

**Political Institutions and the Economic Crisis
in Thailand and Indonesia**

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Abstract

Much of the literature on Asia's financial crisis has focussed on international on region-wide economic weakness in the afflicted countries. While not disagreeing with such arguments, this paper focuses our attention in another direction: domestic political constraints. Taking Thailand and Indonesia as case studies, it examines the way in which political institutions, that is, the basic structure of government, had an important bearing on the way in which political leaders responded to the crisis and that this in turn had a powerful negative effect on investor confidence. In many respects, Thailand and Indonesia (as their political institutions were configured in prior to 1998) represent opposite ends of a spectrum, with Thailand having a highly decentralized political system which tended to produce policy paralysis and Indonesia, by contrast, having a massively centralized system which highly arbitrary and variable policy behavior. At one extreme, investor confidence in Thailand was undermined by the fact timely policy reform was all but impossible, whereas at the other extreme, investor confidence in Indonesia was undermined by the fact that policy could move in any direction at a moment's notice. The key to these two diverse political maladies was the institutional framework of government then in place.

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Overwhelmingly, discussion of Asia's economic crisis has been dominated by a focus on economic and especially international economic factors. Whether the malady is deemed to be inherent flaws in capitalism, limitations in the international market mechanism, the perils of global financial liberalization, or the policy prescriptions of the IMF and the US Treasury, there is a remarkable convergence on international factors as the driving force behind this crisis.¹ To the extent attention has been paid to the role of domestic and political factors, it has been in terms of vague notions of crony capitalism, weak leadership, or autocratic government. I will argue that while an emphasis on the economic and the international is certainly not misplaced, it is seriously incomplete. Ultimately, Asia's economic crisis was about a sudden and profound loss of confidence on the part of local and foreign investors. Underlying this essay is a belief that the collapse of confidence was not just a function of investor calculations about the likely behavior of other investors, but also their calculations about how governments in particular countries were going to respond to the unfolding crisis.

When a diverse list of countries is hit by economic crisis at the same time, it would be foolish to suggest that there were not some powerful common factors at work. We know, for instance, engagement with the global financial system was a critical factor. Vietnam and China both have deep and systemic problems in their banking sectors but were much less hurt by the crisis because their financial systems were only partially opened-up to international capital flows. Deep financial liberalization was a precondition for this crisis. In the context of the highly liquid global financial markets of the 1990s, this permitted the massive inflow of mostly short-term foreign capital that fueled the growth of foreign debt, and then created such havoc when it departed even faster than it came. We can quickly add to this the potential perils of sustained de-facto fixed exchange rates at a time of a yen-dollar realignment and declining local competitiveness – both because this promoted overvaluation of exchange rates which contributed to the initial sell-off of currencies, and because it discouraged borrowers from insuring against currency fluctuations – thus leaving them very exposed once a major depreciation did hit.²

In Thailand and Indonesia we can see these and other problems such as widespread bad debt among local financial institutions combining to create serious vulnerabilities. Once a major depreciation was triggered, a serious economic crisis was unavoidable as a vicious cycle of capital flight, falling exchange rate, and loan defaults took hold. But that does not mean that they were inevitably doomed to suffer a massive economic contraction – in Indonesia’s case apparently the most dramatic economic reversal anywhere since the Second World War. Governments can respond to economic crises in more effective or less effective ways. Once we recognize this, then the role of local politics in contributing to the crisis becomes inescapable. The popular wisdom in both Thailand and Indonesia is that the incumbent governments were responsible for making matters very much worse. I will argue that the popular wisdom is not wrong: governments in both Thailand and Indonesia did greatly compound the economic damage by exacerbating the underlying problem of investor confidence, and that the key to government mishandling in these two cases lay in the political structure – the institutional configuration – of each country. But the institutional features that caused both governments to make matters much worse were very different; Thailand’s political problems were not Indonesia’s political problems.

The paper proceeds as follows. I first spend some time briefly outlining the theoretical literature on which I am drawing and setting up a simple juxtaposition of problems of policy ‘decisiveness’ on one hand, and problems of policy ‘predictability’ on the other. Strong manifestations of either condition can produce undesirable policy outcomes for investors. And while the conditions themselves are not strictly antonymous, the institutional conditions which underpin them are polar opposites. I then turn to the two cases. In pursuing these two cases I will not retrace the ground already covered by others in more synoptic accounts of the crisis in Thailand, Indonesia, and Southeast Asia more generally.³ My aim is not to present a comprehensive account of the crisis in these two countries, but, more narrowly, to explore the impact of political structure. I am thus self-consciously forgoing breadth and completeness of explanation in favor of depth in order to highlight the importance of local institutions. For Thailand, where the problem was indecisiveness, I focus on one key policy variable – financial sector restructuring – and trace it through in order to highlight the way in which repeated policy paralysis both played a partially catalytic role in the outbreak of the crisis and then served to delay stabilization and recovery. By contrast, in Indonesia, the core political problem was the increasingly unpredictable policy of the government. Accordingly, rather than focus on a single

policy issue, I cast the net wider to demonstrate that this problem was afflicting policy initiatives across the spectrum. The various threads of the argument are then drawn together in the concluding section.

Political Institutions and Economic Governance

Within the broad institutionalist literature pertaining to political economy, two separate but strong theoretical currents stand out. Reduced to their essence, one focuses on decisiveness of policy action, and the other on the predictability of the policy environment. Both have important consequences for economic policymaking and economic performance. The former is concerned with the extent to which political institutions promote qualities such as efficiency in policymaking and implementation, or the ability to make and carry out difficult but necessary policy decisions in a timely fashion. The literature concerned with state ‘autonomy’, ‘capacity’, and ‘strength’ falls into this category (inter alia Katzenstein 1978; Johnson 1982; Haggard 1990; Wade 1990; Doner 1992; MacIntyre 1994; Hutchcroft 1998). This macro-institutionalist literature all related directly to the experiences of the high-growth economies of Asia in the 1970s and 1980s. A logically parallel body of literature has been concerned with the efficiency of political institutions in advanced industrial democracies, but rather than being pitched at a macro level (the state) it has a more micro focus on the consequences of variables such as the division of governmental powers, the type of electoral system, and bureaucratic delegation for policy making (inter alia, Weaver & Rockman 1993; Moe & Caldwell 1994; Kiewiet & McCubbins 1991; Shugart & Carey 1992; Tsebelis 1995; Haggard & McCubbins forthcoming).

