Institutions and Economic Crisis:
An Analysis of Policymaking in the Asian Financial Crisis of 1997
Crisis situations call for a unique brand of policymaking, and economic crisis situations are especially unique within this category. Often, an economic crisis signals a defect in the current economic and financial institutions. In order for a country to fully recover from such a crisis, it must work to both counteract the crisis’s effects and reform the economy in such a way as to correct the institutions that first led to the crisis. Not only must a state in crisis create good policy, it must also institutionalize that policy so that it will have a positive effect on economic and financial institutions in the long term. When the crisis is severe, so must the reform measures be to counteract that crisis, creating a potentially politically costly situation for those involved in reform.

In light of these difficulties in creating effective policy in a crisis, it is important to understand a country’s political institutions and how these institutions affect policymaking in such a situation. In the Asian Financial Crisis of 1997, for instance, three of the four hardest hit countries, Thailand, South Korea, and Malaysia, created and institutionalized dramatic reform measures and recovered from the crisis, while the fourth, Indonesia, experienced political indecision and upheaval, deepening the crisis whose macroeconomic problems still hinder Indonesia’s economy to this day. Each of these countries, experiencing very similar economic downturns, had very different policy responses. Why were some of these responses effective while others were not?

Although there is much written about the political and economic causes of the Asian Financial Crisis, there has been little analysis of the policymaking in these countries. The effect of institutional structures on policymaking in general, however, has been studied extensively, beginning with George Tsebelis. Tsebelis (1995) presents a model of policymaking based on the number of veto players a country has and thus how flexible its policymaking can be. A veto player is a person or group who can effectively block the passage of a piece of legislation. Cox and McCubbins (2001) expand this definition of veto players to not only include formal institutions but also parties, factions, and
individuals who have the numbers or the power to curtail the passage of legislation. The fewer veto players a system has, the more easily it can pass new policy. The more veto players a system has, the more rigid and stable are its policies and the harder they are to change. Tsebelis concludes, however, that the most effective governments are those that are more flexible with their policymaking institutions and have the fewest veto players.

Haggard and Kaufman (1995) have examined extensively the political economy of recently transitioned democratic states and weakening authoritarian states, focusing mostly on the economic crises of the 1980s. They have noticed a trend in reactions to the onset of economic crisis in both of these types of states, trends that not only take into consideration institutions but also collective action and elite-polity ties. During an economic crisis in weakening authoritarian states (Peru, the Philippines, etc.) the ruling elite experiences opposition from social organizations and business elites, opposition that prevents the political elites from uniting to implement effective reform measures. Eventually, these divisions lead to the “withdrawal or collapse of authoritarian orders” (53).

In new democracies, the process is quite different. Although newly democratic states seem to show an inability to act amidst signs of potential economic crisis because of strong institutional divisions, they are more able to implement total reform packages after the fact. Amidst the political chaos in Latin America in the 1980’s, many newly democratic countries implemented large neo-liberal reform packages. The failure of these governments to prevent the onset of crisis weakened the elements both within and outside the government that had opposed reform, effectively giving new executives and governments “broad public tolerance for executive initiative” (199). This new “executive initiative” meant widespread and even severe reforms, which became less politically costly than that of further delay. Most of these reforms, unlike the Asian Financial Crisis cases, were homegrown and thus received even wider support (197), but in either case, the weakening of elements
opposed to reform and the broad public and political support for new governments willing to implement reform meant that the new governments could take a harder stance and initiate broader reforms than their stilted institutional structures would indicate.

Haggard and Kaufman also examine one-party dominant states, specifically Mexico and Taiwan. Although they do not examine these cases in terms of an economic crisis, their analysis is useful in that it gives a glimpse of the important factors in determining a one-party dominant state’s effectiveness in creating and institutionalizing economic policy, both keys to success at any point in the policymaking arena. The two main factors that contribute to the creation and institutionalization of economic policy are the centralization of authority in one person and the extent to which there are checks on that authority, either through the private sector or through technocratic agencies with some decision-making power (269). The centralization of authority benefits the creation of policy, while checks on that authority help institutionalize policy by enforcing some degree of policy stability.

In his study of the politics of the Asian Financial Crisis, Andrew MacIntyre (2001; 2003) applies veto player theory to four Asian Financial Crisis cases. Too much flexibility, he argues, could lead to poor policymaking and flip-flopping on legislative issues, deterring investors, while too much rigidity leads to impotence in a crisis situation when change needs to occur fairly quickly. He finds that countries that had the best balance between flexibility and rigidity, with a moderate number of veto players (around three), dealt most effectively with the crisis. Countries with this balance, in this case the Philippines, can produce quality legislation in a timely manner.

There are several major flaws with MacIntyre’s approach. First and most prominent of these is his case selection. He looks at four countries, three of which were hit hard by the financial crisis (Thailand, Malaysia, and Indonesia) and one of which experienced the crisis to a lesser degree (the Philippines). MacIntyre does not account for this disparity in the severity of the crisis in his four
cases, and it is thus no surprise that the Philippines, the country that experienced the crisis to a lesser degree, was also the country that recovered from the crisis the best. If MacIntyre were attempting to explain the degrees of crisis severity that each country experienced, this would be a logical approach. However, in the context of effective policymaking after the onset of the crisis, there must be some consistency on the severity of the crisis within his cases for his findings to be important.

