Governance and Growth: Lessons from the Asian Economic Crisis

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The East Asian financial crisis of 1997–98 has provoked yet another round of controversy on the institutional foundations of the region's growth. This article provides some flavour of this new work by examining three factors that impinge on economic policy and performance: the role of political regime type; the structure of business–government relations; and the design of government agencies. Institutional weaknesses contributed to the onset of the Asian financial crisis.

The East Asian financial crisis of 1997–98 has provoked yet another round of controversy on the institutional foundations of the region's growth. As in earlier debates, the discussion has focused on issues of governance, which I will define as the *design of institutions and organisations for making and implementing collective decisions* (Burki and Perry 1998). Institutions refer to the formal and informal rules and enforcement mechanisms that influence the behaviour of organisations and individuals in society. They include constitutions, laws and regulations, and contracts as well as trust, informal rules and social norms. Organisations are collective social actors, usually characterised by hierarchical patterns of internal authority, that pursue common interests. Organisations operating in the public sphere include government bureaucracies, legislatures, political parties, unions, interest groups, NGOs, and even firms in their political capacity.

The new institutionalism in economics and political science provides the analytic underpinning for the literature on governance. The central insight of this literature is that such institutions and organisations, like markets, structure the incentives facing social actors: politicians, policy-makers, bureaucrats, voters, interest groups, households and firms. Their design thus has implications for economic growth, efficiency and the distribution of income and wealth.

Given the multiplicity of social institutions and organisations, the mechanisms linking them to economic outcomes are numerous. Different strands of literature have focused on different institutions, reflecting to some extent disciplinary divides. The strands of new institutionalism that come out of economics have emphasised property rights (North 1990) and the costs of making and enforcing contracts (Williamson 1985). Institutions can exacerbate or mitigate such problems and thus influence the level of exchange and investment.

A second strand of literature that has received substantial attention in the development policy community takes a more sociological perspective on questions of governance, focusing on the concept of 'social capital'. In his masterful book on the Italian provinces, Robert Putnam (1993) argued that the efficiency of government could

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be traced to the density of social organisations, which in turn facilitated trust among social actors.

In this essay, I will focus on a strand of the new institutionalism that is explicitly political in nature. This work looks at the government more directly, examining how political institutions, organisations and processes influence policy outcomes and implementation (Dixit 1996; Haggard and McCubbins forthcoming). What allows governments to act decisively and credibly in responding to crises and initiating reform? Under what conditions are governments responsive to broad public interests (or the median voter) as opposed to narrower constituencies? Institutional analysis has also focused on principal–agent problems, monitoring and shirking within bureaucracies. This "new economics of organisation", as Moe has called it (1984; see also Horn 1995), seeks to understand the efficiency of bureaucracies in carrying out their functions. Under what conditions is corruption more or less likely? How can regulatory agencies be designed to maintain their independence while they also benefit from private information?

This paper addresses three issues in an effort to convey the flavour of the recent growth of positive analysis of governance: the effects of autocracy, democracy and different varieties of each on policy and performance; the consequences of business–government relations for economic policy; and the question of the efficient design of government agencies. In each case, I examine theoretical debates in light of the economic history of the middle-income developing countries in the region and the recent financial crisis. I consider how governments got into trouble, how they managed the crisis once it broke, and the types of institutional as well as policy reforms that have emerged in its wake.

Regime type, political institutions and economic reform

The particularly poor performance of Indonesia during the Asian financial crisis and the ability of Thailand and particularly Korea to adjust with some alacrity have reopened the debate about the effects of regime type on economic performance. Apart from various cultural arguments advanced by proponents of Asian values, the instrumental argument in favour of authoritarianism typically rested on two pillars: the capacity of the government to reconcile, or over-ride, particular interests in the name of overall social welfare; and the ability of the government to adopt a longer time horizon, unconstrained by elections, short-term political pressures, or the myopia of the electorate.

However, as Mancur Olson (1993) has argued, the case for the advantages of authoritarianism hinges critically on the nature of the authoritarian leadership and particularly its time horizon. An authoritarian leader or party, even if entirely self-interested, might have strong incentives to provide public goods and protect property rights in order to maximise income over the long run. If the autocrat's time horizon is limited, if the leader is myopic or has a misguided model of the world, he may maximise his income through predatory behaviour. Without the checks of democratic rule, such behaviour can persist with disastrous consequences.

