Introduction: The Political Economy of the Asian Financial Crisis

The Asian economic crisis of 1997-98 was a singular event in the region's postwar economic history. Adverse external shocks had struck the developing countries of East and Southeast Asia in the past, most notably the oil price increases of the 1970s and early 1980s. Individual countries had also experienced episodic difficulties. South Korea had a sharp, short recession in 1980, and the Philippines experienced a debt crisis in the early 1980s. Falling oil prices forced substantial adjustments on Indonesia in the mid-1980s, and a number of Southeast Asian countries experienced recession in 1985-86. But since the period of high growth began—a period that dates to the 1960s for Hong Kong, Singapore, South Korea, and Taiwan—East Asia had not experienced a collective shock of this magnitude.

The question of why these rapidly growing countries got into so much trouble and how they managed to return to growth has now been picked apart from a number of different angles, primarily by economists. Somewhat less attention has been paid to the political economy of the crisis (see, however, Jomo 1998c; Pempel 1999b). This book redresses this imbalance by posing three basic questions. First, did political factors contribute to Asia's vulnerability to crisis, and if so how? Second, how did incumbent governments and their successors manage the contentious politics of adjustment, including both short-term crisis measures and longer-term structural change? Third, what if any were the political and institutional *consequences* of the crisis of 1997-98, including for the consolidation of democratic rule?

The central arguments of the book can be stated briefly:

- Close business-government relations that had proven an asset during the period of high growth generated moral hazard, distorted the liberalization process, increased vulnerability to shocks, and complicated the adjustment process once the crisis hit. Reducing the risks of crisis in the future requires not only discrete policy and regulatory changes, but political and institutional changes that check particularistic business influence and increase transparency in business-government relations (chapters 1 and 6).

- Once countries enter a "zone of vulnerability," political uncertainty plays an important, but neglected, role in both the onset and depth of financial crises. Early *economic* warning indicators need to be supplemented with a greater understanding and appreciation of the *political* sources of market uncertainty (chapter 2).

- Contrary to defenders of "Asian values," nondemocratic governments had no apparent advantages over democratic ones in adjusting to the crisis, and a number of disadvantages. These included arbitrary actions on the part of chief executives, political instability, and profound uncertainties about the succession process. Democracies such as South Korea that moved swiftly to build legislative and interest group support were capable of instituting wide-ranging institutional and policy reforms that contributed to rapid recovery (chapters 2 and 3).

- In the four most seriously affected countries—South Korea, Thailand, Indonesia, and Malaysia—"backlash" against the market was partly offset by "market-oriented populists." These reformist leaders, parties, and movements saw the introduction of more market forces, coupled with appropriate and independent regulation, as an antidote to corruption and the undue influence of favored business interests (chapter 3).

- The crisis generated pressures for financial and corporate restructuring, but the process faced substantial political resistance and the reform movement appears to have slowed. However, longer-run institutional, legal, and policy changes put in place in the wake of the crisis are gradually transforming financial systems, corporate governance, and business-government relations in important ways, making them more accountable and transparent, if not fully "Western" (chapter 4).

- Governments were poorly positioned, both politically and administratively, to respond to the social dimensions of the crisis. Their interventions did not always reach the most seriously affected groups, which tended to be in the urban middle, working, and marginal classes. A new social contract is required to mitigate the costs of such crises in the future (chapter 5).

- The crisis showed the democracies to be resilient and has advanced the cause of economic reform in the region. But a deepening of financial, corporate, and social reforms will also require a parallel process of deepening democracy by enhancing the accountability and transparency of government and by reducing the influence of particularistic interests (chapter 6).

The Debate over Causes: A Brief Intellectual History

The Asian financial crisis unfolded in several overlapping phases, beginning in Thailand and spreading first to other Southeast Asian countries. A convenient date for its onset is 2 July 1997, when the Thai baht was allowed to float. On 11 July, the Philippines followed suit, and for the remainder of the year, all the Southeast Asian currencies were allowed to float and depreciated sharply. The Philippines extended an existing International Monetary Fund standby arrangement in July, Thailand reached agreement with the Fund after some delay in August, and Indonesia signed a large standby arrangement in November. The Thai and Indonesian programs were both backed by supplementary resources from other multilateral institutions and donors and were among the largest multilateral rescue programs ever assembled. Nonetheless, neither succeeded in restoring confidence quickly and both required revision during 1998 and 1999.

