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# THE POLITICS OF THE ASIAN FINANCIAL CRISIS

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The Asian financial crisis of 1997–99 came as a shock to both the economics profession and the international policy community. Few inside or outside the region had foreseen the depth of the economic problems that followed, and a rich body of writing quickly emerged to offer competing post-mortems. Much of this analysis, however, was limited to purely economic factors. Beyond some references to moral hazard and cronyism, the political dimensions of the crisis were largely ignored.<sup>1</sup> Yet political factors are crucial to understanding the course of the crisis as well as the ways in which governments responded to it.

Here I want to explore three issues posed by the crisis that are also of broader relevance in assessing how developing countries with open economies cope with the political challenges of increased capital mobility. First, how did different types of government (democracies, dictatorships, and varieties of each) fare in managing the crisis? Second, how did the crisis affect the relationship between business and government? Will East Asian governments, even after enacting reforms in the wake of the crisis, have the political capacity to provide an effective counterweight to private business power? And third, how will these governments manage the social consequences of their countries’ integration into the world economy? Answering these

questions may also provide some insight into the future of the “Asian model.”

When countries exhibit signs of financial vulnerability, the reaction of markets is based in part on expectations of how governments will respond. When crises actually break, an even wider array of actors sit in direct judgment on a country’s adjustment efforts, including international financial institutions, ratings agencies, financial analysts, banks, and institutional investors. Their assessments also are influenced by political expectations. They are concerned, above all, with the ability of governments to act decisively, coherently, and predictably.

We can gain some insight into how different types of governments react to severe policy challenges by focusing on six administrations in four East Asian countries. Four of these were in democratic regimes, two in Korea’s presidential system (the administrations of Kim Young Sam and Kim Dae Jung) and two in Thailand’s parliamentary system (those of Chavalit Yongchaiyudh and Chuan Leekpai); one was in a semi-democratic, dominant-party parliamentary system (that of Mahathir Mohamad in Malaysia); and one was in an authoritarian system (that of Suharto in Indonesia). This sample is clearly too small to say anything definitive about the politics of crisis management, but it is useful for revisiting some longstanding issues about the economic and policy performance of different types of regimes and governments.

### **Thailand and Korea**

There can be little question that certain features of democratic politics in Thailand and Korea diminished the capacity of their governments to respond effectively to warning signals and increased uncertainty, although the reasons were different in each case. In Thailand, the problems were more fundamental.<sup>2</sup> All of Thailand’s democratically elected governments prior to the crisis rested on shaky multiparty coalitions. These were composed of internally weak and fragmented parties that allowed private interests to gain access to the policy process and made that process extraordinarily contentious. Party leaders constructed parliamentary majorities from a pool of approximately a dozen parties, and coalitions typically consisted of six or more parties. Cabinet instability was a chronic problem. Prime ministers were vulnerable to policy blackmail by coalition partners (and in some cases, by individual ministers) threatening to defect to another coalition in pursuit of better deals. The parties, in turn, relied heavily on businessmen who had strong personal interests in financial-market and other economic policies.

The Chavalit government (1996–97), a six-party coalition that included some of the parties from the previous government, attracted a highly regarded team of technocrats. The Central Bank succeeded in staving off two speculative attacks on the baht prior to its final collapse

in July, but the Chavalit government failed to initiate fiscal-policy adjustments or to change the fixed exchange-rate regime. The problems of coalition politics were most apparent in the government's difficulties in confronting the mounting problems in the financial sector, particularly with respect to the finance companies. The government delayed in devising a plan for addressing their weaknesses and continued to provide a number of them with costly liquidity support.

These events unfolded prior to the baht's collapse and were interpreted by market analysts as telling signals of the government's weaknesses. Yet even the onset of the crisis was not enough to spur the government into a more coherent response. The process of reviewing the finance companies that were ultimately suspended was plagued by accusations of corruption. On October 19, a second finance minister resigned in frustration over the reversal of a small gas tax increase a mere three days after it had been announced as part of the government's International Monetary Fund (IMF)-backed program. With public indignation over the government's ineptitude rising, even among the business community, Chavalit resigned, paving the way for a new government.