Moreover, the implicit picture of democracy as in its nature disposed to rent-seeking and myopic policy is also misguided; after all, the advanced industrial states are democracies. Not only is public opinion more rational than this picture allows, but institutional solutions such as strong parties and delegation to independent agencies, for example central banks, have provided solutions to these problems.

The growing body of cross-national empirical work mirrors theory in generally reaching ambiguous results. 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-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 probably more significant (Przeworski and Limongi 1993; Helliwell 1994).

The Philippines demonstrates how democratisation can be beneficial for economic growth

Asia's role in this debate has been quite central. Even if the argument for authoritarianism does not hold generally, it did appear to hold among the first generation of East Asian newly industrialising economies (NIEs) (Haggard 1990). Taiwan was a party-dominant state led by the KMT and Hong Kong until 1997 had a no-party administrative government under British rule. But the political histories of Korea and Singapore provide contrasts between weak democratic governments and authoritarian successors. After the fall of Syngman Rhee in Korea in 1960, a weak but reformist democratic government took office (the Second Republic), but it proved unable to pursue a coherent policy course in the face of serious social divisions and political challenges. Both orthodox and heterodox interpretations of Korea's growth trace its acceleration to policies launched under the military regime that took office in 1961 and the effectively authoritarian rule that followed under Park Chung Hee after 1964. Singapore was also a politically polarised society in the second half of the 1950s and early 1960s. The export-oriented strategy based on attracting multinationals emerged following the defeat of the leftist Barisan Socialis and the consolidation of dominant party rule. Internal political debates within China in the late 1980s and early 1990s suggest that the intelligentsia was well aware of this regional history (and Russia's disastrous performance following democratisation) and crafted justifications for continued Communist Party dominance around it.

Subsequent political and economic developments in Asia complicate the conclusions drawn from this earlier history in several ways. First, a number of the Asian NIEs made successful transitions to democratic rule, including Korea, Taiwan and Thailand, without any significant effect on economic performance. As I have argued elsewhere (Haggard and Kaufman 1995), democratic transitions during times of high growth are likely to result in policy continuity because incoming democratic governments have little incentive to change course. Thus even if it is true that authoritarian governments contributed to earlier growth in a number of the NIEs, it does not follow that democratic transitions will result in diminished performance, assuming that these transitions occur in a relatively orderly fashion.

Secondly, authoritarian rule did not always follow the developmentalist pattern seen in the East Asian NIEs. The most disastrous economic records in the region must be laid at the doorstep of autocracies: North Korea, Cambodia, Myanmar. Ferdinand Marcos instituted an authoritarian order in the Philippines under political conditions that resembled the 1961 military coup in Korea, and even looked to Korea and Taiwan as developmental models. Yet his government degenerated into a highly corrupt political system, in which close ties with favoured businesses, monopolisation of important agricultural markets, manipulation of the banking system, and outright theft contributed to the onset of a serious balance-of-payments and financial crisis in 1984–85.

The Philippines demonstrates how democratisation can be positively beneficial for economic growth. Democratic governments under Aquino and Ramos had strong political incentives to reverse the Marcos legacy and instituted a variety of reforms, including reforms of the banking system, that allowed the Philippines to weather the recent crisis with less disruption than its neighbours. As the American urban machines show, democracy can foster corruption too, but accountability to a wider public provides a mechanism for checking gross abuses.

Even though democratic governments were initially able to maintain high growth in Korea and Thailand, the onset of the crisis raises the question whether democratisation was implicated in any way; Mo and Moon (1998) have made the case for Korea. There is little evidence in Asia of the fiscal populism that was a contributor to earlier crises in Latin America. However, in both Korea and Thailand, as well as in Malaysia, conflicts within the government

contributed to market uncertainty by generating important policy delays. These conflicts were partly the result of short-term political calculations, partly the result of more deep-seated features of their political systems.