MacIntyre’s dependent variable is also problematic. He judges success in policymaking through the mechanism of “investor confidence,” which he says should have a positive correlation with good policy. Investor confidence, however, should be viewed as a secondary variable, if used as a variable at all. Naturally, investor confidence will drop more dramatically in countries more affected by an economic crisis and will most likely not recover to the same extent, as any country after having experienced a severe crisis will inevitably deter many investors regardless of their policy responses. Other macroeconomic indicators, such as inflation and growth rates, would be better indicators of successful recovery, as these are problems that the government can fix through effective policy.

If one fixes these two problems and applies them to MacIntyre’s argument, there is no longer any correlation between veto players and effective policy, as will become clear in this paper. It is thus imperative to take a different approach to analyzing policymaking in the Asian Financial Crisis.

In this paper, I will attempt to apply Haggard and Kaufman’s framework to the case of the Asian Financial Crisis, going beyond veto player theory to not only examine institutions but also the ways that regimes can overcome rigid institutional barriers through collective action and elite-polity ties. In doing so, I will reveal the inconsistencies of MacIntyre’s veto player argument, emphasizing the flexibility of institutional structures in the context of the regimes and despite the numbers of veto players. It is not simply the institutional structure but also the negotiations between specific actors within these institutions and the interaction between these actors and the public that together can
explain the success or failure of overcoming the crisis. I will also expand on Haggard and Kaufman’s argument by applying the one-party dominant state analysis to the crisis situation in Malaysia and see how this analysis holds.

I will examine success in overcoming the macroeconomic effects of the crisis in terms of regime type: democracy, authoritarian states, or “one-party dominant” states. A one-party dominant state lies somewhere in between an authoritarian state and a democracy. These states may hold elections, because “authoritarian elites govern through a political party, and opposition parties face legal and institutional barriers that eliminate any significant probability that they could take office” (Haggard & Kaufman 1995: 267). As Haggard and Kaufman found, the democracies will generally achieve greater success than the authoritarian states in a crisis situation due to the flexibility of their institutions and outlet for dissent. The one-party dominant state has not been analyzed in terms of a crisis situation. From the analysis of economic policymaking in general, however, I expect any one-party dominant states that have centralized authority and checks on that authority to have similar success to the democratic cases.

The dependent variable in this study is “success at dealing with the financial crisis.” By “success,” I refer to a government’s ability to counteract the effects of the crisis within the time period I will be examining (1997-2000), usually through the creation and long-term institutionalization of reform. The main effects of the crisis for the countries I will be examining are decreased growth rates and inflation, the macroeconomic indicators that saw the greatest downturn, and withdrawal of foreign direct investment (FDI), which serves as a secondary indicator. As stated earlier, FDI is a necessary indicator of success in overcoming the crisis, but it is not sufficient on its own to explain that success. If a government, usually by the creation and institutionalization of good policy, counteracts these macroeconomic setbacks, then it will be considered “successful.”
The Cases

In order to tackle this problem, I will focus on the four most severely affected countries in the Asian Financial Crisis: Thailand, Malaysia, Indonesia, and South Korea (Krause 1999; Haggard 2000). I have chosen these specific countries to be representative of the regimes affected most by the financial crisis while also looking for cases that represent the regime types analyzed by Haggard and Kaufman. Thailand and South Korea represent consolidating democracies, while Indonesia was an authoritarian state at the time of the crisis. Malaysia falls less neatly into one of the three categories. Some consider Malaysia a “semi-democracy” because of its dominant coalition, United Malay National Organization, which has dominated politics since the implementation of democracy in Malaysia (Haggard 2000: 107). Yet because of the democratic institutions in Malaysia, including free, fair, and competitive elections, it does not neatly fall into the definition of a one-party dominant state posited by Haggard and Kaufman. In order to accommodate both of these interpretations, I will analyze Malaysia both as a democracy and as a one-party state to see which interpretation prevails. In the context of either analysis, Malaysia should expect to see similar success to South Korea and Thailand.

In each case, I will give a brief background of the lead-in to the crisis, which will present the major problems that each country has to solve. From there, I will look first at whether the country successfully dealt with the effects of the crisis and then attempt to explain why each country reacted the way it did in the context of its success or failure at both creating and institutionalizing policies of reform. In doing so, I will continually refer back to the arguments made by Haggard and Kaufman to see if the Asian Financial Crisis draws on the same logic, that democracies, authoritarian states, and one-party dominant states have dissimilar economic policymaking models, based both on institutions and on elite interactions and elite-polity ties, which, when applied to a crisis situation, determine the success or failure of reform efforts.
EFFECTIVE POLICY – THE CASES

*Thailand*

Thailand never fooled anyone into believing that it had the strong economic fundamentals that many of the other countries seemed to have prior to the crisis. The Thai government, in fact, had for more than a year been ignoring international cries to fix the problems in its financial sector, but this institutionally divided government was unable to accomplish the task. It took an economic crisis to create coherent policy that would fix these institutions and improve Thailand’s economic fundamentals in the long-term.

