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Conclusion: A New Asian Miracle

If the preceding chapters have not already made the point abundantly clear already, it bears reemphasis that there was, and is, no single "Asian model." Generalizations across cases of such diversity are necessarily risky and must acknowledge enduring differences in resource endowments, level of development, history, culture, and politics. Nonetheless, a common geostrategic setting and some political and policy similarities do provide the starting point for more refined comparisons.

For several decades, the middle-income countries of East and Southeast Asia pursued successful, outward-oriented growth strategies, propelled by high levels of investment in both physical and human capital and an emphasis on exports. The extent and nature of government intervention across these countries by no means followed a common pattern. Yet outside of Hong Kong, an orientation toward exports was by no means equivalent to laissez-faire. In differing degrees, governments employed a variety of instruments—selective protection, subsidies, state-owned enterprises, and a host of other interventions—to achieve their investment, export, and industrial objectives.

The political systems in the region were characterized by authoritarian or semi-democratic rule and close, nontransparent, and sometimes corrupt business-government relations. Curiously, both critics and defenders of the model saw these political characteristics as contributing to high growth, whether through the discipline and social order strong states could impose or the assurances—and rents—close business-government relations gave to investors. In either case, these were *regimes of accumulation*—political systems geared to generating high levels of investment.

Leaders did not maintain power simply by coercion alone, although many were not averse to using it. Government also delivered high growth, upward social mobility, and a reduction of poverty. Defenders of "Asian values" argued that these systems were held together and given legitimacy by the glue of a common Confucian, or Asian, value system that prized social order and rested on a strong ethic of individual responsibility and work. Whatever the merits of these arguments—which I believe are rightly seen as ideological justifications for authoritarian rule—there can be little question that political systems limited the participation of the public, opposition parties, and interest groups.

Well before the financial crisis of 1997-98, this "model" had undergone important changes of two sorts. On the economic front, governments in the region had, albeit from very different starting points, begun to liberalize trade and investment, deregulate markets, and reduce and reposition the state's role in the economy. In politics, a number of countries underwent transitions to democratic rule, which meant not simply the staging of elections but the emergence of new parties and interest groups, including labor, and the freeing of intellectuals and the media.

Looking forward, the big questions arising out of the crisis are easily posed. What effect will the Asian financial crisis have on these larger trends toward the market and democracy? But more important, what type of market-oriented economies and democracies will they be? Are they converging on Japanese, Anglo-Saxon, or European varieties of capitalism, or breeding some altogether new hybrid? What sorts of democratic institutions will countries develop? To answer these questions, I first look back, recapping briefly some of this book's findings and how they might complement other work being done on the origins and management of financial crises and on processes of political change. I then turn to the question of whether a new Asian model is emerging and what it might look like, focusing particular attention on possible outcomes of the financial and corporate restructuring process and debates about a new social contract that are beginning to emerge.

The Political Economy of Financial Crises

Goldstein, Kaminsky, and Reinhart (2000) underline neatly the lacuna in economic analyses of financial crises that this study seeks to address:

> Because these exercises concentrate on the macroeconomic environment, they are not capable of capturing the kind of political triggers and exogenous events—the Danish referendum on the European Economic and Monetary Union (EMU) in 1992, or the Colosio assassination in 1994, or the debacle over the Suharto ouster in 1997-98, for instance, which often influence the timing of speculative attacks. In addition, because high frequency data are not available on most of the institutional characteristics of national banking systems—ranging from the extent

> of "connected" and government-directed lending to the adequacy of bank capital and banking supervision—such exercises cannot be expected to capture some of these longer-term origins of banking crises. (17)

Among these longer-term sources of vulnerability, the most frequently invoked with respect to the Asian financial crisis was moral hazard; yet surprisingly little work has gone into tracing the actual sources of moral hazard or why governments would allow themselves to be exploited. Chapter 1 showed that industrial policy, in the sense of targeting particular industries, was not a major source of moral hazard, at least in Thailand and South Korea. But continuing government involvement in the financial sector did create the "risk of socialized risk" in all four countries. Despite purported financial liberalization, politicians in Indonesia, Malaysia, and South Korea still used the banking system as an instrument not only of policy but of politics. In Thailand, owners of financial institutions were able to influence the regulatory process to their benefit. In all cases, these arrangements generated both high social costs and perverse incentives for the managers of financial institutions.

One solution to these problems is for the government to credibly commit to liberalize financial markets, thus eliminating the problems of moral hazard and capture. But liberalization processes can be captured too. Both privatization and deregulation of entry into the provision of financial services have occurred in ways that favored connected firms and individuals or invited outright fraud. The weak prudential regulation, which many have underlined as a cause of the crisis, was not simply the result of inadequate bureaucratic capacity but of more deep-seated political problems centered on the relationship between politicians and private actors.

The channels through which such influence was exercised varied depending on the political system. In Indonesia, it was centered on the executive and highly personalized and clientelistic. In South Korea, it involved campaign contributions and in some cases bribes to legislators. In Thailand, the interested parties were in some cases themselves legislators. It should be underscored that enumerating these risks is not simply an ex post facto rationalization or 20-20 hindsight. The underside of close business-government relations has been a central topic of intellectual controversy in every single country in the region for some time (see, e.g., MacIntyre 1994a; Kim 1997 on South Korea; Gomez and Jomo 1997 on Malaysia; Pasuk and Sungsidh 1996 on Thailand; Robison 1986 and MacIntyre 1991, 1994b on Indonesia, among many others). When the crisis broke, the political debate about its causes quickly homed in on these factors in each of the countries (chapter 3).