With a fixed term and substantial scope for legislative initiative, the Korean president is quite powerful and would appear well-positioned to respond aggressively to economic difficulties. However, policy-making in presidential systems depends on whether government is unified or divided, that is, whether the president's party enjoys a legislative majority or support from a majority coalition, and whether the president and party leadership have control over their own party (Haggard and McCubbins forthcoming). If the president's party is internally weak, divided, or undisciplined, then presidential systems can produce legislative gridlock.

In 1997 Kim Young Sam enjoyed a legislative majority, but his administration fell victim to divisions within the party and ultimately between the executive and the legislature. The source of these divisions was a 'no re-election' rule (and resultant lame-duck status for the president), a succession struggle within the party for the presidential nomination, and subsequent efforts by both the presidential candidate and the ruling party in the legislature to differentiate themselves from a failed incumbent in the context of a hotly contested presidential campaign. In comparison to other countries in the region, Korea's willingness to bankrupt large enterprises stands out as unusual. But during 1997, political conflict prolonged important corporate failures (notably the Kia bankruptcy), delayed the country's approach to the IMF and prevented the passage of important financial reforms. The mismanagement of these issues weakened investor confidence even prior to the collapse of the Hong Kong market in October, and made the crisis worse than it would otherwise have been.

Korea's political system allowed for the possibility of decisive executive leadership; even before his inauguration, Kim Dae Jung was working with his predecessor to initiate and pass important reform legislation through special sessions of the National Assembly. Thailand's constitution and electoral system (until the constitutional revision in late 1997), by contrast, produced serious and recurrent problems for policy-making. The indecisiveness of political leadership in Thailand was a function of the fragmentation of the party system and the tendency to weak coalition governments. With parliamentary majorities constructed from a pool of approximately a dozen parties, each with its own internal weaknesses, cabinet instability was a chronic problem. The prime minister was vulnerable to policy blackmail by coalition partners threatening to defect. Except for the Chatichai government, which fell to a military coup, all democratically elected governments in Thailand since transition in the mid-1980s met their end in this fashion.

The institutional root of these problems was Thailand's particular brand of parliamentarism. Large electoral districts and proportional representation provide incentives for numerous parties, but also induce candidates to campaign on the basis of individualised strategies rather than on the basis of party label because politicians are compelled to differentiate themselves from competitors of the same party. Not only does this create ill-disciplined parties, but the emphasis on candidate-based rather than party-based electoral strategies requires politicians to deliver selective benefits to voters in their electorate, often in the form of cash payments, which in turn requires legislators to court support from businesses in their districts and spawns favouritism. Prior to its constitutional reform, the Japanese political system generated similar political incentives. These institutional problems help explain the way banking problems were handled and greatly compounded the task of dealing with the crisis once it broke.

But if democratic politics did compound the crises in Korea and Thailand, democratic systems also have built-in corrective mechanisms. In both Korea and Thailand, the governments responsible for the crisis (Kim Young Sam and Chavalit) were forced out, allowing new reformist governments (under Kim Dae Jung

and Chuan Leepkai) to take office. In Thailand, the crisis even prompted a constitutional revision designed to lessen the problems of party fragmentation and corruption.

Indonesia suggests both the strengths and vulnerabilities of authoritarian systems. Indonesia's political system under Soeharto was highly centralised, and seemed the very model of the economically successful authoritarian regime. Through swift adjustment in earlier crises, Soeharto had established his government's credibility with both domestic and foreign investors; his initial response to the crisis was applauded and some predicted that Indonesia might even escape the region's problems. However, precisely because political authority was so unusually concentrated, there was always the risk that the president could reverse existing policy commitments, pursue an erratic policy course, or respond to quite narrow constituencies; Malaysia under Mahathir faced somewhat similar problems. The pursuit of conflicting objectives by the president in the last three months of 1997 raised serious questions about the government's intentions.[1]

Moreover, the absence of clear mechanisms for succession raised even more fundamental questions of whether the regime would survive, and if it didn't, what the subsequent system of politics, property rights and inter-ethnic relations would look like. Investor confidence and élite support for Soeharto's rule weakened more or less in tandem. But the authoritarian nature of the regime enabled him to cling to power for several more months, during which time the economic damage was greatly compounded by increasing political and social conflict.[2] The great challenge for Indonesia is not democratisation *per se*, but whether the form that democracy takes so weakens executive powers that political authority is fragmented and the government left unable to act.