Korea would seem to have been much better positioned to respond to the crisis than Thailand. Not only does the country have a presidential system in which the chief executive enjoys a range of legislative powers, but Kim Young Sam (1993–98) also enjoyed a legislative majority when the crisis hit. Beyond the adverse effects of a corruption scandal at the outset of 1997, the government faced a series of constraints associated with the presidential elections scheduled for December. A no-reelection rule and increasing concern about deteriorating economic performance fragmented the ruling party. In the ensuing succession struggle, one faction of the party broke away and chose its own candidate to contest the presidential election, contributing to the ruling party's ultimate defeat at the hands of Kim Dae Jung. Legislative elections were not concurrent with the presidential contest, but neither the ruling party's presidential candidate nor its legislators had strong incentives to cooperate with a lame-duck president.

These political problems affected economic policy making in two areas that proved to be of particular importance prior to the onset of the crisis proper in November—the management of major corporate bankruptcies and the passage of financial-reform legislation. The most damaging corporate failure was that of the Kia group. In the summer of 1997, Kia's management exploited the elections and the government's weakness to mount a major campaign for government support in dealing with its creditors. By late October the Korean banking system had been severely damaged, not just by the bankruptcies themselves but by a highly politicized process that left the ultimate disposition of Kia in limbo for months.

In the meantime, the passage of a package of financial-reform bills

had been stalled by disagreements within the ruling party. Once the crisis broke, their passage became an important signal of government commitment, and it was explicitly included as one of the conditions of the first IMF program. Yet neither the ruling party's presidential candidate nor the opposition had any incentive to cooperate with the government in getting this controversial legislation passed.

These problems are hardly novel in democratic systems; the effects of weak coalition governments, weak parties, divided government, and the electoral cycle have all been noted before in other contexts. Yet democracies have one important advantage over autocracies: Incumbents can be voted out of office. In both Thailand and Korea, the crisis generated disaffection with incumbents and led to changes in government. In Thailand, the fall of the Chavalit government led to the formation of a new government led by Chuan Leekpai (1997–present) and the Democrats. While the Democrats also had to include parties from the previous government in their multiparty coalition, the crisis allowed Chuan's party to maintain control over the key economic portfolios. The new government was thus able to take decisive action on several fronts, most notably by swiftly closing down virtually all of the suspended finance companies and strengthening the agency responsible for managing the disposition of their assets.

The new government was not altogether immune from the constraints that had plagued its predecessor. The legislative process required that all legislation be reviewed by a Senate filled with businessmen with a direct stake in important reform legislation, which they sought to modify and delay. Divisions both within the coalition and among the Democrats in the cabinet slowed the introduction of a number of important reform measures, including new laws governing foreign investment and bankruptcy, for more than a year.

In Korea, by contrast, Kim Dae Jung (with support from his predecessor Kim Young Sam, whose party still controlled the National Assembly) was able to exploit the important legislative window between his election and inauguration. During this period the legislature passed the same package of financial bills that had languished prior to the elections, as well as a range of corporate-governance reforms.<sup>3</sup>

Both countries thus enjoyed the benefits of new governments coming into office. These governments did not simply take advantage of the circumstances of the crisis (something that their predecessors had been unable to do); rather, they exploited disaffection with incumbents to gain electoral and legislative mandates for reform.

### **Malaysia and Indonesia**

How did the nondemocratic governments fare? Malaysia's was clearly the more institutionalized and pluralistic of the two, and its dominant

party, the United Malays National Organization (UMNO), was subject to some electoral and other political constraints. Yet when the crisis struck in mid-1997, UMNO did not face substantial challenges from its coalition partners, from the opposition (who were weak), or from elections, which were not due until 2000. Mahathir did face challenges from within UMNO, however, and these had some influence on the course of policy.