These sources of vulnerability do not necessarily translate into crises or losses of confidence, however; there is still the question of how crises start and are transmitted to the real economy. During periods when governments are challenged by economic pressures (e.g, on the exchange rate), market participants react not only to economic fundamentals but to how they expect governments to respond. Once crises break, expectations will have similarly powerful effects on agents' economic behavior. Such expectations are, in turn, based on assessments of political factors: electoral and non-electoral challenges, the decision-making process, and the nature of business-government relations.

Chapter 2 reexamined the period before the crisis—not from the perspective of the economic changes that were occurring, but to reconstruct the policymaking environment. Much has been made of the fact that the crisis was unanticipated and that few foresaw the problems that would subsequently emerge. But an examination of the cases suggests that there was political uncertainty about the capacity of the government to manage the economy *at the time*.

These uncertainties had several sources. Electoral pressures were an important component of the story in South Korea, and Indonesia's indirect presidential election and the party elections in Malaysia also affected policy in those two countries. Particularly in Indonesia, and to a lesser extent in South Korea and Thailand, governments had to contend with non-electoral political challenges in the form of antigovernment protests, demonstrations, or strikes; in Indonesia, these protests raised the highly unsettling issue of succession. The decision-making processes of government played an important role in framing expectations in South Korea (stalemated government), in Thailand (weak coalition), and in Malaysia (divided decision-making authority).

However, one political constant across the cases was the difficulties governments faced in managing their commitments to private-sector allies. Hill (1999), a leading authority on the Indonesian economy, is worth quoting at some length:

> Thus, corruption was a serious problem, but it is difficult to advance the argument that it was a key precipitating variable. More plausible is the thesis that the particular forms corruption, and the political system in general, had assumed by the 1990s rendered the Suharto government unwilling—indeed unable—to move decisively and swiftly once the crisis had hit . . . corruption deserves great emphasis at this stage of the process, rather than as an initial precipitating factor. (69-70)

If we extend Hill's focus on corruption narrowly conceived to cover the broader problem of business-government relations, it captures perfectly the spirit of the argument advanced here. Reducing East Asia's vulnerability is therefore not simply a question of changing policies, but of reconsidering the privileged political position domestic business has enjoyed during the high-growth period, and subjecting business to greater regulatory restraint and accountability.

A legitimate criticism of this analysis is that the sources of political uncertainty have been cast fairly widely, and that virtually all political systems are subject to political uncertainty, some, if not all, the time. Moreover, these political factors were significant only because countries had already entered a "zone of risk" with respect to other early warning indicators of crisis (Goldstein, Kaminksy, and Reinhart 2000). Clearly, the hypotheses suggested here about the role of politics and financial crises require further testing against a wider array of cases, and some statistical work along those lines has begun (Fisman 1998; Leblang 1999; Mei 1999). However, even within the small number of cases examined here, there is compelling evidence that changes of political circumstance can result in changes both in economic policy and in market sentiment. The transition to new governments in South Korea and Thailand, and to a lesser extent in Indonesia, provided the opportunity for new policy initiatives and a stabilization of expectations. The consolidation of authority under Mahathir in the fall of 1998 also brought an end to internal divisions over economic policy.

These observations suggest a final, crucial point about the political economy of the Asian financial crisis, and that has to do with the relative performance of democratic and nondemocratic systems. Since the late 1980s, an important transPacific debate has occurred on the relative merits of different political forms, usually referenced as the controversy on Asian values. The arguments have many strands, and have to do with the role of culture (Zakaria 1994), with whether human rights are universal or culturally bound (Bauer and Bell 1999), and with the value and meaning of democracy. However, the defense of nondemocratic regimes by political leaders such as Senior Minister Lee Kuan Yew of Singapore, Prime Minister Mahathir of Malaysia, President Suharto, and the Chinese Communist Party leadership has always had a strongly utilitarian dimension. Asian political systems were able to deliver economic growth to their citizens and to lift them out of poverty and should therefore ultimately be judged for their performance in securing various "economic rights" as well as human and political ones.

The dubious ethical foundations of these propositions have been eloquently picked apart by Sen (1999, chap. 10), but recent economic history, including but not limited to the recent financial crisis, also calls their empirical foundations into question. Well before the crisis, South Korea, Taiwan, and Thailand made transitions to democratic rule without any noticeable change in their economic performance, while in the Philippines economic performance improved markedly with the fall of Marcos and the transition to democratic rule. For every high-growth authoritarian country in the region, there are dictatorships that have imposed mind-numbing hardship on their citizens—Cambodia, Myanmar, North Korea, and China itself during the Great Leap period and the Cultural Revolution. At a minimum, we should be agnostic about the relative economic performance of democratic and nondemocratic regimes over the long run.[1]

1. There is a growing body of cross-national empirical work on this subject. Some studies suggest that democratic governments perform less well than autocracies (Barro 1996). Clague et al. (1997) find that long-lived autocracies outperform short-lived autocracies and short-

However, the cases reviewed here provide at least some support for the more hopeful proposition—now strongly ensconced as the new received wisdom of both international financial institutions and US foreign policy—that democracy, the market, and growth can go together in developing and transitional economies. The contrast between South Korea and Thailand on the one hand and Indonesia on the other shows the advantages that democracies can enjoy. Democracy benefits from popular support, which itself stabilizes expectations, provides the basis for monitoring government and private-sector malfeasance, even if imperfectly, and has a crucial self-corrective mechanism, in the form of elections, through which failing governments can be changed.