Uniting this diverse literature is attention to the way in which institutional design can facilitate or hinder decisiveness in the policy process on the one hand, and attention to the way in which decisiveness can facilitate economic policy management on the other. For instance, a polity in which there is a separation of powers between the executive, legislative, and judicial branches, in which the legislature is separated into two houses, in which the electoral system encourages either weak party identification on the part of legislators or perhaps multipartyism, in which bureaucrats are accountable to both the executive and legislative branches, and in which subnational governments have significant economic powers, is likely to respond much less

rapidly and decisively to an economic policy problem than one in which veto points are fewer and authority is more concentrated.

In contrast to this broad literature pertaining to decisiveness, the literature dealing with what I am here referring to as policy predictability (or the credibility of policy commitments) has had almost the opposite preoccupation. Instead of seeing executive autonomy and institutionally rooted decisiveness in policymaking as a boon, this second approach views it as a problem. A number of influential studies have argued that it is firm institutional *constraints* on leaders which were critical in solidifying property rights and thus permitting the expansion of investment and growth in Europe (North 1981; Weingast 1995; Root 1989), in Asia (Root 1996; Montinola, Qian & Weingast 1995), and cross nationally in the telecommunications sector (Cowhey 1993; Levy & Spiller 1996).

In this context, policy predictability essentially refers to the confidence among investors that the government will adhere to its commitments. Precisely the same institutional conditions which permit a leader to take difficult but economically necessary decisions, can just as readily permit a leader to take arbitrary, erratic, and even predatory decisions which undermine investor confidence and thus economic growth. If leaders are subject to little or no institutional constraint their policy promises can have little credibility, and investors therefore cannot be confident that the policy environment will not change quickly in ways that erode or eliminate their profits. If the policy environment is subject to frequent unforeseen change, investment becomes very hazardous. In this view, what is needed above all else for robust economic growth to emerge and be sustained is that private investors should feel confident that the policy commitments leaders make are credible, and this is most likely to happen if leaders need to obtain the cooperation or approval of other institutions – be they a legislature, a second chamber, an independent regulatory agency, subnational units of government or such like. The more veto points – the more separate institutions which must agree to a course of policy action for it to proceed – the more likely that course of policy action is to stick, because the process of reversing agreement on it will also be that much more difficult.

The arguments pertaining both to decisiveness and predictability are based on powerful logic and substantial empirical evidence. And yet, clearly, there is a tension between the two -- even if it is a tension that is seldom discussed. Indeed in many respects the two literatures talk past each other unsatisfactorily. While the concepts of decisiveness and

predictability are not mutually exclusive, their enabling institutional foundations are. The more widely veto authority is dispersed, the more predictable the policy environment becomes but the less able government becomes to respond to pressing problems. And vice-versa. Decisiveness and predictability will be provided in varying degrees depending, in large measure, upon the underlying institutional framework. A severe shortage of either can be very destructive to investor confidence. I argue that Thailand's and Indonesia's handling of the economic crisis illustrate the perils of extreme cases of either condition. Thailand's political system tended to produce great policy stability – to the point of paralysis – because change was extremely difficult to bring about as the institutional framework was antithetical to decisiveness. By contrast, Indonesia's political system had little in the way of institutional constraints on executive action and was extremely decisive, but always carried the risk of policy uncertainty precisely because of this. By different means, then, in both Thailand and Indonesia amplified the economic damage done beyond what might otherwise have been the case once capital was withdrawn and the exchange falls were triggered. Additionally, in the case of Thailand, the institutional framework contributed directly to the outbreak of the crisis to begin with. I turn now to discuss each case.

Thailand

As Thailand sank further and further into economic difficulty through 1997, the recently elected government led by Chavalit Yongchaiyudh was subject to mounting vilification for immobilism, indecisiveness, and corruption. Justified though these criticisms were, they were nothing new. Chavalit's government was not unusually incompetent, divided, or corrupt. With some slight differences from one to the next, this broad characterization applies to all fully elected governments in Thailand. The governments led by Banharn Silapa-archa, Chuan Leekpai, and Chatichai Choonhavan all suffered from similar problems. All these governments were afflicted by serious and ongoing corruption scandals, rested upon very shaky multiparty coalition arrangements, and implemented very little in the way of major economic reform. The strong rate of economic growth enjoyed by Thailand from the late 1980s through the mid 1990s owes very little to policy initiatives by any of these governments. Rather it was the two brief post-coup caretaker administrations led by the highly technocratic Anand Panyarachun that were the policy innovators in the 1990s. Unelected and not being a career politician, Anand and the team

working with him were subject to few of the normal constraints of Thai governments. Prior to this, one has to go back to the semi-democratic period in the early- and mid-1980s under the unelected Field Marshal Prem Tinsulanond to find much major economic policy reform. And even then, this was confined largely to core areas of macroeconomic policy that were shielded by Prem from the fluid, rent-seeking imperatives of the political parties which controlled most sectoral and microeconomic policy issues (Doner & Laothamatas 1994).

This is *not* an argument that economic governance in Thailand has declined with democratization; rather it is an argument that the *particular* institutional configuration Thailand has had in place (until the constitutional overhaul in late 1997) was bound to produce serious problems of policy management and political leadership. Chavalit's government was no more venal or inept than its predecessors; indeed part of the difficulty it faced was the accumulated legacy of reforms not made by previous administrations.

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 composed of about a half a dozen parties, each with its own internal weaknesses, cabinet instability was a chronic problem. Party leaders were always vulnerable to defections by factions and individuals within their own parties who could find better prospects for advancement in another party. And the Prime Minister, as leader of the governing coalition, was always vulnerable to policy blackmail by coalition partners threatening to defect in pursuit of better deals in another alliance configuration. This was the key political dynamic of coalition government in Thailand. Indeed, all democratically elected governments except the Chatichai government, which fell to a military coup, met their end in this fashion. With weak coalitions and parties, strong action on difficult public goods oriented policy issues--whether exchange rate management or Bangkok's notorious traffic congestion--was always severely under-supplied.

The institutional root of these problems was Thailand's combination of a parliamentary structure (in which government rests on party cohesion) and a multimember electoral system (which undermined party cohesion). As Allen Hickey (1998) has argued in important new research, Thailand's multimember electoral system strongly encouraged candidates to campaign on the basis of individualized strategies (rather than on the basis of party label) as they were compelled to differentiate themselves from competitors of the same party. Not only did this create weakly disciplined parties, but the emphasis on candidate-based rather than party-based

electoral strategies ensured that politicians would strive to deliver selective benefits to voters in their electorate in order to differentiate themselves from rivals from the same party (Cox & McCubbins forthcoming). This encouraged vote buying and placed a premium on politicians being able to generate a flow of cash to cover costs while in office. In short, the logic of the country's electoral system made it all but impossible for politicians to agree to economic reforms if they threatened rent-taking arrangements they had put in place for themselves or their key supporters.

