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## Crisis, Political Change, and Economic Reform

Most analyses of the crisis (including in the last two chapters) are preoccupied with the question of causes. But economic crises can also have adverse political consequences: disaffected interest groups, protest, even riots and social violence. These problems can undermine support for reform, generate “backlash” against the market, and bring anti-reformist parties to power. Crises can generate changes of government, but also changes of regime: transitions to—but also from—democracy. To what extent were any of these patterns visible in East Asia?

The link between economic crises and political change begins with the obvious fact that severe economic distress is likely to decrease political support for incumbents. In democracies, the consequences of this disaffection are reflected in the appeals of interest groups, in protest, and most important in electoral outcomes. The worse the economic circumstances in the period before elections, the worse incumbents are likely to fare, *ceteris paribus*.<sup>1</sup> In South Korea, the crisis broke less than a month before the presidential election, and the typically conservative Korean electorate chose longtime dissident Kim Dae Jung as president by a narrow plurality. In Thailand, the crisis led to the replacement of the Chavalit government by a new coalition government led by the Democrat Party under Chuan Leekpai. However, the important point to underscore is that democracy in both countries proved resilient. Despite the severity of the crisis, there was little support in either country for a return to authoritarian rule.

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1. The *ceteris paribus* condition referring primarily to possible differences in the quality and organization of the opposition.

Changes of authoritarian governments are less institutionalized and therefore somewhat more complex, but there are three main reasons why crises can be an important causal factor (Haggard and Kaufman 1995). First, the very absence of institutionalized political channels means that mass-based groups and social movements have little option but to resort to various forms of protest to express their grievances: strikes, protests, demonstrations. These protests typically have political objectives, such as political liberalization and democratization, but they attract adherents and gain momentum when they can also appeal to economic grievances.

Second, crises can lead private sector groups to lose confidence in existing political arrangements. If private-sector actors believe that authoritarian governments are unwilling or unable to manage economic challenges in a coherent way, they can quickly recalculate the costs of political change. Political reform and even democratization may be more attractive than a continuation of an uncertain status quo. This is particularly true when there are opportunities to ally with moderate oppositions that do not threaten basic property rights.

Third, crises can undermine the loyalty of the politico-military elite: the heads of the armed forces, key bureaucratic agencies, and the ruling party. The proximate cause for the fall of authoritarian governments can almost always be found in splits within this elite and the emergence of “softliners” amenable to political reform (O’Donnell and Schmitter 1986; Przeworski 1991). Economic crises can contribute to such splits in a number of ways, such as by reducing the ability of the authoritarian leaders to deliver material rewards to their followers.

However, the greatest challenge crises pose has to do with the problem of coercion. As crises generate political opposition and social protest, authoritarian leaders and their militaries have to make decisions about the use of force. At what point does repression breed more protest rather than quell it? Can officers be counted on to fire on their own citizens? If the military and police do respond with force, what affect does it have on the the military’s integrity or on their future careers if the opposition wins? All of these questions can generate splits within the government and military that favor the process of political reform.

On each of these three dimensions, the challenges facing Suharto and his successor B.J. Habibie were more profound than those confronting Mahathir. This was due in part to the greater severity of the Indonesian crisis, but also to political factors. Mahathir did resort to force and other restrictive practices to curb antigovernment protest. Yet ironically, the greater openness of the Malaysian political system provided some channels for opposition action and served to ultimately *limit* the scope of antigovernment protest and demonstrations (Case 2000). Malaysia’s parliamentary system is at best semi-democratic, but elections provided Prime Minister Mahathir a mechanism of securing support. When he

called snap elections in November 1999, the economy had begun to rebound and he scored a substantial victory.

Second, the Mahathir government was particularly attentive to the interests of the Malay private sector, which saw little future in throwing its lot with opposition forces; this was true not only for Malays but for important segments of the Chinese business class as well. The private sector's loss of confidence in the Suharto regime, by contrast, was more profound. This loss of confidence did not reflect itself in overt political activity, particularly given the highly vulnerable position of the Chinese business community. But it did show up in massive and debilitating capital flight.

Third, the Malaysian military has long been firmly under civilian control, and as we have seen Mahathir also retained firm control over the party. By contrast, the depth of the crisis and mounting protest to the government created important splits within the Indonesian government, ruling party, and military that were the prelude to Suharto's fall.

Changes of government bring new political leaders and parties to office, but of what sort? One often cited fear is that increasing economic openness and exposure to shocks will generate "backlash"—the rise of parties and social movements that are radically opposed to the market or populist in orientation (Rodrik 1997; Friedman 1999). These political forces may find allies—or even be led by—private sector groups espousing ideologies that might be called "business nationalism."

Throughout the region, adversely affected groups signaled their distress in various ways, and governments responded by addressing the social dimensions of the crisis (see chapter 5). The organized private sector pressed the government for relief as well, particularly with respect to interest rates, and in every country some segments of business sought protection and subsidies and resisted reforms that adversely affected them.

Yet populist forces were partly offset by political leaders, parties, and movements reaching quite different conclusions about the crisis than a simple backlash hypothesis would suggest. This alternative diagnosis argued that the crisis was the result of political failures, including overly close business-government relations and the corruption of the policy process. These "market-oriented populists," such as Kim Dae Jung, advanced economic reform for political as well as economic reasons. Liberalization and reduction of the government's role in the economy would establish more arms-length relationships between business and government and reduce opportunities for favoritism and corruption. Greater attention to social issues was a component of this agenda, but a reform of the social contract did not necessarily undercut support for the market; to the contrary, it was increasingly seen as a necessary complement to greater openness. In addition to Kim Dae Jung, similar ideas were also visible in the

resurgence of moderate Islam in Malaysia and Indonesia—for example, in the thinking of Anwar Ibrahim and Amien Rais—and had long been current among segments of the Chinese communities in both countries. In the Philippines, both Corazon Aquino and Fidel Ramos advanced similar ideas, despite other important differences between them (see appendix 3-1).

Moreover, these reformers were not simply interested in discrete policy changes; they also sought more fundamental institutional and even political reforms. These included greater emphasis on the rule of law, more accountability and transparency in government, and both increased independence and greater accountability in the regulatory process. In Indonesia, South Korea, and Thailand, these changes extended to a reexamination of the effects of electoral laws on the quality of governance and to pressure for more political and economic decentralization.

Even where reformist parties and politicians came into office, they differed in their ability to realize their policy objectives. These differences are related to the political constraints outlined in chapter 2—electoral and non-electoral challenges, decision-making structures, and links to private sector actors. Table 3.1 provides an overview. In South Korea, presidential and legislative elections are non-concurrent, and Kim Dae Jung initially confronted a divided government. But Kim finessed this constraint by working with the outgoing government to initiate a number of reforms before taking office. Kim Dae Jung's ties to, and dependence on, the private sector were much weaker than those of his predecessors, while his credibility with labor and the popular sector was high; this allowed him to use consultative mechanisms with business and labor to secure support for a reform agenda. The ability to maintain this momentum naturally declined over time, and as we will see in the following chapter, efforts at corporate reform continued to face resistance from the *chaebol*. But these limitations should not detract from what was achieved.

In Thailand, the Democrat Party historically had stood for similar reformist themes, but Chuan's six-party coalition faced many of the same constraints as its predecessor, and the Democrat Party itself was by no means unified on what to do. The combination of coalition government, weak ties between the Democrats and those most seriously affected by the crisis, and the continuing influence of business significantly constrained its ability to act in a decisive fashion. Decision making on a range of issues quickly stalled.

Indonesia and Malaysia also present interesting contrasts. In the face of a profound political as well as economic crisis, Habibie had strong incentives to remake himself as a reformer and instituted a number of extremely important institutional changes in Indonesia's political life, effectively overseeing a transition to democratic rule. Nonetheless, the incentives to economic reform were offset by ongoing ties to the remnants of the ruling party and favored segments of the private sector.

**Table 3.1 Political constraints on crisis management: New governments**

	<b>Thailand</b>	<b>South Korea</b>	<b>Malaysia</b>	<b>Indonesia</b>
Government, assumption of office	Prime Minister Chuan Leekpai, 11/1997	President Kim Dae Jung, 2/1998	Prime Minister Mohammed Mahathir (reelected 11/1999)	President B.J. Habibie (5/1998), President Wahid Abdurrahman (11/1999)
<b>Political challenges</b>				
Electoral	Seventh party added to coalition strengthen coalition, 4/98	Subnational elections 6/1998; legislative elections 4/2000	General elections scheduled 4/2000, called early for 11/1999	Parliamentary elections 6/1999; indirect election of president, 11/1999
Non-electoral and “backlash”	Some strikes and antigovernment demonstrations by opposition parties and NGOs, first half of 1998	Strikes, second half of 1998 and first quarter of 1999	Pro-Anwar demonstrations, 9-10/1998	Ongoing antigovernment and antimilitary demonstrations; rioting in Jakarta, 11/1998; increased secessionist pressures and social violence in provinces
Decision-making process	Parliamentary, six-party coalition; seventh party added, 11/1998	Presidential. Initially divided government; unified government from 8/1998	Parliamentary, coalition government, but UMNO Party dominant	Transitional presidential government, increasing parliamentary activism
Government links to business	Close links between legislators of all parties and business	Weaker links between Kim Dae Jung and <i>chaebols</i>	Close to politically favored groups	Continuing links with some favored groups and charges of corruption (Bank Bali scandal 7/1999)

Malaysia, finally, is the country where the crisis was most shallow, but also where political continuity prevailed. Not surprisingly, it was also the country in which the extent of political, institutional, and policy reform was the least pronounced.

## Thailand

The crisis in Thailand contributed directly to a change of government that brought a reformist party to office. In contrast to South Korea, the new Thai administration faced a much more complex set of political constraints. But even before the fall of the Chavalit government, the crisis helped propel forward a wide-ranging constitutional reform process that had begun with the return to democratic rule in the early 1990s. The new constitution is of interest because its final passage was so clearly influenced by the crisis and the political and institutional weaknesses of the Banharn and Chavalit governments in managing it.<sup>2</sup>

The origins of constitutional reform date to the first Chuan government, which came to office following the return to civilian rule and the general elections of 13 September 1992. Neither the Chuan nor the Banharn government was able to complete the process.<sup>3</sup> As a result, the task of constitutional reform fell to the Chavalit government, which formed a Constitutional Drafting Assembly (CDA) composed of two indirectly elected groups: representatives from each of the country's 76 provinces; and 23 political, administrative, and legal experts. The CDA began its work in January 1997. Provincial representatives canvassed opinion in their districts, engaging a number of civil society groups in the process, and in April a first draft was passed by the CDA with only one opposing vote.

The CDA thus began to disseminate the draft of the new constitution just as the crisis was beginning to break, and the issues of political and economic reform became closely linked. The CDA revised the draft in August for submission to the National Assembly with a "fast track" provision: the National Assembly could only vote the document up or down. Very shortly after the revised draft was passed by the CDA, pressure mounted on the government to move the constitution toward consideration in the National Assembly.

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2. The following account draws primarily on Klein (1998), Pasuk and Baker (1999), Suchit (1999), and Hicken (1998 and 1999) on the electoral system.

3. The first Chuan government established a Committee for Democratic Development that outlined a process for revising the 1992 constitution, but the government fell on charges of corruption. The Banharn government established a committee that recommended an official review of the constitutional reform process, but the Banharn government also fell on charges of corruption.

The forces arrayed against the document were powerful, including a range of institutions that would be politically checked, exposed to demands for greater transparency, or lose prerogatives: the police, army, judges, senators, subdistrict and hamlet chiefs (*kamnan*), and most political parties, including those in the ruling coalition. Opponents also banked on the conservatism and indifference of rural voters. An important set of allies in the fight against constitutional reform were the *kamnan*, the selection of whom was partly controlled by the powerful and centralizing interior minister. Under the new constitution, they would have to stand for election and would thus be excluded from *ex officio* positions in elected local government organizations.

However, support for the new constitution also came from diverse (and to some extent antagonistic) sources. Constitutional reform pulled support from a variety of reformist civil society groups and from the left, but also from the Bangkok middle class, which has played an important role in the restoration of democratic rule. The opposition Democrats also said that they would vote for the constitution, albeit with some reservations. The Bangkok business elite was initially skeptical about constitutional reform, but as Pasuk and Baker (1999, 9) point out, “The two cabinets in power through 1995-97 dramatically illustrated the danger of entrusting Thailand’s fragile urban economy to the care of provincial business politicians.” On the day before the vote on the constitutional revision, more than a thousand business executives gathered in the Silom Road district—the Wall Street of Bangkok—to demonstrate in favor of the reform (*Far Eastern Economic Review*, 9 October 1997, 20-21). On 27 September, the National Assembly approved the draft, with 578 votes for, 16 against, and 17 abstentions.

The constitution is a large and complex document, and the changes it promises to bring to Thai politics are profound. One of its objectives is to establish constitutional supremacy. The institution of judicial review and the establishment of a constitutional court reduce the ability of both laws and administrative decrees and regulations to take precedence over constitutional guarantees. In addition to the constitutional court, the new charter establishes a range of independent judicial and quasi-judicial institutions designed to protect particular rights and to act as a check on government. These include a new election commission, a human rights commission, an administrative court, an office of the ombudsman, and a strengthened National Counter Corruption Commission.

The constitution also overhauls the electoral system, and Parliament itself. The new constitution addresses the problem of party fragmentation by changing the electoral system to winnow the number of parties and make them stronger.<sup>4</sup> The constitution requires the Senate to be popularly

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4. Representatives were previously elected from multi-member districts. The new system is two-tiered: 100 seats will come from nationwide party lists, which will enhance the power of party leaders; and 400 will come from single-member districts, thus reducing the number

elected for the first time, and seeks to disengage elected politicians both from the bureaucracy (e.g., by prohibiting senators from holding other administrative office) and from business (by prohibiting senators from being the beneficiary of government contracts, by requiring full disclosure of assets, and by requiring cabinet ministers to resign their parliamentary seats).