Malaysia was also forced to give up its currency peg in July 1997. In contrast to the other Southeast Asian countries, however, it avoided recourse to the Fund. On 1 September 1998, the government took the unorthodox choice of fixing its exchange rate and imposing capital controls.

The second phase of the crisis began with Taiwan's decision to float its currency on 17 October 1997. Speculation immediately shifted to the Hong Kong dollar, which had been pegged to the US dollar since an earlier foreign exchange crisis in 1983. Massive reserves and a well-institutionalized currency board allowed Hong Kong's financial authorities to defend the peg. But the sharp increase in interest rates required to do the job produced a dramatic sell-off in the Hong Kong stock market, which has a heavy weighting of interest-rate-sensitive property development firms. For the first time, markets in the United States and Europe felt the events in Asia, and all emerging markets faced a dramatic widening of spreads.

South Korea marked the next stage of the crisis. A number of large South Korean groups failed in early 1997, but in the wake of Hong Kong's difficulties, the country suffered a severe liquidity crisis and on 21 November was also forced to abandon support for the South Korean won. On

3 December, South Korea agreed to a massive Fund program backed by additional resources from the World Bank, Asian Development Bank, and other countries in the region. Within weeks, this package proved inadequate, and on Christmas Eve a new program was unfurled, including additional resources and conditions and negotiations with foreign banks over the terms of a short-term debt restructuring. The events in South Korea did not mark the end of the currency crises of 1997-99; the effective Russian default of August 1998 provided another shock to emerging markets and Brazil faced difficulties in early 1999. But this book focuses on the four Asian countries hit hardest by the crisis: Indonesia, Malaysia, South Korea, and Thailand—with a brief comparative look at two broadly comparable countries that escaped the worst of the crisis, the Philippines and Taiwan.

This sequence of events was not only a shock to the region but a shock for the economics profession and the international policy community as well. Few outside the region had foreseen the nature or depth of the economic problems that followed.[1] Three distinct schools dominated the ensuing post mortem: ''fundamentalists,'' who emphasized macroeconomic and particularly exchange rate mismanagement; ''internationalists,'' who focused on the inherent volatility of international financial markets, self-fulfilling speculative attacks, and contagion; and ''new fundamentalists,'' who underlined regulatory and structural problems, particularly in the financial sector. A fourth controversy surrounded the IMF's prescriptions, and whether the adoption of overly restrictive monetary and fiscal policies and ambitious structural adjustment mitigated or compounded the crisis.

Before turning to these central causal arguments, all would agree on a number of factors that played a background role in the crisis or constituted permissive conditions. The Chinese devaluation of 1994, that country's increasing entry into export markets, and the continued sluggishness in the Japanese economy all had implications for the middle-income countries of the region. The unexpected depreciation of the yen posed difficulties for a number of Asian countries (Noland et al. 1998), particularly for South Korea, which competed head to head with Japan in a number of sectors. Different countries also faced particular terms of trade shocks. For example, South Korea and Malaysia were adversely affected by a collapse of semiconductor prices. But it is highly implausible that these developments were enough, in themselves, to generate crises of the magnitude that ensued.

The process of deeper financial integration constituted a necessary condition for the crisis to occur. Asia witnessed a dramatic increase in international capital flows in the early 1990s, including not only the mobile

1. One prescient warning was Park (1996).

portfolio capital of hedge funds and ''speculators,'' but extensive bank lending as well (Kahler 1998; Institute for International Finance 2000). This increase in capital flows was partly the result of an important policy development. All the high-growth countries in the region (with the notable exception of China and arguably Taiwan) had either opened their capital accounts some time earlier or made moves to do so in recent years.

A major source of vulnerability in South Korea was the fact that the maturity profile of external debt was increasingly skewed toward the short run, partly as a result of policy. In Southeast Asia, much private borrowing, for example by ethnic Chinese banks and enterprises, had always been relatively short-term. But the maturity profile of foreign debt did not appear to be a central determinant of Indonesia's crisis—or Malaysia's.

