(Draft. For discussion only)

Political Failures and Implications for Good Governance: Lessons from the Asian Economic Crisis of 1997

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Introduction

In the aftermath of the Asian economic crisis, questions of what constitutes good governance have emerged as a major discourse in the mass media as well as academia. The generally subscribed characteristics of good governance in the Southeast Asian mode would include transparency, accountability, contestation, pragmatism as well as a committed political leadership. This leads one to further posit this question: would such traits of good governance have steered their respective economies away from the crisis in the form of the public policies prescribed? It is perhaps interesting to note that such traits of good governance veer more towards authoritarian regimes in Southeast Asia and Asia, where paternalistic policies have been the norm to promote the general welfare in the form of security and order in society. Juxtapose this Asian notion of good governance to that of western political ideals emphasizing the mechanisms of the market — that good governance consists of the less and nor more government, and one can see the ensuing dilemma as to what actually constitutes good governance.

Take the case of Singapore, which in a strange way can be used as a representative of the Asian notion of good governance. For the People's Action Party (PAP) Government, good governance aims for transparency in the way public institutions deal with the public, accountability places emphasis on the positive policy outcomes promised to its electorate, as well as committed political leadership to the principle of shared growth. Judging from the favorable ratings that the Political and Economic Risk Consultancy Ltd (Perc) gave to Singapore's civil service, and its attributing Singapore's 'authoritarian streak' to its ability to push through unpopular policies, it would thus seem that the above said characteristics of good governance are synonymous with the principles guiding public policy making, with goals of security, economic growth, equity, efficiency and liberty as the desired outcomes.[1] However, experience would tell us that not all goals of governance could be achieved through public policies.

Among the obstacles to achieving desired policy outcomes include the crux of all public policy problems—limited resources. The result of which would require some form of governmental intervention to achieve a better allocation of resources. Often and usually, the market shoulders the distinction of being the most efficient method for resource allocation. However, when markets fail to achieve the ideal efficiency, solutions in the guise of government intervention "to promote general welfare" may also come up short.

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[1] Ho Khai Leong, *The Politics of Policy-making in Singapore*, Singapore: Oxford University Press, 2000.

Besides Southeast Asian society's ambivalent attitudes towards government, a bureaucracy that is out of touch with the masses is also a hindrance to good governance. Despite receiving consistently glowing reports in the mass media, attention had been drawn to the rigidity of the bureaucracy as a major hindrance. Even in Singapore, where the bureaucracy has been hailed as efficient and effective, this problem is apparent. Appeals from Singaporean businessmen for more state assistance for home grown small and medium enterprises in the wake of the economic slowdown had been rebuffed with the typical hard-headed (some may say pragmatic), tough talking approach to policy making. The approach and the resultant policy outcome may be seen as justified coming from a government that has "delivered the goods". However, the gulf between policy-makers and the citizenry has been decidedly stretched. From the Singapore case, one may perhaps add to the list of traits of good governance –the ability to take into account people as pre-policy contributors instead of being consulted as post-policy commentators.

Asian Economic Crisis as Market Failure

Let me return to the theme of what caused the economic crisis. There are two notions: market failure and political failure. Let me deal with market failure first.

Computer and information technology has speed up the globalisation of financial market and allowed capital to move swiftly from one centre to another for higher returns. Professor Jonathan Kirshner, an economist from Cornell University, argues that as a consequence, unregulated flow of financial capital has inevitably led to the crisis. This unregulated flow of capital can be identified as a source of market failure if we recall that market failure occurs when the pursuit of self-interest does not lead to the socially/economically optimal condition. Why does it not lead to social/economic optimum? There are three reasons for this scenario.