But let us turn from this general discussion of how Thailand's political institutions constrain policymaking to focus on the crisis. To this end I will trace the government's handling of one policy variable – restructuring of Thailand's ailing financial sector – through the lead-up period and the course of the crisis. I focus on this issue both because it was clearly central to the crisis⁴ and, more importantly, because it provides a very useful window through which to view the way that the country's political institutions constrained policy making and thus both helped to create the policy problems in the first place, and then compounded the loss of market confidence as the crisis unfolded.

Thailand's financial sector began to expand rapidly with the beginning of the process of financial liberalization in the late 1980s. An important part of this was the creation of the Bangkok International Banking Facility in 1993, which was intended to launch Bangkok as an international financial center, but in practice functioned to facilitate greatly the inflow of capital from foreign lenders to Thai financial institutions and real-sector companies. With hindsight, it is easy to see that one of Thailand's biggest weaknesses (as in a number of countries in the region) was the liberalization of financial markets with inadequate oversight or prudential regulation. By the second half of 1997 Thailand was beset with an estimated Bt1 trillion in bad debts held by banks and finance companies and the government had spent an estimated Bt430 billion in propping up failing financial institutions (roughly, US\$28.6 billion and US\$12.3 billion) (Bangkok Post, 10/12/97, 8/14/97).

Early warning signs of the problems and malpractice in financial institutions came as far back as 1994 when the Bank of Thailand (the central bank) began to examine the affairs of a struggling mid-sized bank, the Bangkok Bank of Commerce (BBC). Rolling over several years, the BBC scandal is widely regarded as one of the early and important dents to business confidence in Thailand and to the reputation of the central bank.⁵ More important for our

purposes, however, is what this saga reveals about the political constraints of financial sector management in Thailand.

After becoming concerned about the situation at BBC, the Bank of Thailand failed in its clumsy efforts to gain supervisory representation on BBC's board. As the extent of mismanagement at BBC and its estimated US\$3 billion in non-performing loans became public in mid-1996 following disclosure by the opposition, there was a run on the bank. Having indulged BBC for an extraordinary period, the central bank finally stepped in forcefully in May, taking formal control of BBC as it crashed and its management fled. Ultimately, a total of US\$7 billion was spent to keep BBC afloat. The central bank governor was forced to resign in disgrace over the episode, but the reputational damage had been done. In addition to any possible impropriety on the part of the central bank governor, suspicion was directed to several politicians within Prime Minister Banharn's Chart Thai party, who, it emerged, had been the beneficiaries of large loans from BBC (The Nation, 4/18/97, 3/13/97, Pasuk & Baker 1998b).

In September Banharn's government collapsed when key coalition partners deserted him. After what was widely regarded as the country's dirtiest election (with an estimated US\$1 billion handed out to buy votes) and having benefited from large scale defections from Banharn's Chart Thai party, Chavalit's New Aspiration Party narrowly emerged as the largest party in the parliament and proceeded to construct a six party coalition comprising many of the parties from the previous government. Notwithstanding the massive vote buying on behalf of his NAP (FEER: 11/28/96: 16-22), Chavalit entered government with perhaps the most promising credentials for policy action of any elected Thai government. Chavalit himself had strong military links, support from big business, and a reputation as a skillful politician. Banharn's government (of which Chavalit had been part) was widely regarded as inept, hopelessly corrupt and blamed for presiding over the country's sagging economic fortunes. Chavalit, by contrast, declared his cabinet would be built around a so-called "economic dream team". And though three respected technocrats were appointed to key ministries (most notably, Amnuay Viruwan as Finance Minister), the logic of Thailand's political structure very quickly reasserted itself.

The BBC saga came to life again when it emerged that criminal charges laid against several BBC executives had lapsed because Bank of Thailand officials had failed to act before the statute of limitations came into play in early 1997. Chavalit ordered the suspension of a deputy governor at the central bank and several other senior officials over the affair, but this did

little to conceal the fact that politicians who were now members of his party maintained strong links to BBC. Problems in the Thai financial sector – and the government’s inability to deal with them effectively – ran much broader and deeper than just BBC. Indeed, the biggest area of concern was not the banks themselves, but the finance companies. The country’s fifteen banks dominated the financial sector, but with entry by new banks tightly limited, finance companies came to play an increasingly prominent role through the 1990s. By the end of 1996, Thailand’s 91 finance companies (25 were pure finance companies and 66 performed both finance and securities functions) accounted for nearly 25% of total credit (EIU 1998 pp. 31, 50). By the beginning of 1997 their difficulties were also coming rapidly to a head as long smoldering problems of non-performing loans were suddenly whipped up into a blaze. Several interrelated factors came together here: the end of a prolonged property boom in late 1996 (real estate was the core collateral for much of the borrowing), mounting nervousness about the currency in the face of repeated speculative attacks, and higher interest rates designed to help support the currency and dampen inflationary pressures.

On February 5 the first Thai company (Somprasong) defaulted on a foreign loan repayment. And then, late in the month, it was suddenly announced that the largest of the finance companies, Finance One, was seeking a merger with a bank to stave off collapse. In the face of widespread fears of an impending financial implosion and the beginnings of hurried depositor withdrawals, all attention rapidly focused on the government’s response to the situation. In a joint move on March 3, finance minister Amnuay and central bank governor Rerngchai Marakanond suspended trading of financial sector shares on the stock exchange and went on national television to announce a series of emergency measures designed to reassure nervous markets. The two key elements of the policy intervention were a requirement that all banks and finance companies make much stronger provision for bad debt and an announcement that 10 of the weakest financial companies would have to raise their capital base within 60 days.

These measures did little to reassure markets, and when trading resumed the following day (March 4), financial shares fell heavily amidst reports of a rush to withdraw funds. Underlying continuing market nervousness were doubts about the government’s ability to follow through with its restructuring plans. Such fears proved well founded. No sooner had Amnuay and Rerngchai targeted the 10 ailing finance companies than a familiar political dynamic reemerged as the plan encountered heavy resistance from within the government. Several senior

members of Chart Pattana, the second largest party in the coalition, had controlling interests in some of the ten targeted institutions. Not only did they succeed in vetoing the plan and ensuring that no action was taken against the 10 companies, the fact that they were permitted to remain open meant that – as with BBC – the central bank had to pump in large sums of new capital in order to keep them afloat in the face of runs by panicked investors.