From the outset of the crisis, Mahathir's heterodox views, implicit threats to impose capital controls, and attacks on "speculators" and hedge funds created profound uncertainties and contributed to the rapid decline of the ringgit in the second half of the 1997. Efforts to bail out politically favored companies added to the uncertainty. In December, Mahathir reversed course, delegating authority to Deputy Prime Minister Anwar Ibrahim, who introduced an "IMF program without the IMF." At the same time, however, Mahathir established a parallel decision-making structure, the National Economic Action Council, which served to undermine Anwar's authority. For the next six months, policy see-sawed between Anwar's more orthodox views and those of his reflationist opponents.

These disagreements were related to the question of succession. Anwar's position as deputy prime minister suggested that he would ultimately take over leadership of the party and, with it, the prime ministership. Following the fall of Suharto in May 1998, Anwar appeared to issue a more direct challenge to Mahathir, but Mahathir was able to rally the party at the UMNO General Assembly, to sideline Anwar, and ultimately to have him arrested and convicted on corruption charges. As this political drama was unfolding, Mahathir also dismissed the governor of the Central Bank, took over the finance portfolio, and moved economic policy in a more expansionary direction. The imposition of capital controls on 1 September 1998 was the final act in a set of policy and political conflicts that had been unfolding for over a year.

In Indonesia, by contrast, Suharto cleaved closely to economic orthodoxy and was initially seen as enjoying some of the purported advantages of dictatorship. As in the past, he responded quickly to the crisis by freeing the rupiah rather than subjecting the country to a costly defense of its currency, and he initiated a number of reforms, some of which appeared to cut against the interests of his cronies and his family. Within months, however, Suharto began to take a number of rearguard actions that undercut these initiatives, launching several costly investment projects and extending liquidity support to a number of crony banks following a mismanaged bank closing in November 1997.

In December, Suharto failed to participate in an important international meeting, and rumors circulated that he was in poor health. (It was later revealed that he had had a stroke.) Although such rumors can also be unsettling in democracies, in a highly centralized system like

Indonesia's with uncertain succession procedures, they threatened the regime itself and the entire set of property rights that went with it. Even before Suharto's controversial budget was read in January 1998, it was clear that Indonesia was experiencing much greater difficulties than other countries in the region. Suharto's imposition of B.J. Habibie as his vice-president and anointed successor alarmed investors, as did the growing opposition to his regime, which crested in the violence of mid-May that ultimately resulted in his ouster.

It is clear that Indonesia fared worse than other countries in the region. Less attention is paid to the fact that Malaysia's economic decline was much worse than might have been predicted, given that it had a less fragile banking system and a more favorable external position than either Korea or Thailand. Obviously, the outcomes in each country were the result of a number of factors, and Mahathir (along with many American economists) placed particular emphasis on the external ones.

Yet politics mattered as well. The purported advantages of decisive leadership hinge critically on what leaders actually do. In both Indonesia and Malaysia, leaders exploited their powers to isolate technocratic advisors and pursue erratic policies that increased market uncertainty. Indonesia suffered from the more profound uncertainty, due to the absence of channels for managing opposition and the problem of succession. Although the democracies also had difficulties in making timely adjustments, they, at least, provided legitimate procedures for replacing failing incumbents.

### **Business and Government Before the Crash**

Although the account of the crisis given above necessarily focuses on the role of government institutions, it also touches on the influence of business on the policy process—as seen in the Kia bankruptcy in Korea, the policy toward the finance companies in Thailand, and the favored treatment of politically connected firms in both Malaysia and Indonesia. Close ties between business and government have long been a distinctive feature of many of the rapidly growing Asian economies, but it was generally believed that these countries had structured business-government relations to minimize the political risks. Some even argued that the costs of rent-seeking and corruption were outweighed by such benefits as increased information flow, trust, and the signaling of government commitment. As Sylvia Maxfield and Ben Ross Schneider put it, “trust between business and government elites can reduce transaction and monitoring costs, diminish uncertainty, lengthen time horizons and . . . increase investment.”<sup>4</sup> Even the World Bank became a cautious advocate for consultative institutions linking the public and private sectors.<sup>5</sup>