Malaysia presents a challenge to these ideas, as Prime Minister Mahathir has not hesitated to point out. The country has enjoyed phenomenal economic success in the past and appeared to escape from the crisis no worse off than the democracies or those that were forced to go to the IMF. However, the analysis offered here suggests a somewhat less charitable interpretation. The Malaysian government has convinced a substantial international audience that it has done well pursuing its unorthodox policy course, but this begs an important question of what the counterfactual should be. Should Malaysia have in fact experienced the shock that it did, or should we have expected its performance to look more like the Philippines', Singapore's, or Taiwan's? A review of the events of 1997 and 1998 makes it hard to escape the conclusion that whatever the role of international capital movements in Malaysia's difficulties, some portion of them were self-inflicted.

Crisis and Political Change

Well before the crisis, the Asian region (and the world more generally) had seen a historic shift toward more democratic forms of governance. South Korea, the Philippines, Taiwan, and Thailand all made transitions to democratic rule beginning in the 1980s. What effect, if any, did the crisis have on this regional trend? A first point, and one that should not be taken for granted, was that the crisis did not lead to *reversals* of democratic rule. Only in Thailand at the end of the Chavalit government did there appear to be any question of the military reentering politics, and that discussion was flatly quashed by the military itself. The new democracies in Asia all proved robust in the face of quite substantial economic and social distress.

lived democracies, but stable democracies perform best of all. However, a wide review of the evidence suggests that there is probably no significant relationship between economic performance and regime type one way or the other and that variations within each type are more important (Przeworski and Limongi 1993; Helliwell 1994).

The role of the crisis in the transition to more democratic rule in Indonesia has already been spelled out in chapter 3, but the Malaysian case again requires some further discussion. It is clear that the crisis, both at home and in Indonesia, spurred Anwar to issue a more pointed challenge to Mahathir's leadership, and that challenge included references to the creeping authoritarian tendencies in the system. It is also clear that the crisis as well as the handling of the Anwar case contributed to increasing support for the opposition after Anwar was sacked and that political demands—for a freer press, for greater judicial and police independence, for an end to the political use of the Internal Security Act—were a component of these opposition efforts.

Yet Mahathir survived, suggesting that the relationship between crisis and regime change is not straightforward (Haggard and Kaufman 1995). Much depends on the nature of political institutions. Malaysia exhibits a number of features that gave it advantages when compared to Suharto's New Order in Indonesia. Among these are first and foremost a strong political party, which serves as a means of co-opting political support and contesting elections. Indonesia's Golkar was a much weaker instrument; nor did the channels of electoral representation and opportunities for the opposition—however circumscribed in Malaysia—exist to the same degree. Such findings are sobering for understanding the prospects for change in other countries in the region that may be vulnerable to economic crises in the future, such as China and Vietnam. As the North Korean case shows in most appalling fashion, strong political parties with military backing can survive the worst economic crises, even if at extraordinary cost (Noland 2000a, chapter 5).

The nature of political change is of course not limited to the question of whether regimes fall. In democracies, governments change as the result of elections, and in all systems, economic decline is plausibly associated with a variety of other political changes: increases and decreases of political support for existing parties, the formation of new parties, demonstrations, protests, riots, and other forms of social violence.

A motivating question in the discussion in chapter 3 was the question of backlash: To what extent did the crisis give rise to parties and movements that were populist and anti-market in their orientation? These political forces cannot be dismissed; in each country, business groups sought to maintain existing privileges or extend them, organized labor was rightly concerned about job loss, and NGOs at the grass roots sought to deal with localized social distress.

Yet although the reaction against incumbent governments was ubiquitous, it did not simply reflect populist backlash. Reformers in each country gained adherents through programs that targeted the exact same political problems identified in chapter 1: weak regulation and regulatory institutions, lack of transparency, overly close business-government relations, and corruption. These particular actors were not necessarily associated with the right or conservative wing of the political spectrum; indeed, such characterizations confuse the nature of political cleavages in the region. Rather, they made appeals precisely on populist grounds of greater democracy, fairness, and equity. At the same time, these appeals are poorly understood in terms of traditional populism either. Reformers did argue for the necessity of disciplining concentrated private power. However, they saw the introduction of greater market forces as a means for achieving that objective.[2]

This brand of progressive, market-oriented policy is extraordinarily important in understanding not only the politics of the crisis, but the politics that has surrounded its interpretation. There can be little question that external constraints, including both market pressures and the operations of international financial institutions, were crucial to the political economy of reform; these pressures are well known. But contrary to the assertions of some analysts (Wade and Veneroso 1998)—as well as a variety of self-interested parties in East Asia—the reforms that accompanied the crisis were not simply an imposition of outside forces. Nor was support for them limited to technocrats. In each case, they had important domestic proponents and bases of support as well.