This was a critical juncture in the development of the crisis in Thailand. There was a clear and pressing need for effective government action with widespread concern among Thai and foreign investors about the scale of the bad debt problem in the financial sector. At the same time the currency was coming under mounting pressure with money market players sensing exchange rate vulnerability. Amnuay and Rerngchai did not dare pursue the strict path favoured by financial hawks: forcing shareholders to accept big losses by allowing ailing institutions to fail, or to permit foreign investors to take a controlling stake in these institutions. However, even the intermediate path they opted for – lifting capital adequacy provisions and singling out the weakest institutions for immediate attention – proved politically unattainable. These initiatives failed not because they were blocked by popular outcry or parliamentary opposition, but because they were, in effect, vetoed by other members of the ruling coalition. Rather than risking the collapse of his new government by alienating Chart Pattana, Chavalit preferred to gamble on compromise and delaying measures.

The finance minister's inability to follow through on even the moderate plans he had outlined had a very corrosive effect on investor confidence. In addition there were high objective costs to deferring action: a side effect of injecting large scale emergency funding into the ten failing finance companies was blowing out the money supply (by 10% in the month of June alone). This served only to sharpen the fundamental contradiction in the government's overall macroeconomic position. At the same time as it was pumping money into insolvent finance companies to keep them afloat, the central bank was also spending down reserves to prop up the exchange rate. As was increasingly recognized by markets, this was not a sustainable strategy. In mid May the baht suffered its heaviest assault, but by this time it was no longer just big Thai companies and foreign investors that were betting against the baht, middle class Thais were also increasingly moving to dollars (Ammar 1997, p. 2).

Frustrated by his inability to persuade the coalition's leaders in cabinet to move on more extensive financial sector reforms (as well as on other fronts such as cutting more pork

from the budget), Amnuay resigned from the government on June 19. The leader of the government's technocratic dream team had lasted just seven months in office. With a few exceptions, his attempts at major reform had been blocked by other parties within the government. And so otherwise promising initiatives never went anywhere. As one minister lamented: "To solve economic problems we cannot simply announce economic measures, we have to follow up on their progress." (FEER, May 29 1997, p. 15). But of course this was the problem; with diverse coalition and all parties having incurred massive debts in order to win office, there was little prospect of the cabinet agreeing to take tough measures that might hurt the economic interests of ministers or those of their financial benefactors. Even if a majority was in favor of taking action, a minority that was prepared to play hard ball could veto the action by threatening to walk out of the coalition.

After struggling to find a prominent figure that would accept the post of Finance Minister, Chavalit offered it to Thanong Bidaya, the head of the Thai Military Bank. Thanong fared little better than Amnuay. Seeking to seize the initiative, on June 27 he announced the suspension of 16 finance companies (including 7 of the original 10), giving them 30 days to implement merger plans. And, with the central bank no longer able to sustain the exchange rate, five days later on July 2, it was announced that the baht was being cut loose. The baht immediately fell very sharply, depreciating by 17%.

In his efforts to push financial restructuring, Thanong stumbled on the same obstacle as Amnuay: while he had won approval for the announcement, Chart Pattana leaders were again able to block the implementation of the initiative. Not only did Chart Pattana succeed in preventing the closure or forced merger of the 16 finance companies, it also managed to persuade the central bank to continue injecting large sums of capital. In late July, in the context of negotiations with the IMF to obtain a rescue package, it was revealed that loans to the 16 finance companies now totaled a staggering Bt430 billion. (This figure exceeded the actual capital funds of the finance companies themselves and corresponded to about 10% of GDP.) The government naturally sought to downplay its own direct involvement in this scandal, and instead forced the resignation of central bank governor Rerngchai as well as another senior and respected official (Bangkok Post, August 14 1997).

A week later, on August 5, in an effort to regain the initiative and to satisfy IMF demands for policy commitment the new Finance Minister, Thanong, announced that a further 42 finance companies would be suspended because of the scale of their loan problems and imminent insolvency. A total of 58, or two thirds of the country's finance companies, had now been suspended. Like the earlier 16, this batch was given a short period in which to meet tough new capital adequacy rules, merge with a stronger institution, or go out of business.⁶ Continuing the effort to clean up the financial sector under the terms of the agreement with the IMF, Virabhongsa Ramangkura, a respected technocrat newly appointed as deputy prime minister in a hurried cabinet reshuffle in mid-August, replaced the official in charge of the committee established to vet rescue plans of the suspended finance companies. In his place, he installed Amaret Sila-on, the respected head of the Thai Stock Exchange in an effort to counter reports of corruption and malpractice in the committee's operations (Bangkok Post, August 26 1997).

But as one section of the government was moving to force an overhaul of the financial sector, another was moving in precisely the opposite direction. The pattern was familiar, and the Prime Minister was powerless to resolve the tension. As one senior Thai business commentator put it: "What investors are worried about is political interference in the implementation of the measures, something that we have seen over the past two to three years, where previous attempts to address the problems have failed because of political interference (Bangkok Post, October 15 1997). With the deadline for deciding the fate of the suspended finance companies looming, the politics intensified in early October as the Association of Finance Companies vigorously courted Chart Pattana leader Chatichai as well as prime minister Chavalit seeking a relaxation of the criteria for their rehabilitation. The IMF responded by publicly expressing concern that the independence of Amaret's screening committee not be undermined. Nevertheless, a week later he resigned after only a short tenure, declaring that he was being undercut by forces within the government (Bangkok Post, October 12 1997).

Further concessions were soon made to Chart Pattana and the finance companies when, at the same time as announcing the creation of two new independent agencies to handle the evaluation and processing of the finance companies, Thanong also revealed that the deadline for their restructuring would now be extended (without a new date being set) and that loans earlier extended to the ailing finance companies by the central bank could be treated as equity –

thus opening the probability that the public resources injected into these companies would never be recovered (Bangkok Post, October 14 1997). And in another successful rearguard move, Chart Pattana succeeded in holding up the approval by cabinet of the plans for the two new agencies announced by Thanong until text was inserted in the decrees specifically reversing their independence from the government (EIU 1998 p. 13).

By this stage however, the political situation was in a state of collapse. On October 19 finance Minister Thanong resigned over the reversal of a petrol tax a mere three days after it had been announced as part of the government's very long awaited policy response to the IMF bailout. And in the wake of maneuvering in preparation for the formation of an expected new government led by Chart Pattana and impending defections in Chavalit's own party, the crippled prime minister announced his resignation on November 3. Thailand was in very deep disarray.

My focus here has been on a single, albeit key, issue: restructuring of the financial sector. There are many others that would have yielded a similar picture (e.g. the process of designing and approving the new constitution or fiscal management). The fundamental proposition here is straightforward: Thailand's combination of a parliamentary structure with multiple weak parties (in turn, linked to the electoral system) meant that policy making was bound to be particularly indecisive. This was not a function of the character of particular personalities or the combination of interests represented in Chavalit's government; the same pattern applied in previous governments. Under this political structure, party and faction leaders were compelled to work assiduously to generate resources to hold their members together, and prime ministers had to struggle to keep their coalitions together. This meant that there were numerous veto players within the government and it is thus scarcely surprising that major policy initiatives of any sort were extraordinarily difficult to undertake.