How did Asian countries manage to maintain relatively close

business-government relations without the risks? Chalmers Johnson's analysis of Japan outlined a theme central to all subsequent analyses of the region's political economy: that a "strong," "developmental" state guaranteed a commitment to overall economic growth, while developing a pattern of cooperation with the private sector that "avoided an emphasis either on private profit or the state's socialization of wealth."<sup>6</sup> The aspect of Johnson's thesis that attracted most attention—and ire—was its emphasis on the benefits of industrial policy. But Johnson's account also had a second political dimension: He argued that "strong" governments (in some cases, authoritarian ones) enjoyed an independence or autonomy from private actors that allowed governments to control the policy agenda and granted them the capacity to discipline the private sector by conditioning various kinds of government support on performance. Thus they were able to guarantee that industrial-policy tools did not result in the misallocation of resources so common elsewhere in the developing world.

This picture also featured competent, meritocratic bureaucracies and the concentration of decision-making power in lead economic agencies. By socializing government officials toward common goals, meritocratic bureaucracies limited the opportunities for rent-seeking. Centralizing bureaucratic authority and granting discretion to bureaucrats made policy more decisive and coherent.

Finally, the governments of the region were able to limit rent-seeking by controlling the way business was organized and how it interacted with government. In some cases, as in Korea, the government directly established and effectively ran sectoral business associations. In others, "deliberation councils" made up of representatives of government, business, and other sectors guaranteed broad representation and a certain degree of transparency that limited the opportunities for private dealing.

Over time, this careful historical analysis hardened into an "Asian model" of business-government relations that was generalized across widely disparate cases. As Andrew MacIntyre and his colleagues showed, the Southeast Asian countries differed quite substantially from Japan, Korea, and Taiwan, in that the former lacked not only the industrial policies of the first generation of newly industrializing countries but also the political conditions required to conduct such policies efficiently.<sup>7</sup>

This rosy picture of close business-government relations also downplayed a number of risks and costs. The first of these risks was structural—the high and sometimes growing concentration of private economic power. In some cases this concentration was a direct result of government supports for certain large firms, as in the case of the Korean *chaebol* (large, family-run industrial conglomerates), the expansion of the Indonesian-Chinese conglomerates or Suharto-linked firms, and the ethnically motivated privatizations in Malaysia under the Mahathir



government. In other cases, it was a result of government inaction, as in Thailand's *laissez-faire* stance toward the high degree of concentration and collusive behavior in the banking sector. Size did not always translate into proportional political influence; in Indonesia, the ethnic vulnerability of the Indonesian-Chinese conglomerates actually made size a liability. Yet there can be little question that "big business" did wield political influence in all four countries.

A second problem was the way in which government support for the private sector generated moral hazard. Moral hazard has been invoked indiscriminately to explain the crisis; everything from IMF lending to deposit insurance has been held accountable for this particular sin. Some purported sources of moral hazard, such as the existence of industrial policies, either had been reduced (in Korea) or were too small to be consequential (Thailand). Nonetheless, the government's deep involvement in the financial sector in Korea, Malaysia, and particularly Indonesia created the danger that banks and firms would either be protected against excessive risk-taking or (much the same thing) would be allowed to walk away from bad debts.

Corruption and cronyism are an additional source of moral hazard that has received substantial attention in popular Western accounts of the crisis. The Hanbo case of direct bribery of government and bank officials in Korea appears to be a relatively isolated incident in that country. Corruption was more widespread in Thailand and Indonesia, and in the 1990s there was clearly an increase in nepotism in Indonesia. The corruption problem, however, is often misunderstood; the issue is not simply its role in generating moral hazard, but also its effect on governments' management of the crisis. In Korea, the Hanbo scandal further weakened a lame-duck president. In Malaysia, the government's efforts to support politically connected firms at great public expense raised questions about the integrity of the corporate restructuring process. In Thailand, the government exhibited costly forbearance toward ailing financial companies with close ties to the government. In Indonesia, the Suharto government's responsiveness to cronies and close family members raised serious doubts about the government's commitment to reform in the crucial months of October and November 1997.