For idealists who believe that all good things go together, it must be acknowledged that a number of authoritarian governments in the region have been able to overcome commitment problems, protect property rights and institute reforms that promoted long-term growth. On balance, however, the recent historical record casts doubt on the purported advantages of 'Asian-style democracy'. Democratic transitions did not substantially disrupt the economic success initiated by authoritarian leaderships, and if democratic politics did contribute to economic problems in Korea and Thailand, these political systems also had self-correcting mechanisms in the form of elections that authoritarian governments such as Indonesia lacked. Non-democratic governments in Singapore and Hong Kong, with particularly coherent governments and high levels of administrative capacity, managed the crisis effectively and China has to date been untested by the challenges of open financial markets. But Indonesia's difficulties can be attributed in part to a highly centralised regime accountable to relatively narrow constituencies and lacking both effective checks on executive authority and a succession mechanism.

Governing business–government relations

One of the most challenging governance questions is how to manage the political relationship between the government and business. On one hand, close business– government relations have been identified as an integral feature of the 'Asian model' that contributed to the region's

1 A question inevitably arises here: if Indonesia's massively centralised political system under Soeharto was inimical to investor confidence, how is it that there were 30 years of strong investment and sustained economic growth? Given that the country's political framework was much the same in 1987 and 1977, how can it have suddenly become a critical problem in late 1997? MacIntyre (1998) argues that for much of the past three decades there have been factors in place which mitigated the credibility problem inherent in the political system. Indonesia offered very strong rates of return, had a demonstrated record of reasonably sound macroeconomic management, and imposed a policy constraint on its own behaviour in the form of an open capital account. However the nature and the scale of the economic problems that gripped Indonesia from late 1997 were such that these mitigating factors were swept aside and investors were left to contemplate the full consequences of unconstrained executive authority.

2 In this, Malaysia exhibits a fundamental difference from Indonesia; even if the succession issue was equally uncertain, as the Anwar case proved, the existence of an organised dominant party provided Mahathir with both the means of political control and for the mobilisation of support that Soeharto's weakly-institutionalised Golkar lacked.

growth (Evans 1995, 1999; Campos and Root 1996). As Peter Evans puts it, "effective government business relations depended on large quantities of high quality information flowing between government and corporations and on mutual confidence that predictions and commitments were credible" (1999:76). The World Bank itself endorsed the value of deliberation councils in its 1993 report on the Asian miracle, although it also emphasised the role of 'contests' which distributed various policy supports and favours on the basis of competition and merit rather than on the basis of political connections.

On the other hand, close political relationships between politicians and business constituencies and particular firms have also been held responsible for the crisis. This argument has at least two distinct strands. The first is that the Asian crisis is the cumulative result of misguided industry policies that favoured well-connected firms. These firms could socialise risk or gain access to subsidies, preferential credit, protection and other sorts of rent through the political process. Government intervention also created moral hazard: excessive risk-taking, inefficient allocation of capital and the weakening of domestic financial institutions. Weaknesses in the financial system, in turn, were key to the wider economic crises that ensued.

A second line of argument—that 'crony capitalism', corruption and nepotism were to blame for the region's difficulties—differs only in that the exchange relationship between the government and firms is altogether lacking in any social welfare rationale. Favours were passed out either on purely political grounds (to gain support of various sorts) or simply to enhance the wealth of politicians. An increasing body of empirical evidence suggests that such corruption (or at least international business perceptions of corruption) correlates negatively with economic growth over the long run (Mauro 1995).

If we take industry policy as the effort by the government to promote the development of particular sectors through subsidies, protection and other instruments, the argument for its significance as a cause of the Asian financial crisis appears weak. The case is most often invoked with respect to Korea (for example, *The Economist*, 15 November 1997). However, industry policy in Korea peaked during the Heavy and Chemical Industry Plan of the late 1970s and was gradually dismantled over the 1980s and 1990s as the country liberalised (Chang 1998). The government continued to intervene in the activities of the newly privatised commercial banks—for example, continuing to appoint their directors—and played a direct role in bank financing of a number of large (and dubious) private projects through the state-owned Korean Development Bank. Government involvement in banking may have sent misleading signals to the private sector, but Korea was distinctive among the countries affected by the crisis in allowing a number of large firms to fail in 1997 (Chang 1999).