The Thai economy set off what many have called a “contagion” that spread throughout Southeast Asia, leaving economic ruin in its wake. Thailand had undergone a massive construction boom since the mid-1980s, one that required a strong financial sector to provide money to keep construction companies building. It is thus no surprise that problems began in Thailand when finance companies began to default on their loans. Finance companies acted as banks, accepting deposits and issuing loans, but did so initially without the same strict regulations that banks saw. By 1996, finance companies could no longer pay the high interest rates they were giving to depositors because too many people were defaulting on loans. Investments now had to be guaranteed by the Thai central bank, draining this bank’s assets near the point of disaster and changing the course of monetary policy in Thailand. This caused concern amongst many foreign investors, who now saw a greater level of uncertainty around the baht’s stability and worth.

Only with the resignation of the finance minister, which removed one strong barrier to reform efforts, did the Thai government finally begin negotiations to devalue the currency. The Thai parliament, under the leadership of Prime Minister General Chavalit of the New Aspiration Party (NAP), floated the currency on July 2, 1997, a now infamous day in Southeast Asia.
The suddenness and severity of this crisis in Thailand must be attributed not only to weak financial institutions but also to weak political actors and coalition governments that had neither desire nor the ability to deal with a crumbling economic situation, like in Latin America in the 1980s. The party system in Thailand was incredibly weak, with disloyal and fragmented parties, a lack of clear ideology, and very little discipline (King 1999: 208). The multiple parties were factionalized and regionalized, two characteristics that also contributed to the fragmentation of the party system. In order to gain a majority in the lower house of the Thai parliament, parties had to form extensive and unstable coalitions. At the time of the Asian Financial Crisis, the NAP was in a ruling coalition with five other parties, all of whom were factionalized and all of whom had veto authority in policymaking. It is little wonder, then, that policy in Thailand was very stable, and we can thus confidently blame the Thai government itself for the crisis that was to follow July 2.

This crisis, caused by the inhibiting effects of multiple institutional veto players, was quite severe. In order to counteract the effects of the crisis, including decreased growth rates, high inflation, and loss of FDI, Thailand had to both create and institutionalize extensive reform efforts. For this to occur, Thailand had to remove the obstacles in the way of reform and create broad public and governmental support behind new reform efforts.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>- Thailand Macroeconomic Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
</tr>
<tr>
<td>Growth Rates (%)</td>
<td>-1.4</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>5.6</td>
</tr>
<tr>
<td>FDI (US$ million)</td>
<td>3894.7</td>
</tr>
</tbody>
</table>

By 2000, the Thai economy had returned to normal growth rates and levels of inflation. FDI also saw a dramatic increase in this period before a gradual and natural decline (Table 1). Despite its institutional constraints, Thailand successfully recovered from the crisis in a span of three years.

---

1 Statistics from this table and the tables following are from *Key Indicators of Developing Asian and Pacific Countries*, 2003 and 2004.
Although the Thai political institutional structure was too weak to prevent a major crisis in Thailand, the nature of a democracy, with its built-in mechanism for public affirmation or negation of policy and governments, meant that the regime would not be too weak to implement and institutionalize reforms. Under the leadership of Prime Minister Chavalit, the Thai parliament took somewhat delayed action, calling in the International Monetary Fund (IMF) to help organize a recovery in the country. Weighing the political costs of further delay, Chavalit used his “executive authority” to adopt a very strict and severe IMF program. This is the best decision that the Thai government could have made for the economy. Soon after the devaluation of the baht, the currency began to stabilize, increasing investor confidence in the Thai monetary situation (see Table 1), and IMF loans helped service at least some of the foreign debt Thailand had accrued during its construction boom.

This short term economic recovery, however, did little to help the political situation in Thailand. The populace and investors blamed Chavalit and the NAP for the onset of the crisis, and by September 1997, Thai voters began to demand strict constitutional reforms. These reforms included changing the electoral system so that it would move away from individualistic parties and more towards party unity and discipline through a combination of single member district plurality voting (SMDP), which promotes more individualistic politics, and proportional representation voting from a party list (list PR), which promotes party unity (Kokpol 2002: 272). The hope was that the new list PR method of voting would help reduce factions within parties, while the retention of SMDP voting would still allow for representation of minority groups and create close elite-polity ties. After the passage of this new constitution in late 1997, Prime Minister Chavalit resigned in order to make way for a new government of economic reform based on a newly reformed electoral system.
These political reforms were the first steps to removing the obstacles in the way of economic reform efforts, bringing together diverse and previously antagonistic actors under support for the same policy initiatives. The newfound unity over political reform subtly transferred to the arena of economic policymaking when the Democrat Party finally consolidated a new ruling coalition in early 1998. When the opinions of separate parties overlap on policy choices, it eliminates much of the coalition-building and bargaining that must occur between these parties in order to pass legislation. The Democrat Party came into power under the promise of economic reform, and thus the base of popular and governmental support for this party and its coalition was broad (Haggard 2000). The Democrats and their coalition would stay in power for several years, creating long-awaited stability in the Thai parliament which also transferred to stability and institutionalization of the economic reforms that it passed. The new Prime Minister Chuan would still have to keep his coalition members in check and bring in the viewpoints of the prominent businessmen in the Senate, but he did so under a wide base of political support, which allowed him to pursue reform efforts on a broad scale without worrying about potential political costs.