One objection to the focus on moral hazard and corruption is that these problems had existed for some time and had not impaired the region's spectacular growth in the past. This objection, however, is a bit too facile. First, the history of East Asia's growth is far from crisis-free. Korea, for example, has seen government-led investment booms followed by crises in the past, most recently in the wake of the chemicals and heavy industry drive of the late 1970s. Second, it is not necessarily the case that corruption has been a constant. Although measurements of corruption are always difficult, the case could be made that corruption

in Indonesia, Malaysia, and Thailand actually increased during the 1990s.

More importantly, the opening of the economy to capital movements makes it more vulnerable to problems of moral hazard, corruption, and the lack of transparency in business-government relations. When growth is high, foreign investors are perfectly willing to tolerate (and even to contribute to) these problems. But when growth slows, the nontransparent nature of business-government relations can generate substantial uncertainties. Will some firms enjoy special treatment? Will contracts be honored? What financial condition are banks and firms actually in?

This brings me to the final, and perhaps most important, point. Not all of the region's problems stemmed from rent-seeking as traditionally conceived; a final source of risk was the mismanagement of liberalization, particularly in the financial sector. The dangers of opening the capital account while maintaining a fixed exchange rate have attracted most scrutiny in accounts of the crisis, but the failure of prudential regulation of the banking system was an equally important problem. These failures stemmed not only from the weakness of regulatory statutes but also from politically generated laxity toward the government's financial and corporate oversight role and outright corruption of regulators. These problems were visible in the licensing of Korea's merchant banks and in a variety of weaknesses in Korean corporate governance, in the expansion of the finance companies in Thailand, and most egregiously, in the liberalization of the banking sector in Indonesia, where industrial groups acquired banks, with all of the attendant problems of related-party lending that ensued.

In sum, the region's vulnerability stemmed not simply from discrete policy failures but from a deeper political problem: Business-government relations were often structured in ways that did not allow for effective oversight by outsiders, whether these outsiders were parties, legislatures, regulatory agencies, public-interest groups, financial analysts, stockholders, or voters. The result was policies and practices that increased vulnerability.

### **Business and Government After the Crisis**

The Asian financial crisis is forcing important changes in business-government relations. To understand the politics of this process, it is useful to distinguish policy responses along two dimensions: the decisiveness of governments in addressing the crisis and the ability of governments to assert regulatory authority over banks and firms.

Banks and firms experiencing severe distress have a strong interest in delaying the recognition of losses, since the timing of such decisions can affect their very survival. Delay, however, can also compound losses and increase uncertainty. A second and closely related issue is the extent

to which governments support or show forbearance toward distressed banks and firms. Of course, there is no virtue in bankrupting potentially viable firms. In periods of distress, however, all companies have an interest in claiming that they are viable. To limit the public costs of such crises, governments require the political as well as administrative capability to distinguish among the competing claims for financial support and forbearance and to impose regulatory conditions on banks and firms that will limit future risks.

These issues are visible in the problems surrounding financial and corporate restructuring. The crisis initially focused attention on problems in the financial sector. The immediate task was twofold: to decide which financial institutions were nonviable and to close them, and to develop a rehabilitation plan for the remainder. Once these basic decisions were taken, the government confronted the task of disposing of nonperforming loans (NPLs) and recapitalizing the banks.

Comparing strategies across countries is always difficult because initial conditions and the magnitude of their problems vary. Nonetheless, some interesting patterns are visible across the six administrations in the four most seriously affected countries. In Korea, the Kim Young Sam government supported the banking system following the corporate failures of 1997, nationalizing two major banks, but it had no clear strategy for rehabilitating the sector. Following Kim Dae Jung's election, the government quickly established a powerful new regulatory agency to manage the crisis and set aside funds to buy up nonperforming loans (NPLs) and recapitalize the banking system. All banks were subject to thorough review, on the basis of which five were shut down and merged with others under government direction. A large number of nonbank financial institutions were also shut down, although many weak ones were left open. Korea's record in disposing of acquired assets remains weak, but it has moved more aggressively than Indonesia, Malaysia, or Thailand, where governments took a relatively hands-off posture with respect to the banking sector until late 1998. One result of the nationalizations and capital infusions was that governments came to occupy a commanding position in the financial sector; although this was true to some extent in all countries, the change was most pronounced in Korea.