The paralysis of Thai politics had clear institutional roots. It takes little imagination to recognize how ill-equipped this system was either to head-off the mounting economic problems in the country in the lead-up to the fall of the currency, or to manage and contain the situation once capital started rushing out. Added to straightforward policy paralysis, the constant turnover of key personnel in this highly fluid system did little to engender investor confidence.

Chavalit's government endured for twelve months and experienced three cabinet reshuffles, three finance ministers, and two central bank governors.

To summarize, then, the argument to come out of this discussion is that we can see Thailand's political structure exerting a powerful negative influence over the economic policy environment, an influence which allowed serious economic problems to accumulate, thus helping to set the stage for the currency crisis and the rapid outflow of capital. And once the crisis broke, we can also see the same effect heightening the economic destruction suffered by Thailand because of the inability of government to respond to the situation in a timely or effective manner. It is difficult to believe – especially in the context of widespread uncertainty and even panic – that this systemic governmental incapacity was not a major source of discouragement to local and foreign investors. A focus only on international economic factors misses all of this.

Drawing back from the dynamics of the crisis itself, if we take a broader view of what was happening in Thailand in 1997, it is clear that that it was not just investors who were despairing of Thailand's political system. Widespread public disillusionment with the system and its alarming impotence in the face of the crisis propelled the introduction of dramatic constitutional change in the latter part of 1997. This is not the place to discuss those changes, but it is worth noting that along with deep and widespread economic hardship then, Thailand's economic crisis has also given birth to a new political system.

Indonesia

The political economy of Indonesia's stunning economic reversal in 1997/98 differed from that in Thailand in important ways. To be sure, there were some key shared vulnerabilities: open financial systems with weak prudential oversight, an effectively fixed exchange rate⁷, and large and rapid inflows of foreign capital, most notably short-term debt. As in Thailand, the co-existence of these conditions meant that as the currency came under pressure – in Indonesia's case, because of contagion – the economy was dangerously vulnerable. Thus, we saw the same vicious cycle at work: as short-term capital initially moved out in self-fulfilling anticipation of an exchange rate depreciation, the currency dropped and quickly created serious problems for borrowers holding unhedged foreign loans. The scramble to buy dollars by these borrowers

pushed the exchange rate down further, making debt repayment even more difficult and raising the specter of non-repayment of loans. And as this caused more capital to leave and the currency to fall lower still, defaulting on foreign debt became a reality.

But there were also important differences. Many observers have pointed out that the key features of Indonesia's macroeconomy were in much better shape than Thailand's. As Hal Hill (1998 p. 8) put it: "...almost every technical economic indicator looked safe." Inflation was moderate; although substantial, the current account deficit-to-GDP ratio was less than half that of Thailand; there was no major bubble economy effect as in Thailand (and elsewhere); and there had been no tell-tale sharp outflow of capital or sustained decline in the stock market before the crisis. Much less remarked upon however is the fact that problems in the financial sector did not play the leading role they did in Thailand (or Korea). To be sure, Indonesia's financial sector suffered from very serious weaknesses, and these did indeed compound the country's economic problems as the crisis took hold. But this was a less critical factor than in Thailand (and certainly Korea) as most of the corporate debt in Indonesia was not held by Indonesian banks, but by foreign banks. With a longer history of open financial markets, Indonesian companies had borrowed directly from foreign banks (both offshore and onshore). Consequently, although the solvency of the Indonesian banking system certainly became an issue, this was not where the crisis started. In Indonesia, the crisis backed up into the financial sector from the real sector, rather than the other way around.

More important for the purposes of this paper than these economic contrasts, are the differences in the political circumstances of the two countries. Although I argue that politics played a critical role in undermining investor confidence and intensifying the economic damage in both countries, in Indonesia this happened in a different way, for different reasons, with a different timing, and ultimately with even more devastating consequences. If the basic political problem in Thailand was that the institutional framework produced hopelessly divided and thus indecisive government (of all coalitional complexions), in Indonesia it was that the institutional framework imposed no constraints upon executive action – thus opening the way for erratic policy behavior.⁸ Not only was Indonesia's political system not democratic, it provided for an extraordinary centralization of decision-making authority in the presidency. Quite simply, no

other institution or collection of political actors had the ability to veto the implementation of his policy preferences or to initiate alternative policies (MacIntyre forthcoming-b).

While certainly producing a highly decisive policy process, such a centralized political structure of course gave rise to potential problems of policy unpredictability. I argue that the unfettered power of the presidency and the resulting uncertainty about his policy commitments was highly destructive of investor confidence in the context of a region-wide economic crisis. With no institutional checks on his power and with no effective mechanism for replacing him as leader – short of political upheaval – the only option open to investors as the value of their assets continued to plummet was exit. As local and foreign investors pulled their capital out and the economy went into a tailspin, it was only a matter of time before the resulting economic dislocation and pain produced a political backlash strong enough to force Suharto's fall. But with such a firmly entrenched authoritarian regime this did not happen quickly and thus the process of economic hemorrhaging went on for much longer than in Thailand.

Before proceeding to elaborate on this argument it is first necessary to pause and address a seeming contradiction: if Indonesia's massively centralized political system under Suharto 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? I have argued elsewhere (MacIntyre forthcoming-a) that for much of the past three decades there have been factors in place which mitigated the credibility problem inherent in the political system. Briefly, the key points here are that Indonesia offered very strong rates of return, that it had a demonstrated record of reasonably sound macroeconomic management, and importantly, that from very early on the government effectively imposed a policy constraint on its own behavior in the form of an open capital account.⁹ Together, these factors served to ease the problem of policy predictability and nurture investor confidence. In seeking to illustrate my argument about the impact of political institutions on Indonesia's handling of the economic crisis, rather than tracing a particular policy issue through the crisis as I did for Thailand, I will broaden the focus so as to capture the scope of the policy unpredictability that opened up in Indonesia in the latter part of 1997.

When exchange rate uncertainty spread to Indonesia's shores in late July, investors fully expected it to weather the storm. Not only were the economic fundamentals apparently stronger in Indonesia, unlike Thailand Indonesia had a political framework where the leadership was more than capable of taking decisive policy action in the face of economic shocks. While Indonesia was of course notorious for rent-seeking practices and cronyism, if pressed by economic crisis the government had an established track record of moving to implement tough policy measures to restore investor confidence – including measures that involved setbacks to the interests of allied business groups. This had been initially demonstrated in the late 1960s, and then as the regime took shape, in the mid-1970s in the wake of the huge debt problem created by the state oil company, in the early 1980s as oil prices began to fall, and then again in the mid-1980s as the country was squeezed by a severe balance of payments crisis. And, indeed, this is how the government seemed to behave at the outset of the 1997 crisis.