The massive reversal of capital flows clearly did not fit the profile of the ''traditional'' balance of payments crisis first modeled by Krugman (1979) in which monetary and particularly fiscal policy generated unsustainable current account deficits.[2] In none of the most seriously affected countries were budget deficits problematic, and a number of the countries in the region were even in surplus.

However, a common feature of policy in the region was a commitment to fixed or heavily managed exchange rates, and the related problems of overvaluation that can ensue (Corsetti, Pesenti, and Roubini 1998). Moreover, there is evidence in several countries of a basic failure to understand the policy constraints associated with an open capital account. When governments recognized overheating and sought to slow economic activity, the use of monetary policy instruments only had the effect of inducing more capital inflows, thus further contributing to real appreciation.

But there is both ongoing debate and important differences across countries with respect to their external position. Export growth slowed in all countries in the region in 1996, and Thailand's current account deficit was quite large at the time its crisis broke. But South Korea and Indonesia had deficits that did not deviate substantially from levels that had been financed by private capital inflows in the past. Moreover, the extent of overvaluation was certainly not profound.[3] However, the fixed rate regime nonetheless encouraged excessive risk-taking because it was perceived

2. However, there arguably were massive budget deficits associated with the implicit or explicit guarantees to faltering banking systems.

3. Using consumer price index-deflated trend real rates, Chinn (1998) finds overvaluation as of May 1997 of 30 percent in Indonesia—almost certainly too much—and 13 percent in Thailand. But South Korea shows a slight *undervaluation* using the same measure, and if deviations from a purchasing power parity rate are considered, the extent of overvaluation in Thailand is nearly halved, and Indonesia shows up as slightly undervalued (see Furman and Stiglitz 1998).

as constituting a guarantee to investors; the fact that so much offshore borrowing was unhedged suggests just such a perception.

Critics of this ''fundamentalist'' view place greater emphasis on self-fulfilling speculative attacks and contagion (Obstfeld 1996; Radelet and Sachs 1998a, 1998b; Baig and Goldfajn 1999; Masson 1999). In this class of models, creditors are not responding to fundamentals but to the actions of other creditors and what Radelet and Sachs (1998b) have neatly labeled ''rational panic.'' Prima facie evidence of the panic-driven nature of the crisis include the fact that it was largely unanticipated and the substantial overshooting of exchange rate adjustments that followed its onset (Radelet and Sachs 1998a, 1998b).

When such crises start in one country, there are a variety of channels through which they can be propagated to other countries, including fears of competitive devaluation or financial linkages of various sorts (Calvo 1999, Masson 1999). As we have seen from the brief sketch above, Thailand begat Indonesia and Malaysia; Taiwan's devaluation begat the market meltdown in Hong Kong in late October; and that meltdown begat South Korea, which in turn resonated back through the Southeast Asian markets at the end of 1997.[4]

As the depth of domestic financial and corporate distress became more apparent, attention shifted to a third set of domestic vulnerabilities. ''New fundamentalists'' focused particular attention on the weakness of Asian financial sectors, included rapid lending growth, high corporate leveraging, and excessive risk-taking (Krugman 1998d; Caprio 1998; Pomerleano 1998; Harwood, Litan, and Pomerleano 1999; Goldstein, Kaminsky, and Reinhart 2000).[5] Malaysia, South Korea, and Thailand all underwent bank-financed investment booms before the crisis, during which lending grew rapidly (despite low and declining returns on capital) and bank balance sheets deteriorated.

Krugman (1998d) pushed this line of analysis back toward more fundamental issues of business-government relations. As he put it succinctly, ''the problem began with financial intermediaries—institutions whose

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4. Malaysian Prime Minister Mahathir's imposition of capital controls fed directly into this debate about the weight of external influences (Krugman 1998d, 1999; Montes 1998; Wade and Veneroso 1998). If short-term capital movements were the proximate cause of the crisis, couldn't such vulnerability be reduced by maintaining capital controls, or at least exercising extreme caution in their removal? Interestingly, none of Malaysia's neighbors followed Mahathir's departure from orthodoxy, although the international policy community became somewhat less hostile to controls in the wake of the crisis.