Finally, the constitution also includes a number of initiatives for decentralizing government and increasing direct citizen input. The most important of these are political and administrative decentralization and the guarantee that locales have a greater say in the management of resources. The latter issue pitted developers against small landowners and commons, and had become one of the most bitter and divisive during the boom of the 1990s. The constitution also allows for direct citizen participation in the law-drafting process (through ad hoc legislative committees with civil society membership) and establishes a referendum process.

The full implementation of this ambitious agenda would naturally take years and require changes in habit as well as law. Nonetheless, the change wrought by the constitutional revision was far-reaching, and it is highly doubtful that it would have occurred in the way it did in the absence of crisis circumstances.

Despite the expeditious passage of the constitution, economic policy-making by mid-October was in complete disarray. Even with a near complete collapse of confidence on the part of both the markets and the international financial institutions, Thai politics reverted to intercoalitional conflicts.<sup>5</sup> On 21 October, a cabinet meeting considered a declaration of a state of emergency, but in an important indicator of the strength of the new democracy, the proposal for a curfew and media censorship was blocked by the military (*Far Eastern Economic Review*, 6 November 1997, 20-21). Chavalit did succeed in putting together a cabinet that included nonpolitical appointees to key economic portfolios. However, after Chavalit resigned on 3 November, the coalition failed to find an alternative leader and the Democrat Party was allowed to form a government.

As in South Korea, the position of the new government was strengthened by the patent failures of its predecessor. Even though Chuan still required five additional parties to form a coalition (see table 3.2), the Democrat Party was the largest and he was able to insist that it occupy all of the top economic positions as a precondition for forming a government.

The ideological positions and even support bases of the parties in Thailand are difficult to pin down because of the fluidity of the system and

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of parties per district. Party switching is also prohibited between elections, therefore increasing discipline.

5. A power struggle emerged between the New Aspiration Party (NAP) and its main coalition partner, Chart Pattana, over Chavalit's plan to bring in nonpartisan outsiders because it implied a reallocation of cabinet seats (*Bangkok Post*, 29 September 1997).

**Table 3.2 Party composition of Thai governments and oppositions, 1996-2000**

<b>Chavalit government (11/1996-11/1997)</b>		<b>Chuan government (11/1997-11/1998)</b>		<b>Chuan government (11/1998-7/1999)</b>		<b>Chuan government (7/1999-1/2000)</b>	
<b>Government parties</b>	<b>Number of seats</b>	<b>Government parties</b>	<b>Number of seats</b>	<b>Government parties</b>	<b>Number of seats</b>	<b>Government parties</b>	<b>Number of seats</b>
NAP	125	Democrats	123	Democrats	123	Democrats	123
Chart Pattana	52	Chart Thai	39	Chart Pattana	52	Chart Pattana	52
Chart Thai	39	SAP	20	Chart Thai	39	Chart Thai	39
SAP	20	Cobra faction	12	SAP	20	Cobra faction	12
Prachakorn Thai	18	Solidarity	8	Cobra faction	12	Solidarity	8
Muon Chon	2	Seritham	4	Solidarity	8	Seritham	4
				Seritham	4		
<b>Percentage of seats</b>	65		53		66		61

*(continued next page)*

**Table 3.2 Party composition of Thai governments and oppositions, 1996-2000 (continued)**

<b>Chavalit government (11/1996-11/1997)</b>		<b>Chuan government (11/1997-11/1998)</b>		<b>Chuan government (11/1998-7/1999)</b>		<b>Chuan government (7/1999-1/2000)</b>	
<b>Opposition parties</b>	<b>Number of seats</b>	<b>Opposition parties</b>	<b>Number of seats</b>	<b>Opposition parties</b>	<b>Number of seats</b>	<b>Opposition parties</b>	<b>Number of seats</b>
Democrat	123	NAP	125	NAP	125	NAP	125
Solidarity	8	Chart Pattana	52	Prachakorn	5	SAP	20
Seritham	4	Prachakorn	5	Thai		Prachakorn	5
Thai	1	Thai		Palang Tham	1	Thai	
		Muon Chon	2			Muon Chon	2
Palang Tham	1	Palang Tham	1	Thai	1	Palang Tham	1
		Thai	1			Thai	1
<b>Percentage of seats</b>	<b>35</b>		<b>47</b>		<b>34</b>		<b>39</b>

NAP = New Aspiration Party

SAP = Social Action Party

Note: The Thai Party supported the government after 11/1997 but was not a coalition member. The Cobras were a faction of the Prachakorn Thai Party (PTP). When the Cobras left PTP in 11/97, one PTP member resigned, bringing the number of seats to 392. Chavalit reshuffled the cabinet in 10/1997, but there were no changes in party composition.

the need for all parties to compromise with regional power brokers to be effective at the national level. Nonetheless, the Democrat Party is the oldest party in the country, the most institutionalized, with the strongest ties to the Bangkok elite; it has also always had the easiest time attracting support from technocrats. To a substantial degree, Girling's (1981, 166) description of the party of nearly two decades ago still rings true: Democrat leaders are "people of wealth, standing and integrity: they were loyalists, supporters of a *laissez-faire* economy . . . and proponents of constitutional government and honest administration." In the more recent past, it had stood both for democracy against military rule (e.g., in the 1992 elections) and in favor of a technocratic, cautiously reformist approach to economic policy. Although the party suffered from its own corruption problems—indeed the party lost power over this issue in 1998—it generally was free of the more egregious patronage, pork-barrel spending, and corruption of a number of its opponents (e.g., in the 1996 elections). In the fall of 1997, the Democrat Party was the closest thing on the Thai political scene to a party of economic reform.

In some areas, particularly with respect to the management of the ailing finance companies, the new government moved with dispatch not only to address problems but to make needed institutional changes, such as increasing the independence of the Financial Restructuring Agency (see chapter 5). However, from the beginning, Chuan faced a more complex set of political constraints than in South Korea (see table 3.1). The government faced more diverse social protests and had to contend with business opposition to the government's (and the IMF's) macroeconomic policy stance that found reflection in important divisions within the Democrat Party's technocratic team itself. In seeking to pass reform legislation, these problems were compounded by the fact that the Senate contained a number of businessmen who would be adversely affected by proposed reforms and had the constitutional power to review, and thus delay, reforms.

As if these problems were not enough, Chuan had to continually contend with the problem of coalition maintenance. Despite the advantages the Democrat Party gained from the incompetence of the preceding government, its overall legislative majority was initially razor thin, and even that majority was sustained only by including two parties in the coalition that had participated in the failed Chavalit administration (see table 3.2). In combination, these factors contributed to a much more gradual reform process than that seen in South Korea, and one that yielded more modest results.

As early as January, the government faced the problem of how to deal with violent labor actions in the private sector (Hewison 1999). Problems with labor were later compounded by the announced intention to privatize a number of state-owned enterprises, a process that quickly stalled.

But the strongest social pressure on the government initially came not from the urban areas but from the rural Northeast. The Northeast was the poorest, most neglected region of the country and the one most heavily affected by the crisis. In February, a rural farmers' lobby assembled protesters in the Northeast in Chavalit's constituency and marched to the capital, and again in April farmers' groups organized demonstrations for relief of agrarian debt. The New Aspiration Party (NAP) had also built its appeal in the early 1990s as the representative of the region and made an effort (only partly successful) to tap into these concerns. The government made concessions on the debt issue that divided the different farmers' organizations, but social pressures did not abate. The NAP's new program, published in early 1999, emphasized help for the rural poor through decentralization and redistribution, and NGOs that had participated in the constitutional debate continued to place pressure on the government to implement the political reforms.

The self-evident failure of the opposition while in office limited its ability, at least initially, to capitalize on the crisis, and censure votes in early 1998 and early 1999 failed badly. More difficult for the government was the growing chorus of complaints from the private sector and the fact that the cabinet itself was quite sharply divided over economic policy (Pasuk and Baker 1998). Finance Minister Tarrin supported the IMF's approach, at least in its broad outlines, but Supachai (originally a deputy prime minister, minister of commerce, and senior economic cabinet member) argued publicly that the government should devote more attention to recovery.

As in all of the crisis countries, a major source of controversy was the conduct of fiscal and particularly monetary policy. In the third letter of intent of 24 February 1998, the IMF and the government reached an agreement on relaxing fiscal policy (although much too late in the eyes of some critics). But given that the baht was sinking to new levels, the program maintained a tight monetary stance (Ammar 1997). The core complaint of the business lobby and the pro-business wing of the cabinet centered on the question of interest rates and the priority that should be given to stabilizing the baht and reforming the financial sector, as opposed to addressing problems in the real economy. Throughout the spring of 1998, the government faced ongoing complaints over its high interest rate policy and pressure to relax them or devise other mechanisms to ensure an increased flow of credit.

Given the coalition nature of the government and the close links between all parties and the private sector, the government was more responsive to these pressures than in South Korea, and it made a number of concessions to private-sector demands.<sup>6</sup> The IMF sanctioned these

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6. State-owned banks were used as vehicles to increase lending to adversely affected sectors, and in April the prime minister himself stated that the central bank should bring interest rates down. In May, Parliament passed important financial reform legislation that also

changed views to some extent in its fourth Letter of Intent (26 May 1998), which relaxed liquidity constraints while simultaneously laying out an ambitious timetable for financial restructuring and privatization.

But these divisions within the economic cabinet continued, usually surfacing in most visible form whenever new Letters of Intent were under consideration.<sup>7</sup> These divisions account for the failure of some legislation, including a much-needed liberalization of the rules governing foreign direct investment, and as will be seen in the next chapter, complicated the passage of bankruptcy legislation.

These various pressures both inside and outside the coalition naturally made it difficult to count on stable bases of support. In November 1998, Chuan bowed to his interior minister and party deputy to reach a deal with the 52 members of the opposition Chart Pattana (CP) that would bring them into the coalition, thus enlarging his political base (see table 3.2). The basic problem, as always in Thailand's fragmented party system, was that to bring Chart Pattana into the coalition not only meant compromises with politicians of less than sterling reputation, but granting them portfolios as well. The Democrat leadership managed to keep them away from most economic posts, but Chuan had to concede some.<sup>8</sup> As a result, a move that was designed to increase Chuan's margin and insulate him from opposition in fact resulted in a coalition in which the loyalty of the different parties and factions became even more dubious.

However, the opportunities for the opposition to capitalize on the weaknesses in the ruling coalition were limited by their own divisions and continuing doubts about their efficacy and probity. The recovery blunted the ability of the opposition to capitalize on the question of economic management, and the NAP's own history and reputation made it poorly positioned to make charges with respect to corruption.<sup>9</sup> A third censure

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granted both the Financial Institutions Development Fund and the Ministry of Finance greater authority to borrow abroad in support of increased liquidity.

7. After the fourth Letter of Intent (LoI) in May, LoIs were signed in August 1998, December 1998, March 1999, and September 1999.

8. The inclusion of the CP also served to splinter both the Democrat and Social Action parties, and in July 1999 the Social Action Party withdrew from the government after the party finally broke up over the allocation of ministries.

9. On March 4, 2000, direct Senate elections were held for the first time. Candidates were prohibited by the new constitution from identifying themselves with political parties. As a result, the election results did not provide straightforward information on support for the government or the reform process. Some analysis suggested that reformers and candidates with links to civil society groups had done better than expected (*Bangkok Post*, 5 March 2000). However the elections also provided evidence of the difficulty of rooting out patronage politics and corruption. A total of 78 successful candidates were disqualified by the Electoral Commission for fraud. However, most of these candidates were allowed to run in a second round of balloting and 44 of the 78 were elected again.

motion in December 1999 failed decisively (229 to 125, with 12 abstentions).

In sum, the crisis in Thailand brought a reaction to the crony politics of the Banharn and Chavalit administrations and a return to rule by the Democrat Party, with its more reformist ambitions. The crisis also helped mobilize support for sweeping constitutional change. Nonetheless, a combination of social and business protest, the Democrats' reliance on more traditional parties for support, and the fractious nature of coalition politics made policymaking in Thailand difficult, slow-moving, and ultimately timid.

## South Korea

Following Kim Dae Jung's election on 18 December, both international and domestic concern about South Korea centered on the management of the transition, and the danger that policymaking would drift. The IMF program signed in early December had failed to stabilize the won, and fears quickly centered on whether the Christmas Eve package would suffer a similar fate. With two months before the inauguration (25 February), a power vacuum at the center or conflict between the outgoing and incoming leaders would have had devastating consequences.

The conditions surrounding Kim Dae Jung's victory did not appear particularly auspicious for effective crisis management. Kim's margin of victory against ruling party candidate Lee Hoi Chang was extremely narrow (40.3 vs. 38.7 percent), and he was elected with only a plurality of total votes cast.<sup>10</sup> The non-concurrence of presidential and legislative elections raised the possibility of deadlock; from his first day in office, Kim Dae Jung's ruling coalition would face divided government.

Political circumstances appeared inauspicious for a second set of reasons as well. Because of his long history as an opposition figure and his identification with the poor, Kim Dae Jung appeared to be a populist. Both the international financial institutions and the United States viewed his election with some concern, particularly following his remarks about the need to reexamine the IMF program.

In fact, the international community had an extremely poor understanding of Kim Dae Jung. Kim's diagnosis of South Korea's problems was surprisingly orthodox and emphasized both the failures of state interven-

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10. Kim Dae Jung's support was also geographically concentrated. In his home province, he received 95 percent of the vote; outside it, his average vote share was only 30 percent (Jaung 2000). Moreover, his victory was only possible because of an unlikely alliance between Kim Dae Jung's National Congress for New Politics (NCNP) and conservative Kim Jong Pil and his United Liberal Democrats (ULD)—a marriage of convenience that raised the specter of intra-coalitional conflict.

tion and the need for political checks on government. His analysis of the crisis in his book *DJnomics* (D. J. Kim 1999) notes the short-term problems of mismanaged liberalization and loss of confidence by foreign investors, but gives greater weight to the failure to develop “the rules and principles of a market economy [and] failing to implement structural reform policies consistent with changes in the international environment” (10). Kim strongly underlined the problems of moral hazard and corruption, and he traced them back to political factors that impeded the operation of the market: “one is unwarranted influence from political power figures and bureaucrats; the other is monopolistic and other anti-competitive behavior within the market” (31).