The reform measures also gained widespread public support. Much of the public agreed with the decision to turn to the IMF for help, as the government had proved its inability to deal with the economy on its own (Krause 1999: 22). Because the public and government officials now had a vested interest in the success of these reforms, the strict IMF package remained a reality in the new Chuan government and become an institutionalized part of Thai economic policy, a crucial step to success in overcoming the effects of the crisis.

Although Thailand did see some of the negative effects of policy stability in the Asian Financial Crisis that comes from having multiple veto players vying for power in one government, this potential setback did not hinder Thailand’s progress towards recovery. On the contrary, the ability of
this democracy to, first, reform electoral rules and transfer power from a defunct government (under Chavalit) to a reform-minded government (under Chuan), and second, to gain broad public and governmental support for “executive initiative” under the banner of reform, helped in both the creation and institutionalization of economic reform policy in Thailand. Democracies have the ability to create legitimacy for large reform efforts through public support, and the interest that both governments and the public have in the success of these reforms insures that they become institutionalized. The change of power between the Chavalit and Chuan governments gave the now-ruling Democrat Party, who ran under a platform of economic reform, the public support to continue with and implement even more strict reform measures. The normally fractionalized and rigid political atmosphere of the Thai government looked more unified during this period – both unified behind economic reform and unified behind the excitement of a new constitution. This unity led to the creation and institutionalization of policy that adequately reversed the trends of the Asian Financial Crisis.

South Korea

In 1997, South Korea faced similar problems to those of Thailand in the wake of the crisis. It, too, was experiencing bank insolvency, a result of an industrial boom with the creation of chaebols (large state-owned corporations) in South Korea. Banks had invested in these chaebols to encourage the growth that they brought to the South Korean economy, but by July 1997, the corporations were failing and unable to make payment on their loans. In order to bail these corporations out of extreme debt, the South Korean government (through the Korean Asset Management Corporation) purchased their debts, keeping them liquid and the banks solvent (Krause 1999, 12).

Because these corporations were state-run, they garnered very deep loyalty within the governmental apparatus (Yoo 1999, 140), holding power both within the government and within the
public sector whom they employed, and they often used this power to pressure policymakers. Because of this pressure, they were one of the major factors prohibiting extensive economic liberalization in South Korea, which would have contradicted idea of a state-owned corporation.

On June 23, for instance, one of the major Korean chaebols had its own crisis, making the entire economy vulnerable to the Thai crisis that would hit two weeks later. Kia, a car manufacturer, called for the government to bail it out of non-performing loans at a very high level, and when the government agreed to do so, Kia complained that the package was not large enough to deal with the problems that it faced. As a result, the chairman of Kia’s board started a “Save Kia” campaign, backed with public support, which undermined government authority and created tension in the already weak banking sector (Korea Newsreview, 26 July 1997: 16). This chaebol crisis, combined with the financial crisis already occurring in Southeast Asia, further eroded investor confidence in the South Korean economy and caused South Korea to “catch” the same contagion that was spreading throughout East Asia.

Korea, like Thailand, also faced political restraints in dealing with first the chaebol crisis and then the onset of the Asian Financial Crisis. South Korea has a presidential-parliamentary system, which produces at least two veto player elements, the president and parliament, both with the authority to veto policymaking decisions. The parties in the legislature are also quite weak, divided, and regionally-based (Chung-si and Hun 1999: 141) meaning that party discipline is quite low and party members usually vote individualistically instead of with the party, leading to policy gridlock in the South Korean parliament and between parliament and president. These two factors, combined with the support chaebols and labor unions received from the public and individual legislators, explain why, when the chaebols first started to crumble, there was little done to stem what would be an outpouring of financial troubles.
The crisis in South Korea, caused by the inhibiting effects of an outside power that had broad public and governmental support (the chaebols) was equally severe to that of Thailand. In order to counteract the effects of the crisis, including decreased growth rates, high inflation, and unemployment, South Korea had to remove this inhibitor by undermining the chaebol’s power, clearing a path to both creation and institutionalization of liberalizing economic reforms.

<table>
<thead>
<tr>
<th>Table 2 – South Korea Macroeconomic Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth Rates (%)</td>
</tr>
<tr>
<td>-----------------------------------------</td>
</tr>
<tr>
<td>Inflation (%)</td>
</tr>
<tr>
<td>FDI (US$ million)</td>
</tr>
<tr>
<td>Unemployment (%)</td>
</tr>
</tbody>
</table>

Most scholars agree that the policymaking process in South Korea was very successful (e.g. Krause 1999). Through work with the IMF during 1998, South Korea’s growth rates, inflation rates, and FDI all returned to normal or better-than-normal levels by 1999 (see Table 2). In fact, FDI increased by more than 4 times in this period, signaling increased investor confidence in the South Korean economy as a result of its financial and economic reforms. This increase in FDI is also an indication of an opening economy, one that is turning away from the self-industrializing chaebols of the past and encouraging foreign sources of investment for development (Mo 1999: 55).

