Institutions and Investors: The Politics of the Economic Crisis in Southeast Asia

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The most dramatic development in the international political economy during the 1990s—the Asian economic crisis—deserves our attention. Given that Asia's rapid economic rise spawned so many debates in the literature, it is peculiar that a radical interruption to Asia's economic development has not engendered more theoretical argument among political scientists. Economists have engaged in furious and productive debate but have been unable to deal with the political dimensions of the crisis. In this article I make a strong claim about the importance of politics in explaining one of the big puzzles in the overall saga: why the investment reversal was greater in some countries than in others.

I argue that a tight focus on political institutions yields a remarkable degree of analytic purchase in explaining why some countries coped better than others during the crisis. Specifically, I stress the distribution of veto authority, highlighting the way this shaped the overall character of the policy environment and in turn affected investors. I identify two policy syndromes—rigidity and volatility—that are at opposite ends of a continuum and are severely suboptimal for investors, particularly during times of crisis. I show that these two syndromes can be directly linked to the institutional framework of government. The wider the dispersal of veto authority, the greater the risk of policy rigidity; conversely, the tighter the concentration of veto authority, the greater the risk of policy volatility. These two policy syndromes bear directly on the differing responses of governments to the crisis.

Much of the best literature on the Asian crisis has come from economists and falls into one of three theoretical clusters: variants of "first-generation" currency crisis models that emphasize imbalances in macroeconomic fundamentals; variants of

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"rational panic" models that focus on the systemic instability of international short-term capital markets; and variants of a "moral hazard" argument that highlight accumulated microeconomic dysfunctionality under crony capitalism, relationship banking, and other kindred practices.[1] These different approaches all help to shed light on important aspects of Asia's extraordinary economic reversal. My complaint about this literature is that it is so deaf to the politics of the story. To be sure, much of the economics literature makes reference to the importance of "political factors," but, almost invariably, nothing analytically serious is done about it. A fundamental idea underlying the approach taken here is that government policy responses—particularly during times of regional currency instability—are consequential for investors. In other words, regardless of the initial conditions in a given country or in the international economy, governments can make the situation better or worse for investors.[2]

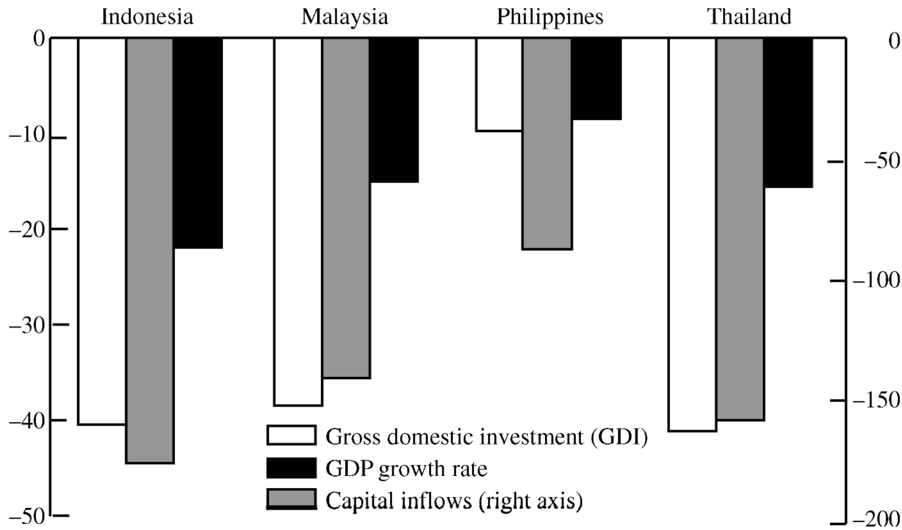
The still modest literature that does deal explicitly with the politics of the crisis has overwhelmingly taken the form of single-country studies.[3] While rich in important details of the particular cases, the single-country focus typically makes it hard to identify common factors and push theoretical debate. I argue that the politics of the Asian crisis can best be clarified by combining theories of institutional analysis, comparative process-tracing across cases, and insights from economics. I do this by focusing on cases that I have worked with and that strongly lend themselves to comparison for this purpose: Thailand, the Philippines, Malaysia, and Indonesia, the four main Southeast Asian countries involved in the crisis. Their economies are fairly comparable in structure and level of development; the broad orientation of economic policies and the coalitions underlying their governments were similar at the time; they are located in the same region, which helps to control for any possible neighborhood effect; and they are linked temporally by having been hit by the first wave of currency collapses in Asia. Although their initial conditions and level of economic vulnerability were not identical, the differences were, for the most part, not great and, more importantly, do not correlate clearly with the economic outcomes.