The solution to the first problem was to be found in more effective democracy. “Democracy supports the development of the market by preventing activities like corruption and collusive ties between the government and businesses . . .” (35). Problems of moral hazard, corruption, and collusion required regulation, but would also be addressed by making the economy more market-oriented: “opening and expanding competition within the market is critical for eliminating preferential treatment and irregularities that fundamentally distort the economic order” (32). In his often-used phrase, “democracy and the market economy are like two sides of the same coin” (35).

Kim Dae Jung was able to make substantial progress on his program by exploiting the crisis and his political assets wisely at the outset of his administration. Two days after the election, Kim Young Sam and Kim Dae Jung met and formed a joint 12-member Emergency Economic Committee (ECC). For the 2 months before the inauguration, this body, made up of six members from the outgoing and incoming governments but effectively under the president-elect’s control, served as the de facto economic cabinet. Kim’s coalition (NCNP and ULD) and the majority GNP also agreed to convene a special session of the National Assembly to deal with a series of reform bills required under both the original IMF program and its 24 December revision; two further special sessions followed (see table 3.3). As a result of these institutional agreements, Kim Dae Jung enjoyed an unusual executive and legislative position. Not only did he and his advisors effectively control the cabinet, but they also enjoyed a legislative majority because of the ability of Kim Young Sam and Lee Hoi Chang to deliver GNP cooperation in the National Assembly.

The importance of these arrangements for the course of South Korea’s economic reform cannot be exaggerated. Table 3.3 suggests the range of the reforms passed during the special legislative sessions held during the transition. Of particular importance were financial reforms that had been stalled under the previous government. Although controversy continued to surround this legislation (see chapter 4), the government did succeed in creating a new financial regulatory agency and delegating substantial power to it.

**Table 3.3 Reform legislation passed during the transition period, South Korea, 1997-98**

Session	Legislation approved
186 <sup>th</sup> (22-30 December, 1997)	Act Establishing Financial Supervisory Institution Bank of Korea Act (r) Bank Act (r) Act Concerning the Restructuring of Financial Industries (r) Security Exchange Act (r) Insurance Act (r) Mutual Trust Company Act (r) Depositor Insurance Act (r) Merchant Bank Act (r) Forward Business Act (r) Act concerning the Abolition of the Interest Rates Limits Special Consumption Tax Act (r) Act Concerning the External Auditing of the Corporation (r)
187 <sup>th</sup> (15-21 January, 1998)	Session called to consider labor legislation, but defers to Tripartite Commission
188 <sup>th</sup> (2-16 February, 1998)	Bankruptcy Act (r) Corporate Composition Law (r) Corporate Reorganization Law (r) Monopoly Regulation and Fair Trade Act (r) Foreign Investment and Foreign Capital Investment Act (r) Corporate Tax Act (r) Tax Reduction Act (r) Labor Standards Act (r) Employment Adjustment Act (r) Government Organization Act (r)

(r) = revised.

Source: Office of the Secretary, National Assembly.

But the Kim administration did not rely solely on legislation to initiate reform; it also created corporatist arrangements—albeit temporary ones—that permitted negotiation with business and labor. This strategy had a number of objectives, including placing pressure on the groups to make concessions and facilitating tradeoffs among them. The corporatist strategy also circumvented the legislative problems that would arise from working in a context of divided government; it would be hard for the now-opposition GNP to oppose reforms to which the major interest groups had already agreed.

Exploiting the unpopularity of *chaebol* management, their short-term financial weakness, and his relative political independence from them, Kim Dae Jung used an ad hoc meeting with the heads of the top 5 *chaebol* on 13 January, and on 6 February with heads of 30 others, to outline an agreement on five principles of corporate restructuring. The ambitious agenda of the early meetings (see table 3.4) reveals clearly that the govern-

**Table 3.4 Five principles of corporate restructuring, South Korea**

Objective	Measures	Schedule
Enhanced transparency	Adoption of combined financial statements	FY1999
	Adoption of international accounting principles	October 1998
	Strengthening voting rights of minority shareholders	May 1998
	Compulsory appointment of outside directors	February 1998
	Establishment of external auditors committee	February 1998
Resolution of cross-debt guarantees	Resolution of existing cross-debt guarantees	March 2000
	No new cross-debt guarantees between subsidiaries	April 1998
Improvement of financial structure	Agreement with banks to improve capital structure	April 1998
	Removal of restrictions of capital infusions	February 1998
	Introduction of asset-backed securities	August 1998
Streamlining business activities	Adoption of corporate-split system	June 1998
	Liberalization of foreign ownership of real estate	June 1998
	Full liberalization of mergers & acquisitions	May 1998
	Streamlining of bankruptcy procedures	February 1998
Strengthening accountability	Strengthen the legal liability of controlling owners	June 1998
	Introduction of cumulative voting systems	June 1998
	Allowing institutional voters rights	June 1998

FY = fiscal year.

Source: Reference Information: the Korea Forum, Ministry of Finance and Economy, October 1998.

ment's motives were political as well as economic; namely, to increase the transparency and accountability of the *chaebol*.

The political pressure to "do something" about the *chaebol* was closely related to another area of structural reform that was also to prove highly contentious: increasing the flexibility of the labor market while guaranteeing an adequate social safety net for adversely affected workers. To reach agreement on these issues, Kim Dae Jung resorted to a mechanism that Kim Young Sam had attempted without success (Kim and Lim 1999)—the tripartite commission.<sup>11</sup> The unions were aware from the beginning

11. The formation of the group was closely related to legislative politics. The government called a special session of the National Assembly (the 187th) to amend existing labor legislation to allow layoffs, but the GNP was reluctant to cooperate because of the potential political price; the National Assembly thus deferred to the tripartite commission.

that the objective of the commission was to extract labor concessions on the issue of layoffs. However, Kim Dae Jung's status with labor and the promise of political as well as economic compensation allowed the government to bring representatives from both labor federations (FKTU and KCTU) to the table.<sup>12</sup> Government-labor relations on social issues turned more stormy over time, but the tripartite mechanism did serve to secure some important reform legislation (see chapter 6).

In addition to his economic program, Kim Dae Jung also had an ambitious administrative reform agenda designed to create a "smaller but more efficient government." The central thrust of the administrative reforms (January-February 1998 and May 1999) was to reduce the size of the public sector by eliminating agencies and even whole ministries and to reallocate powers away from traditional ministries that had exercised substantial influence over economic policy in the past (E. Kim 1999). The Ministry of Finance and Economy was a particular target; it was stripped both of its budget powers (to a Planning and Budget Commission directly under the president and an independent Office of the National Budget) and most of its financial supervisory functions (to the Financial Supervisory Agency; see chapter 4). The Fair Trade Commission also saw its powers enhanced.

In sum, the period of transition was an extremely fertile one. Kim Dae Jung exploited the crisis and the unusual institutional circumstances to push through wide-ranging reform legislation, the most important part of which was the creation of a new supervisory agency, the Financial Supervisory Commission, which had substantial powers with respect to the management of the financial crisis. The president also exploited his stature and public opinion to strike agreements with both the *chaebol* and labor on wide-ranging adjustment measures, using concessions from each to gain concessions from the other in a kind of grand bargain.

Once this initial burst of reform activity was launched, the problems shifted from initiation to implementation, and the government began to face increasing political constraints. The greatest concern of the government was the high level of unemployment that accompanied the crisis; of the four most seriously affected countries, South Korea experienced the sharpest increase in unemployment.

But the government also faced important electoral constraints. Presidential, legislative, and subnational elections are non-concurrent in Korea. As a result, policymaking during the first 18 months of Kim Dae Jung's presidency took place under the shadow of elections that were cast as referenda on the government's reform efforts. The president's NCNP-

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12. The tripartite structure included the major business associations (the Federation of Korean Industries and the Korean Employers' Federation), government officials (the Ministry of Finance and Economy and the Ministry of Labor) and representatives from each of the four major parties.

ULD alliance sought to use the elections to confirm public support for reform; the opposition GNP, by contrast, sought to discredit the government's efforts.

The results of early by-elections are difficult to interpret because of the powerful effect of region on voting behavior,<sup>13</sup> but the subnational elections of June 1998 were a nationwide contest and were read as a referendum on his government's performance in its first 6 months. The results outside of Seoul tracked regional bases of support to a large degree, but the president's victory in Seoul provided a mandate to continue and deepen the reform process. Shortly after the election, the government unveiled another round of reform measures (*Far Eastern Economic Review*, 18 June 1998, 24).

The June elections were also significant because of the effect they had on realignment within the National Assembly. After his inauguration, inter-party cooperation fell apart and the deadlock of divided government emerged.<sup>14</sup> This deadlock ultimately proved politically costly for the opposition (GNP), because divided government gave the president's (NCNP-ULD) coalition strong incentives to woo opposition legislators. The president was not above using the powers of his office, including prosecutorial powers, to persuade opposition legislators to defect (Diamond and Shinn 2000, 26). This effort finally proved successful in early September 1998, when the NCNP-ULD coalition won a majority. Another round of reform legislation followed.<sup>15</sup>

The survey data that we have from around this time (October 1998) suggest that the government was not wrong to believe it had a mandate to pursue reform, despite the depth of the crisis. Shin and Rose (1998) found that 32 percent of respondents ( $n = 1,010$ ) were very or somewhat satisfied with the president's handling of the crisis, while 26 percent were somewhat or very dissatisfied; the remainder were neither satisfied nor dissatisfied (39 percent) or didn't know (3 percent). However, fully 63 percent believed that "economic reforms have to be pursued, even if it means significant hardship for people like you," and 45 percent believed

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13. E.g., the 2 April by-election to fill four National Assembly seats was the first by-election under the new government, but the seats were contested in Kyongsang Province, where ruling party support was weak; the government coalition did not carry a single seat (*Korea Herald*, 4 April 1998).

14. The opposition in the National Assembly was unwilling to confirm Kim Dae Jung's appointment of Kim Jong Pil as prime minister; the president appointed him as acting prime minister and named his first cabinet on 3 March. Nonetheless, until August, when the GNP finally relented, every National Assembly session was dominated by unproductive controversy over the confirmation issue, blocking a number of other legislative initiatives (E. Kim 1999).

15. The coalition continued to expand thereafter, and as of August 1999, the NCNP held 105 seats, the UDL 55, and the opposition GNP 135, with 4 independents.

that the IMF had helped economic recovery either a lot (5 percent) or somewhat (40 percent), with another 33 percent saying “half and half”; only 12 percent believed that the IMF had hurt prospects of recovery.

Nonetheless, the second honeymoon provided by the June 1998 elections and the legislative majority also had limits. Kim Dae Jung reshuffled the cabinet in May 1999 to support a second round of administrative reforms (B-K. Kim 1999). But a series of corruption scandals broke in the middle of the year, and the opposition GNP capitalized on public resentment to soundly defeat the NCNP and ULD candidates in by-elections held on 3 June.<sup>16</sup>

The administration’s attention increasingly shifted to political reform, and particularly to the question of how to reduce corruption and regionalism. Ongoing problems of corruption were linked to the rising costs of electoral politics, which in turn were attributed to the winner-take-all nature of single-member legislative districts. But the administration’s efforts to sell multiple-member National Assembly districts were seen as self-interested by both the opposition and the NCNP’s own UDL partners.<sup>17</sup>

By late 1999, the looming National Assembly elections of April 2000 made it difficult to initiate new economic or political reforms. Rather, Kim Dae Jung turned his hand to foreign policy with the dramatic announcement of the North-South summit just weeks prior to the election. The significance of the elections for the economic reform process is by no means straightforward. On the one hand, the elections were interpreted in Korea as a victory for the opposition GNP, which gained several seats, and a setback for Kim Dae Jung’s coalition. The GNP had tried to capitalize on a number of unpopular policy reform measures including the privatization of state-owned enterprises and the sale of Daewoo to foreigners.

On the other hand, voting continued to be driven primarily by regional factors, the GNP did not secure a majority in the National Assembly, and

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16. The scandals were for the most part small in scale, but undercut the administration’s strong stance against corruption. Newly appointed Justice Minister Kim Tae Joung became embroiled in the “boutique scandal”; his wife had received expensive clothing from those seeking influence during his tenure as prosecutor general. Kim Dae Jung initially decided to retain him, but reversed his position following the by-elections in June. Longtime economic advisor North Cholla Governor You Jong Keun was forced to resign from his advisor position following a report that \$120,000 in cash had been stolen from his house, leading to suspicion of corruption. The new environment minister, Son Sook, an actress, was forced to resign on 24 June after it was discovered that she had accepted \$20,000 from Korean businesses (Economist Intelligence Unit, *EIU Country Report: Korea*, 3<sup>rd</sup> quarter 1999, 16; *Korea Herald*, 5 June 1999).

17. The ruling party’s solution for regionalism was to form more broadly based political parties, in the first instance through a merger of the NCNP and UDL; however, this plan also fell through, and the NCNP was left to undertake a party reorganization on its own (*Newsreview*, 4 September 1999, 5).

the losses to Kim Dae Jung's coalition came not from his party—which actually gained seats—but from his smaller UDL coalition partner. Kim Dae Jung's new Millennium Democratic Party enjoyed the political benefits of economic recovery, and despite typical election posturing the two parties did not in fact divide sharply on issues of economic policy. In a post-election interview, GNP leader Lee Hoi even criticized the government for not being decisive enough in addressing problems in the financial sector (*Far Eastern Economic Review*, 18 May 2000, 22) and Kim Dae Jung immediately reconfirmed his commitment to completing the reform process. If not a resounding victory for the president, the elections provide little evidence of backlash either.