Under Chavalit, the Thai government also initially continued to support weak institutions, particularly finance companies. Although some were suspended and the government created a resolution agency (the Financial Restructuring Agency), the government lacked a clear strategy for managing these distressed companies. After taking over in November 1997, the Chuan government moved quickly to close a number of finance companies and to dispose of their core assets over the next 18 months. It did not recapitalize the banks or purchase NPLs from them directly; rather, it sought to induce banks to recapitalize by

enforcing capital-adequacy and loan-loss provisions. This strategy failed because a number of major banks proved unwilling or unable to raise new capital, and in August 1998 the government was finally forced to announce a plan that committed substantial resources to bank recapitalization. The conditions for participation were tough, but precisely for that reason few banks participated, and the government has been forced to manage the crisis through regulatory forbearance and acceptance of a continuing high level of NPLs in the system.

Malaysia's banking problems were less serious, but the government responded to them fairly aggressively, through a combination of recapitalization and a comprehensive merger plan. The Malaysian response was influenced by longstanding issues of ethnicity; the bailout of state banks used to finance investments made by ethnic Malays, and a controversy arose over whether the merger plan would weaken the Chinese presence in the banking sector.

Indonesia responded more decisively to its banking crisis than Korea or Thailand, but the initial closing of 16 banks was badly handled and actually exacerbated the crisis. The government continued to support a number of politically connected banks, with disastrous consequences, and reform efforts were undermined by the deepening political uncertainty about the regime's survival. The Habibie government initiated a strategy for recapitalizing the banking sector and sought to recover debts to the government, but implementation was subject to delay and charges of political interference. By the end of 1999, the government had clearly made the least progress of the four countries in addressing the problems in its banking sector.

A second set of issues surrounds the corporate-restructuring process. Like banks, corporations may have an interest in delaying financial and operational restructuring and may even collude with banks to do so at public expense. The government can solve this problem in one of two ways, each of which requires some political capacity. First, it can enforce capital-adequacy and loan-loss provisions rigorously, while providing incentives for banks to engage in out-of-court settlements. This so-called London Rules approach depends heavily on the credibility of the government's commitment to its regulatory stance. An alternative strategy is for the government to play a more active role. This may include coordinating intracreditor and creditor-debtor relations, monitoring and enforcing agreements, or using various instruments to enforce financial and operational restructuring objectives.

The incentives to corporate restructuring are powerfully affected by foreclosure and bankruptcy laws. If foreclosure and bankruptcy laws are weak or poorly enforced, firms have an incentive to delay debt and operational restructuring and even repayment. Reform of the bankruptcy process and clear enforcement of bankruptcy and foreclosure laws are important not only for managing actual firm failures but also for

providing incentives to creditors and debtors to reach out-of-court settlements.

Bankruptcy procedures were strongest in Korea and Malaysia when the crisis hit. In Thailand, bankruptcy reform was delayed; in Indonesia, despite reforms, bankruptcy processes remain weak. In all four cases, out-of-court settlement predominated, but major differences separate Korea from the other cases. Despite nominally embracing London Rules, Kim Dae Jung has negotiated directly with the five largest *chaebol* over their restructuring plans, and the Financial Supervisory Commission has successfully pushed corporate debt restructuring. Moreover, “corporate restructuring” in Korea has included wide-ranging corporate-governance reforms, ultimately enforced through the government’s control of the banking system. In Thailand and Indonesia, debt restructuring has been much slower, with much weaker links, if any, to corporate-governance reform. Malaysia lies between these two poles; the government has established a restructuring agency with ambitious goals for the operational restructuring of enterprises, but as of this writing, it remains unclear whether those objectives are being fulfilled.