Looking Forward I: The Reform of Business-Government Relations

Chapter 4 outlined the initial management of systemic distress in the four Asian countries, and underlined some of the differences that had emerged across the countries. But financial and corporate restructuring involve longer-term institutional and organizational changes, and thus the final resolution of these problems remains far from clear. As of mid-2000, a number of short-term problems—now already of some duration!—continued to weigh on the region. A number of banks in each country remain weakly capitalized (particularly if they were required to fully provision against loan losses) and nonperforming loans remain extremely high, nearly 40 percent in the Thai banking system. A curious result of the crisis is an inadvertent change in the state's role in the economy. Through the end of 1999, more than 20 banks in the four countries had been nationalized. Through these nationalizations, recapitalization, and purchase of nonperforming loans, the government has acquired substantial ownership claims over corporations as well. Again, the problems in Indonesia are the most daunting; by early 2000, the Indonesian Bank Restructuring Authority held assets equal to approximately 40 percent of

2. A useful historical parallel to this mix of ideas can be found in the American progressives of the early twentieth century.

GDP at face value. Devising an appropriate exit strategy remains an important issue.

If we attempt to see through the dense fog of these problems, the basic political issue is how and in what way to restructure the relationship between the government and the private sector, and more specifically, among the government, banks, firms, and other relevant stakeholders.

A first possibility is that the crisis will in fact have very little effect on the nature of business-government relations, regulation, and corporate governance. This might occur for four reasons. First, the region began to witness a strong recovery in 1999. As a result, incentives to restructure fell as waiting appeared to be a more rational strategy and banks and firms grew out of their problems. Second, even the most reformist governments cannot sustain the pace of policy and institutional change as reform fatigue sets in and adjustment costs rise. Third, private actors, including private banks and particularly debtors, remained politically powerful and were able to resist regulatory and institutional changes that would make them more accountable and responsible. They sought to shift the burden of the crisis onto the shoulders of the taxpaying public while escaping with their assets unscathed.

Finally, as Hamilton (1999) has argued eloquently, it is important to recall that not all Asian firms fell into the financial difficulties associated with the crisis. And even if they did, many had already adjusted to the changed policy environment of greater openness and competition, in part through tight integration into cross-border production networks. The crisis may have accelerated these firm-level adjustment strategies, but they have been going on for some time.

This scenario contains important elements of truth, but it underestimates the political as well as policy change that has occurred as a result of the crisis. Taxpayers have paid and will continue to pay dearly for the crisis, a number of banks and debtors have been bailed out, and private actors have resisted both reform legislation and its implementation. But we have also seen important legislative and regulatory reforms and the emergence of political support for a restructuring of business-government relations as well.

A second possible outcome is that the crisis would lead to rapid convergence not only on ''Western'' standards of financial regulation and corporate governance, but also on ''Western'' patterns of corporate finance (i.e., with greater reliance on capital markets and less reliance on bank financing) and bank and corporate forms of organization (assuming that such a common model exists). This position can also not be dismissed out of hand. For example, the trend in financial markets away from bank-based systems toward capital-market based systems has been going on for some time and appears to have accelerated with the crisis. But in other areas, the legal framework that would force such convergence is not yet in place, assuming again that there is in fact a common "Western" model. And even if the legal and regulatory framework for such convergence were adopted quickly, it would take some time for those changes to generate convergence at the level of particular markets and firms.

The intermediate view is that both politics and market forces are already pushing toward some reorganization of the business-government relationship in the region. At the most basic level, the central task is to establish a more healthy, balanced relationship between the government and large private-sector actors. This requires a system in which the private sector enjoys strong guarantees of property rights and is capable of airing its views and influencing the political and policy process. But the system must also be one in which the exercise of private economic power is checked by countervailing interests, there is greater transparency both in business-government relations and in corporate governance, and the inevitable social risks and negative externalities associated with private risk-taking are subject to regulation. This outcome can be achieved in part by the strategic use of the market, but it also involves a variety of institutional and ultimately political capacities.

These problems can be introduced by considering several outstanding issues in the reform of financial markets and corporate governance. With reference to the financial sector, a first step is to reduce the government's ownership of banks. The existence of financial market failures is well known, and there may be some limited role for specialized banks or preferential credit programs to address those problems. But the case studies show repeatedly that public ownership of banks poses a range of political economy problems, including the temptation on the part of politicians to use banks for political ends and the corresponding incentives for private firms to lobby state-owned banks and to shift risk to them.[3]

With respect to the private banking sector, the core of the new political bargain involves recognition of the need to develop franchise value and provide incentives for banks to develop reputational capital. This might require some forbearance in the short run with respect to reaching international capital adequacy requirements or regulating entry. (Of course, the public has already made a huge down payment in the form of recapitalization and purchase of nonperforming assets.) But in return, the financial community needs to be exposed to more rigorous prudential regulation and to greater competition. The latter can be achieved by permitting the entry of foreign banks and by developing capital markets and reducing reliance on bank financing; as noted, the latter trend is already under way and is likely to accelerate. The core elements of a new regulatory

3. La Porta, Lopez-de-Silanes, Schleifer and Vishney (2000) present cross-national evidence that government ownership of banks has adverse effects on growth. On the difficult institutional requirements for avoiding capture and moral hazard problems, see Haggard and Lee 1995.

regime, including the emphasis given to disclosure, have been dealt with elsewhere in detail, including in the work of the Basel committee and other international reform proposals (Bank for International Settlements 2000); they need not detain us here.