The crisis in South Korea brought a strongly reformist president to office. Kim Dae Jung aggressively (and sometimes controversially) exploited his powers and public support to push through a number of policy and institutional reforms early in his administration. In the face of divided government, he used consultative mechanisms to secure business and labor support, sometimes, as we will see, for measures of questionable legality (chapter 4). He sought to enhance the powers of independent regulatory agencies (e.g., the Fair Trade Commission and particularly the Financial Supervisory Commission) in support of his program. Kim Dae Jung's style raised important questions about the accountability of strong presidents, but dispels the notion that democratic governments are incapable of providing support for decisive policy action.

## Malaysia

Malaysia is the one country of the four examined here where the crisis did not produce a change of government. If the crisis generated political change in Malaysia, it appeared to be in the direction of increasing concentration of authority in the hands of the prime minister and creeping authoritarianism. The dismissal of Anwar Ibrahim left Mahathir serving not only as prime minister, but also as home minister and finance minister, and provided him with the opportunity to appoint a close protégé who had headed the controversial privatization program to the position of central bank governor. Following Anwar's arrest, Mahathir purged the party of a number of Anwar supporters, and left the deputy prime minister position open, forcing loyalty on any who might have ambition to succeed him (*Far Eastern Economic Review*, 15 October 1998, 18). The government effectively contained the spread of protests and demonstrations, including through the use of force, and used a variety of both legal and legally questionable means to limit the growth of the opposition. Anwar's trial raised serious questions about the integrity of the judiciary and police in

the country,<sup>18</sup> but it ended in a 6-year sentence that removed his most serious challenger from the scene. In November 1999, Mahathir called snap elections, and the National Front government was not only returned to office but also retained a substantial legislative majority.

Yet if the crisis did not lead to a change of government in Malaysia, economic developments nonetheless had an important bearing on politics after the fall of Anwar. Although the opposition was strongly motivated by the Anwar case and called for political reform, it also sought to highlight the government's economic failures, ongoing problems of business-government relations and corruption, and social inequality. Despite overwhelming odds, the opposition coalition (Barisan Alternatif, or Alternative Front) made gains in the 1999 election and is forcing important realignments in Malaysian politics.

The period under consideration here begins on 2 September 1998 with Anwar's dismissal from the government. Anwar did not go quietly; rather, he took his case to the public through a series of rallies in various parts of the country in the first three weeks of September 1998. Anwar's speeches during this period naturally focused on the political motivations behind his dismissal; but at the same time, he returned to broader themes that were very much related to the economic crisis, including misuse of UMNO funds, executive intervention in investigations by the Anti-Corruption Agency, the bailout of favored companies, and nepotism.<sup>19</sup>

On 20 September, Anwar was detained without trial under the Internal Security Act (ISA), and his wife, Wan Azizah, was prohibited from speaking in public or holding political gatherings in her home.<sup>20</sup> In the weeks

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18. The initial charges against Anwar were twofold: first, that he had committed sodomy and adultery; and second, that he had abused his office by trying to cover up his behavior. However, shortly after the trial began, one of the witnesses for the prosecution, head of the police intelligence branch Mohamad Said Awang, testified that the sexual charges were "baseless" and that there was in fact a conspiracy to smear Anwar's reputation. A second prosecution witness retracted allegations that were key to the sexual misconduct case, and in December the prosecution was forced to drop those charges, leaving the allegations of abuse of office as the core of the first trial. The trial on sexual conduct was launched in June, but was suspended before the November 1999 elections. In January 1998, the attorney general was forced to admit that the police chief was responsible for Anwar's injuries while in custody. The presiding judge's use of contempt charges against the defense team raised concerns about intimidation, and led the bar association to issue a call in late 1999 for an inquiry into judicial independence; they were subsequently enjoined from even debating the issue in a ruling that suggested that such debate might even fall under the Sedition Act. The major documents of the first trial, including the judgments, are contained in *Malayan Law Journal* 1999. A useful chronology of the trial can be found on BBC Online at [http://news.bbc.co.uk/hi/english/special\\_report/1998/10/98/malaysia\\_crisis](http://news.bbc.co.uk/hi/english/special_report/1998/10/98/malaysia_crisis).

19. See Anwar's speech of 20 September 1998, as translated in the Internet newsgroup at <http://www.soc.culture.malaysia> (this site may now be defunct).

20. During the next 10 days, 17 of Anwar's supporters were also detained, although all but 2 were subsequently released.

that followed, the loosely organized protest movement brought together a diverse set of political forces, from Muslims disaffected by the treatment of Anwar, to portions of the urban middle class, to social activists, grassroots organizations, and NGOs seeking to capitalize on the crisis (Case 1999, 6-7). This movement crested with large antigovernment demonstrations in October.

The police broke up these demonstrations, on occasion with force. The government also made it clear that it would use its full battery of legal weapons to deter an expansion of antigovernment protests.<sup>21</sup> Demonstrations flared again in February (following the finding that Anwar had in fact been beaten by a police official while in custody), in April (when Anwar was sentenced), and in September (the first anniversary of Anwar's arrest). But these demonstrations were not of a magnitude or momentum to threaten the regime or produce the splits within the government or military and police visible in Indonesia. In each case, they were broken up by the police.<sup>22</sup>

Nonetheless, the combination of the crisis and political developments did contribute to the formation of a new opposition in Malaysia, and the strengthening of existing opposition parties. The first organized response to Anwar's dismissal was the formation of the Social Justice Movement (Pergerakan Keadilan Sosial, or ADIL) by Anwar's wife, Wan Azizah, in December 1998 and then the National Justice Party (Keadilan) the following April. The central thrust of the multi-ethnic, multi-religious movement and party was clearly political: to defend political and civil liberties and "to check the present dangerous slide towards one-man rule where all institutions of governance are directed towards preserving the power of a certain individual." However, these themes extended to the abuse of power, corruption, and the concentration of wealth. From jail, Anwar also continued to stress economic as well as political themes, including opposition to costly "megaprojects," such as the Bakun dam and Kuala Lumpur light rail system, lack of transparency in awarding privatization contracts, and the bailout of connected companies (*Far Eastern Economic Review*, 8 April 1999, 24-26).

The UMNO confronted an even more important challenge from the Islamic Party (PAS), with its stronghold in the northern part of the penin-

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21. These weapons included denial of police permits (making rallies illegal), arrests, threatened use of the Societies Act (which permits up to 5-year imprisonment for those involved in managing unregistered groups), and the Universities and University Colleges Act (which prohibits students from engaging in opposition political activity).

22. Other forms of opposition activity were also attacked. Efforts to ferret out government and business malfeasance and corruption were countered with extraordinary lawsuits under the country's liberal libel laws, the press was subject to heightened scrutiny (and self-censorship), and even the efforts of opposition groups to use the Internet were frustrated by filters and blocks (Case 1999, 12).

sula.<sup>23</sup> The PAS embraced more fundamentalist Islamic positions in the first half of the 1980s. But this line reduced the party's electoral appeal, and it gradually swung back toward a more moderate line in the 1990s that resonated with a wider political audience, including urban Malay professionals and business people. The party did not shed its longer-run religious ambitions, but the platforms of the 1990s emphasized "questions of ethical values, greater egalitarianism, free and fair elections, governmental transparency, the preservation of the environment [and] the repeal of unjust laws (particularly the Internal Security Act). . . ." (Hussein 2000, 30).

On 20 November 1999, Mahathir called snap elections (elections were required by April 2000). Calling the general elections early capitalized on increasing signs of economic recovery and the ability to exclude an estimated 600,000 younger voters who had registered but would not be eligible to vote until 2000. The National Front had a number of advantages, including superior financing, close ties with both Malay and Chinese business, and extensive grass-roots organization through the UMNO and its allied parties. The National Front effectively controlled the dominant broadcast and print media. Control of government also meant control of electoral districting and a highly disproportionate electoral system.<sup>24</sup> The ruling coalition enjoyed the cushion of a number of safe constituencies, so many in fact that they could lose more than half of the popular vote and still retain not only a legislative majority but also the supermajority (two-thirds) required to engineer constitutional changes.

The four opposition parties—PAS, DAP, the new Justice Party, and the small Malaysian People's Party—labored under a number of their own disabilities in forming an electoral coalition, the Alternative Front. The PAS had demonstrated strength in the northern states of Kelantan, Terengganu, Perlis, and Kedah, and controlled the state government of Kelantan, the only one of Malaysia's 13 states not run by the ruling coalition. A number of indicators, such as the sales of the PAS newspaper *Harakah*, indicated that the party was breaking into more middle-class urban Malay

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23. The UMNO has always defined itself as a defender of Islam, but after the PAS left the ruling coalition in 1979, the party paid increasing attention to Islamic issues. Anwar, who had been the leader of a Muslim student organization (Malaysian Islamic Youth Movement, or ABIM) was invited to join the party in 1982, precisely to help the UMNO project an image that was both Islamic but at the same time progressive, moderate, and modern in its outlook.

24. Proportionality in electoral systems refers to the correlation between the share of the popular vote and the share of legislative or parliamentary seats; in a perfectly proportional system, the shares are identical. In disproportional systems, a given vote share is reflected in higher and lower share of seats, and can frequently result in "manufactured majorities," in which popular vote shares of less than 50 percent nonetheless produce legislative or parliamentary majorities. Virtually all electoral systems have some degree of disproportionality, although highly disproportional systems raise questions of basic fairness.

districts as well. Yet despite the gradual moderation of the PAS's rhetoric, the party had a minority fundamentalist wing to contend with and had only come recently to the idea of forming alliances and even having non-Muslim members. The National Front had the weapon of previous PAS party manifestos advocating the imposition of the *sharia* and other radical measures, a weapon that it did not hesitate to use.

The Chinese-dominated DAP had long criticized the government along lines strikingly similar to the PAS's and Anwar's, highlighting issues of creeping authoritarianism and corruption.<sup>25</sup> But at the same time, they had also long opposed ethnic favoritism; this was the key issue that differentiated them from the Malaysian Chinese Association (MCA), which was a member of the National Front coalition and continued to receive a majority of the Chinese vote. Yet despite these potential divisions, the four parties did agree on a common platform that downplayed religion and emphasized common political and economic themes: political reform, including of the state security apparatus, as well as reform of business-government relations and elimination of corruption.<sup>26</sup>

But on the crucial issues of ethnicity and religion, the DAP and the PAS were anything but natural allies, and the National Front exploited this point ruthlessly in its campaign. The ruling coalition raised the specter of Islamic fundamentalism, ethnic conflict, and even social violence. Some segments of the Chinese community recognized that Malay disaffection with the handling of the Anwar case and the economy enhanced their leverage vis-à-vis the National Front. In August, a group of important Chinese associations issued a list of 17 demands, which tracked the *reform-asi* agenda in important regards, including both political reforms (advancing democracy and human rights, restoring confidence in the police) and economic ones (making the privatization policy more transparent, reducing corruption) (*Straits Times*, 2 September 1999; *New Straits Times*, 24 September 1999). In the end, however, fears about the PAS outweighed whatever distaste some Chinese might have had for the National Front and UMNO, and the Chinese swing vote played a role in the National Front victory.

At one level, the election showed the continuing power of the National Front. Despite both the economic crisis and the handling of the Anwar case, the coalition still managed to secure 56 percent of the popular vote and 76 percent of legislative seats. But this was a long fall from its commanding performance in the 1995 elections, and only marginally better

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25. The writings of Lim Kit Siang are exemplary; see Lim Kit Siang 1998.

26. Like the National Front, they also managed to coordinate electoral strategy within the coalition so that Alternative Front candidates from different parties did not contest the same districts: 152 of 193 parliamentary contests and 367 of 394 state seats were one-on-one contests between the National and Alternative fronts, the highest in history (*Straits Times*, 21 November 1999).

**Table 3.5 Popular vote share of the National Front, Malaysia, 1969-99 (percent)**

1969	1974	1978	1982	1986	1990	1995	1999
45	61	57	61	58	53	65	56

**Table 3.6 Election results in Malaysia, 1995 and 1999**

	Parliament		State assembly	
	1995	1999	1995	1999
Barisan Nasional	161	148	335	281
Parti Islam	7	27	35	98
Democratic Action Party	9	10	12	11
Semangat46	6	0	12	0
Parti Bersatu Sabah	8	3	0	0
Keadilan	0	5	0	4
<b>Total</b>	<b>192</b>	<b>193</b>	<b>394</b>	<b>394</b>
Barisan Nasional percentage of total	83.8	76.7	85.0	71.3
Opposition, percentage of total	16.2	23.3	15.0	28.7

Note: Includes one direct candidate in 1995 parliamentary with opposition.

Sources: *Straits Times*, 27 April 1995; 1 December 1999.

than in the elections of 1990, during which government and UMNO corruption had also been an issue (see tables 3.5 and 3.6).

Moreover, underneath the aggregates were some trends that called the UMNO's dominance into question. The National Front as a whole lost 13 seats, but the UMNO lost 16 seats, including no fewer than five ministers. Important regional shifts were also visible, particularly in the Malay heartland of the North (see table 3.7). The UMNO won no parliamentary seats in Trengganu (8 seats); only 1 in Kelantan (14 seats); and only 7 of 15 in Kedah, the prime minister's home state. This partisan and regional shift was even more evident in the battle for state-level assembly seats.<sup>27</sup>

Disaggregating the vote says something about the opposition as well. The new Keadilan Party managed to win five parliamentary seats, including the symbolically significant victory of Wan Azizah in Anwar Ibrahim's

27. The Barisan Nasional held 335 state assembly seats in peninsular Malaysia before the election but only 281 after. Virtually all of the losses came out of the UMNO. The PAS continued to hold the Kelantan state government, but the oil-rich state of Terengganu also fell to the PAS. Pahang and Perak saw sharp increases in the number of opposition seats in the state assembly.