What accounts for these differences? One hypothesis is that a government’s ability to assert its authority depends on the nature of the political links between it and the corporate and financial sectors. In Korea, the government already exercised strong control over the banking sector, and Kim Dae Jung was a relative outsider to the networks of business-government relations that had built up under his predecessors. He was therefore much less indebted to the business sector than his counterparts in Thailand, Malaysia, and Indonesia, where business support was a crucial element of the political formula. In sum, the success of reform requires a new politics, with politicians and parties less beholden to the status quo.

### **A New Social Contract?**

The social fallout from the crisis, manifest in rising unemployment, falling real wages, and a sharp decline in asset values, has naturally forced an immediate response from governments in the region. Whether the crisis will affect the nature of the social contract and the provision of social insurance over the longer run, however, remains to be seen.

Discussions of the political economy of the welfare state have not given much attention to the nature of social bargains in the developing world. For new democracies, the possibilities for welfare policy depend heavily on the implicit social contract and the development strategies inherited from prior authoritarian periods. For example, while welfare reform in Eastern Europe involves some inevitable shrinkage of public commitments and an expansion of private insurance and service provision, East Asia’s smaller governments, stronger fiscal position,

and limited social contract provide the space to move in the opposite direction.

Prior to the economic crisis, countries in East and Southeast Asia did have an implicit strategy of social protection. It had the following components: 1) healthy per-capita-GDP growth rates, rapid employment growth, increasing participation in the work force (especially of women before marriage), and increasing returns on capital to small businesses and farmers; 2) high levels of private and public investment in education and basic health care; 3) balanced growth strategies that emphasized labor-intensive manufacturing and addressed rural poverty through land reform (Korea and Taiwan) or investment in rural infrastructure and agricultural technologies (Indonesia and Thailand), which made it possible for the countryside to absorb displaced workers during downturns in the urban manufacturing sector; 4) strong traditions of family support, with high levels of private transfers between generations and from urban workers to rural households; and 5) an emerging tradition in some segments of the economy (and most notably in Korea) that made the firm the provider of social insurance.

Notably absent from this picture were extensive government commitments to social insurance. This might be attributed in part to these countries' level of development, but comparisons with other middle-income countries suggest that politics also mattered. Social-democratic and populist parties and movements had little room to operate under authoritarian rule. Labor movements have historically been weak, repressed, or both; even with the transition to democratic rule, labor movements have not been influential political actors, except in Korea. Other features of Asian societies noted above, including traditions of private social assistance, extended family networks, and flexible labor markets linking the urban and rural sector, have all reduced the demand for an extensive state role in providing social insurance.

As a result of this history, the countries hurt most by the crisis had neither social-insurance mechanisms that could serve as automatic stabilizers during a recession nor the capacity to monitor and target those most seriously affected by the crisis. Nonetheless, governments in the region quickly acknowledged the need to deal with the potential social costs. Encouraged by the international financial institutions, Asian governments launched a mix of "social safety-net" programs.

Whatever the successes and failures of these programs in the short run, the more interesting question is what the longer-term future of the social contract might be. One can imagine several possibilities. In Korea, where the labor movement is strongest, there could be movement in the direction of a European-style welfare state. Kim Dae Jung used his credentials with labor to convene a tripartite committee in early 1998, and in the process he extended unemployment insurance to a broader group of workers and raised benefits. The Korean exercise was relatively

modest, however, and was aimed in no small part at extracting concessions from labor on issues of labor-market flexibility. Labor fully understood the downside of this bargain, and the more progressive of the two union confederations ended up boycotting subsequent meetings of the committee. This episode casts doubt on the viability of the welfare-state option in the absence of strong unified labor movements and social-democratic parties.