However, two particular problems bear underlining because they were central to Asia's difficulties. The first has to do with the licensing of banks. As we saw in chapter 1, the problems in the financial sector were not limited to the public sector. Weakness or outright capture of the bank licensing process contributed powerfully to Indonesia's banking-sector difficulties, and is visible in the licensing of merchant banks in South Korea and finance companies in Thailand as well. A second problem is that regulators need to be alert to the ways that banks with ties to nonfinancial enterprises within a group structure can transfer risks to themselves in order to exploit the safety net. Regulators need full disclosure of these relationships with respect to ownership, portfolio, and risk structure.

The financial risks associated with the group structure point to a second cluster of policy issues surrounding the public-private divide—the need to reform corporate governance. The manifest success of the East Asian firm, even in national settings where the rule of law was weak, have led some analysts to downplay the significance of legal rules and to celebrate the advantages of informality, private enforcement of contract and the personal connections known in Chinese as *guanxi*. However, evidence is now accumulating that legal rules matter (see Johnson and Shleifer 1999 for a review). For example, countries with less protection for minority shareholders have smaller equity markets, firms in countries with weaker investor protection use less outside finance, and countries with weaker corporate governance can also suffer larger collapses when hit by adverse shocks.

But for our purposes there are additional political reasons to be attentive to corporate governance. An important parallel exists between an accountable, transparent political system and accountable and transparent systems of corporate governance. Just as accountability of government serves to check the abuse of public authority, so accountability and transparency of firms serves to prevent the abuse of private power in the form of expropriation, insider dealing, fraud, and corruption.

Principles of corporate governance differ across advanced industrial countries in important ways, and promotion of improved corporate governance does not necessarily imply the wholesale rejection of existing Asian models. But the principles drafted through the Organization for Economic Cooperation and Development[4] are indicative of the central objectives of any system of sound corporate governance. These include:

4. Available at http://www.oecd.org/daf/governance.htm.

- Guaranteeing shareholder rights;
- Guaranteeing the equitable treatment of all shareholders, including minority and foreign shareholders;
- Recognizing the role of other stakeholders in the firm, including workers and suppliers;
- Ensuring transparency and full disclosure;
- Guaranteeing that the board exercises effective monitoring of management.

Given the dominance of family ownership in a number of Asian countries and the lack of transparency in corporate operations, these rules challenge prerogatives long enjoyed by majority shareholders, managers, and insiders that have allowed them to expropriate wealth. One strategy for addressing this problem would be to directly attack the group form per se, and require firms to be broken up or to change their ownership structure; the Kim Dae Jung administration flirted with this strategy, and in cases where firms are in fact insolvent it is wholly justified. However, it is not clear that such a strategy makes sense for firms that are viable and have demonstrated their competitive powers. Rather, the emphasis (as with financial regulation) needs to be placed on changing incentives.

Such a strategy involves at least three distinct components: the market, direct negotiations with firms, and encouraging countervailing private actors with incentives to monitor the firm. The governments in the region have all substantially liberalized rules governing foreign investment, including allowing foreign firms to participate actively in the market for corporate control through mergers and acquisitions, even hostile ones. Trade liberalization is also gradually changing the competitive landscape across the region and will continue to do so. External liberalization is an important solvent against domestic collusion. However, it will have to be complemented by a strengthening of competition policy and antitrust law, including a shift from reliance on administrative enforcement, which remains vulnerable to capture, to judicial enforcement that can encourage monitoring by affected parties (Bollard and Vautier 1998).

A second component of such a strategy is more directive and involves more explicitly negotiated quid pro quos with the largest firms and their representative organizations. Government support for restructuring of corporate debt, including the granting of haircuts, can be exchanged for commitment to principles of good corporate governance and operational restructuring, using the government's short-run advantage as a bank shareholder as a lever. Finally, governments can assist in the development of other agents with an interest in corporate accountability, including shareholders' movements and more aggressive monitoring of firms by pension funds, mutual funds, financial analysts, think tanks, and the media.

The core question with all of these reforms centers on implementation and enforcement. As has been emphasized throughout this book, these problems are not simply ones of administrative capacity; they also involve avoiding problems of capture of the regulatory process, particularly with respect to the core agencies for financial regulation and the oversight of monopolistic and collusive practices.

The formal independence of these entities is no doubt important. In South Korea, the Kim Dae Jung administration transferred most, but not all, regulatory and supervisory responsibilities out of the Bank of Korea and the Ministry of Finance and Economy into a new Financial Supervisory Commission (FSC). In the short run, such agencies can serve to reduce the problems caused by the existence of multiple veto gates and private-sector resistance. However, as argued in chapter 4, it is important not to confuse cause and effect. The differential capabilities of the FSC in South Korea and the Indonesian Bank Restructuring Authority (IBRA) in Indonesia are not simply administrative; indeed, the IBRA has a strong reputation for the quality of its management. Rather, the weaknesses have been political.

Ultimately, the regulation of the private sector requires support from political coalitions willing to check private power and hold themselves accountable for their relationships with private actors. As Schedler (1999, 17) argues, "A is accountable to B when A is obliged to inform B about A's past (or future) actions and decisions, to justify them, and to suffer punishment in the case of eventual misconduct"; accountability involves information, justification, and punishment. In a number of countries in the region, political reforms of government itself may be necessary to achieve this goal of horizontal accountability.