Unemployment, a factor that hit the South Korean economy harder than any other during the crisis, also improved substantially after the implementation of IMF policy, from a high of 7.0% in 1998 to 4.1% by 2000, only slightly higher than the unemployment rates prior to the crisis (Key Indicators of Developing Asian and Pacific Countries 2003). There were, of course, still weak areas of the South Korean economy, including the banking sector. The fundamentals of this sector had been weak prior to the crisis, and even by 2000, banks were still recovering. The macroeconomic

---

2 This dramatic increase in FDI can also be partly attributed to the increased importance of South Korea as a geo-strategic point of influence for the United States, as Mo Jongryn 1999 posits.
fundamentals that kept this country afloat, however, had all returned to normal, signaling that the economic situation in South Korea was turning around and that the liberalizing reforms recommended by the IMF and implemented by the Dae Jung government were effective in dealing with the crisis.

Only the removal of inhibiting factors to reform could allow South Korea to achieve such success. The first such removal came with the election of Kim Dae Jung to the office of president in December 1998, replacing a president whose inaction both before and in the face of the crisis had been the cause of its severity. Finally, a week before the election, a weakened President Kim Young Sam met with the IMF to initiate negotiations, but it was the reform-minded Kim Dae Jung that instituted and institutionalized these IMF-recommended reforms.

The honeymoon period that the Kim Dae Jung government experienced after its election in December gave it the popular support and “executive initiative” to implement sweeping reforms (CERN 1999). As Jongryn Mo notes, “Crisis shocked Korea out of traditional policy patterns and practices, disorganizing interest groups that used to veto policy reform, and generating pressure for politicians to change the failed policies” (Mo 1999: 53). Kim Dae Jung came into power with a platform of economic reform and action, and because of the honeymoon period provided after any election to office, Kim found the public and political support to implement wide-sweeping reforms.

The economic crisis also contributed to the downfall of many of the extraneous, extra-governmental veto holders that had been plaguing South Korean policymaking. These included such groups as the chaebols, labor unions, and bureaucrats, whose influence had been blamed for the onset of the crisis and the weakness of financial and oversight institutions prior to the crisis. After seeing the devastation that the “Save Kia” and other such campaigns had on the economy, the public took away its support from these state-owned corporations and thus took away their veto power over policy. When the chaebols lost public support, they also lost political support from inside the
Instead, the normally politically-divided Korean legislature became united in the task of fixing the Korean economy and overcoming the crisis. Party affiliation became less important at this time, and Kim Dae Jung’s popularity and economic policies encouraged many members of the opposition coalition to defect to his party, showing unity behind the reform efforts. Yet Dae Jung, unlike the leaders in the Malaysian and Indonesian cases examined below, did not wield ultimate power to create and destroy economic legislation. Rather, once these efforts were in place, the politicians and the public both had a vested interest in their success, indicating that policy would be stable and have the opportunity to institutionalize.

Like the Thai case, the institutions of this democracy as well as the inherent fickleness of public support for reform inhibitors allowed Korea to, first, transfer power through electoral means from a paralyzed president (Kim Young Sam) to a reform-minded one (Kim Dae Jung), and second, to undermine extra-governmental veto powers like the chaebols and unify broad public and governmental support for reform. Both of these steps, unique to the institutions of a democracy, helped in the creation and institutionalization of economic reform policy in South Korea. After the devastation wreaked by the chaebols, they inevitably lost public support, and the reform-minded president with large parliamentary support and unification had the authority to create legislation that would dramatically alter economics is South Korea, doing away with the state-owned enterprise altogether. This unity led to the creation and institutionalization of policy that adequately reversed the trends of the Asian Financial Crisis.

**Indonesia**

Prior to the crisis of 1997, Indonesia appeared to have very solid economic and financial institutions. Its growth rates were high, its currency was stable and its devaluation controlled, inflation
was present yet contained, and foreign direct investment was high but not overly so. The banking sector seemed sound, with fewer apparent nonperforming loans and more control over the financial sector of the economy than countries like South Korea and Thailand. Investors had very high levels of confidence in the Indonesian economy, but as Weiss and Hobsen have noted, even the most unexceptional vulnerabilities can lead to disaster when institutional fundamentals are not strong (Weiss and Hobsen 2000: 10). In the case of Indonesia, a crumbling authoritarian state under the rule of one man (Suharto), the inability of the government to ignore extra-governmental groups, who created barriers to reform efforts, devastated the economy, creating the deepest and most severe of the crises in East Asia.

The devaluation of the baht in July 1997 revealed that many of the weaknesses present in the other three countries were also quite severe in Indonesia, merely hidden by a fairly opaque political system. The national banking system allowed for significant “self-loaning” to managers or employees of the banks and anyone who had clientelistic connections to these people, creating a system of “crony capitalism” in Indonesia. This self-loan principle liquidated the resources of these banks and called into question their solvency. At the same time, government oversight into these corrupt practices barely existed, so the problems inherent in the institutions went undetected and therefore unchanged.