5. Among the oft-cited regulatory failures were low capital adequacy ratios; weak, and weakly enforced, lending limits to related managers and enterprises; permissive asset classification systems and provisioning rules; and, in general, poor disclosure and transparency of bank operations. These problems compounded the effects of weak institutional development by the banks themselves, which tended to lend on the basis of collateral and personal relationships rather than cash flow; see chapter 1.

liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems.'' When the bubble burst and asset prices started to fall, collateral values also fell, and the illiquidity and insolvency of financial institutions became apparent. This development in turn forced banks either to curtail lending or cease operations altogether, leading to yet further asset deflation. Kaminsky and Reinhart (1998) and Goldstein, Kaminsky, and Reinhart (2000) provide support for the conclusion that the causal relationship between foreign exchange crises and financial crises ran in both directions, and that domestic financial weakness increases vulnerability to foreign exchange crises.

The final, most heated controversy surrounded the policy content of IMF-supported programs. Critics argued that fiscal and monetary policy tightening had perverse effects (Radelet and Sachs 1998a, 1998b; Furman and Stiglitz 1998, Krugman 1999). Rather than stabilizing the exchange rate, they sent markets the signal that further decline was in store, contributed to the overshooting of exchange rate adjustments, and severely compounded problems in the financial and corporate sectors. Feldstein (1998) argued that the IMF's efforts at financial market reform were also overly ambitious and intrusive and had similar adverse consequences.

The IMF cannot be held blameless in the crisis, but any assessment hinges on some counterfactual and a weighing of unpleasant tradeoffs (Corden 1998; World Bank 2000b, 29). For example, critics of the IMF tended to discount the risks of even further currency depreciation and its effects on the servicing costs of foreign debt (Fischer 1998). The evidence for perverse exchange rate effects is mixed at best (Goldfajn and Baig 1998; Dekle, Hsiao, and Wang 1998), and the IMF did in fact move—albeit perhaps too slowly—to reverse its initial monetary and fiscal policy prescriptions. Given the extent of the collapse, it was also impossible to avoid reform of the financial and corporate sectors. Moreover, any assessment requires attention to how the actions—and inaction—of governments affected markets, and that brings us back to the central role of politics.

Bringing Politics Back In

With the exception of the implicit political economy of those emphasizing moral hazard, the striking feature of the debates among economists just outlined is the absence of systematic political analysis.[6] The arguments

6. A number of political scientists and political economists did enter the intellectual fray, but their analyses had little apparent influence on the debates among economists on the causes of the crisis. Political economy accounts include Jomo (1998b), Arndt and Hill (1999), and particularly Pempel (1999b). *The Journal of Democracy* also published a number of essays on the politics of the crisis; see Suchit (1999), Harymurtri (1999), Mo and Moon (1999), and Emmerson (1999). Also see Noble and Ravenhill (2000a).

of both the "fundamentalists" and "internationalists" are seriously limited by this lacuna. In both interpretations, investors are clearly responding to what governments do. A given exchange rate can be sustained if the government is willing to take the necessary actions (Frieden 1997), but these actions carry substantial political cost in the form of an adequate increase in interest rates, a decline in real wages, or—if necessary—an adjustment of the peg. It is thus not economic developments alone that trigger the exit of investors, but the expectation that the government is unwilling or unable to adjust.

Similarly, in the model of self-fulfilling speculative attacks adopted by Radelet and Sachs (1998a, 1998b), it is not evident why the first investor decides to panic; the trigger of the panic is exogenous to the model. But because the model is based on the subsequent reaction of investors to the first in the queue to exit, this is a serious analytic flaw. In fact, the earlier speculative attack models made much more explicit room for politics along the lines already noted: The government would choose to defend a pegged exchange rate, but crises would arise when the markets believed that the government would not have the political capability to sustain it (Obstfeld 1996). Moreover, such models require a trigger or coordinating mechanism, and while that trigger might be provided by an exogenous shock, it can also be provided by political developments that produce uncertainty about government policy (Krause 1998, Leblang 1999, Mei 1999).[7]

Considerations of political economy are also clearly germane to the debate between critics and defenders of IMF programs. As shown in chapter 2, the onset of the crisis was preceded by a period of substantial uncertainty about the course of government policy in South Korea and Thailand; similar periods of uncertainty followed the collapse of the currency in all four of the countries examined here. Yet the debate has proceeded on the assumption that the consequences of a given monetary policy stance (or any other policy measure, for that matter) are independent of market assessments of government credibility and political capacity.