Information is clearly the cornerstone of accountability at both the corporate and governmental levels. A first step of great importance is to increase the transparency of relations between politicians and their financial supporters. How tightly campaign contributions can or should be regulated remains a topic of substantial debate in the advanced industrial states, but again the principle of transparency and the provision of information are minimum first steps. If such contributions are transparent, voters at least have the ability to reach judgments about the political commitments of their legislators and can vote accordingly.

Other institutions of accountability can also help solve informational problems by monitoring the government, including public interest associations and the media, which has itself been captured and dominated by business interests in a number of countries in the region. But these institutions are not adequate to achieve a healthy business-government relationship unless buttressed by "justification"—a set of rules clarifying the boundaries of the public and private spheres—and institutions for punishing malfeasance, such as independent corruption agencies and ultimately the courts.

In drawing up a balance sheet and looking forward, it is important once again to underline a particular fallacy: to discount the effects of legal and regulatory changes that have been put in place by the crisis but have not had a chance to fully take hold. These measures include bankruptcy and foreclosure laws, the liberalization of foreign direct investment, the strengthening of rules on corporate governance, and financial regulation. In Thailand they include a new constitution. But these reforms cannot hold unless backed up by institutions of accountability, in short by a deepening of democracy itself.

Looking Forward II: Toward a New Social Contract

If the relationship between business and government constitutes one cornerstone of a new Asian model, the other is the nature of the social contract.[5] The financial crisis accelerated changes that were already undermining the implicit social contract of the pre-crisis model of growth with equity. The crisis made clear that the next generation of poor people could not necessarily count on unremitting growth to lift them out of poverty, and also that the achievements of the nascent working and middle classes were more fragile than thought. With the aging of populations, urbanization, more open economies, and the recurring risk of financial shocks, the holes in the social safety net became more apparent, leading to new insecurities. Ideally, a new contract would continue to address the problem of poverty alleviation that was so effectively managed through high growth. But at the same time, it would begin to address the insecurities faced by the growing urban working and middle classes.

What might such a social contract look like? Again, it is possible to consider several limiting cases. One possibility might be called "conservative reaction." During the crisis, governments in both Malaysia and Thailand outlined a conservative critique of the European welfare experience, citing the traditional reliance on family and community in Asia, and their past success in harnessing work, discipline, and responsibility at the individual level to produce high growth. The idea of "social welfare" programs (including entitlements to government transfers), they argued, contradicted the roots of past success based on productivity-enhancing investments in health, education, and performance-based small-credit programs. Business groups also expressed skepticism about any further extension of the safety net on the grounds that it would adversely affect recovery in the short-run and competitiveness in the long run.

A danger of this sort is already present. Because of the large real devaluations that have occurred and the corresponding fall in unit labor costs,

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5. This section draws on Birdsall and Haggard 2000. See also Manuelyn-Atinc 1999.

governments might be tempted to revert to a growth strategy relying on low-cost labor. Of course, exchange rate adjustments are designed precisely to promote expenditure switching. But relying on real wage adjustments as a solution to problems in the manufacturing and services sectors seems self-defeating in the long run, particularly given the presence of a number of labor-abundant economies in the region, including both China and India, and the increasing importance of knowledge-intensive economic activity. Such a strategy would deflect attention from the fact that tight labor markets caused by economic booms often masked weaknesses in the *quality* of the workforce that need to be addressed through upgrading; this was particularly true in Thailand.

It is at least possible that political forces could arise that would push in the very different direction of a European-style welfare state. The one country in which this might happen would be South Korea, where the labor movement is strongest. Kim Dae Jung did use his credentials with labor to convene a tripartite committee in early 1998, and in the process both extended unemployment insurance to a broader group of workers and also increased benefits. But the Korean exercise was relatively modest, and was aimed in no small part at extracting concessions from labor with respect to labor market flexibility. Labor fully understood the downside of this bargain, and the more progressive of the two peak union organizations ended up boycotting subsequent tripartite meetings. The exercise casts doubt on the viability of the welfare state option in the absence of strong, unified labor movements and social democratic parties, and nowhere in the region do such political forces currently exist.

Some sort of middle way remains that builds on the strengths of East Asia's past growth strategy while addressing the new requirements of those vulnerable to external shocks. Political debate on these issues is likely to revolve around five central policy areas: the provision of social insurance, the reform of industrial relations and labor market issues, education, decentralization, and how to address persistent or structural poverty.

Of the four areas, the provision of social insurance of various sorts is likely to be the most contentious, encompassing issues as diverse and complex as health insurance and pensions. One type of social insurance that should be particularly salient to the "striving class" has to do with employment.[6] In addition to its social insurance function, unemployment

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6. Such programs are of two sorts. The first provide income support for the unemployed, financed either by the budget or preferably by some form of earmarked "contributions" made by employers and employees. Even when these contributions are, for all practical purposes, payroll taxes, they are typically understood to provide "insurance" rather than unearned transfers. Even when employers contribute, it is not clear who bears the real costs of the payroll tax. Employers can pass on the costs to consumers in the form of higher prices, as long as the demand for their product is not too price-elastic. In open economies, this will be difficult in the tradable sectors. The more flexible wages are, the more employees

insurance has other benefits, the first of which is playing a macroeconomic policy role as a countercyclical Keynesian stabilizer. Reform of social insurance (and particularly of pensions) can also deepen and "democratize" capital markets by creating an increased supply of long-term financing, providing alternative sources of financing to commercial banks, and giving individuals a greater stake in the economy. Unemployment insurance can encourage job mobility—an advantage to economies undergoing needed structural change—and reduce resistance to temporary layoffs, often a more efficient step for firms than reducing wages or firing workers.