In the early 1980s, Malaysia also experimented with a heavy industry push, but in the wake of the recession of 1985–86, the government began to pay more attention to the development of the private sector through privatisation and generic supports, such as tax credits. Indonesia also undertook a number of high-profile industry policy projects, including a state-owned steel company, a national car project and a highly visible effort to develop an indigenous light aircraft industry. Whatever criticisms might be levelled at these efforts, they played no significant role in the crisis of 1997–98. Thailand's industry policy efforts were minimal.

The arguments about the effects of cronyism and corruption in generating the crisis require somewhat more detailed treatment. Their effects were not only the declining efficiency of investment, but also the uncertainty about government policy and property rights that close business–government relations created.

In Korea, outright corruption played a role in the Hanbo failure in January 1997, which first rattled market confidence in that country's economic management. The scandal centred on both political interference and outright bribery aimed at influencing lending decisions. Clearly, these efforts would not have been mobilised if

Hanbo's managers did not expect them to have effect; thus this is a clear case of what might be called *ex ante* moral hazard. Politically motivated decision-making and corruption also appear to have played a role in the expansion of the merchant banking sector. Licences were granted to smaller regional institutions with little attention to their capacity to manage risk or their tendency to borrow short and lend long.

However, virtually all Korean firms were over-leveraged; corruption does not appear to have played a central role in the other major companies facing financial distress (although it may subsequently be revealed; business payments to politicians during the Chun and Roh administrations were massive). The political opposition quickly capitalised on the Hanbo case, and the firm was allowed to fail, precisely because of the political embarrassment that would have ensued had efforts been made to save it. Despite a prolonged and difficult political fight, Kia was also allowed to fail, as were the merchant banks. In sum, while there may have been some *ex ante* moral hazard, in the form of expectations about continued support, the existence of strong political competition, a reasonable level of transparency and concerns about precedent limited the capacity of firms to secure bail-outs. However, *uncertainty* about what the government would do constituted a serious problem and contributed to the undermining of confidence.

Uncertainty also plays a central role in the unfolding of the Indonesian crisis. The story of Indonesian cronyism is now well known. Personal contacts between the president and a small group of Chinese businessmen catapulted their business groups into major conglomerates, aided by such policies as officially sanctioned private cartels (cement, glass, plywood, rice and paper); price controls (cement, sugar, automobiles); and exclusive licensing (clove marketing and flour milling). In the late 1980s and early 1990s, immediate family members appeared more prominently on the list of the favoured.

Once the country began to experience distress, a crucial question for investors was how the government would respond. On the one hand, the fact that Soeharto did appear willing to go after some cronies unsettled the prospects of those firms, and constituted a reversal of what might be called their political property rights. On the other hand, the willingness of Soeharto to protect pet projects was unsettling to foreign investors and the international financial institutions, which interpreted it as a sign of unwillingness to undertake necessary reforms.

Corruption also played a role in the Thai crisis, although there is some controversy about its extent and nature. The political structure outlined in the previous section allowed multiple opportunities not only for business to influence politicians but for businessmen to enter politics and politicians to enter business. Phongpaichit and Piriyarangsan (1994) have documented in some detail the political manipulation of the budget and budget-related scandals which have been a recurrent feature of Thai politics in the 1990s. But if politics contributed to the crisis, it was also the way that the financial system was regulated. The Nukul Commission (1998), established by the Chuan government to investigate the causes of the crisis, does not present evidence that corruption was responsible for misguided and lax regulation. But the mismanagement of the financial difficulties of the Bangkok Bank of Commerce (BBC), the failure to regulate and act aggressively against a number of failing finance companies, and the extraordinarily costly efforts to save a number of financial institutions in the spring of 1997 were all important in setting the stage for the crisis and reflected in part a new responsiveness to business interests. Moreover, as in Korea and Indonesia, uncertainty existed about the government's intentions under Chavalit.