Firstly, unregulated flow of financial capital does not allow some basic price stability for the economies.[2] It bestows on the investors the ability to move huge amounts of money almost instantaneously, at very little cost resulting in value of assets including national currencies fluctuating. As can be witnessed at the onset of Asian economic crisis, fund managers in charge of hundreds of billions of dollars of America and Europe sold out their assets in all ASEAN countries.[3] Their selling brought down the stock markets and by converting the local currencies they received into US dollars, they caused a further fall in the exchange rate. Since July 1, 1997, the Thai baht and the Korean won

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[2] Jonathan Kirshner, "Market Failure: the cause of crisis," *Straits Times*, September 24, 1998.
[3] Lee Kuan Yew, " What caused the currency crisis," *Straits Times*, February 8, 1998.

have depreciated by 40 to 50 percent, while the Malaysian ringgit and the Philippines peso have lost about 40 percent and the Indonesian rupiah has fallen by more than 70 percent against the US dollar.[4] The case of even Singapore and the New Taiwan dollar have nearly lost 20 percent of their value despite strong economic fundamentals can signal that the crisis had more to do with market weaknesses than by political failures.

Secondly, financial assets become worth what people think that they are worth, increasing their vulnerability to sudden reversals of market confidence resulting in panic and financial stampedes.[5] As can be observed prior to the crisis, the massive inflows of investment and credit into the region had generated a euphoric atmosphere resulting in unrealistic ballooning of asset values of properties and stocks. When the bubble burst, collapse of investor confidence and the subsequent sudden withdrawal of funds triggered a chain reaction, which quickly developed into a financial panic in the region as a whole.

Thirdly, unregulated flow of capital allows investors to create pressures for conformity across country macro-economic polices and a deviation would result in capital flight.[6] Despite the different economic and political conditions of the states, the region was classified together as "emerging markets" and the lost of confidence in Thailand became a contagion that attacked other ASEAN economies. Malaysian Prime Minister Mahathir's offensive remarks against George Soros and currency speculators had the result of capital flight too.

Therefore, the unregulated nature or "costlessness" of contemporary capital movements resulted in greater financial mobility than is optimal from a global societal perspective. Such negative effects unfortunately were not part of the calculations of producers. This unregulated capital can be seen as a market failing which can be traced as a contributory factor towards the crisis.

Asian Economic Crisis as Political Failure

Now the second notion of the Asian financial crisis needs to be forwarded: political failure.

The Asian economic crisis cannot be due to a mono-causal factor like the market failure. If we take into account the magnitude of the crisis and the varying degrees of impact of the countries, we can plausibly conclude that government had a complementary role to play in the crisis. Four failings of the government would be highlighted as contributing to the crisis.

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[4] Ibid.
[5] Jonathan Kirshner, "Market Failure: the cause of crisis", *Straits Times*, September 24, 1998.
[6] Ibid.

Firstly, a major failing on the part of governments was that the governments had liberalised their financial markets without strengthening their loose financial and banking regulatory and supervisory systems. Private sector borrowing in Asia took place in the context of an economic boom that started in the latter part of the 1980s. Easy credit led to great increases in borrowing short-term US dollars but was used for long-term projects, which do not generate foreign exchange. Although private-sector companies were the main borrowers the government failed to check excessive and reckless borrowing. Therefore, one could argue that had there been adequate legislation and rigorous supervision on the part of government the excessive borrowing that went into real estate, stock market and unproductive industrial expansion would have been noticed and checked before they ballooned out of control.

The second failing on the part of government can be seen in the inflexible exchange rates of local currencies tied to the US dollar. This was wise when the US dollar was weakening against the yen and the German deutsche mark (DM) after Plaza Accord in 1985. However, the Thais and others continued this link even after the US dollar began to strengthen against the yen and DM and all currencies in mid-1995. Thai exports became more expensive and decreased and Thai baht could not be defended because Thailand needed more dollars than it was able to earn through its exports. After defending the Thai baht by spending US$23 billion of their foreign reserves, the Thai government floated the baht, which depreciated greatly. Thai firms who had borrowed in US dollars because its interest rates was much lower than Thai baht interest rates and assumed that the exchange rates would remain the same, now faced bankruptcy. To underscore the role of political failure in the crisis, Singapore can be a valid example. Since the 1970s, the Singapore dollar has been managed against a basket of currencies. When in mid-1990s the US dollar strengthen against all currencies, Singapore dollar interest rates were kept lower than US dollars to make it unattractive for Singapore firms to borrow US dollars. Subsequently when the crisis occurred Singapore companies had little US dollar debts and relatively less affected.