The "new fundamentalists" who focus on deeper vulnerabilities associated with regulatory weaknesses and problems of moral hazard veered the farthest into political territory, but their analysis also begged a number of important questions. Why was the financial sector weakly regulated? Was it the result of sins of omission, simply the lack of administrative capacity and know-how? Or was it in fact due to sins of commission, in the form of forbearance to favored parties? If the latter, the source of vulnerability and moral hazard is not simply bad policies but the politics and institutions that generate them.

7. Radelet and Sachs (1998a) revert to these factors at a number of points (e.g., p. 28 on Thailand).

If most accounts by economists paid only passing attention to the way politics contributed to the crises, then they demonstrated even less interest in its political *consequences*. But for citizens of the affected countries, the crisis was major political as well as economic news: Governments, and even regimes, fell as a result of it; politically significant groups saw a destruction of their wealth and sharp declines in income; and citizens vented their frustrations at the ballot box, in the streets, and sometimes in disturbing social violence. Contending parties and coalitions, incumbents and oppositions struggled to balance strong external pressures from international financial institutions and markets and equally strong pressures from domestic constituents.

Our experience of other severe economic crises suggest that they not only have political roots, but are followed by important, sometimes fundamental, political changes (Gourevitch 1991). The advanced industrial democracies came out of the Great Depression, and the world war to which it contributed, with altogether new economic theories, policy commitments, and political alignments and institutions. The debt crises of the 1980s transformed the economic models developing countries had pursued since the 1940s, particularly in Latin America. In a number of countries in that region and elsewhere, crises played a direct role in the transition to democratic rule as well (Haggard and Kaufman 1995). And whereas the transition from socialism ultimately had international political roots in the transformation of the Soviet Union, the economic crisis of the 1990s in the former socialist countries of Europe has had wide-ranging consequences for political alignments in that region as well.

The Asian financial crisis does not rank with these other three economic cataclysms in either its depth or duration; therefore, its longer-term political significance may well be less profound. However, the crisis contributed to the collapse of the Suharto regime, the installation of new governments in both South Korea and Thailand, and the birth of a new political reform movement in Malaysia. The crisis has also forced reforms that have profound longer-term implications for the role of government in the economy and society.

The Arguments in More Detail

Chapter 1 sets the stage by looking at the nature of business-government relations in the most seriously affected countries. Close interaction between the public and private sectors is a hallmark of the region, and a feature of governance that contributed to its high levels of investment and rapid growth in the past. But such relationships and the interventions they spawned are not without risks, particularly in an era of greater capital mobility. In all four countries, government intervention in and through the financial sector created perverse incentives with respect to the ability of banks to monitor their clients and politicized both lending decisions and subsequent losses.

However, it is important to underline that equal if not greater risks were associated with poorly conceived and regulated liberalization and privatization. These reforms are often seen as antidotes for rent seeking and corruption. But they can also be ''captured'' by business and distorted in ways that shift risk back to the government and increase vulnerability to shocks, typically by weakening the regulatory process.

Underneath these discrete policy problems lie deeper political and institutional features of business-government relations in the region. In Western commentary, these are frequently reduced to corruption, cronyism, and nepotism. In some instances, particularly in Indonesia, these problems were indeed acute. But the sources of vulnerability were not limited to the illegal and illicit. They sprang, rather, from the political commitments of governments to favored portions of the private sector, the absence of countervailing political checks on business influence, and the lack of transparency in business-government relations.

Whatever the long-run sources of vulnerability, we still need some explanation for the onset of the crisis. Chapter 2 outlines the responses of the governments that were incumbent when the crisis struck—Kim Young Sam in South Korea, Chavalit in Thailand, Mahathir in Malaysia, and Suharto in Indonesia. Political uncertainty was implicated in the onset of the crisis, but political factors were even more important in shaping the subsequent adjustment process.