**Table 3.7 Election results in peninsular Malaysia by state, 1995 and 1999 (parliamentary seats)**

State	Barisan Nasional		Opposition parties		Barisan Nasional as percentage of total	
	1995	1999	1995	1999	1995	1999
Perlis	3	3	0	0	100.0	100.0
Kedah	15	7	0	8	100.0	46.7
Kelantan	2	1	12	14	14.3	7.1
Trengganu	7	1	1	7	87.5	12.5
Pahang	11	11	0	0	100.0	100.0
Kuala Lumpur	6	6	4	4	60.0	60.0
Johor	20	20	0	0	100.0	100.0
Malacca	4	4	1	1	80.0	80.0
North						
Sembilan	7	7	0	0	100.0	100.0
Selangor	17	17	0	0	100.0	100.0
Perak	23	20	0	3	100.0	87.0
Penang	8	6	3	5	72.7	54.5
Total	123	103	21	42	84.8	71.0
<b>State assembly</b>						
Perlis	15	12	0	3	100.0	80.0
Kedah	34	24	2	11	94.4	66.6
Kelantan	5	2	38	41	11.6	4.7
Trengganu	25	4	7	28	78.1	12.5
Pahang	37	30	1	8	97.4	78.9
Johor	40	40	0	0	100.0	100.0
Malacca	22	21	3	4	88.0	84.0
North						
Sembilan	29	32	3	0	90.6	100.0
Selangor	45	42	3	6	93.8	87.5
Perak	51	44	1	8	98.1	84.6
Penang	32	30	1	3	97.0	90.9
Total	335	281	59	113	85.0	71.1

Note: One direct candidate in 1995 not allocated by state.

Sources: *Straits Times*, 27 April 1995, 1 December 1999.

old district. But the party struggled and was divided in the post-election period over the question of how to define an identity that transcended the issue of Anwar. The biggest gainer in the election was clearly the PAS, which displaced the DAP as the largest opposition party. The decline of the DAP can be traced directly to the difficulties of forging the Alternative Front. Malays who opposed the government might still vote against the Alternative Front if they were uncomfortable with either the DAP's nonracial stance or PAS's Islamic positions. Chinese voters forced to choose between the PAS and the National Front clearly preferred the latter, but many abandoned the DAP as well. In the days before the elections, peak Chinese and Indian business associations publicly backed the National Front, as did the main non-Islamic interfaith council (Malay-

sian Council of Buddhism, Christianity, Hinduism, and Sikhism) (*Straits Times*, 30 November 1999).<sup>28</sup>

The immediate aftermath of the election suggested continuity in Malaysian politics. If we return to the political factors highlighted in table 3.1, electoral pressures had passed, the government had contained antigovernment protest, and the private sector had signaled its support for the Barisan Nasional government. The new cabinet exhibited strong signs of continuity, for example in the inclusion of Daim Zainuddin. In the spring of 2000, Mahathir drew on the loyalty of party regulars to smother a leadership challenge within the UMNO, reconfirming both his personal dominance of the party and the status of his chosen successor, Abdullah Ahmad Badawi.

Over the intermediate run, the government would have to address the issues of race and religion raised once again by the election, perhaps by accommodating PAS's religious demands at the margin or by reinvigorating the ethnic preferences of the New Economic Policy. But a postmortem by a Malaysian politician, Abdullah Ahmad (1999), reveals an alternative, less sanguine interpretation of the election within some factions of the National Front government:

[N]otwithstanding [the government's economic successes], old issues related to business and the economy must be re-addressed. Efforts must be redoubled to lessen corruption and wear away the links between business and politics . . . Moreover, the government and companies can do with greater transparency and a higher standard of governance—you can't have too much of either. This would go a long way in bettering citizens' quality of life and buttress their individual freedom. Indeed, Umno must be well aware that the latter has economic payback: Protecting freedoms creates conditions that allow innovation and creativity to flourish. . . (31)

## Indonesia

If Malaysia provides a case study of a nondemocratic regime that survived the crisis intact, Indonesia shows how crises can, under different circumstances, have the opposite effect. We have already seen in chapter 2 how a sequence of political events—questions about Suharto's health and the succession, the emergence of the opposition, the presidential election, and increasing protest—complicated economic policymaking. Yet the causal arrows also work in reverse. Economic circumstances contributed to

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28. An analysis of 144 electoral districts for which we have information on ethnic composition is revealing. The National Front carried 83 percent of the districts that were more than 30 percent Chinese (53 of 63), 75 percent of the districts that were more than 40 percent Chinese (31 of 41), and even managed to carry 63 percent of the districts that were more than 50 percent Chinese (15 of 24). In the aftermath of the election, both the DAP and the Keadilan expressed bitter disappointment about the defection of Chinese voters.

Suharto's fall and the initiation of a gradual process of democratic reform under Habibie. We begin with a brief analysis of the political consequences of the crisis and why it had such different effects in Indonesia than Malaysia, before turning to the achievements and failings of the Habibie government and the nature of the opposition that ultimately deposed it.

Indonesian politics under Suharto could never be construed as open or democratic, but in the late 1980s the government briefly signaled a political opening. Following the general elections of 1992 (in which support for Golkar slipped) and Suharto's indirect election in March 1993, politics turned back in a more authoritarian direction. Suharto centralized power within both the government and the ruling Golkar. He initiated an extensive purge of the military that both divided the organization more sharply into "red and white" (secular-nationalist) and "green" (Islamic) factions, while promoting loyalists, including his son-in-law Prabowo Subianto. One of the two opposition parties allowed to operate—the Indonesian Democratic Party (PDI)—was brought to heel in 1996 by purging its charismatic leader, Megawati Sukarnoputri, and her followers.<sup>29</sup> Increased labor activism, including efforts to form a new political party, was met with repression, and the country's most respected independent publication, *Tempo*, was closed.

As in Malaysia, Suharto reached out to "modernist" Islam,<sup>30</sup> which was undergoing a similar revival: through Habibie and his Indonesian Association of Muslim Intellectuals; through cabinet appointments; and through promotions within the army (Schwarz 1999, 327-31). As we have seen in Malaysia, however, modernist Islam was not necessarily hostile either to democracy or to market-oriented reform, and indeed found religious grounds for supporting both. Amien Rais, chairman of the mainstream modernist Muhammadiyah organization (approximately 28 million members and supporters) was among the first of major opposition leaders to argue that the economic crisis could not be overcome as long as Suharto remained in office. He was also a constant critic of the regime's authoritarianism, corruption, and lack of attention to social justice.

The crisis and government efforts to co-opt modernist Islamic forces contributed to a different ethnic and political dynamic than in Malaysia.

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29. The PDI was the result of a forced merger of nationalist and Christian parties. The second nongovernment party allowed to operate in New Order Indonesia was the PPP (Partai Persatuan Pembangunan, or United Development Party), which appealed to an Islamic constituency.

30. "Traditionalist" Muslims, generally found in less affluent rural areas, are socially conservative, but also less sectarian, more pluralist, and even secular in their view of relations between Islamic organizations and the state. They were represented by the Nahdlatul Ulama (NU; approximately 40 million members and supporters), headed by Abdurrahman Wahid (Gus Dur), who was periodically critical of the Suharto government and ultimately succeeded Habibie as president. "Modernist" Muslims, by contrast, are more urban, wealthy, and

With the Chinese constituting between 25 and 30 percent of the Malaysian population, the National Front coalition headed by the UMNO had an interest in courting Chinese financial and electoral support and keeping a lid on ethnic polarization. In Indonesia, by contrast, some of the more radical Islamic groups and individuals that had gained access to the government in the 1990s were openly hostile to the Chinese, and went so far as to blame them for the crisis (Schwarz 1999, 345-48). The Chinese business community thus found itself in a much more vulnerable position vis-à-vis the government than in Malaysia. With no political channels through which to air grievances, they voted through massive capital flight.

A second major difference with Malaysia was the inability of the government to control the scope of protest. The most important actors in this regard were the students, but they were eventually joined by other opposition groups and proto-parties. The movement was diverse and fragmented into a number of competing organizations (Aspinall 1999), but it united around a number of simple themes: reduction in prices of basic commodities; elimination of *korupsi*, *kolusi*, and *nepotisme* (KKN); and political reform. At a minimum, students demanded that Suharto step down; “radicals” argued for constitutional change, a reduction of the military’s political role in government, and complete democratization. Student protests gained force in February in direct response to the collapse of the economy, strengthened again before the People’s Consultative Assembly (MPR) session in March that elected Suharto, and exploded in May following the announcement of price increases on fuel and a number of other commodities. The killing of four students outside Triskati University on 12 May marked a critical turning point in the political crisis. The funerals the next day brought even larger student protests and were followed by the riots and social violence on 13-15 May that ultimately brought the Suharto era to an end.

The third and critical difference with Malaysia is that the combination of economic collapse, mounting protest, and the riots began to split the political elite; Mahathir never faced defections on this scale.<sup>31</sup> On 18 May, the speaker of the Parliament, a close associate, called on Suharto to step down, threatening impeachment proceedings if he did not. An effort by Suharto to form a new reform cabinet found no takers. The military appeared divided on how to handle the challenge of mounting protests, and Chief of Staff Wiranto finally came to support a transition to Habibie after rejecting the suggestion that the military take over directly. On 21 May, Suharto resigned.

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formally educated, but also harbor more explicit religious objectives and champion in varying degrees the Islamization of government and supports for the *pribumi*.

31. The most credible account of the endgame is Schwarz (1999, chap. 11), but for a flavor of the rumors and plotting of the last days, see Mann’s (1998b) more sensationalist account.

If we simply list the political constraints under which the new Habibie administration operated, it would be quite easy to predict complete political and policy immobilism (see table 3.1). The economy had yet to hit its nadir, which arrived with another round of rice price increases in September. Habibie faced challenges from the military, the ruling party, students, and newly emergent opposition parties. Even some legislators elected or selected under Suharto had an interest in distancing themselves from the new government.

In the second half of 1998, the *reformasi* movement, which had been concentrated largely in Jakarta and other major urban centers, spread rapidly throughout the country. Local movements challenged provincial and local officials and elites who had benefited from the ancien regime, eroding both the government's and Golkar's hold on the country. The economic crisis and reaction against the political and economic abuses of the old regime unleashed a wave of armed secessionism, social violence of various sorts, political confrontations, and crime. Although estimates must be treated with the appropriate degree of caution, table 3.8 provides some rough sense of the magnitude and geographic scope of the problem. Such social violence could not be traced solely to the crisis; 1997 witnessed an upsurge of such conflicts before the crisis broke and the major trouble spots—East Timor, Aceh, West Kalimantan—were of long standing (see, e.g., *Inside Indonesia*, April-June 1997, 6-8). But there can be little question that the crisis exacerbated old conflicts and created new ones. More than in any other country in the region, the economic crisis in Indonesia threatened the integrity of the country and its very basic social fabric.

However, Habibie was not without his own bases of support. In the first several months of his administration, he managed challenges from within the military by elevating General Wiranto—who supported constitutional processes during the succession—sidelining General Prabowo, and sanctioning a purge of a number of Suharto and Probowo loyalists (Crouch 1998). Habibie's cabinet, appointed on 22 May, kept 21 members of Suharto's. But it also jettisoned Suharto's daughter and the cronies and reached out to modernist Muslims and to respected technocrats who could mend fences with the international financial institutions (Schwarz 1999, 373; *Far Eastern Economic Review*, 25 June 1998, 24-25). Drawing on support from Wiranto and provincial leaders, Habibie was able to narrowly defeat his opponents in Golkar and install his ally Akbar Tandjung as head of the party. In 1999, he engineered Golkar's nomination for the presidency as well. Habibie had managed to assert his authority over, or at least strike bargains with, the military, a cadre of reformist technocrats, and the ruling party.

Managing the opposition was a much more daunting task. Student demonstrations continued in the early days following the transition, but were partly neutralized by counter-demonstrations from modernist Mus-

**Table 3.8 Major social violence in Indonesia, 1998-99**

Province or region	Locale, nature of violence, and dates	Estimated deaths 1998 to Nov. 1999
Aceh	Armed secessionist movement (Gerakan Aceh Merdeka [GAM] or Free Aceh Movement); ongoing clashes with military and opponents; large-scale refugee problem (>10,000)	>200
East Java	Banyuwangi, killing of Muslim clerics, late 1998	>200
East Nusa Tenggara	Kupang, burning and vandalization of mosques, November 1998	
East Nusa Tenggara	Sumba, riots and killing triggered by bureaucratic corruption and communal tensions (Loli and Wewewa Timur), November 1998	23
East Timor	Armed secessionist movement; ongoing clashes with military and militias; large-scale refugee problem (>100,000)	>200
Irian Jaya	Independence demonstrations, clashes with military and riots, July and October 1998	5 to 50
Jakarta	Riots and anti-Chinese violence, 13-15 May, 1998	>1,200
Jakarta	Student protests, 13 November, 1998	15
Jakarta	Communal violence (Ketapang; Muslim-Christian), November 1998	14
Maluccas	Communal violence in Ambon and other villages (Christian-Muslim, indigenous peoples, antimigrant), January 1999 to present; large-scale refugee problem (>200,000)	>1,500
Riau	Batam Island, communal violence (Batak and Flores migrants), August 1999	14
South Sulawesi	Antimigrant communal violence, September 1998 to January 1999	25
West Java	Ciamis, vigilantism and contract murders, early 1999	>50
West Kalimantan	Communal violence (Malays, Dayaks, and Muslim migrants), early 1999	>300
Various locations	Anti-Chinese violence over price increases in a number of cities and towns, in Java Sumatra, Sulawesi, Nusa Tenggara, Lombok, Sumbawa, and Flores; extensive property damage, February-March 1998	>10

Sources: Author's estimates from *Jakarta Post* and *Far Eastern Economic Review*, various issues, and Human Rights Watch (2000); For the Maluccas, *The Economist*, 15 January 2000, 17.

lim students supporting Habibie. Perhaps the biggest test for Habibie was the convocation of the Special Session of the MPR in November 1998, called to validate his proposed electoral reforms. The body was made up entirely of politicians elected or appointed under Suharto. As a result, the special session became a lightning rod for the opposition. Antigovernment protests increased again, and the MPR session ended in a confrontation between protestors and the military, military-controlled gangs, and other Habibie supporters that left 15 dead. These events further weakened the reputation of both the army and Habibie. But plans to use the Special Session as the opportunity to remove the new president immediately and form some sort of interim government faltered when the main opposition leaders failed to support it.