It is little wonder, then, that the Indonesian economy suffered the longest and most severe crisis of any other country in this study. This crisis, hidden from both Indonesians and outside investors, deepened in severity up until 1999, when a semi-democratic regime came to power. In the meantime, Suharto’s unchecked authoritarian power to create and destroy any and all potential reforms in Indonesia meant that none of these reforms ever became institutionalized, leaving an unstable economic environment and a devastated economy.
Table 3 – Indonesia Macroeconomic Indicators

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth Rates (%)</td>
<td>4.7</td>
<td>-13.1</td>
<td>0.8</td>
<td>4.9</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>6.6</td>
<td>58.5</td>
<td>20.5</td>
<td>3.7</td>
</tr>
<tr>
<td>FDI (US$ million)</td>
<td>4677.0</td>
<td>-356.0</td>
<td>-2745.0</td>
<td>-4550.0</td>
</tr>
</tbody>
</table>

Growth rates and inflation reached frightful levels in 1998 and 1999 (see Table 3).³ Foreign direct investment, however, caused the worst troubles for Indonesia, a result of Suharto’s indecisiveness in the face of crisis. Because policy never became institutionalized in Indonesia, investors lost confidence in the authoritarian system’s ability to control the economy, and they never regained that confidence. FDI levels were almost as negative in 2000 as they were positive in 1997, indicating that large amounts of FDI actually left the economy after 1997. Even in the most recent data from 2002 still put FDI in Indonesia at $-1513.4US million (Key Indicators of Developing Asian and Pacific Countries 2004), indicating that the confidence lost in the authoritarian and politically centralized management still lingers in the minds of potential investors. The “fits and starts” of policymaking characterized by this one veto-player authoritarian state not only led to ineffective policy but also to the downfall of the Suharto regime. Indonesia is still recovering economically and politically to this day.

The crumbling authoritarian nature of this regime prevented effective reform efforts from institutionalizing. Suharto made quick and decisive choices, saying that he would implement all of the international community’s recommendations without hesitation. Soon after this decision, however, businesses and banks reminded him of the inherently corrupt nature of Indonesia’s economy, corruption that provided the basis of Suharto’s weakening authoritarian power.

³ These indicators may have recovered by 2000, but they experienced downturns again in 2001 and 2002 in the wake of a worldwide recession, perhaps indicating that the fundamentals behind growth and inflation had not been adequately reformed.
In October of 1997, Suharto turned to the IMF for assistance, accepting a package by the end of that month. The deal consisted of cracking down on insolvent banks and tightening monetary and fiscal controls. The leaders of many of these insolvent banks, however, were relatives or supporters of Suharto, creating a political and personal dilemma for this very personalistic leader. In the wake of the crisis, Suharto and his group of crony advisors took almost total control of economic and financial institutions and created an even more centralized state (MacIntyre 1999b: 272-273) and thus had to take almost total responsibility for policy outcomes. To counter the devastating effects that the IMF deal would have on his cronies, Suharto worked quietly to make sure that his connections could stay in business, contradicting his earlier public commitment to fully implementing IMF policies. By attempting to ensure his own power, Suharto undermined the potential positive effects of the IMF bail-out package (Azis 1999: 51). Even after a third IMF bailout, Suharto was still sending mixed signals to his country and his cronies. Political centralization had led to a “reform process characterized by fits and starts,” as Haggard succinctly puts it (2000: 120). This is certainly not a process conducive to achieving positive macroeconomic results. Power was so centralized in the case of Indonesia that there was ultimately no means of constraining Suharto’s policy choices short of removing him from office (MacIntyre 1999b), and this is exactly what happened in late 1998.

Because no institutional outlet for public dissent existed in 1997-1998, public outcries went to the streets. As in the cases of Peru and the Philippines studied by Haggard and Kaufman, the loss of public confidence and the inability of Suharto to fix any of the problems caused by the crisis also led to a loss of business confidence and created a split amongst Suharto’s cronies (Niles 2001: 94). By January 1999, there was no choice but to remove Suharto from office and place Vice-President B.J. Habibie at the head, with the assumption that political as well as economic reforms would be the result.
As Haggard and Kaufman have noted, the loss of business confidence in an authoritarian regime equals its downfall in an economic crisis. Although Suharto’s authoritarian regime had the ability to create legislation, the unchecked power of that one man resulted in inconsistent and contradictory policies which never became institutionalized and thus never had positive effects on the economy. In the face of a crumbling regime, as Suharto lost public and business support, he also lost his job, and the resulting traumatic exchange of power only served to deepen investor doubts about the Indonesian economy and create an atmosphere detrimental to economic reforms.

**Malaysia**

Like Indonesia, Malaysia too seemed to have strong financial and economic fundamentals before 1997. Inflation was low, growth high, and the currency (ringgit) fairly stable. There were some concerns about bank lending practices in Malaysia, especially concerning property buying, but these had not escalated to the point of major concern prior to 1997. Once the Thai baht devaluation hit, however, the ringgit began to fall dramatically, aggravating the other weaknesses in the financial system and revealing such problems as bank insolvency and an overheated economy.