A second possibility would be a conservative reaction. During the crisis, governments in both Malaysia and Thailand outlined a conservative critique of the European welfare experience, citing Asia's traditional reliance on family and community and their own countries' past success in harnessing work, discipline, and responsibility at the individual level to produce high growth. The idea of "social-welfare" programs involving entitlements to government transfers, they argued, contradicted the lessons of past success stemming from productivity-enhancing investments in health, education, and performance-based small credit programs. Business groups also expressed skepticism about any further extension of the safety net, cautioning that it would adversely affect recovery in the short run and competitiveness in the long run.

The large real devaluations that have occurred and the corresponding fall in unit labor costs might indeed tempt governments into reverting to a growth strategy relying on low-cost labor. Yet relying on real-wage adjustments seems self-defeating in the long run, particularly given the presence in the region of China's massive labor-abundant economy. Moreover, such a strategy would overlook the fact that, in some cases (especially in Thailand), the tight labor markets caused by economic booms have masked weaknesses in the quality of the work force that need to be addressed.

A third option is some sort of middle way that builds on the strengths of East Asia's history of equitable growth while addressing the new requirements of those vulnerable to external shocks. This might emphasize a continuing commitment to education, including guarantees of state support for keeping children in school in the event of future shocks (as in the existing Indonesian and Thai programs along these lines), and an expansion of incentives for training, both public and private, in return for labor's commitment to labor-market flexibility.

Yet more than an emphasis on education and labor-market flexibility is probably needed to deal with the insecurities associated with slower and more erratic growth and the likelihood of greater exposure to external shocks. The model that is most likely to fit East Asia's history is something like Singapore's Central Provident Fund, which bundles together pensions with emergency medical and unemployment insurance, rests on employer and employee contributions mandated by the government, is not redistributive in nature, and emphasizes personal control. Such programs offer security against economy-wide shocks,

provide benefits that are valued by the emerging middle class, and (except for some transitional costs) do not necessarily have adverse fiscal consequences. Instituting such programs in new democracies would require pressure from middle-class parties and interest groups, including labor, and would have to overcome resistance from cost-conscious employers. Yet even this modest middle way may prove too difficult, leaving incremental expansion of existing efforts as the only remaining option.

Democratic progress in East Asia was already creating pressures for greater attention to social policy as well as greater transparency in business-government relations, and the economic crisis of 1997–99 has accelerated these trends. It has contributed to a change of regime in Indonesia, to a strengthening of political oppositions elsewhere, and to growing pressures for changes in regulatory regimes and in the social contract. It is still too soon to tell, however, what the legacy of the crisis will be. Ironically, the very resilience of the Asian economies and the speed of their recovery may serve to limit the long-run impact of the crisis (except in Indonesia), allowing a reversion to political habits and institutions that bear a closer resemblance to the past than most observers had initially anticipated.

## NOTES

1. See, however, Lawrence Krause, *The Economics and Politics of the Asian Financial Crisis of 1997–98* (New York: The Council on Foreign Relations, 1998); K.S. Jomo, *Tigers in Trouble: Financial Governance, Liberalization and Crises in East Asia* (London: Zed Books, 1998); T.J. Pempel, ed., *The Politics of the Asian Economic Crisis* (Ithaca, N.Y.: Cornell University Press, 1999); and Stephan Haggard, *The Politics of the Asian Financial Crisis* (Washington, D.C.: Institute for International Economics, forthcoming).

2. See Suchit Bunbongkarn, “Thailand’s Successful Reforms,” *Journal of Democracy* 10 (October 1999): 54–68.

3. See Jongryn Mo and Chung-in Moon, “Korea After the Crisis,” *Journal of Democracy* 10 (July 1999): 150–64.

4. Sylvia Maxfield and Ben Ross Schneider, eds., *Business and the State in Developing Countries* (Ithaca, N.Y.: Cornell University Press, 1997), 13.

5. The World Bank, *The East Asian Miracle* (New York: Oxford University Press, 1993).

6. Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy 1925–1975* (Stanford, Calif.: Stanford University Press, 1982), 57–58.

7. Andrew MacIntyre, ed., *Business and Government in Industrializing Asia* (Ithaca, N.Y.: Cornell University Press, 1994).