Habibie not only survived his first 6 months, but made it clear quite early his desire to stay in office. Given the depth of the crisis, the growing strength of the opposition, and the discrediting of the old regime, it was impossible to achieve this objective by insisting on the constitutionality of serving his full term (until 2003). Habibie's only hope was to remake himself as a political as well as economic reformer. There will long be debate over whether Habibie deserves credit for the political reforms that followed, or whether he was simply bowing to the inevitable in order to position himself for the 1999 elections. In either case, the reforms were sweeping, including most fundamentally freedom of association and expression. The government released a number of political detainees and prisoners, guaranteed press freedom, and ended restrictions on the formation of political parties, unions, and other associations.

Habibie also acknowledged that his government was a transitional one and established a timetable for elections under new rules: general elections for Parliament (DPR) and subnational governments by the middle of 1999, followed by the indirect election of the president by a new People's Consultative Assembly (MPR) later in the year (Masters 1999). The electoral rules and design of the two national representative institutions retained several features that biased outcomes at the margin in Habibie's and Golkar's favor.<sup>32</sup> Nonetheless, the changes in the electoral system

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32. The most significant and controversial of these was the continuing, albeit reduced, participation of appointed military representatives in the two legislative bodies (although in the end their loyalty Habibie proved uncertain). Military representatives were to make up 8 percent of the DPR, and those representatives also sat in the larger MPR that would choose the president (and constituted 5.7 percent of it). The government also retained disproportionate (although not exclusive) influence over the constitution of the all-important electoral commission and in the appointment of 65 functional group representatives to the MPR (representing 9.3 percent of the body). Because of its continuing organizational strength at the subnational level, Golkar also appeared to gain from the inclusion of 135 provincial representatives in the MPR (19.3 percent of the body).

were deeply democratizing, and the main opposition endorsed them in their broad outlines.<sup>33</sup>

On the economic front, Habibie's position as reformer was more ambiguous, reflecting the tension between the need to work with the IMF and project a reformist image and the need to build a support base in the private sector. One of the central demands of the opposition in the wake of the crisis was to address the problem of KKN. This would require not only legal reform to improve governance and increase transparency in the future (Lubis and Santosa 1998), but also an effort to right past wrongs through a thorough investigation of the wealth of the Suharto family and their cronies. Habibie showed much greater willingness to undertake the first task than the second, on which he dragged his feet until the very end of his term. This reluctance was not simply a matter of personal loyalty to Suharto; it also reflected his ongoing links to private-sector groups that were critical to financing his political ambitions and that were ultimately to embroil his presidency in scandal (see chapter 4 on the Bank Bali scandal).

At the same time, Habibie was also under pressure from a variety of political forces that sought to exploit the crisis to advance ethnic redistribution (Schwartz 1999, 414-19). The central source of this effort within the government was Minister of Cooperatives Adi Sasono. He wanted to see assets taken over from failing banks transferred to his ministry for distribution to the cooperatives, which constituted a wide-ranging patronage machine for Golkar (*Far Eastern Economic Review*, 3 December 1998, 14-16). Such ideas also received support from indigenous business groups that stood to profit directly from preferential distribution of seized assets.<sup>34</sup>

As we will see in chapter 4, the result of these conflicting political pressures was a reform process characterized by fits and starts, as well as a number of irregularities. But Habibie's support for economic reform cannot simply be dismissed. He publicly embraced the IMF in his very first statement as president, and worked quickly and successfully to restart the structural adjustment initiatives that had stalled under Suharto. Habibie retained Ginanjar as chief economic minister, despite the fact that he openly called for new elections, and strengthened the independence of the central bank and the Indonesian Bank Restructuring Authority (Kenward 1999; chapter 5 of the present volume).

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33. Moreover, although the government did not seek to revise the 1945 constitution, important institutional changes checked the central government, including limiting the president to two terms in office, revoking a number of his extraordinary powers, and recognizing the need for greater political and economic decentralization.

34. These included the Indonesia Association of Young Businessmen and the Indonesian Chamber of Commerce and Industry, and even some newly mobilized labor groups, such as the Indonesian Muslim Workers Brotherhood.

Habibie's commitment to restoring the confidence of the Chinese business community was ringed with reservations and thus the cause of somewhat greater concern.<sup>35</sup> However, on this front there were also signs of rapprochement. The Special Session of the MPR adopted an ambiguous resolution on a "democratic economy," but the government deflected language that would have instituted a Malaysian-style redistributive program. In any case, some of the concerns of the Chinese constituted special pleading, because a number of reforms would also strike at privileges held by crony Chinese-Indonesian businesses.

The convergence between the government and the opposition on a number of important reform issues can be seen in the eight-point Ciganjur Declaration signed by the three leading opposition figures, Megawati, Amien Rais, and Abdurrahman Wahid, on 10 November 1998 (Young 1998, 96-97) before the Special Session of the MPR. The declaration underscored commitment to democracy, honest elections, and decentralization of government. The "Big Three" also called for an end to the military's role in government ("dual function," or *dwifungsi*), but to be achieved gradually during 6 years. Only in its insistence on a full investigation of Suharto's wealth would Habibie have found anything objectionable in the declaration.

Thus, despite the depth of the crisis, the parliamentary elections of 1999 did not appear to yield much support for radical or "backlash" parties and candidates; rather, the elections would be fought over the broad center of Indonesian politics. What did that center look like?

A total of 48 parties ultimately qualified for the June parliamentary elections. All the parties supported the rule of law, greater regional autonomy (although there were subtle divisions on this point), rooting out corruption, and good governance. All supported democratic political processes, and the overwhelming majority acquiesced to the new rules of the game drafted under Habibie. The parties divided on three different axes (MacIntyre 1998; *Van Zorge Report*, 23 April 1999). The first and most basic was between Golkar—the incumbents—and the opposition. Although Golkar clearly lost members with the transition, it could still draw on its roots in the subnational administration and portions of the military, from Habibie's appeal to some modernist Muslims, and as a haven for those seeking some continuity with the past. Nonetheless, the party quickly recognized the disabilities of incumbent status and quickly democratized its structure, shed its connections with Suharto, and attempted to project a reformist image.

A second cleavage divided the opposition on the question of religion. Megawati's PDI-P party dominated the secular-nationalist camp, emphasizing ethnic and religious diversity, a clear separation of religion from

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35. See, e.g., the interview in *Business Week*, 3 August 1999.

government, and nationalist ideals that could be traced back to Soekarno. "Mega" was also popular among the urban poor and projected a populist image, but this did not mean that she adopted a populist or redistributive economic line. To the contrary, her chief economic advisor, Kwik Gian Kie, had leveled criticisms of the Suharto and Habibie governments that were quite orthodox in their implications.

The Muslim camp—if it could even be called that—was anything but homogeneous (Nakamura 1999). Eighteen of the 48 parties identified themselves as Islamic. This number included parties that might be labeled "fundamentalist" in the sense of vigorously asserting an Islamic identity, in being strictly exclusivist, or in calling for redistribution. But the larger Islamic parties were busy crowding the center on issues of political and economic reform. Amien Rais' National Mandate Party (PAN) was the party that emphasized most strongly issues of social justice and had close ties to the modernist Islamic Muhammadiyah organization; he also went further on issues of decentralization, advocating federalism. But at the same time, Rais' was also the party that reached out to policy intellectuals and progressive business interests and formulated the most sophisticated, market-oriented policy platform. Wahid's National Awakening party (PKB), with ties to the traditionalist Nahdlatul Ulama (NU) organization, did not develop a distinctive identity on economic questions beyond support for the general *reformasi* themes such as eliminating KKN. The same could be said for most of the other Islamic parties, which primarily sought to differentiate themselves on religious issues.

The results of the June election confirmed Megawati and her PDI-P as the dominant voice of the opposition and thus the natural candidate to succeed Habibie (see table 3.9). But although Megawati received a third of the popular vote, this translated into just 30 percent of the seats in the DPR and just over 26 percent in the MPR, only marginally higher than Habibie's Golkar. Clearly she would have to forge coalitions in the MPR to win, but with whom? Aligning with Golkar or conservative Islamic parties would be impossible, and some parties found the idea of a woman as president anathema. Aligning with Wahid—a close personal friend—made the most sense. But Amien Rais used his political skills to forge a highly tactical "Central Axis" that advanced Wahid as an alternative to both Habibie and Megawati.

The complex drama of the MPR need not detain us. Outside the hall, Megawati's supporters were converging on Jakarta, fearing that she would be denied the presidency and threatening a rampage if she did. Inside, Golkar and the Central Axis reached an agreement that gave Amien Rais the speakership of the MPR and Akbar Tanjung the leadership of the DPR; this was the first concrete sign that things were not going Megawati's way. When Habibie was ultimately forced to withdraw his candidacy and Golkar did not nominate an alternative, it set the stage for a straight

**Table 3.9 Indonesian parliamentary elections, 7 June 1999**

Party	Key figures	Percentage share of valid votes cast	Seats won in DPR	Percentage share of seats in DPR	Percentage share of related faction in MPR
Indonesian Democratic Party of Struggle (PDI-P)	Megawati	33.7	154	30.1	26.4
Golkar	B. J. Habibie, Akbar Tanjung	22.4	120	24.0	25.9
National Awakening Party (PKB)	A. Wahid (Gus Dur)	12.6	51	10.0	8.1
United Development Party (PPP)	Hamzah Haz	10.7	39	7.8	10.0
National Mandate Party (PAN)	Amien Rais	7.1	35	7.0	6.9
Justice and Unity Party (PKP)		1.0	6	1.2	2.0
Indonesian Democratic Party (PDI)		0.6	3	0.6	*
Crescent Star Party (PBB)		1.9	2	0.4	2.0
People's Rule Party (PDR)		0.4	2	0.4	*
Other parties and factions		9.4	50	10.0	2.0
Military	General Wiranto		38	7.6	5.4
Functional group representatives					10.4
Regional representatives					Distributed among other factions

\* = included under "other parties."

Note: The MPR calls for 135 representatives selected by provincial parliaments and 65 representatives of functional groups. The provincial representatives distributed themselves among the other factions in the MPR, which explains the differences in the seat shares in the two bodies. Of the 135 representatives, 1 elected member and the 5 representatives from East Timor did not attend, making for an effective total of 694 members. Seat shares are calculated on the basis of the statutory 700 members (the DPR does not have functional or regional representatives).

Sources: International Foundation for Election Systems, <http://www.ifes.org>; Thompson (1999).

fight between Wahid and Megawati, Wahid's victory (373 to 313), and the concession of the vice presidency to Megawati.

This brief outline of Indonesia's complex transition to democracy suggests two conclusions. First, the crisis was deeply implicated in the fall of Suharto: through its generation of protest, through the collapse of local as well as foreign private sector confidence, and ultimately through the split in the regime. Second, although the constraints that Habibie faced appeared daunting, the introduction of political competition in this transitional context pushed his hand in a strongly reformist direction.

If the crisis had several silver linings, they are more than offset by disturbing aspects of Indonesia's transition. As we have seen from the comparison of Korea and Thailand, not all democracies operate with equal efficiency, and Indonesian democracy is far less consolidated than in either of those two countries. If we look at the political constraints facing the new government, they do not augur well for its ability to manage the lingering problems associated with the crisis. *Electoral constraints* are temporarily alleviated, but *non-electoral political challenges* have become even more intense. Sectarian, ethnic, and secessionist violence have not abated with the transition to democratic rule but have become much worse. The religious war in the eastern Maluccas intensified following the transition, communal fighting has continued or escalated on the islands of Sulawesi, Bali, and Lombok, and the secessionist movements in Aceh and Irian Jaya have deepened.

*Decision-making processes* have rendered the government highly ineffective in the making of economic policy. Wahid's decision to form a "government of the whole" was reflected in the fragmentation of economic decision-making authority within the cabinet between a number of competing ministers and outside advisors, culminating in the embarrassing suspension of IMF support in late March 2000. Parliament is similarly fragmented into ten party factions, the second largest of which is Golkar, and the chairman of the assembly is Amien Rais, a direct political competitor to the president. Finally, with respect to *business-government relations*, the president did move to address issues of KKN, including the thorny issue of Suharto family wealth. But some in Wahid's entourage are not above such problems and the magnitude of financial and corporate distress is so great that it may be impossible to avoid some accommodation with beneficiaries of the old regime (see chapter 4). In sum, Indonesia's problems remain quite fundamentally ones of politics and institutions.

## Conclusion

The Asian financial crisis set in motion complex political changes in all four countries. The first thing to note is the resilience of the democracies. Economic crises have not been kind to democracies in the past, particularly

when they generate sharp political and social polarization. In the 1960s and 1970s, poor economic performance was the prelude to the installation of authoritarian governments in a number of Latin American countries, including Brazil (1964), Chile (1973), and Argentina (1973), as well as in South Korea (1961) and Indonesia (1965-66). Yet military intervention was never an issue during the crisis in Korea and was explicitly rejected by the military itself in Thailand in the fall of 1997. Democracies were also resilient in a second sense: Changes of government provided opportunities to initiate new programs and to change policy course. But all democracies are not created equal, and Thailand's fragmented party system and close business-government relationships continued to create problems for the reform process.

In both Indonesia and Malaysia, oppositions gained strength from economic grievances and sought to link them to the undemocratic nature of political rule. Yet all authoritarian regimes are not created equal either, and Malaysia's hybrid political system, with a number of democratic features, proved more resilient. Elections provided some channels for the opposition to operate, and Mahathir could draw support from the private sector and a well-organized party machine that occupied the political center on the most salient issues, particularly ethnic and religious ones. Indonesia lacked these advantages and proved surprisingly fragile in the face of concerted challenge.

A final conclusion concerns the nature of the opposition that emerged in the wake of the crisis. We have seen that business groups sought support and protection in the face of high interest rates and a reform agenda that threatened long-standing privileges. It would be wrong to dismiss their agenda as wholly self-interested. The IMF itself came to recognize the importance of relaxing fiscal and monetary constraints.