One source of difficulty was precisely in the way business-government relations hindered the government from reacting to emerging difficulties in a timely, coherent fashion. However, broader political uncertainties were also relevant. Given the heated controversy during the past decade over ''Asian values,'' and the purported advantages of authoritarian and democratic rule, it is worth asking to what extent these uncertainties were correlated with the type of political regime.

One purported advantage of authoritarian rule is the capacity for decisive action. In the past, Suharto had responded aggressively, even preemptively, to economic challenges. But the events of late 1997 exposed a number of weaknesses of authoritarian rule in both Indonesia and Malaysia. These weaknesses included the risk of arbitrary action, the lack of transparency surrounding business-government relations, and the uncertainties that surround succession in such systems. These problems were particularly acute in Indonesia, which differed from Malaysia in lacking any meaningful channels for political participation. Once Suharto's grip on power became uncertain, challenges to the regime mounted, and the credibility of the government underwent a swift deflation. It is not coincidental that the country undergoing the most profound political change also experienced the deepest economic crisis.

In the two democracies, South Korea and Thailand, electoral and non-electoral challenges and the nature of government decision-making processes delayed initial reform efforts and diluted their coherence; Malaysia's semi-democracy faced these problems to some extent as well. But the democracies had an important self-correcting mechanism that the authoritarian regimes lacked: The system of government enjoyed support even if incumbents did not, and elections could bring new reformist governments to office. In Indonesia, this could occur only through a change of regime, which—however desirable in the long run—was of necessity traumatic and destabilizing in the short run.

Chapter 3 turns to the political consequences of the crisis and the reform efforts of "successor" governments. In the two democracies—South Korea and Thailand—new reform-oriented governments came into office. Kim Dae Jung was able to advance a wide-ranging reform program early in his term, while in Thailand, the Chuan government was somewhat more hamstrung by features of Thai institutions, including a fragmented party system. Nonetheless, the democracies not only survived this first major economic test to their stability but were able to initiate important policy reforms.

Malaysia's semi-democratic government is the one of the four in which there was continuity in both the political system and its leadership. That continuity did not go unchallenged; the crisis gave birth to a *reformasi* movement, spawned by the arrest and prosecution of Anwar Ibrahim, and breathed new life into the Islamic opposition. The opposition put a dent in the ruling UMNO party's dominance, but Prime Minister Mahathir was able to use the advantages of office and a hierarchical political party to gain reelection. The result, however, was that the crisis did not generate the extent of reform visible in the democracies.

In Indonesia, the crisis played a direct role in the fall of the Suharto regime. Suharto's successor, B.J. Habibie, confronted a variety of non-electoral challenges, any number of which threatened his tenure, including splits within the military, serious ethnic and communal violence, continuing democracy and student protests, and a resurgence of Islam. The transitional Habibie government also faced strong electoral challenges from a variety of new parties that sprang up following Suharto's fall. These political challenges were not inimical to reform; to the contrary, political competition pushed Habibie to remake himself as a reformer. But the transitional nature of his government, the near-revolutionary nature of political change in 1998 and 1999, and severe administrative constraints on government limited the government's capacity to undertake meaningful reform.

Despite the very important differences across these four countries, certain commonalties are also visible in the political fallout from the crisis, including in the nature of the political opposition. All governments had to contend with pressures from business and social reactions to the crisis, but the focus of the opposition was not necessarily directed against the reforms sought by the international financial institutions. Some reformist leaders and parties arose or gained strength by targeting the weaknesses of the old growth model: demanding more accountable and transparent government; greater attention to social welfare; and a revision of the explicit and implicit rules governing business-government relations. Reforming business-government relations implied greater transparency and more independent regulation, but also the introduction of more competition and an end to various forms of protection, subsidy, and privilege. In sum, it is misguided to see the course of policy solely as a response to external political pressures from the international financial institutions and the United States (Wade and Veneroso 1998). At least in some important policy areas, domestic groups were reaching surprisingly similar conclusions on the need for reform.