<table>
<thead>
<tr>
<th>Table 4 – Malaysia Macroeconomic Indicators</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth Rates (%)</td>
<td>7.3</td>
<td>-7.4</td>
<td>6.1</td>
<td>8.3</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>2.7</td>
<td>5.3</td>
<td>2.8</td>
<td>1.5</td>
</tr>
<tr>
<td>FDI (US$ million)</td>
<td>5136.5</td>
<td>2163.4</td>
<td>3895.3</td>
<td>3787.6</td>
</tr>
</tbody>
</table>

Yet the crisis in Malaysia was the least severe of the four countries analyzed in this paper, and the Malaysian government had the most success in dealing with this crisis (Table 4). Malaysia is also the least studied of the countries in this paper, and scholars have found that, unlike the other countries in this study, the exact cause and effects of the Malaysian crisis are unclear. Most likely, the crises in its neighbors and trade partners had the largest effect on the Malaysian economy and aggravated some
of the banking and oversight weaknesses present in many of the other countries. Just as in the other cases, in order to overcome the crisis, Malaysia would need to implement and institutionalize broad economic reforms, but it seems to have had fewer institutional and extra-governmental barriers than the cases of South Korea and Thailand.

In 1997, the National Front coalition dominated politics in Malaysia. This was a coalition of several smaller parties and one large party, UMNO (United Malay National Organization), with Prime Minister Mahathir at the center of power. The National Front had ruled Malaysia since the beginning of electoral politics in that country. As the head of the dominant party, Mahathir had immense power and almost the sole ability to create legislation. This description of the Malaysian political system seems to fall in line with the definition of one-party dominant state used by Haggard and Kaufman, but this distinction is not that clear. Malaysia, unlike one-party dominant states, is a democracy. It holds free, fair, and competitive elections, and though it seems that the National Front coalition always comes into power, there are other competitive parties in the system, indicating that the country does function as a democracy. Yet because there has never been a transition of power from the National Front coalition, economic policymaking in Malaysia resembles a one-party dominant state, a very important distinction that allows it to have institutional flexibility in its reform efforts.

Mahathir, the prime minister, chose a different course from the other countries in this study; instead of opening the Malaysian economy to international help from the IMF, he isolated it by criticizing the international financial sector and aggressive currency speculators. When his advisors, such as finance minister Anwar Ibrahim, proposed a different set of policies, Mahathir initially chose

---

4 Some scholars consider Malaysia only a semi-democracy (see Haggard 2000, for instance). This is because a transition of power from the National Front, headed by the United Malay National Organization (UMNO), has never occurred. There are certainly elements of the authoritarian in the Malaysia system, but on the whole UMNO and Mahathir have returned to power again and again through free, fair, and competitive elections. There is a very visible opposition in the Malaysian system; in fact, there are two growing opposition coalitions, the Democratic Action Party (DAP) and the Pan-Malayan Islamic Party (PAS) with significant representation in the lower house.
to dismiss them instead of incorporating these ideas into his own (Gomez and Sundaram 1999: 242). However correct about currency speculation he may have been, these policies did little more than further encourage the downward spiral of the ringgit, destroy investor confidence, and deepen the crisis in Malaysia. It was only in December, with the formation of the finance minister Anwar’s economic package that Malaysia saw a glimmer of sound policy.

As discussed earlier, Haggard and Kaufman have found that the two main factors that contribute to the creation and institutionalization of economic policy in a one-party state are the centralization of authority in one person and the extent to which there are checks on that authority, either through the private sector or through technocratic agencies with some decision-making power (1995: 269). Mahathir definitely had that centralization of power, but it was Anwar who provided the check on that power. Anwar’s package was a complete reversal of the trend thus far implemented by Mahathir in Malaysia. It encouraged strict adherence to spartan economic and financial rules while hoping to encourage international re-investment in the Malaysian economy, especially after the alienation that Mahathir caused. It strove to liberalize the economy and reduce controls on the currency and on trade (Sumer 2003: 110). Malaysia had still not yet turned to the IMF, but this package was as close to an IMF package as Malaysia would get without Mahathir losing face after his months of IMF and international criticism.

Anwar’s exact policy, however, was never implemented. Before the December date on which Anwar’s economic package was to take effect, Mahathir formed a National Economic Action Council (NEAC) to “evaluate” Anwar’s overall proposal. In fact, this council was little more then a ploy to wrestle control away from Anwar and to ultimately undermine his policy package. A power struggle had ensued between Mahathir and Anwar, the man who was originally destined to be Mahathir’s successor. Throughout the late months of 1997 and early 1998, Anwar generated a following both in
the international community and within the National Front coalition. He often openly criticized the policies of the Mahathir government, signaling potential fractionalization within the ruling coalition and also creating a threat to Mahathir’s ruling power. Anwar attempted to create the ultimate “check” on Mahathir’s economic power by attempting to supplant him in office. Mahathir, however, retained centralized control. Instead of compromising with Anwar, Mahathir chose to simply kick Anwar out of the party and remove him from office while taking credit for his ideas, a move that occurred in September 1998 (Gomez and Sundaram 1999: 152). Despite Anwar’s mobilization of support behind his economic policies, Mahathir ultimately had control over the fate of policy (and the fate of his ministers, for that matter), and he chose to maintain that control and thus insure political future.