However, it is also important to be clear about the nature of the opposition that emerged in the wake of the crisis, because it was not wholly defined by business nationalism and social backlash. A consistent theme of a number of diverse opposition forces was that the crisis could be traced to insufficient democratic oversight, particularly of business-government relations: This was a theme of Kim Dae Jung's campaign, was visible in the Thai debate on constitutional reform, and was the centerpiece of the *reformasi* movement in both Indonesia and Malaysia.

Reformers urged not only discrete policy changes but also changing institutions of governance to increase both their independence (from narrow interests) and their accountability (to the public at large). Nor were oppositions necessarily hostile to market-oriented reforms. To the contrary, the idea that policy had been insufficiently market-oriented was a theme of a number of these reform forces as well. This can be seen by turning to the intimidating problems of financial and corporate restructuring that were a defining element of the crisis.

## Appendix 3.1: Two that Got Away—the Philippines and Taiwan Compared

The foregoing chapters have looked at both the longer-term vulnerabilities and short-term adjustment efforts of the most seriously affected countries in the region. However, the account suffers from a clear bias: the absence of discussion of those cases that did somewhat better than their counterparts, particularly Taiwan and the Philippines. Neither country completely escaped regional contagion; Taiwan's growth slowed from 6.8 percent in 1997 to 4.8 percent in 1998, whereas in the Philippines growth ground to a halt in 1998, falling from 5.2 percent in 1997 to -0.5 percent in 1998 before showing signs of recovery in 1999. However, the crisis in the two countries was clearly less severe than in the other countries in the region, and in Taiwan there is little basis for considering it a crisis at all. Why?

This appendix retraces the steps of earlier chapters, albeit in much condensed form. First, it is important to underline fundamental economic differences that might have made these countries less vulnerable to crisis in the first place. Taiwan's external position—perennially in surplus with virtually no foreign debt—was clearly very different from those of the other middle-income countries in the region. The Philippines, on the other hand, was not a small debtor, although its more recent reentry into international financial markets served to limit its exposure.

I then turn to the nature of business-government relations in the period before the crisis and the extent to which they alleviated or compounded risk. The two countries show somewhat different trajectories in this regard. The Philippines under the rule of Ferdinand Marcos (1969-86) resembled the Suharto regime in a number of respects, including the increasing weight of crony and family interests in economic policymaking. The transition to democratic rule certainly did not eliminate corruption in the Philippines, but it did reduce the grossest abuses. In Taiwan, by contrast, democratization has resulted in a marked increase in the role of business in politics and challenged the independence of the regulatory process. Taiwan exhibited a number of regulatory weaknesses that resembled in important respects those seen in other countries in the region. But their magnitude was less, and because of the absence of a foreign exchange and debt crisis they did not have the same consequences for the real economy that they did elsewhere.

Finally, I consider the political circumstances when the crisis hit, and how they created uncertainty that either facilitated or impeded the adjustment process; those conditions are summarized in table A3-1. In the Philippines in particular, political circumstances did contribute to the country's initial problems, but the president retained substantial political powers in addressing the crisis.

**Table A3.1 Political constraints on crisis management in the Philippines and Taiwan**

	<b>The Philippines I</b>	<b>The Philippines II</b>	<b>Taiwan</b>
Government, term in office	Fidel Ramos, 6/1992-6/1998	Joseph Estrada, 6/1998	Lee Teng Hui, 3/1995-3/2000 (last term)
Electoral	Impending presidential and congressional elections 6/1998	None	Continual pressures from nonconcurrent elections, including local (11/1997 and 1/1998), legislative (12/1998) and presidential (3/2000) elections
Non-electoral and “backlash”	Widespread public opposition to proposed constitutional amendment, mid-1997	Not significant	Not significant
Decision-making process	Strong presidential system with majority in lower (but not upper) house	Strong presidential system	Premier-presidential system with strong president, but narrow legislative majority; increasingly divided ruling party
Government links to business	Reduction of cronyism under Aquino and Ramos, although all parties dependent on business support	Increasing concerns of crony links	Increasing reliance by all parties on business support

## The Philippines

The Philippines<sup>37</sup> presents the more interesting of the two cases because it would appear on initial inspection to be no less vulnerable to external shocks than Malaysia. The Philippines experienced a substantial debt crisis in 1983-84. The transition to the government of Corazon Aquino in 1986 and a Brady bond deal in 1992 permitted a gradual reduction of the external debt burden and a return to international capital markets. Following a stabilization and recession in 1990-91, the government was able to relax fiscal and monetary policy, and in the early 1990s the Philippine economy began to take off.

Thailand and the Philippines opened their capital accounts at roughly the same time. Although the Philippines' success in attracting capital was somewhat less than Thailand's, the country did experience real appreciation and a modest slowdown in export revenues. At the end of 1996, the total stock of external debt stood at just over \$41 billion. However, the Philippines benefited from being a relative latecomer to the financial markets (Montes 1999; Hutchcroft 1999). New borrowing under Aquino and Ramos was relatively modest, and from 1992 to 1995 foreign direct investment, much of it associated with privatization efforts, dominated capital flows. Not until 1996 did the Philippines face the problematic surge of foreign borrowing and growth of portfolio investment visible in the other countries in the region; the country's ratio of debt to GNP fell every year from 1990 to 1996. Most important, the share of short-term debt in total debt was modest—peaking at 19 percent in 1997—and nearly half of that was trade-related. The Philippines was also less exposed to troubled Japanese banks than other Asian borrowers (Noland 2000b).

A second crucial factor for understanding the comparative performance of the Philippines lies in the banking sector. The Aquino administration spent most of its time in office trying to reestablish the integrity of the financial system, which had been the locus of cronyism and massive abuses during the Marcos years (Hutchcroft 1998). These efforts involved cleaning up the balance sheets of the major state-owned banks, at enormous cost to the central bank, and providing the major domestic banks with preferential access to high-return, low-risk government instruments. But these supports were accompanied by corresponding regulatory changes that included “strengthening prudential regulations in relation to minimum capitalization requirements; increasing compliance with the minimum capital to risk asset ratio, the single borrower limit, the limit on DOSRI [directors, stockholders, and related interests] loans, and the stipulations regarding interlocking directorships and management; making provision for loan losses or doubtful accounts, tightening audit and

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37. This section draws on Lim (1998), Montes (1999), Hutchcroft (1999), Sicat (1999), Intal et. al. (1998), Lamberte (1999), MacIntyre (1999a), and Noland (2000b).

reporting requirements; and reviewing the bailout policy for problematic banks” (Intal et al. 1998, 147).

These reforms were carried forward by the Ramos administration, which pushed further liberalization of the banking sector through decontrol of interest rates, cautious opening to foreign banks, and relaxation of restrictions on bank activities. However, at the same time the administration secured congressional support for a new central bank law in 1993 that substantially increased the institution’s independence and regulatory reach. The reforms of the central bank coincided almost exactly with the relaxation of foreign exchange controls (Satyanath 1999) and gave the bank new instruments to deal with the corresponding risks. For example, just before the crisis in the region broke, the central bank limited bank lending to the real estate sector. On the eve of the crisis, the Philippine financial sector was in relatively strong shape, and the corporate sector less heavily leveraged.

In sum, the Philippines’ overall vulnerability to crisis was reduced by a conjuncture of fortuitous reasons, policy choices, and institutional reforms. First, the Philippines’ prior debt problems delayed and limited the country’s reentry into international financial markets. Second, the past crisis had set in train important regulatory changes in the banking sector. Hutchcroft (1999) argues that the Philippine banking system continued to show signs of collusive behavior; evident, for example, in high spreads between deposit and lending rates. But the potential for gross abuses and moral hazard was clearly reduced, and liberalization was undertaken in a cautious fashion, complemented by substantial strengthening of the government’s regulatory capacity. When the government did face problems in the banking sector, as in the case of the failure of the Orient Bank, the central bank was firm that bailouts were not in order.<sup>38</sup>

Underneath these regulatory changes were more fundamental changes in business-government relations between the late-Marcos, Aquino, and Ramos periods, changes representative of the “market-oriented populism” outlined in chapter 3. Aquino did her share in reversing some of the worst crony abuses in the economy as a whole by selectively reintroducing market forces in a number of areas that had been dominated by monopolistic practices, protection, and various forms of subsidies (Dohner and Haggard 1994). These reforms included an important liberalization of foreign direct investment in 1991.

But it was the administration of Fidel Ramos (1992-1998) that pushed through some of the most substantial structural reforms in the Philippines’ postwar history under the banner of “Philippines 2000.” Ramos explicitly underscored the importance of reforming business-government relations

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38. In addition to closing Orient Bank, the government also shut down about 50 small and weak thrift and rural banks (Satyanath 1999, 27).

for achieving these objectives (Lamberte 1999). In his inaugural address, he promised reform of an economic system that “enables persons with political influence to extract wealth without effort from the economy,” and later argued that the reason for the Philippines’ slow economic growth relative to the region was the political dominance of oligarchic groups (cited in Hutchcroft 1999, 165). The means of limiting these abuses combined a strengthening of regulatory capabilities already noted with liberalizing reforms: a quite dramatic liberalization of trade (average nominal tariffs fell from 23 percent in 1993 to just over 10 percent in 1999), deregulation of a number of cartels and monopolies (telecommunications, inter-island shipping, and the airlines), and a major privatization program.

These reforms did not insulate the Philippines from regional contagion. Immediately following the successful attack on the Thai baht in July, the peso also came under severe pressure. After seeking to defend it briefly, the Philippine central bank allowed the currency to depreciate while simultaneously pursuing a tight monetary policy, imposing some mild capital controls,<sup>39</sup> and substantially toughening prudential regulation of banks (Intal et al. 1999, 151-53).<sup>40</sup>

Yet despite the fact that the country was less vulnerable to external shocks than its regional counterparts, the extent of exchange rate depreciation was only slightly less than in Malaysia, South Korea, and Thailand. To what extent might this outcome be traced to politics?

On the one hand, a number of political developments appeared decidedly *inauspicious*, including important constitutional uncertainties and challenges to the government, a lame duck president, and a strongly contested but highly uncertain presidential race. Just before the onset of the regional crisis, the Ramos administration—operating nominally through its supporters—launched an initiative to amend the constitution to allow the president to stand for a second term. A petition drive collected 6 million signatures, a million more than required by law to put the issue to a referendum. A second proposal was to transform the Senate and House into a constituent assembly that would undertake the “charter change” (“cha-cha”). Ironically, these efforts gained momentum precisely because of the success of Ramos’ economic reforms and fear that his achievements would be undermined if his populist vice president, former movie star Joseph Estrada, were to become president.

The petition drive was challenged in a series of lawsuits by its opponents, and both former president Aquino and the influential Catholic

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39. The central bank placed a cap of \$100,000 on over-the-counter sales of foreign exchange for non-trade-related purposes at the end of June, which was lowered to \$25,000 at the end of July; this ceiling was partly lifted for residents in September.

40. These controls included further limits on lending to the property sector and a tightening of rules governing loan loss provisioning and lending to the property sector.

prelate Cardinal Sin weighed in against the change. Shortly after a massive demonstration against constitutional revision on 21 September, the Supreme Court ruled that the enabling law governing petitions for referenda was legally inadequate and Ramos abandoned his quest for a second term. These developments turned the Ramos administration into a lame duck and effectively signaled the onset of the presidential campaign that culminated in the elections of 11 May 1998.<sup>41</sup>

The presidential campaign constituted an additional source of uncertainty. The race engaged a number of aspirants, many motivated by the desire to stop the highly popular candidacy of Joseph Estrada. In his movies, Estrada often played Robin Hood-like characters, and one of his core campaign slogans was “Erap is for the poor.” His lack of economic expertise and concerns about the potential for both cronyism and populism would all appear to be textbook ingredients for the generation of policy uncertainty.

Although counterfactuals are always risky, it is probable that the efforts of the Ramos government to lift the constitutional ban on term limits had the opposite effect from that intended. Rather than stabilizing expectations, the cha-cha movement unleashed widespread protest against the government, and this probably contributed to the peso’s slide during the early months of the crisis. However, these adverse circumstances were partly offset by features of the presidential system that granted Ramos substantial legislative powers in addressing the crisis (MacIntyre 1999a).

If we were to look only at the party system, the Philippines appears to bear a number of similarities to Thailand. The party system is fragmented, with a shifting pool of six to eight parties capable of garnering some representation in the legislature at any time. Internally, Philippine parties are notoriously weak institutions, built around personalities and geographic bases of support rather than enduring programmatic lines. However, unlike Thailand, where such parties must form coalitions to rule, the Philippines has an unusually strong president with substantial powers to allocate resources to those who support him. As a result, presidents are typically able to build legislative coalitions fairly easily, despite electoral outcomes that appear to fragment legislative support. Indeed, it is quite common in the Philippines for legislators elected under one party label to switch to the president’s party following elections. Ramos enjoyed a solid majority in the lower house as a result of this phenomenon, and shortly after Estrada’s election in May legislators from other parties started to defect to him as well.

The ability of the president to control the legislative agenda provides an interesting contrast not only to Thailand but to South Korea under

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41. These elections would also replace one-half of the Senate and the entire House of Representatives.

Kim Young Sam as well. As in those two countries, the policy challenges for the government centered on the legislation required to secure IMF support. Since 1962, the Philippines had had an uninterrupted succession of standby agreements with the Fund, the last of which was an Extended Fund Facility (EFF) agreement set to end in June 1997. However, the conclusion of the EFF program had been stalled by debate between the administration and Congress over a comprehensive tax reform; Congress had sought to apply tax exemptions to higher tax brackets than those proposed by the IMF and the administration, no doubt with electoral considerations in mind. The administration was unilaterally able to tighten fiscal policy through an across-the-board cut in expenditures, but passing tax reform and controversial legislation to assure the effective deregulation of oil prices required intense negotiation. Nonetheless, the president was able to prevail in both instances, albeit with a delay, setting the stage for the negotiation of a “precautionary” standby arrangement with the IMF that picked up following the termination of the EFF in early 1998.