The economic conditions for launching initiatives in this area are in some ways more propitious in Asia than in other developing countries. Household savings is already high in the region, and formal insurance schemes would simply channel some portion of these savings through new institutional mechanisms. Moreover, most middle-income Asian countries have good records with respect to the conduct of fiscal policy.

Conversely, the politics of such insurance programs is by no means clear cut. What political bargains would support such a system? For both political and administrative reasons, social insurance is likely to emerge earlier in the more developed countries—South Korea and Malaysia—in which a substantial portion of the workforce is in the formal sector; such a system is already highly developed in Singapore (Low and Aw 1997). Thailand, the Philippines, and particularly Indonesia are likely to follow more slowly. In this second group of countries, emphasis might be placed initially on improving the design and administration of public works programs and institutionalizing them to ensure they are automatically triggered in response to crises.[7]

In the first group of countries, conservative biases and the absence of either strong encompassing unions or social democratic parties suggest that such schemes should avoid emphasizing strong redistributive objectives and instead focus on an ethic of individual responsibility. For insurance schemes, this would imply an emphasis on prior contributions and, in the case of other forms of insurance such as pensions and health, the maintenance of individual accounts.[8] Gaining political support for such

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will indirectly bear the costs of employer contributions. However, as we note below, it may be politically sensible to charge employers anyway. A second kind of insurance, employed on an ad hoc basis during the crisis, addresses employment and income losses through labor-intensive public works programs.

7. This would include wage-setting below the prevailing market to avoid the work disincentives that have plagued European unemployment insurance programs. More generally, unemployment programs financed by general revenues can be made more politically palatable, as well as efficient, if the macroeconomic conditions under which they kick in are transparent and automatic.

8. Such programs can also reduce risk by giving individuals defined rights to borrow against their insurance accounts—not only during spells of unemployment, but also for housing, children's education, and small business investments (Stiglitz 1999).

programs will still require overcoming financing concerns. Smaller businesses are most likely to complain about the cost of employee contributions, and the support of larger export-oriented firms facing stiff cost pressures is by no means guaranteed.

The South Korean experience suggests that the optimal political sequence for initiating insurance schemes should begin with workers in larger firms. This approach is vulnerable to the criticism that it addresses the needs of the best organized first. But if successful, the program will generate its own demand for expansion to other categories of workers, including smaller firms and even the self-employed.

But gaining political support for such programs is not simply a question of financing; it also depends critically on their governance structures. These structures must guarantee effective oversight of funds and prevent theft and diversion. This can be done by ensuring the political independence of fund managers or their regulators, while simultaneously insisting on high degrees of transparency and opportunities for citizen oversight through participation on boards or panels.[9]

The formulation of these programs is related to a second component of the social contract: a new approach to labor relations. The traditional social bargain in East Asia rested on an authoritarian approach to labor relations in which unions were simply repressed or more typically brought under various forms of government control (Deyo 1989). Democratization made such arrangements anachronistic; and in all the newly democratic countries, old unions sought to remake themselves and new competing federations and unions entered the political fray.

A wide array of factors will influence the nature of the new union structure and its relationship with government,[10] but some simple principles can guide a new political deal for labor in the region, and thus contribute indirectly to advancing the cause of the new social contract. The first task is to get government out of the union business and to recognize the right to form unions, engage in collective bargaining, and strike. In return, the government should insist on its right to guarantee that unions themselves are organized and run in a democratic, transparent fashion and to mediate disputes that cannot be settled between management and labor directly.

9. The problem of government involvement in public works programs is more difficult. In Indonesia, the *padat karya* programs were welcomed by incumbents and bureaucrats but hotly contested by opposition groups, which saw them as little more than traditional patronage. However, the World Bank is working with the Indonesian government to devise a system of oversight that would involve participation by NGOs and other groups as well.

10. These include industrial structure and the size of the informal economy, political factors such as the nature of the authoritarian status quo, the party system and the partisan identity of incumbents, and current economic conditions (see, e.g., Deyo 1989; Frenkel 1993; Frenkel and Harrod 1995).

Once such broad frameworks are in place, it is difficult to predict what political role labor will play; a variety of patterns are possible. Where union organization is relatively concentrated, governments may draw labor into broader tripartite discussions, as in South Korea. However, South Korea is likely to be an exceptional case, and the assessment of this experiment also requires a dose of skepticism. Kim Dae Jung was able to do what he did because of his stature as a champion of labor, crisis conditions, and the temporary cooperation of the two union federations; in the end, one of those balked at continuing the process. Elsewhere in developing Asia, labor's overall influence has been small, in part because of the newness of democratic rule, in part because of structural factors such as the size of the small-firm and informal sectors and the emphasis on export-oriented manufacturing. This may change over time, but we must look beyond labor to lead the debate on the new social contract.

A third issue that is likely to have strong cross-class appeal and build strongly on Asia's past development record is education. An obvious ingredient of a post-crisis social contract is a guarantee that public spending on primary and secondary education will not be cut in the event of future economic downturns. Moreover, direct support for poorer students, as in stay-in-school subsidy programs in Indonesia and Thailand, was a noteworthy crisis-induced innovation.

