flow has become the vanguard of a new revolution. It has undermined despotism, revealed the unsustainable nature of corruption and motivated change in policies that curtail domestic competition or impose the high costs of protectionism. A key to understanding this process is that capital can no longer be thought of as having a specific national base. A world without national capital is one where attempts by governments to control or restrain capital will cause it to migrate. No hegemonic forces or small groups of financiers control the capital markets. The migration of capital reflects the will of the many small individual savers in all countries who require their funds to be placed prudentially so that risk is balanced against return.

Although there will be substantial adjustment costs, in the future there will be rounds of vigorous institutional competition that will lead to the discovery of arrangements that best attract capital. This 'race to the top' will mean that those countries with the most attractive arrangements for capital will be rewarded with the highest rates of economic growth and job creation.

Successful economic development in the future will depend on a number of conditions that shape and define the so-called global economy. Perhaps the most important momentum behind the internationalisation of economic activities arises from the high degree of capital mobility. The capacity of capital to migrate and reside elsewhere more or less at will ensures that the search for the gains from trade arising from comparative advantage is temporary, elusive and increasingly contested. It will be increasingly important for countries to develop greater flexibility and responsiveness in their economic and political institutions. Otherwise the automatic adjustment mechanisms that contribute to stability and aid growth will be obstructed.

Countries wishing to be players in the global marketplace will have to face up to the implications of this simple observation. It will be important to countries in the early stages of development that might pursue development through the promotion of export-oriented production, and the more advanced economies that need to tease higher rates of growth to keep living standards high and unemployment low in order to maintain social harmony.

Aspirants in the global marketplace that wish to remain competitive and enjoy economic success will be guided towards policy mixes and institutional arrangements that are flexible and responsive. Otherwise industrial and commercial aspirants will lose market share to competitors while national economies will experience an exodus of capital. In the event of a truly global economy, the institutions of every country will be affected by external shocks generated by repetitive waves of competition. Those countries with inadequate institutional flexibility will simply break down in face of these challenges. Indeed this is what happened when the East Asian economies stumbled at the first hurdle in July 1997.

On the micro side, small and medium-sized enterprises will be well placed with nimble responses to exploit niche opportunities. This will work best in situations where there is extensive domestic competition among firms, including allowing foreign producers in to contest local markets. On the macro side, capital-friendly policies combined with a liberal trade regime will increase and enhance linkages with international markets that facilitate trade and capital flows.

There are risks and challenges associated with such arrangements, not least of which is the risk that upsetting traditional relationships will lead to some political instability. However the political stability associated with the cosy relationships between many Asian governments and commercial interests has proved to be a recipe for disaster.

Unfortunately there is impatience with certain aspects of progress in developing countries, whether with emerging economies or not. In essence there is a presumption that the institutional infrastructure required for long-term success in the global market can be implemented overnight. Optimists who wish good things for the region as well as apologists for 'Asian values' tend to overlook several deficiencies in the institutional environment of the region. Many governments have embraced the voting rules associated with democracy (majority rule elections). However the mere superimposition of such trappings on a collectivist culture creates a number of internal, perhaps fatal contradictions. In the conservative political culture of much of East Asia, vigorously contested, multiparty elections are far from the norm. One-party and one-family states dominate the civic landscape.

Most countries in the region pursued similar policies for growth, whereby export-led, 'directed' development involved the politicisation and underdevelopment of domestic capital markets. Not only did this provide opportunities for corruption and nepotism, it also led to substantial malinvestment, whereby funds were directed towards projects with little or no economic merit or commercial viability. Indeed the hundreds of billions of dollars in bad debt burdening the region arose principally from these homegrown circumstances.

As a matter of policy, industrial and commercial investments were funded principally through the banking system. This approach allowed for greater political control over investment flows since bank managers could be influenced to direct funds toward activities or sectors favoured by technocrats or politicians. While some investments were based on technocratic inspiration, political considerations and cronyism drove many others. In all these cases, proper risk analysis was not seen as necessary since government support meant that profits would be privatised and losses would be nationalised and paid by taxpayers.

In contrast, controlling capital markets is similar to herding a room full of cats. Participants are independent and disconnected, with disparate plans. What links them is a desire for some sufficiently high rates of return relative to associated risk by demanding that asset managers exercise due diligence in seeking adequate information.

The inefficiency of the underdeveloped domestic financial markets meant that most of the economies in the region were dependent on international capital. In contrast to comments by Malaysian Prime Minister Mahathir, the exposure of East Asian economies to the whims of global capital reflects policy decisions by governments in the region. It reflects the outcome of their failure of governance and is not a neocolonial conspiracy.

East Asian leaders did not seem to realise that by engaging in the world trading system they were riding a tiger. As in Indonesia, this tiger is global capital markets that dethrone autocratic or inept governments. It will come as a shock to Marxists that the greatest force for democratic change and freedom is global capital.

MODERNISATION AND INSTITUTIONAL REFORM

Much of the high growth experienced by the East Asian economies reflected the extension of the radical changes that Margaret Thatcher introduced to the world. The familiar core of her reform package included the

privatisation of state-run enterprises and extensive deregulation to increase competition, and the opening up of the country to international investment.

Many countries wishing to introduce Thatcherite reforms of their capital markets failed to understand that the most crucial requirement was supportive institutional arrangements. This oversight was not accidental since it would require a dramatic change in their respective political cultures. In sum, the full benefits of interacting in a market-based global economy require an ascendancy of individualist-based institutions. As such there must be a shift from collective decision making and control towards arrangements where individuals play a decisive role in shaping political and economic outcomes.