Where Thailand spent down billions in reserves in a vain defense of the currency and then moved very slowly to introduce policy reforms, Indonesia responded decisively. Nine days after the unpegging of the baht, as currency uncertainty began to spread around Southeast Asia Jakarta moved preemptively to widen the currency band within which the rupiah traded from 8% to 12%. As pressures mounted in late July and early August and the central bank found itself unable to contain the rupiah within this band, it cut the currency free rather than enter a costly and vain defense. And then, as the exchange rate continued to slide and uncertainty spread from currency markets to capital markets, the government moved to launch a series of reform measures designed to shore up market confidence by demonstrating its preparedness to deliver the policy goods.

Suharto was giving off all the right signals. His Independence Day speech in mid-August was notable for its sober assessment of the problems, and he set up a special crisis-management team comprising all the key technocratic ministers and placed it under the charge of widely respected former economic coordinating minister, Widjono Nitisastro. Beginning in early September a steady stream of major reforms was unveiled. Restrictions on foreign ownership of shares in companies listed on the Jakarta Stock Exchange were lifted, cuts in public spending and new taxes on luxury goods to preserve a stable fiscal position were outlined, a range of costly high-profile infrastructure projects valued at Rp38.9trn (US\$13.3bn) were singled

out to be postponed and another batch valued at Rp62.7trn (US\$21.4bn) to be reviewed, tariff cuts on an extensive range of products were introduced with a view to helping foreign exchange earnings, and the central bank signaled preparations to move against a list of struggling banks. Particularly notable was the rescheduling of the big-ticket investment projects – both because many of these were representative of the excesses of the developmental boom (the world’s tallest building, the world’s longest bridge etc.) and because many of them were directly linked with the president’s children or other business people closely associated with the palace. Even though some pet crony projects were not on the list (for instance, the symbolically potent though economically trivial national car project) there was a sense that this was a clear and strong signal that the president was willing to make whatever cuts where necessary to restore investor confidence and stabilize the currency even if this meant paring back the interests of expansionist ministers in government and crony interests in the private sector.

At the same time as Mahathir was attacking Jews and foreign speculators more generally, and Chavalit was beset by resignations and policy gridlock, Suharto seemed to present a model of sober and effective leadership in the face of crisis. Suharto was widely applauded in the regional and international media for his actions. Apparently in response to these efforts, the slide in the rupiah was checked as it held its value through September. It was impossible for Chavalit to act in this way: if he had attempted reforms of this scope his government would have collapsed overnight. Suharto was seen to be acting in the same way he had in the past whenever confronted by a serious economic challenge.

By early October the rupiah was again falling. With a fresh round of regional nervousness being triggered by Dr. Mahathir’s attack on George Soros and as the inevitable ramifications of the falling rupiah began to work further through the economy, it became apparent that – its best efforts notwithstanding – Indonesia could not deal with the crisis on its own. On October 8, Indonesia announced it was seeking the assistance of the IMF. The decision to approach the IMF was also seen as a positive development. Just three weeks later an agreement had been signed for a US\$23 billion bailout package (shortly rising to US\$38 billion), and immediately the government began releasing detailed sets of reforms beginning the implementation of the IMF agreement – in marked contrast to Thailand which took months. The same day, October 31, it was announced that controversial import monopolies on wheat,

soybeans, and garlic would be abolished. On November 1 it was announced that 16 small banks (many controlled by relatives or cronies) were closed. On November 3 it was announced that there would be further major tariff cuts in industries affecting crony firms, that Indonesia would abide by whatever ruling the WTO reached on its national car project, that the strategic industries of technology minister Habibie would be reviewed with a view to cost saving, and that the wholesale and distribution sector would be opened up to foreign investors.

Again, these measures were impressive both for the speed with which they came forth and for the apparent preparedness of the president to allow the privileges of allied business to be cut back. However, even as the government was apparently forging vigorously ahead on these various fronts, the picture was becoming clouded. For it was from about this time that Suharto started giving off decidedly mixed signals as to his real policy intentions. The effect was very corrosive. On November 1, amidst the flurry of IMF-related initiatives, Suharto quietly signed a decree giving a green light to eight of the large investment projects postponed in September and seven of the projects subject to review. This was disturbing for a number of reasons: all of the rescued projects belonged to relatives or close cronies; some of them would have made little commercial sense under any circumstances, let alone in the midst of an economic crisis (for instance, four new power plants at a time when the power grid was coming up against serious oversupply); and most importantly because it highlighted the weakness of the country's political framework – if Suharto chose to change his mind, there was nothing anyone could do about it.

On November 5, in an extraordinary public spectacle the president's second son, Bambang Trihatmodjo, announced that he would sue both the central bank governor and the finance minister for their decision to close his bank. On November 6, he was joined in this action by the president's half-brother, Probosutedjo. Investors and the public at large were left to wonder what game Suharto was playing. Finance Minister Ma'rie Muhammad would not have dared to close these banks without the president's approval. Had the president now changed his mind? A few days later Ma'rie informed a parliamentary committee that the original decision would stand, thereby indicating that the president had confirmed he would not reverse the bank closures. Shortly thereafter the lawsuits were dropped. But by November 20 Bambang was gloating before the press that he had just taken over another small bank and would transfer all the assets of his closed bank into the new one, making public mockery of the decision to close the

bank in the first place. On November 21, a prominent and politically connected businessman, Aburizal Bakrie, announced that Suharto had agreed that a US\$5 billion loan from Singapore could be used to help struggling Indonesian firms to pay their debts. Not only did this distress the Singaporeans (who had given more to the Indonesian rescue effort than any country other than Japan and had participated in coordinated central bank efforts to support the rupiah) it raised further questions about Suharto's commitment to the terms of the IMF agreement, under which bailouts for banks and firms had been specifically prohibited. These countervailing signals did much to undo the confidence-building effects of all the promised reforms. Not coincidentally, around this time the celebrated crisis-management team headed by Widjojo seemed to lose momentum as their ability to influence the president was called into doubt. Throughout November, then, the rupiah fell, sped on by the outbreak of serious problems in Korea.

Indonesia was entering dangerous and uncharted water. If the president was unwilling to adhere to his policy commitments, the economy was heading for the rocks, for no other political players could delay, alter, or countermand his decisions. In December a new element of uncertainty was introduced when Suharto's health – indeed his survival – was thrown into doubt after he was forced to take a prolonged rest from presidential duties, officially because of fatigue, and unofficially because he had suffered a stroke. The rupiah fell very sharply in response to this development, and though it strengthened briefly when it was clear that he was not about to die, it continued to fall rapidly through December as investors grappled with the uncertainty of how political succession might play out. Indonesia was now in very deep trouble. By the end of the year the rupiah had depreciated by 54% (of its pre-crisis value) – already equaling the lowest point in Thailand. But with Suharto's leadership and commitment to giving markets the reassurances they craved now in deep question, the rupiah still had much further to travel on its way down.