The third failing was political uncertainty in the region, which prevented the governments from heeding the warnings from the market. Thailand has had six governments in five years and therefore none was able to look into the growing current account deficit.[7] In Indonesia, Thailand, Korea and Philippines political uncertainty hastened the credit withdrawals, since each country faced the potential

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[7] Lee Kuan Yew, "What caused the currency crisis," *Straits Times*, February 8, 1998.

for a change of government.[8] Lastly, vested interest of the political leaders and bureaucrats in the form of corruption, cronyism and nepotism exacerbated these problems. Lending was not based on feasibility of the projects but on the personal relations or cronyism. In some instances, ministers were unwilling to discipline wayward financial institutions because politicians were linked with, and politically funded by these same institutions.[9]

Besides cronyism, the lax in private-sector borrowing is largely euphoria. Since the mid-eighties, governments in East Asia and ASEAN countries in particular thought the euphoria of growth would carry on eternally, against the wisdom of Paul Krugman who had warned the world about the East Asia "eternal growth" spurred on by Asian Values.[10] Companies borrowed foreign currency from banks far too easily, and some of these projects were unproductive. Governments not only did not check against this but actually encouraged it and thus creating a "euphoric environment".[11]

This euphoric environment may be extended to explain for countries like Malaysia's rush to meet their grand and ambitious vision as well as artificially raising the economic standings of the Bumiputras (native Malays) through unsound economic policies. This rush to meet Prime Minister Mahathir Mohammad's Vision 2020 is done without adequate consideration for prudent financing. To redress the historical inequities of the Bumiputras, the Malaysian government established too many public enterprises and financed too many Bumiputra projects to ensure their prosperity.

Government profligacy is another political reasons that led to the Asian currency crisis. For example, the Thai government led by Prime Minister Chavalit Yongchaiyudh used up more than half of the Thai's foreign reserves to defend the baht. Although successful initially, the baht sank after the announcement of allowing it to float. This renders the initial defending of the currency by the government futile and money which could be used for other more constructive projects, wasted. Banks and companies which had borrowed in US dollars when the baht was 25 baht to the dollar found out to their horror that their debt more than doubled virtually overnight for the baht had fallen to 52 to a dollar. This led to a loss of confidence among investors. Indeed, Lee Kuan Yew, the Senior Minister of Singapore, termed the crisis as a "crisis of confidence".[12]

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[8] Steven Radelet & Jeffrey Sachs, *The Onset of the East Asian Financial Crisis*, Cambridge, Mass: National Bureau of Economic Research, 1998. p. 22.

[9] It must be said, however, that the lax in government bureaucrats of directing banks to lend to friends and relatives (cronyism) is both a market as well as political failure. The imperfect competition is both the doing of sleazy bankers who lack "moral hazard" for lending money and the failure of the government to curb this anomaly. Governments who did not check the rapid credit expansions eventually saw their economies falter and collapse.

[10] Paul Krugman. "Wrong, It Never Existed." *Time,* September 29, 1997.

[11] Lee, *Op Cit*.

[12] Lee, *Op Cit*.

Political Failures as Bad Governance

My main interest in the economic crisis is to decipher the contributions of political failures, and to relate them to good government practices. The following issues are most apparent.

Corruption in Politics

The presence of widespread corruption in the Asian countries resulted in political instability. In Indonesia, there existed an inverted pyramid accumulation of wealth where the government and its cronies accumulated wealth at the expense of the general population. This resulted in widespread dissatisfaction and hence riots and protests against the government, thus eroding investors' confidence. Moreover, the presence of vote buying in Thailand also meant that the politicians who got elected might abuse their powers of office to pursue policies for their private interests at the expense of society's interests so as to recoup their losses.