Initiating policy change is one thing; implementing it is another. To explore the political economy of reform in more detail, chapters 4 and 5 examine the two issues that will define the nature of the region's development model in the future: the restructuring of the financial and corporate sectors and the redefinition of the social contract.

A central feature of the Asian financial crisis is systemic distress: the simultaneous illiquidity if not insolvency of large numbers of banks and firms. Systemic distress posed two political questions in the short run. First, how quickly would governments recognize losses and seek to allocate them among parties? Second, would governments engage in forbearance and bailouts of banks and firms? Or would they exploit the crisis to close nonviable entities, devise new regulatory regimes, and—most basically—reform the patterns of business-government relations that had generated vulnerability to crisis in the first place?

Under conditions of systemic distress, the line between a viable and nonviable bank or firm is blurred; all the countries of necessity engaged in forbearance and public losses in all cases were large. South Korea's political system produced a more ambitious restructuring program than those of the other countries, but the government continued to confront entrenched *chaebol* resistance to a number of its efforts to reform corporate governance, particularly among the largest companies. Even greater continuity is visible in Thailand's relatively arms-length approach to restructuring, Malaysia's continuing defense of favored enterprises, and Indonesia's cronyism.

However, these discouraging judgments on the extent of financial and corporate reform are misleading in one crucial regard: They underestimate the longer-term consequences of the legal and regulatory changes and liberalization measures governments adopted in response to the crisis. These changes include strengthened financial regulation and rules on corporate governance, improved bankruptcy procedures, and the liberalization of foreign direct investment. Such measures necessarily take time to make themselves manifest in the capital markets, in corporate practice, and in the terms of competition in particular markets, but they are gradually reforming the nature of business-government relations in the region.

The problems of financial and corporate restructuring are closely related to the social dimensions of the crisis: How will governments manage the social dislocation arising from the crisis and the policy reforms and firm-level restructuring efforts that ensued (chapter 5)?

In the past, Asian governments generally relied heavily on growth to resolve social welfare questions. They invested in human capital (with Thailand a partial exception), but limited formal social insurance. This approach had already come under pressure from a combination of political as well as economic changes—democratization, urbanization, aging, and increased openness to trade and investment. The crisis only underlined that governments in the region did not have good information on those vulnerable to crises, and the coverage in place was limited in both scope and depth. Although many were adversely affected by the crisis, those hardest hit included urban workers in lower-paid construction and manufacturing jobs, particularly in small and medium-sized enterprises, and in those rural areas linked to or dependent on these workers. These social groups were not effectively represented in the political system; what representation they did have stemmed from political forces without clear or compelling programmatic alternatives.

The governments in the region quickly developed short-term programs to defend social spending and provide relief to the most vulnerable through public employment programs. Outside South Korea, however, neither the nature of the dominant political parties nor of organized interest groups appeared propitious for a redefinition of the social contract. Governments advanced models that continued to rely heavily on informal mechanisms.

It is still too soon to determine the implications of the crisis for the "Asian model," of which there is in any case clearly more than one. But this preliminary review of the crisis suggests cautious optimism that goes beyond the swift economic recovery the region witnessed beginning in 1999. On the social front, the crisis has not spawned the backlash that many feared, but has at least generated debate over the need to revise the implicit social contract to cushion more social groups from the risks of greater openness.

The financial and corporate picture remains the least settled, and it is naturally in this area where interests are most strongly entrenched. But reforms in train include not only increased openness to foreign investment, but efforts to strengthen the regulatory environment and to place business-government relations and corporate governance on a more transparent footing. It is doubtful that these policy changes will lead soon to convergence with Western practice, but there is no reason they should. The diversity of national systems of regulation and corporate governance has served both Asia and the world economy in the past, and will no doubt continue to do so.

Finally, the crisis has shown the resilience of democratic forms, contributed to a remarkable political transition in Indonesia, and generated reformist pressures in Malaysia as well. The crisis has mobilized new social forces for greater participation, accountability, and transparency in government. This deepening of democracy remains the most crucial task, both in its own right and as a key to sustaining other economic, institutional, and social reforms.