The presidential election also proved somewhat less unsettling for confidence and the general direction of policy than it might have, in part because of Estrada’s efforts to calm business and middle-class fears (*Far Eastern Economic Review*, 14 May 1998, 14-24). Despite his populist rhetoric, his policy pronouncements were surprisingly conservative and market-oriented. His approach to poverty alleviation emphasized job creation and greater spending on rural infrastructure rather than transfers. Estrada made strong efforts to alleviate concerns both about his populism and his connections to a variety of unsavory businessmen by announcing in advance an economic team that included respected business leaders, technocrats, and academics. He also promised to retain the central bank governor Gabriel Singson until the end of his term, and he “pre-announced” a successor who commanded wide respect.

The actual performance of the Estrada administration proved disappointing in a number of respects. By early 2000, his popularity had plummeted and his finance minister had resigned in protest at a growing “culture of corruption.” A number of promised reforms had failed to materialize, and the president was forced to clean house by firing a number of appointees and seeking to initiate delayed reforms that would have carried on the Ramos legacy (see, e.g., *Asian Wall Street Journal*, 7-8 and 10 January 2000). However, these reform efforts subsequently ran into trouble in Congress (*Financial Times*, 13 April 2000)

A detailed evaluation of Estrada’s performance would take us beyond the purpose here, which is to underline some of the key features of the onset and initial management of the crisis that are of comparative interest. First, it is important to reiterate that the Philippines was less vulnerable at the outset of the crisis. This different starting point was related in part to the later entry of the Philippines into the capital markets, or what Paul

Hutchcroft (1999) has called the country's "lower elevation": The country had less far to fall. However, this different starting point was not unrelated to important changes both in policy and in the nature of business-government relations, including particularly a reduction in cronyism and a strengthening of the regulatory environment.

In the short run, politics did contribute to the Philippines' troubles, particularly the campaign to extend Ramos' term. Moreover, the need for the president to buy support for reform proposals in Congress and legislative reticence about tax reform and the deregulation of oil prices did lead to some delays in legislation. But in contrast to South Korea, the president's powers held, and despite the rhetoric of the Estrada campaign there seemed little support for reversing any of his reforms; the larger risk seemed to be the reluctance to continue the forward momentum of the Ramos period. Estrada did not exploit his powers to initiate new reforms in the way Kim Dae Jung did, although he confronted a number of the same financial, corporate, and social issues. But this should perhaps not be surprising because the crisis proved less profound in the Philippines than in Korea as well.

## Taiwan

As currencies in Southeast Asia began to depreciate after July 1997, the Central Bank of China (CBC) experienced strong selling pressure on the New Taiwan dollar (NT dollar). The difference was that Taiwan's<sup>42</sup> monetary authorities controlled reserves in excess of \$93 billion (end-1996) and could mount a sustained defense; before the CBC gave up and let the NT dollar depreciate on 17 October, the central bank spent more than \$7 billion on the effort. Once floated, the currency quickly fell from 28.6 to the dollar to 31.4 and then to 33 following the collapse of the won in November, where it remained before strengthening somewhat in late 1998. The stock market also fell victim to regional trends. After peaking in August, the market began a steady descent thereafter, losing roughly 20 percent of its value by the end of the year.

At one level, it is easy to explain why this sequence of events was not the prelude to a broader economic crisis. All the most seriously affected countries, as well as the Philippines, ran current account deficits in the 1990s, even if their magnitude was not particularly large. All four countries accumulated a corresponding amount of external debt, with a dangerous amount of it in Thailand and South Korea being short term. Taiwan, by contrast, had run a current account surplus for more than 20 years. Its average current account surplus—the excess of savings over investment—

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42. The following draws on Kuo and Liu (1998); Noble and Ravenhill (2000b); and particularly Chu (1999a, 1999b).

from 1990-97 was 3.9 percent of GDP. As a result, the country did not increase its net foreign debt before the crisis. Government-guaranteed debt was less than 0.05 percent of GDP. The external liabilities of Taiwan's private sector totaled 10.6 percent of GDP, but this was less than the value of foreign assets held by domestic residents (Chu 1999a).

In 1998, Taiwan did feel the effects of the Asian financial crisis through two important channels: a decline in exports to the region and problems with foreign investments by Taiwanese firms in Southeast Asia; these factors contributed to the slowdown that we have already noted. But Taiwan was a net creditor to the rest of the world and as a result was simply not vulnerable to the rapid withdrawal of foreign funds and exhaustion of reserves that were the defining moment of the crisis elsewhere.

However, this explanation begs the deeper question of why Taiwan has pursued such conservative macroeconomic and exchange rate policies in the first place. As Chu (1999a, 190) summarizes, "The Nationalist government has invariably maintained a positive real interest rate, minimum public-sector foreign debt, small fiscal deficit, a fixed exchange rate pegged to the U.S. dollar, restrictions on the convertibility of the NT dollar, a rigorous regulatory regime over financial institutions, and a conservative ethos that permeated the entire banking sector." This discipline has eroded somewhat with the democratization process, particularly with respect to the conduct of fiscal policy (Cheng and Haggard 2000). But in the conduct of macroeconomic policy, in the design of financial liberalization and deregulation, and in the opening of the capital account, there can be little question that Taiwan has been relatively cautious.

The reasons can be traced to the political interests of the ruling Kuomintang (KMT) party, which dominated politics in Taiwan before the gradual transition to democracy in the late 1980s and early 1990s and continued to hold the presidency and a majority in the legislature until the presidential elections of March 2000 as well. For a series of historical reasons, political leaders have had a strong interest in the independence of the central bank, both in its conduct of macroeconomic policy and its role as regulator of the financial system (Cheng 1993). These reasons begin with the great Chinese hyperinflation of the late 1940s that contributed to the KMT's loss of the mainland. In the wake of that experience, the CBC was given a strong mandate for macroeconomic stability. The governorship of the bank became the senior economic post in the cabinet, and was always occupied by an individual with close political ties to KMT leaders.

The CBC's powers extended to regulatory authority over the banking system, which until the 1990s was overwhelmingly state-owned. State ownership of banking was seen as a way for the KMT—a party of exiled mainlanders, primarily government officials and employees—to control the commanding heights of the economy and to check the economic as

well as political power of indigenous Taiwanese business (Cheng 1993). Credit from the state-owned banks tended to flow primarily to state-owned firms and a handful of larger private enterprises with collateral in land. Corruption was not altogether absent, and the highly conservative nature of the country's banking system was arguably a drag on its growth. But neither did the country develop the close bank-group relations, high levels of industrial concentration, or high corporate leveraging that constituted such a problem in other crisis countries, particularly South Korea (Noble and Ravenhill 2000b).

Over time, the CBC's role effectively extended into security issues. Taiwan's international position has become more rather than less exposed over time as a result of Beijing's efforts to isolate it and advance the cause of reunification. Taiwan is not a member of the IMF, and thus cannot count on its resources in times of crisis. Nor can it be assured that private investors would remain steadfast in the face of diplomatic shocks, economic sanctions, embargo, or actual military threats, such as the missile tests it endured before the presidential elections in 1995. Moreover, military support from its erstwhile ally, the United States, is the topic of ongoing controversy with China and remains purposefully ambiguous. These political vulnerabilities have undoubtedly influenced political leaders' preference for what otherwise would appear to be an excessively high level of reserves.

These same political considerations have also contributed to the government's hesitance to open the capital account. The CBC was highly resistant to the removal of foreign exchange controls, but the accumulation of massive surpluses in the mid-1980s (reaching nearly 20 percent of GNP), strong pressure from the United States, and the need to manage an emerging speculative bubble in equities and real estate led to a gradual liberalization process beginning in July 1987 (Kuo and Liu 1998). Foreign access to the securities market was also opened in stages beginning in 1991. Nonetheless, the central bank continued to intervene in a variety of ways to limit the internationalization of the NT dollar and to restrict the foreign assets and liabilities of banks. Some have suggested that this might have been a blessing in disguise, just as the timing of the Philippines' reentry into capital markets partly inoculated it against regional contagion. However even if capital movements had been completely free, it is doubtful that Taiwan would have experienced the problems of the most seriously affected countries; it was the country's external position, not capital controls, that provided the ultimate inoculation against crisis.

Nonetheless, political changes in Taiwan since the early 1990s, including the nature of business-government relations, have raised issues that are surprisingly similar to the difficulties seen in other countries in the region—even if their ramifications for the economy as a whole have been muted. During the period of authoritarian rule, the KMT encouraged the

development of the indigenous Taiwanese private sector, but did not rely on it for political support: The government and party had substantial financial as well as administrative resources at their disposal, business was not organized, and there were fewer electoral incentives for the KMT to court business support. Moreover, the executive did not rely on legislative support to undertake policy initiatives, or to the extent that it did it was able to exercise strong control over legislators.

With the transition to democratic rule, however, these conditions changed quite dramatically. The party (and factions within it) had strong interests to reach out to business groups for political and financial support (Chu 1994). This tendency was reinforced by features of Taiwan's electoral system that bore surprising similarity to Thailand's. Electoral rules created strong incentives for candidates to pursue personal vote strategies that were heavily dependent on campaign contributions and thus on business support.<sup>43</sup>

And finally, the executive had to manage a contentious legislature. The KMT's share of votes in legislative elections dropped from 66.7 percent in 1986 to 46.1 percent in 1995, while its share of seats dropped from a commanding 83.1 percent to the narrowest of majorities—51.8 percent—during the same period. Not only did the government have to contend with the opposition, but legislators from within its own ranks also faced strong electoral pressures and the temptation to defect.

These political changes manifested themselves not only in upsurge of charges of corruption and "money politics" but also in broader changes in public policy. One way in which the government and ruling party could reach out to business was by engaging in deregulatory initiatives that benefited them (Chu 1999). Beginning in 1988, the government began to dismantle long-standing entry barriers in a range of sectors, including construction, mass transportation, airlines, segments of the petrochemical and power sectors, and, most important for our purposes, commercial and investment banking.

Beginning in 1991, the Ministry of Finance began to cautiously issue licenses for new banks while still exercising quite strict regulatory supervi-

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43. Taiwan's electoral system is single nontransferable vote, or SNTV. Many legislators are elected from a single district, but each voter can only cast one ballot, and the votes a candidate gets cannot be transferred to other candidates of the same party. Under an SNTV system, any political party that has the potential to win more than two seats from a district faces the vote-division problem; parties may run too many or too few candidates in a district and may fail to equalize the votes among their nominees sufficiently. However, this issue is less significant than the politician's "product differentiation" problem: given intra-party competition, politicians must devise a strategy to distinguish themselves from candidates from their own parties seeking election in the same district. Numerous studies of SNTV in Japan and Taiwan have demonstrated how parties use pork, particularly public construction projects, to assist individual candidates in cementing personal support bases and securing campaign contributions. For an overview of the literature, see Haggard and McCubbins (2000).

sion over the sector, for example, in setting very high minimum capital requirements and sharply limiting the ownership share of corporate investors. The ministry also issued a series of directives limiting the amount of secured loans banks could extend to real property. In contrast to other countries in the region, the quality of portfolios and return on assets slipped only slightly with the liberalization (Noble and Ravenhill 2000b).

However, political pressures on the banking system of the sort outlined in chapter 1 were not altogether absent.<sup>44</sup> The provincial government of Taiwan, an artifact of the historical fiction that the KMT government ruled all of China, controlled three major commercial banks. With a widespread branch network on the island, these banks were periodically turned to patronage purposes before the central government—in a major constitutional revision in 1997—finally pushed through the elimination of the provincial level of government altogether. Local financial institutions, especially community credit cooperatives and credit bureaus for farmers and fisherman, “have been plagued by endemic problems of politicization, inefficiency and incompetence” (Noble and Ravenhill 2000b, 25), even though they accounted for only a small portion of the overall financial sector.

The liberalization of bills financing companies also shows some striking parallels to other cases in the region (Chu 1999a, 1999b; Noble and Ravenhill 2000b). Under strong political pressure, the Ministry of Finance opened the commercial-paper and unsecured-corporate-bond market in 1995, without putting in place an adequate regulatory system. When the regional economy began to contract in 1998, a number of export-oriented industries, such as steel, felt the effects. The stock market, which had rebounded during the first half of the year, underwent another sharp sell-off. The failure of a number of speculators to meet margin calls threatened to set off a chain reaction from the finance companies to stock and land prices. The government seized the opportunity to strengthen the regulatory framework. But with legislative elections looming in December, the government followed an earlier fiscal stimulus with a bailout plan that not only provided financial relief for particular firms but also specifically sought to stabilize the stock market.

## Conclusion

This brief examination of these “two that got away” helps shed light on the other countries in the region. First, Taiwan makes abundantly clear that vulnerability to crisis depends in the first instance on a country’s debt and reserve position; even when the NT dollar fell under attack, the

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44. The following draws extensively on Chu (1999a, 1999b).

effects were muted by the absence of significant external debt and abundant reserves. The Philippines confirms this view. Later entry into financial markets and less reliance on short-term debt clearly reduced the government's vulnerability.

However, this observation does not obviate the importance of political factors; to the contrary, the comparison underscores the importance of both business-government relations and short-term political constraints on crisis management. One of the reasons why the external shock in the Philippines did not spread to the domestic economy to the same extent was precisely because of the cautious nature of the external liberalization and the prudential reforms that had been put in place as a result of a previous financial crisis. Monetary authorities in Taiwan have generally managed to maintain a strong regulatory framework. Nonetheless, changes in the business-government relationship have eroded regulators' independence at the margin; the costs of this erosion were real, but buffered by the strong external position the country enjoyed.

Finally, if a country—namely the Philippines—was vulnerable to external shocks, short-term political constraints, including protests against the administration and an election campaign, did have adverse consequences. However, these were partly offset by a strong presidency and at least some initial continuity between the Ramos and Estrada administrations.