Policy Inconsistencies

The lack of continuity and consistency in policies enacted also resulted in an economic crisis for countries like Thailand. Thailand had three governments in three years and six finance ministers in two years. Moreover, many coalition partners have vested interests which led to inconsistent policies and misguided priorities. For countries like Indonesia, the failure of the government to implement effective policies to solve the inter-ethnic problems resulted in riots and hence an erosion of investors' confidence.

Government-Business Links

Many of the banks and firms in the Asian countries were also closely linked with the government. This encouraged cronyism and corruption. The businesses received preferential treatment from the government. For example, Renong, a conglomerate in Malaysia, which is run by Prime Minister's Mahathir Mohammad's close associates, received favourable treatment in terms of acquiring contracts. The contracts were thus awarded based on relationships and not merit. Also, the Malaysian government should have closed down banks that could no longer hold up. However, due to cronyism, to protect the many influential personals who had vested interests in the banks, the government held up the banks.

Economic Rigidity

Several of the Asian economies also suffered from rigidities in the labour and capital markets because of government regulations and laws. For example, South Korea has a law which bans firms from sacking workers. In other East Asian economies, the mobility of capital has been impeded by the government's reluctance to allow firms to fail, and by ineffective bankruptcy laws. However, for an economy to function well, there is a need for resources to constantly move to more productive uses. One of the reasons why Taiwan was able to escape much of the crisis was because its government was willing to allow inefficient firms to fail and this made it easier for new firms to be set up.

Implications for Governance and Policies

It is fair to suggest that crony capitalism, the lack of transparency in the political systems, and unsupervised financial institutions are valid factors which explain the situation in Asia. However, one must be careful not to lump all the ills in the region as accruing from political failures. Implicit in the cause of the crisis was the easy availability of foreign capital. With excess funds floating around in the economy, the tendency was that this money found its way into shadowy investment projects.

Furthermore, advances in technology have meant the radical reduction in the costs of borrowing and lending across national boundaries. As recent events in Asia have shown, foreign capital was available easily and funds could be channeled into and out of a country with the slightest ease. However, while this burgeoning global system has been demonstrated to be a highly efficient structure in facilitating cross-border trade in goods and services, the system also carries within itself inherent risks. [13]

If anything, the efficiency of the global system became a double edged sword: on one hand it offered unprecedented opportunities -- creation of jobs, speedy transactions; on the other, the very same efficiency in technology threatened to expose and punish the underlying economic weaknesses in the Asian countries. And punished it did the Asian economies and swiftly too. This coupled with the dominance of private enterprises in the Asian economies severely limited the government's ability to intervene and control the capital flows.[14]

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[13] Alan Greenspan, *Testimony of Alan Greenspan*: Before the Committee on Banking and Financial Services, U.S House of Representatives, January 30, 1998, http://bog.frb.fed.us/boarddocs/testimony/19980130.htm

[14] Linda Lim, "Whose model failed? Implications of the Asian economic crisis", *Washington Quarterly*, Vol 21(3), 1998, p. 29.

In the final analysis, what happened in Asia was thus a case of government “sins” being severely “punished by globalization and technology.” The institutional infrastructure and managerial expertise that could have mitigated the government’s lack of currency controls, was however, sorely lacking in the Asian countries. In addition, the easy availability of foreign funds further exacerbated the situation.

What is needed is the realization that lessons on governance can prove to be positive for all the countries concerned. What used to be features of regime maintenance have to be transformed to commitments of good governance. The problem of course is that there is no consensus on what constitute good governance. The political leaders and policy-makers in Southeast Asia and Asia will have to find their own formula to solve their own problems in the long run, but implementing policies and running the polity with the basic taxonomy of transparency, accountability, efficiency and contestation, would not be a bad start.

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