The biggest challenge will come at the tertiary level. Political pressures for increased public spending on university education will inevitably mount as the emergent middle class seeks upward mobility for its children.[11] The key principle for a post-crisis social contract on higher education should be to channel public spending on universities primarily into research and other public goods while avoiding across-the-board support, which can contribute to overbuilt, inefficient public university systems. Misguided spending on tertiary education can be highly costly, particularly in poorer countries, draining human and administrative as well as financial resources from other levels of education and ultimately making public spending on education highly regressive.

A fourth element of the social contract is the greater decentralization of social programs. The arguments in favor of decentralization of service provision—as well as the risks—have been examined in detail elsewhere and need not be fully rehearsed here. Greater decentralization is a critical part of the new social contract, because education and health services that are publicly financed will only continue to be efficient and effective

11. The demands of a number of technology-intensive sectors will require that the middle-income countries of Asia, while maintaining incentives for private research and development, also ratchet up public investment in basic and applied research. Larger firms are likely to support public-private partnerships with universities.

if providers, whether public or private with public financing, are accountable to immediate consumers.[12]

The central political dilemma of decentralization of services is that it requires not only the ceding of greater functions to lower levels of government, but the institution of electoral accountability, local revenue-raising capacity, and the involvement of local community groups and NGOs in the decision-making and implementation process. These changes are clearly not just administrative; rather, they involve a replication of the national level process of democratization at the local level, including the formation of responsible, accountable governments, the formation of local party organizations that can recruit leaders and politicians, and the institutionalization of accountable, transparent government. There is clearly strong support for such measures. Given the barriers to entry at the national political level, oppositions in particular tend to favor political decentralization. Decentralization was a central feature of Thai constitutional revision and has become a burning political issue in South Korea and particularly in Indonesia. Yet there is great resistance at the center among both politicians and bureaucrats to ceding power to lower levels of government, and reform on this dimension is likely to be strongly contested.

The final component of the social contract has to do with the needs of the poor. During the crisis, the attentions of international financial institutions were very much focused on the needs of the structurally poor, but there is some question about whether their gradual departure will result in diminished attention to poverty questions. Even in mature democracies, the poor are unlikely to command a political voice consistent with their numbers. Poverty programs are vulnerable to the political critique that they generate moral hazard—that programs designed for the poor will induce the very behavior that leads to poverty—and that programs meant for the truly poor will end up benefiting the nonpoor (always a legitimate technical concern with social welfare subsidies) or, worse, will end up as a source of patronage and corruption of local politics.[13]

Despite these political problems, there is cause for cautious optimism about the prospects for social protection of the poor. When the poor have benefited from programs of social protection, it has often been because the middle class has endorsed program designs that in effect provide help to all who face some risk of falling into poverty under well-defined

12. Decentralization does not eliminate the possibility of some redistributive transfers, but these should not be the only—nor in most cases the major—source of financing.

13. Strict targeting of social expenditures on the poorest minimizes the financial burden on middle-class taxpayers but implies a limited number of beneficiaries, who by definition will not be politically powerful and also may carry a social stigma.

circumstances. Indeed, the poor may gain more from a small portion of a large program than from a large portion of a targeted but underfunded one (Nelson 1999). Second, politicians do have some incentives to appeal to the poor wherever they can be counted on to vote; the strong showing of Megawati in the Indonesian elections was based in no small measure on her implicit appeals to the urban disadvantaged.[14] Finally, there is the relevance of social solidarity and moral impulses. Historically, it seems to be the case that once citizens act collectively through government to provide social protection in some form, the moral imperative of including the poor is likely to receive at least some attention. In politics, it is too narrow to rely only on the play of interests without some understanding of reciprocal obligations that have deeper social roots.

A New Asian Miracle

The quest for the taproot of East Asia's extraordinarily rapid economic ascent has been a major preoccupation in the social sciences for more than two decades. Among economists, a dominant strand of thinking is the idea that Asia's remarkable growth is in fact not remarkable, but can be traced to rapid capital accumulation (Krugman 1994). Given the inexorability of declining marginal returns, as well as long-term demographic changes now in train, Asia's rapid growth will necessarily fall back to earth. Of course, the crisis of 1997-98 can in no way be taken as a confirmation of that prediction, but it is nonetheless probable that past rates of growth cannot be replicated.

But the past is not a relevant benchmark; what we want to know is how the region—given these fundamental constraints—is likely to do. Moreover, an assessment of the region's performance needs to look beyond economic indicators to other features of the development process, including political and social developments, and the advance of human freedom.

This study provides the basis for some substantial optimism. First, many of the fundamentals that have long been highlighted by analysts of the region remain in place, including high rates of savings and investment, strong commitment to education, openness to learning from abroad, and exposure to international competition. Despite a number of worrying problems in the financial and corporate sector, in three fundamental ways the crisis has strengthened the institutional framework for growth in the future. First, it has given rise to demands for reforms of economic governance both at the level of the state and of the firm. Second, the crisis

14. Graham and Kane 1998 show that politically "opportunistic" social expenditures may benefit the poor (and help build the case for economic reform), but at the risk of inefficiency and misuse.

has generally strengthened rather than reduced countries' commitment to engagement in the international economy. Third, these two developments have occurred under auspices that are more and more—although not yet uniformly—accountable and democratic. The crisis also initiated debate on social contracts to make those democracies better able to withstand shocks in the future. Taken together, these developments constitute a silver lining to an otherwise costly episode in the region's economic history.