In January Indonesia parted company with Thailand (and Korea) as its problems worsened dramatically. For Suharto the situation had become terminal. The final straw was the unveiling of the state budget on January 6. After the heavy fall of the rupiah through December, much was riding on the budget. Although given an unfair reception in some quarters, the reality was that the budget severely disappointed commentators and markets, both in Indonesia and internationally. Among other weaknesses, the budget's core assumptions about the exchange

and growth were seen as quite unrealistic and seemed to suggest the government was simply not coming to grips with the seriousness of the situation. Local and foreign currency traders pushed the rupiah sharply down to a new all time low of 7,000 to the dollar, and then, when it was reported that continued IMF support was in doubt in the wake of the budget, the rupiah went into free fall, dropping below the previously unimagined psychological barrier of 10,000 to the dollar. Wealthy Indonesians dumped rupiah for dollars, while poorer Indonesians dumped rupiah for food staples, triggering runs on supermarkets.

As panic broke loose, other heads of government frightened by the possible geo-strategic implications of regime-collapse in Indonesia hurriedly telephoned Suharto urging conspicuous compliance with the IMF. At the same time, senior IMF and US Treasury officials rushed to Jakarta and worked with key economic ministers to draw up a truly stunning list of structural reforms which would radically hack at remaining restricted market arrangements enjoyed by crony businesses. This was a last ditch effort to prop up the regime's standing with investors by seeking to demonstrate a renewed commitment to make cuts where it hurt most. Although Suharto did not hesitate to sign the new agreement on January 15, it was all too late. By this stage his credibility with investors inside and outside Indonesia was irreparably damaged. The promise to implement a reform package of unprecedented scope failed to impress; investors continued to dump the rupiah and its value kept on falling through January.

Some commentators at this time began to argue that the IMF's approach was either misguided for being overly contractionary in its fiscal posture (requiring a deficit not greater than 1% of GDP), or incomplete for having given inadequate attention to the issue of corporate debt, or simply politically unrealistic for requiring the government to cut back crony privileges. Still others faulted the IMF for leaking its unhappiness with the January 6 budget to the press, arguing that this undermined what might otherwise have been a viable budget. In my view there is substance to all of these arguments, though none is compelling. While the news of the IMF's reaction to the budget no doubt affected the markets, it is unrealistic to expect that the IMF would not express a view about the budget given the circumstances. And while it may be that Suharto never had any intention of really cutting back core crony privileges, given that this was one of the key issues markets were focussing on in terms of the government's commitment to promoting microeconomic efficiency and export competitiveness, any program that did not

include major reforms of this sort would have been instantly dismissed. More difficult to set aside, in my judgement, are the claims that the IMF's requirements were too fiscally austere and that the absence of measures to tackle the corporate debt issue constituted a gaping hole in the overall economic strategy. Though, in each case, there were powerful complications with attempting to do otherwise: what would have been the reaction of the US Congress if the IMF were seen to be involved in bailing out 'crony capitalists' in Indonesia? And though the Sachs critique of fiscal overkill has found significant support in the ensuing months, it is far from clear that markets in early January would have reacted favorably to expansionary budget settings. Indeed, part of the problem with the January 6 budget was that it was interpreted (mistakenly) by some market analysts as expansionary.

The simple reality is that there were no good economic options left for the Indonesian government by January. And, more fundamentally, regardless of the economic strategy the government had said it would pursue, Suharto's policy commitments were no longer of any value to the market. It no longer mattered what he said. The institutionally rooted problem of policy unpredictability that had always been embedded in the political framework of his regime had now been completely exposed. The factors which had in the past helped to ease the inevitable concerns of investors about policy reversals and predictability – strong rates of return, a solid macroeconomic track record, and the discipline of an open capital account – were all now swept away in these catastrophic circumstances. Investors were left with the stark reality that there could be no confidence in a regime in which there were no constraints on presidential power; he could – and was – reversing earlier commitments almost as fast as he was making them.

From this point on the Indonesian economy quickly ground down. As January progressed the rupiah continued to fall, reaching as low as 17,000 to the dollar at one point. With the currency having depreciated by as much as 86% since the outbreak of the crisis, the formal economy could no longer function. With firms needing three, four, or even five times as many rupiah as before the crisis to service their dollar denominated loans, repayments simply stopped even for the healthiest of firms. The domestic banking system was by now at the brink of systemic insolvency. All local lending had stopped. Trade fell rapidly as imported goods became prohibitively expensive, but many exports suffered as well as international banks

declined to open letters of credit with Indonesian firms. Inflation had begun to accelerate rapidly and as firms began to cut back operations or simply close down, so too did unemployment.

As was by now widely recognized, the nature of Indonesia's problems had changed: the crisis had shifted to become as much political as economic. Suharto had become a fundamental obstacle to revival. The economy could not recover until the exchange rate recovered; the exchange rate could not recover until local and foreign investors brought capital back into the country, and this would not happen until they again had some confidence in the direction of government policy and leadership. Suharto did nothing to help the situation. His decision in late January to nominate technology czar, B.J. Habibie as his vice-presidential running mate panicked the markets, as did his decision to fire the governor of the central bank for his resistance to Suharto's flirtation with the idea of a currency board. As one businessman put it in early 1998, "The problem is he doesn't seem to listen to anyone any more. A feeling of helplessness prevails. You can't do anything any more. Some mid-level businessmen with a few million dollars have left the country because they think social unrest is unavoidable." (FEER, 1/22/98:16) And as an Indonesian political commentator delicately put it: "There's been a real change in his political behavior. These are not normal times. We have to try and understand him and why he is thinking in such a different way." (FEER, 2/26/98: 14)

With Suharto's credibility terminally damaged there was little prospect for a recovery while he remained in power. But with the president effectively controlling the presidential selection process and enjoying firm control of the military, there was not yet any prospect of replacing him. What followed was a waiting process, as rapidly rising economic hardship and dislocation generated mounting protests, violence, and elite disaffection. Finally in late May, abandoned by almost all his supporters, Suharto stepped down amidst a sea of violence and destruction.