The Malaysian case is complex because the government has long maintained ethnic preferences which are by their very nature discriminatory. The government has also exercised a substantial degree of discretion in implementing its pro-*bumiputra* policy (Gomez and Jomo 1997). Procedures for letting government contracts and privatisation have not always been transparent, and the lines between government, party and private roles are also severely

blurred. Several prominent government officials have had a hand in economic decision-making in the government while simultaneously running party businesses and their own private enterprises. The potential for conflicts of interest is high, and the issue of corruption has been a highly contested one within the Malaysian political system. Conflicts over macroeconomic policy in 1998 were closely related to conflicting ideas about how to structure business–government relations and whether more transparency and less direct support were required (Haggard and Low 1999; Jomo 1998).

The line between outright corruption and political responsiveness to business interests is a fine one

In sum, there is ample evidence that weak financial regulation and poor systems of corporate governance were important precursors to the crisis. Can we attribute this regulatory laxity to corruption? No, but the line between outright corruption—which implies illegal activities—and political responsiveness to business interests is a fine one. What is visible is a pattern of business–government relations in which specific firms were able, or believed that they were able, to secure special treatment. A combination of a high level of discretion coupled with relatively weak regulatory agencies permitted policies which, even if not technically corrupt, created both classic economic distortions and a high degree of uncertainty over the government's policy stance.

In general, solutions to these problems have fallen into four categories. The economists' approach is rooted in the observation that government intervention itself breeds rent-seeking and moral hazard, and thus liberalisation, privatisation, market means of resource allocation and a reduction in the state's discretion provide a political solution to the problem. This idea is not simply a Western conceit; it has champions among Asian politicians. Corazon Aquino, Kim Dae Jung, and Anwar Ibrahim all exhibit elements of 'market-friendly populism', the ideology that overly close business–government relations are responsible for numerous economic as well as social problems, and that a greater dose of the market is a partial solvent.

The second perspective, championed by the international financial institutions, focuses on the incentives facing bureaucrats, who are often assumed to be the central point of cronyism and corruption (for example, Klitgaard 1991; World Bank 1997: Ch. 6). These analyses focus on removing discretion, but also on the manipulation of bureaucratic incentives, both through carrots (guaranteeing adequate public service pay) and sticks (monitoring and punishment of corrupt behaviour). Bureaucratic corruption is important and can be extraordinarily costly. However, large-scale corruption typically involves politicians as well as bureaucrats. Moreover, bureaucratic corruption must be understood in a broader political context, since politicians (in their roles as ministers) are frequently the key actors with a political (if not direct financial) interest in corruption within their ministries. The emphasis on bureaucratic reform, while important, cannot be divorced from the need to monitor the relationships between politicians and the private sector and to make them more transparent.

A third perspective places faith in the power of information and thus emphasises transparency. As the World Bank (1997:98) argues, "Governments should publish budgets, revenue collection data, statutes and rules, and the proceedings of legislative bodies… Unauthorised secret funds or extra budgetary funds available to chief executives are an invitation to corruption." Outside of the government, vigorous media act as a check on government by exposing, and threatening to expose, corruption. The call for transparency needs also to be extended to relations between business and government. Campos and Root (1996:79) argue that institutionalising business–government contacts in formal corporatist bodies can have this effect. By providing a forum for the open negotiation over rules and how rents will be distributed, councils provide incentives for mutual checks among business interests and avoid the highly

individualised patron–client relations and particularism visible in Indonesia.

The World Bank also concludes that "information is of little value, however, without mechanisms for using the knowledge gained to influence government behaviour" (World Bank 1997:108). Thus it is crucial that there are formal checks on politicians and business in the form of institutions with incentives to root out corruption and punish it. It is sometimes thought that democracy itself can accomplish this goal, but I am sceptical. Certain types of political parties thrive on corruption and competing political parties may engage in mutual forbearance on the issue rather than competing to expose it (Geddes 1994).

Here is where the fourth solution for managing business–government relations comes into play: the design of government institutions. A central paradox of economic policy-making is that all governments require independent institutions that are beholden to the law rather than to politicians. Primary among these is a judiciary which is independent and can count on its rulings being enforced, but the model of the independent agency capable of checking politicians extends to other bodies in the government as well. Anti-corruption units, auditors-general and commissions responsible for monitoring and disclosing political contributions, which constitute the basis for most corrupt practices, deal directly with the issue of business–government relations, but implicitly independent central banks and regulatory agencies do as well. However, in the end it is ultimately politicians who design such institutions and to whom they are ultimately accountable; as the name implies, even the most independent agency has some principal. It is to the design of these principal–agent relations within the government itself that I now turn.