In a macro context this implies increased democratic involvement by citizens and greater accountability by politicians. At the same time, arbitrary rule by rulers or ruling parties has to be replaced by non-arbitrary outcomes governed by the rule of law. In a micro context, expanded individual and private property rights allow for greater self-ownership by each and every market participant. This allows for entrepreneurial-driven growth and provides greater corporate accountability.

There are few countries where Thatcher's wisdom has been completely implemented. However it is in East Asia where the contradictions wrought by incomplete implementation have been so fully and fatally exposed. Throughout most of East Asia, governments intervene extensively in the workings of the market. Political considerations too often reflect inept and inappropriate interference with the logic of the market and are motivated by a collectivist mentality. The resulting economic and political institutions tend to limit individualism. Political slogans such as 'society above self' and 'the exposed nail is hammered down' express the collective instincts that are reflected in many of East Asia's institutions.

For many it is counterintuitive that individualist-based institutions can provide social harmony. The political philosophy in favour of 'Asian values' gains its deepest inspiration from the idea that individuals should transfer power and initiative to collective institutions. The rapid economic change in East Asia has – after almost twenty years of phenomenal growth – reached the point of social development where it is clear that individualist-based institutions are the logical and necessary outcome of the process of modernisation.

Civil society reflects the spontaneous emergence of voluntary associations of individuals in order to limit abuses of power by governments, groups or other individuals. These associations may support special interests (such as trade unions or producer groups) or seek to promote general interests (such as freedom of speech as advanced by a free, open media).

These groups serve to offset the type of authoritarianism advocated in the 'Asian values' concept and liberate individuals in a way that is implicitly criticised by the same philosophy.

The market can act as a civilising force on individuals because economic exchange becomes more impersonal. Economic arrangements in emerging economies tend to be based on personal relationships that limit the scope of exchange. Under these conditions there is little mutual trust outside narrow groups defined by personal, ethnic, racial, regional or other characteristics. Those who do not possess these specific attributes are generally the objects of discrimination. The ethos of the group may even endorse the cheating of others.

In more advanced markets there is tendency to break down discrimination. Individuals expand their scope of trust and respect for others in order to expand their market reach to increase their wealth. Market processes also expose people to the need for compromise and provide greater confidence in surviving what may initially appear to be chaotic change.

The economies of East Asia have been characterised by communal, personalised institutions wherein individual attributes are not valued so are sometimes discouraged. Herein lies an important development problem in the Asian model. Since entrepreneurs are the true engines of change and economic growth, their actions are the key to sustained economic growth. Entrepreneurs are essentially individualists who aim to break up the economic or political *status quo*.

Activities initiated by individual entrepreneurs are often described as part of the 'creative destruction' process. Economic innovations destroy older structures because of their higher productivity (Schumpeter, 1976). An open economy introduces creative destruction through trade and capital flows even if domestic innovation is low. This process works against the cosy relationships and the ideal of social stability that have historically existed between most East Asian governments and conglomerates such as the *keiretsu* in Japan and the *chaebol* in Korea.

Similarly the high value of consensus evident in East Asian political culture is counterproductive to the modern market economy. The search for political harmony has often resulted in limits on free speech and the secretive protection of information flows in order to control or shape public opinion. These actions further restrain the entrepreneur by restricting access to information that would inspire them to create new products or services.

The East Asian crisis can be interpreted as part of the ongoing struggle in the competition between modern, individualist-based institutions and conservative, collectivist institutions. Resolution of the economic crisis in

East Asia will occur only when there is deeper commitment to the lessons of Thatcher's grand experiment.

INTO THE FUTURE, DARKLY

The simple explanation for the decline of East Asia's 'miracle' economies lies in the incompatibility of their political and commercial institutions with an increasingly efficient global capital market. While these arrangements worked under other conditions, they did not allow for a ready response to the external competitive shocks that visited their shores.

Ultimately, those countries with the most flexible and efficient institutions that can support responsive economic arrangements will attract foreign capital. These conditions underlie innovation-driven growth, which differs from the sort of catch-up growth experienced by most East Asian economies. Innovation-driven growth is long-lived, because creative problem solving and invention constantly rejuvenate it.

In contrast, although catch-up growth may appear to be meteoric, it is short-lived because it only represents the belated incorporation of technology or ideas developed elsewhere. Thus governments characterised by strict and inflexible hierarchical rule will inadvertently hinder high rates of economic growth by stunting innovation. In the context of global mega-competition, such a politically self-serving approach is fatally flawed. Unless these governments can create an intellectual environment that is conducive to technological innovation, the 'miracle' of Asia's stunning economic successes will be short-circuited. Unfortunately the East Asian economies faced the same sort of catastrophic contradictions faced by the communist economies. In the end, the prospect of an 'Asian century' was no more likely than a 'Soviet century'.

According to the 1999 Global Competitiveness Report of the World Economic Forum, prepared in collaboration with the Harvard Institute of International Development, China (World Economic Forum, 1999), Indonesia, Japan, South Korea, Taiwan, Malaysia, Thailand and the Philippines rank quite low in technological capability and in the quality of their governmental institutions. To a considerable degree their lack of technological capacity reflects a dearth of research collaboration between universities and industry, and there is a serious shortage of qualified scientists and engineers.

The next century might best be characterised as the beginning of a 'Global millennium', where competition among institutions and cultures is as vigorous as any competition in goods and services. This new order of

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.