The impact of politics on Indonesia's economic crisis is striking. There was nothing in the country's economic profile or its linkages to the global economy that would have lead one to expect such massive devaluation. (Indeed, some would argue that were it not for the contagion effect spreading currency pressures from Thailand, there was no economic reason to expect a major shakeout in Indonesia.) It is not possible to understand why Indonesia's

economic reversal was so extensive without reference to the political situation. Rather than focusing on crony links or the fact that Suharto was an aging, ailing, and out-of-touch autocrat, I argue that the key to understanding the utter rout of investor confidence was the political structure. The same institutional structure which had permitted the government to respond so decisively to earlier economic crises – and indeed to the initial stages of this one – proved a devastating liability once local and foreign investors concluded that Suharto could no longer be counted on to deliver the policy environment demanded by the market. Extreme decisiveness comes at the price of a highly changeable policy environment. And with the open capital account constraint now overrun by the currency crisis, there were no institutional checks at all on executive action. Compounding this problem was that precisely because Suharto was in such a powerful position, it would be extremely difficult to dislodge him. And thus, as Thailand and Korea began to stabilize through the first half of 1998, Indonesia went from bad to worse.

Conclusion

The economic crises in Thailand and Indonesia are part of a wider regional and global economic phenomenon. There are crucial shared characteristics in the severe economic problems they and other countries have experienced. However this is not just a story of the perils of being exposed to fluctuating global capital flows. To complete the picture – to understand the variation across cases – we need to see how local politics played into the collapse of investor confidence. In the cases I have explored, it is local political structure that stands out as the intervening variable. I have argued that in Thailand and Indonesia we can see political structure prolonging the crisis and thus intensifying the economic destruction. Additionally, in the case of Thailand, we can see local political structure actually contributing directly to the initial outbreak of investor loss-of-confidence, which then swept the region.

The nature of the institutional problems in Thailand and Indonesia were quite different and they played through in different ways, though ultimately produced similar outcomes – a massive loss of investor confidence. Where Thailand suffered policy paralysis as a result of weak multiparty parliamentary government, Indonesia suffered from almost the opposite set of institutional circumstances, massive centralization of power which left government vulnerable to deep problems of credibility due to unreliable policy commitments.

Thailand's system of government suffered from too many veto points and Indonesia's suffered from too few.

My basic purpose in this paper has been to argue the importance of political institutions as an essential supplement to international economic factors in explaining the crisis in these two countries. Of course the crisis was a product of very much more than political structure; my claim is simply that this cannot be left out of the story for Thailand and Indonesia. Further, it should be emphasized, I am not proposing that there is some optimal institutional configuration that would enable any given country to escape a major economic crisis of this sort unscathed. Though an optimal institutional configuration is, in principle, perhaps a logical possibility, I have no basis for such a claim here (and nor, indeed, is there consensus on this even the theoretical literature). The core claim advanced here is more cautious: severe cases of either indecisiveness or unpredictability are invitations for a serious loss of investor confidence. More broadly, whether one favors an institutional framework that makes it hard or easy to change policy will depend upon whether one favors the existing policy environment. The economic crisis of 1997-98 was a situation that required governments to be able move swiftly in implementing difficult policy changes and then to be able to sustain them in the face of opposition. Thailand was unable to initiate the changes while Indonesia was unable to sustain them.

The two cases examined here represent institutional extremes – Thailand's very divided structure and Indonesia's very centralized structure – producing economic policy outcomes that were highly destructive to investor confidence. As the region moves on from the economic crisis, there are many new questions relating to the economic consequences of politics to be explored. While we can see that political structures at either extreme can produce policy behavior that undermines investor confidence, that still leaves a large moderate grey middle in the spectrum of institutional possibilities. And it is into this grey middle that both countries now seem to be entering in the wake of the economic crisis as their political systems undergo radical institutional surgery.

Endnotes

¹ See inter alia, Radelet and Sachs (1998), Johnson (1998), Wade and Veneroso (1998), Bhagwati (1998), Krugman (1998), and Feldstein (1998).

² Identifying these factors as key elements in the crisis does not necessarily imply that the policies behind them were hopelessly misguided. Financial liberalization can bring important benefits in terms of capital mobilization, and stable or predictable exchange rates greatly facilitate international transactions. The lesson here is not that these earlier policy reforms were wrongheaded, but simply that financial liberalization without adequate regulatory oversight can be very dangerous, as can be a fixed exchange rate if it fails to respond to major currency realignments or encourages borrowers to disregard currency risk.

³ There are a number of comprehensive accounts of events, particularly economic events, on Thailand (Ammar 1997; Bhanupong forthcoming; Warr 1998; Pasuk & Baker 1998c; Pasuk & Baker 1998a; Yos & Pakorn 1998; Anek 1998), Indonesia (Soesastro & Basri 1998; Pincus & Ramli 1998; McLeod 1998; Azis 1998; Tubagus 1997) and empirically-based comparative studies (Hill 1998; Krause 1998; Garnaut 1998; McLeod & Garnaut 1998; Jomo 1998; Montes 1998).

⁴ Radelet and Sachs (1998 p. 28) even go so far as to say that if this issue had been handled differently by Thai authorities, Thailand might have avoided a major economic crisis.

⁵ Another dimension of the institutional story of Thailand's handling of the economic crisis that I do not have space to pursue here is the changing status of the central bank. There is a clear and fascinating account to be told about the rise of ministerial control over the central bank (and the bureaucracy more generally) as a normal consequence of democratization.

⁶ The government also announced that all depositors would be protected and that a deposit insurance would be set up for remaining healthy institutions. But as before, this failed to prevent a three day bank run.

⁷ Although not actually fixed, the rupiah had been weighted heavily to the US dollar in a managed float and, in a well-established policy, it had been permitted to depreciate at a gradual but highly predictable rate of 4-5% per year. As in Thailand (prior to the baht coming under pressure in late 1996) investors believed there was little or no risk of major exchange rate fluctuation.

⁸ There is an extra dimension to this story that I do not pursue here: Suharto's motives. The institutional framework permitted him to behave erratically, but it did not cause him to do so. Identifying Suharto's political preferences is a highly speculative exercise. Among the most frequently encountered guesses are that he was simply unwilling to cut back the business privileges of his children (cf. his willingness to cutback crony privileges in previous crises); that he suffered from seriously inadequate information on the true precariousness of the economic situation because his advisers no longer dared to bring him unwelcome news; or that he suffered from seriously diminished political judgement through some combination of age and hubris.

⁹ The open capital account was important for two reasons. First, and most obviously, it promoted investor confidence by enabling them to get their money out easily at any time. Second, and more subtly, the existence of an easy exit option for investors served as something of a constraint on the policy behavior of the government, for if it allowed the overall business environment to deteriorate or to become too uncertain, it would be punished swiftly by an outflow of capital. In a sense then, by opening the capital account in 1970, the government was tying its own hands. It could of course always untie its hands by imposing capital controls, but to do so would have been very costly in terms of investor confidence.

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