Reforming the state: some problems in the design of regulatory institutions

Most analyses of the Asian financial crisis concur that failures of regulation were central to its onset. Financial regulation has received particular attention given weak standards for capital adequacy, loan classifications and loan provisioning, and the general lack of information on the part of regulators. Governments in the region are also being called on to take on a variety of other regulatory functions to guarantee that markets work efficiently, including competition policy and oversight of newly privatised utilities, telecommunications, and transportation companies. One effect of democratisation is that public interest groups and NGOs are making demands for strengthened regulation in areas such as the environment, occupational health and safety, and product liability.

Economists have tended to think of regulatory failure as reflecting misguided models of the world. There can be little doubt that the weakness of regulatory regimes does stem in part from the rising costs of old practices in a new environment. For example, weak financial regulation had lower cost when domestic financial markets were closed than when they are open to rapid, short-term capital movements. However, regulatory failures may also have political roots, and spring from the design of regulatory institutions themselves, including the lack of independence from the influence of politicians and their clients. To the extent that this latter problem is at issue, regulatory reform is no longer an issue of getting policy right or changing incentives in the bureaucracy; rather, it is a political process of re-writing the contract between politicians and bureaucrats.

Central to these contracts is the concept of delegation. Indeed, all democratic politics can be seen as a complex chain of delegations: from voters to legislators, from legislators to executives (in presidential systems) and party leaders (in parliamentary systems) and from executives and legislators to government agencies. From an efficiency perspective, delegation is the organisational equivalent of the division of labour since it allows gains from organisational specialisation and expertise. Delegation also plays a crucial role in solving collective action problems among politicians. For example, legislators have a collective interest in effective fiscal management, since it affects overall economic performance and thus

their reputations as incumbents. But legislators also have electoral concerns that may tempt them to seek particularistic benefits for their constituents. If all legislators succeed in this strategy, for example through legislative deals, then it is easy to see how sub-optimal policy might arise; Barbara Geddes (1994) has called this the "politician's dilemma". Even if the problem is recognised, it may be difficult for parties or legislators acting collectively to organise appropriate responses because of conflicts over the distribution of benefits. Delegation to control committees within the legislature, to party leaders, to the executive or to bureaucratic agencies can solve these collective action problems (Kiewit and McCubbins 1991).

The economic crisis has pushed politicians to grant greater independence to central banks

The potential for delegation to solve various political problems has given rise to what I call the technocratic fallacy: the idea that difficult and contentious policy problems can be solved by removing them from the hands of politicians, insulating them from interest group pressures and assigning them to knowledgeable and well-socialised technocrats.[3] Benign dictatorships—a distinct minority of all autocracies—might be able to accomplish such a feat, but politicians in a democracy have an interest in controlling and monitoring bureaucratic agents so that they are attentive not only to the public interest but to politicians' electoral, constituent and interest group concerns.

There are a number of ways politicians seek to accomplish the objective of bureaucratic control (Kiewit and McCubbins 1991; McCubbins, Noll and Weingast 1987). *Ex ante* means of control include selection of personnel and specifying the scope of the regulatory decisions that are delegated to agencies and the legal tools that an administrative agency can use. Politicians are also likely to exercise ongoing (*ex post*) oversight over agencies. One way of doing this is through auditing, monitoring and reporting requirements, but these 'police patrol' mechanisms are quite costly and run up against both moral hazard problems and the difficulty of specifying all future contingencies.

This problem can be overcome by establishing decision-making structures that build institutional or interest group checks (veto points) into the agency decision-making process. For example, politicians may require intra-agency consultation or empower affected parties directly (for example, by allowing interest groups the opportunity to comment on agency decision-making), by structuring participation in regulatory agencies, by granting constituents standing in quasi-judicial administrative procedures and by strengthening the judicial process more generally. These 'fire alarm' structures are less costly, reveal less biased information, and shift policy-making authority to the bureaucracy while allowing for the ongoing representation of affected parties even as unexpected contingencies arise.