Anwar’s “check” left a lasting impression, however, creating a debate within UMNO itself. When Mahathir kicked Anwar out of the party, Anwar’s supporters still remained, and Mahathir had to work with these agents within his party in order to create economic policy. UMNO’s final policy solution closely resembled Anwar’s initial package, a testament to his influence in the one-coalition state. In the end, Mahathir had much of the centralized authority inherent in a one-party dominant system while also experiencing the same “checks” that those states see through Anwar and through the other members of the National Front coalition. He could thus easily create broad and sweeping economic reforms to improve the Malaysian economy, but once he implemented those reforms, the “checks” on his power within his party insured that they remained in place and became institutionalized. By acting like a one-party dominant state in the context of a democracy, Malaysia had the greatest success in overcoming the effects of the financial crisis.
CONCLUSIONS

The effects of an economic crisis on policymaking in these varied regimes are somewhat unexpected but not illogical. Although policymaking procedures in democracies are sometimes slow and confront more gridlock, in a crisis situation, democracies can overcome those barriers to create effective change and institutionalize that change better than can authoritarian states. In the cases of Thailand and South Korea, elections and changes of power allowed for the once-divided legislatures to unite under the banner of economic reform by bringing down those elements that had been wary of or opposed to reform. By eliminating both institutional and extra-governmental barriers to reform through electoral politics, democracies can gain legitimacy behind dramatic reforms, and the same institutions that make reform in a non-crisis situation difficult allow crisis situation reforms to institutionalize and have the greatest positive effect on the economy.

The weakening authoritarian state, Indonesia, experienced a remarkably different outcome. Because the leader Suharto, who had ultimate control of economic policy, had to both attempt to fix the economy and cater to his cronies in business and the financial sector, he dictated contradictory policy with no checks on his power to do so. Although he was easily able to create policy, the lack of coherence in his policy stances meant that those policies were never internalized into true, long-lasting reform efforts. As a result, growth rates and interest rates dropped dramatically, and as of 2002, FDI had yet to make a recovery.

Out of the four cases above, however, it was Malaysia that fared the best. Malaysia, although mostly a democracy, exhibited many policymaking traits characteristic of Haggard and Kaufman’s one-party dominant states. With power very centralized in the executive but also a check on that power in the form of Anwar and a party divided between policy paths, Malaysia could both create policy easily and make sure those policies institutionalized into coherent and long-lasting reform
efforts. Malaysia is a case less often examined in the literature on the Asian Financial Crisis, perhaps because it does not fit into the neat categories of democracy, authoritarian state, or one-party dominant state. In taking this case into account, I hope that I have taken a step to help solve the quandary of Malaysia’s role in the Asian Financial Crisis.

This paper has attempted to expand on the literature examining the creation of policymaking by tackling the policymaking quandary of an economic crisis. In doing so, I hope reader will take away a few important points.

First, allow institutions do play an important role in a country’s economic policymaking, it is rather the ability of a country to overcome its institutional constraints through collective action amongst government officials and between governments and the public that provides the best explanation for differing levels of success in an economic crisis. Suharto in Indonesia and Mahathir in Malaysia had the fewest institutional barriers to reform and were thus very efficient policymakers. The reforms both put in place, however, were not effective; Suharto attempted to both follow the IMF’s recommendations and cater to his cronies, two contradictory policy stances that kept the economy on its downward spiral, while Mahathir initially did little but criticize international speculators and ignore international advice until Anwar brought his voice into the policymaking arena.

Thailand and South Korea’s policymaking procedures were not perfect and were certainly not as efficient, as is the nature of a democratic system that relies on both politicians and the public to garner support for reforms. In the long run, however, the democracies overcame the institutional and extra-governmental barriers by the change of power from non-reformers to reformers while simultaneously garnering support for these reform measures through elections. The less efficient policymakers produced more effective policy because they were able to both create the policy and institutionalize the reforms for long-term, systematic change. At the same time, the country that had both
centralization of power and checks on that power, Malaysia, fared the best in the wake of the crisis because it was able to balance policy stability and flexibility.

Second, unlike the theory proposed by Tsebelis, policy stability does not necessarily equate with political inaction and thus instability during a crisis situation. As is apparent with the cases of Thailand and South Korea, governments could overcome policy stability at first by uniting the public and other policymakers behind change, and then policy stability institutionalized those changes so that they could positively affect the economy in the long term. These new governments still created policy in a timely manner and showed their commitment to that policy through dramatic reform efforts. In Indonesia, on the other hand, policy instability led to political instability, as Suharto’s flexibility in policymaking meant inconsistent and contradictory implementation of economic reform. The inability of Suharto to enact consistent policy not only led to a drop in investor confidence but also led to the populous losing faith in his ability to govern. This popular discontent culminated in a bloody uprising that threw Suharto out of office, eventually creating a change from an authoritarian regime to a democratic one.

The analysis of crises in developing countries has just begun, and there is much research yet to be done to explain how the institutional structure of a country ultimately affects its policy decisions in a crisis situation. In the economic realm, it seems democracy, or at least semi-democracy is the most desirable regime to have in a crisis situation. As democracies consolidate their institutional structures and as authoritarian countries transition to democracy, it is important to keep in mind these conclusions.
BIBLIOGRAPHY