Perhaps the clearest example of delegation has come in the area of monetary policy. The economic crisis has pushed politicians to grant greater independence to central banks in both Korea and Indonesia. But such legal autonomy is only a necessary, not a sufficient, condition for the conduct of an independent and stable monetary policy. Cukierman, Webb and Neyapti (1992) find that independence defined in terms of legal rules has an influence on monetary policy in the advanced states but not in developing ones, where turnover is higher and informal channels of political influence operate to a greater degree. Other studies of the developing countries suggest that 'independent' central banks typically maintain linkages to private sector financial interests that constitute checks on political manipulation (Maxfield 1996); the structure of the Federal Reserve system in the USA provides an example. Creating independent central banks is not simply a question of statute, but of building constituencies, including foreign banks, which support an independent and stable monetary policy.

3 For similar criticisms see Bresser Pereira, Maravall, and Przeworski 1993.

These observations on balancing independence with the participation of interested parties extend to the institutions created for managing widespread financial distress. These institutions have taken on a number of important tasks, all of them fraught with political risks: closing banks and financial institutions; purchasing and disposing of non-performing loans, recapitalising financial institutions and encouraging debt rescheduling between creditors and debtors and wider corporate restructuring. Pursuing these goals is clearly a challenge given the enormous stakes involved for the major stakeholders and the inevitability of imposing losses; this is where a clear statutory mandate and a degree of independence (backed with real resources) are important. At the same time, such agencies need to be responsive to the concerns of private sector actors who are crucial to resolving the problems at hand, including potentially viable institutions as well as purchasers of distressed assets, such as foreign institutional investors.

Governments have recognised that the creation of independent agencies can play an important role not only in accomplishing these tasks but in restoring market confidence. In Korea, the Financial Supervisory Commission has played an important role not only in managing distressed banking institutions, but in pushing corporate debt rescheduling. It did this by assisting in the creation of creditor committees, providing information and establishing procedures and incentives for debtor–creditor negotiations.

The Thai government delegated the task of assessing the health of the country's financial companies to an independent Financial Restructuring Agency. The agency quickly took the decision that virtually all of the finance companies were insolvent and should be liquidated, gaining the country substantial credibility in the markets. Subsequent efforts to auction properties ultimately involved negotiations with, and some accommodation to, foreign buyers.

In Indonesia, by contrast, questions have persisted over whether the Indonesian Bank Restructuring Agency is in fact independent from political pressures. While Indonesia's problems are clearly more grave than those in other countries, institutional and more fundamental political uncertainties have contributed to the slow pace of financial and corporate restructuring in that country.

To summarise, an important component of governance in the post-crisis period will be reform and strengthening of state institutions in areas such as the conduct of monetary and fiscal policy, regulation and the management of systemic financial and corporate distress. Delegation to independent regulatory agencies does not mean lack of accountability; a variety of mechanisms exist through which politicians can exercise oversight while limiting their direct involvement in agency decision-making. These include not only statute and the selection of personnel, but procedures that allow private actors a monitoring function in agency decision-making while simultaneously guaranteeing that procedures are transparent. An important question for further research in the wake of the crisis is to examine how different institutional designs have fared in meeting the objectives of financial restructuring.

Concluding thoughts on an institutionalist research program

Good governance is the perennial slogan of reformers, from the Progressives in early twentieth century America to the international financial institutions at the century's end. In this essay, I have argued that the analytic underpinnings of the normative literature on governance lie in the new institutionalism in economics, politics and sociology. The new institutionalism has addressed questions of how market institutions facilitate investment and exchange, while more sociological approaches have looked at how social institutions affect economic activity and the quality of government. In this essay, I have tried to convey the flavour of a strand of work that is more explicitly political in nature, and sees governance as endogenous to political institutions, processes and interests.

So far, analysis of the East Asian financial crisis has focused overwhelmingly on its economic determinants and the appropriateness or inappropriateness of different policy responses. Focusing on political institutions and processes suggests that these analyses are incomplete. Regime type, variation in democratic institutions, the structure of business–government relations and of regulatory agencies have played important roles in how the crisis developed and was managed. The next stage of work is to take these and other insights and to test them through comparative analysis of a large sample of countries and through small-n (comparisons of small numbers of countries) and case studies. This is clearly intellectual terrain that can benefit from close collaboration between economists and other social scientists.

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