The cases exhibit strong differentiation in relation to the dependent variable (investment) and the independent variable (the institutional framework of politics). For the dependent variable the story is clear and well known: the Philippines suffered the least severe (though still dramatic) reversal, Malaysia and Thailand were hit hard, and Indonesia suffered a truly radical reversal. Because of problems of scope, periodization, and availability, there is no single

1. On the theoretical foundations of the first, see Krugman 1979. On the second, see Diamond and Dybvig 1983; and Cooper and Sachs 1985. On the third, see Ross 1973; and Fama 1980.

2. As such, my approach fits closely with so-called second-generation currency crisis models with their emphasis on investor calculations about likely government policy action. See Obstfeld 1994 and 1995.

3. See, for example, Lauridsen 1998; Hutchcroft 1999; Haggard and Low 1999; Robison and Rosser 1998; and Pempel 1999. For a notable exception that is strongly comparative, see Haggard forthcoming.



Note: GDP figures are percentage point changes in the rate of growth.
Capital inflows = foreign direct investment + portfolio investment + other inflows (banks, etc.).
Source: GDI and GDP figures are from the Asian Development Bank. Capital inflow figures are from the IMF (IFS 1999), except for the 1998 figures for Malaysia, which are from the Malaysian central bank.

FIGURE 1. *Investment indicators: Percentage change from 1996 to 1998*

measure we can use to neatly capture all private investment (foreign and local, short term and long term). Accordingly, three indicators are presented here: gross domestic investment, capital inflows, and the rate of gross domestic product (GDP) growth. Collectively, they capture the story. As Figure 1 shows, they all present a broadly similar picture of the severity of the reversal from 1996 to 1998. If we turn to the independent variable (the institutional framework of politics), we also see strong differentiation: a wide dispersal of veto authority in Thailand, an intermediate configuration in the Philippines, a tight centralization in Malaysia, and an even tighter centralization in Indonesia. I discuss the cases in detail in the following sections.

As noted, a core idea in this article is that policy responses made a difference in containing investor panic as the economic instability mutated from a currency crisis into a full-blown economic crisis, in varying degrees backing up into the financial and industrial sectors. Policy is thus the intervening variable between the institutional framework of government and investment. Consistent with an institutional approach, my interest is less in suggesting that there was a "correct" package of policy responses that should, ideally, have been adopted, and more in examining the overall policy posture.[4] I focus on two generic policy syndromes that are polar opposites: policy rigidity and policy volatility. Policy rigidity refers to situations in which governments have extreme difficulty making desired policy adjustments (such as failing to deliver on a promised reform keenly sought by the market or being extremely slow to do so). Policy volatility refers to situations in which governments vacillate wildly from one policy position to another (such as swinging between a strongly contractionary and a strongly expansionary macroeconomic posture). I argue, a priori, that these polar syndromes create significant problems for investors, particularly during a regional crisis. (If the policy status quo were perfectly optimal, rigidity would be desirable—but almost by definition this is not the case when crisis strikes.)

In sum, I contend that the overall policy postures of governments varied in basic ways, that this was consequential for investors, and that we need to explain this variation. I seek to show that the institutional framework of politics provides a powerful lens for examining this problem. In stylized form, my argument flows as follows:

Institutional framework → *Policy posture* → *Investment*

I do not dispute that other factors mattered, such as short-term capital flows, financial regulation, and patterns of business-government relations. I take it as given that the crisis was complex. Accordingly, rather than present a synthetic overview or retrace the arguments developed in the various strands of economic literature, I focus tightly on political institutions while holding other factors constant; thus the approach here is self-consciously partial. The spirit of this exercise is to suggest that an independent and significant relationship exists between institutions and investment that sheds necessary light on the dynamics of the economic crisis. The methodological limitations imposed by a small sample of case studies dictate modesty: nothing can be strongly demonstrated here. Nonetheless, by combining careful analytic narratives with deductive intuition I seek both to illuminate the political economy of the Asian crisis and to suggest new lines of theoretical inquiry.

I proceed as follows. I draw on two competing strands of institutionalist literature to set up a simple model of the relationship between political institutions and investor confidence. I seek to resolve the inherent tension between that strand of the literature emphasizing credible policy commitments and that strand emphasizing policy flexibility. I argue that both positions have force. Building on a veto player framework, I posit a U-shaped relationship between the degree of centralization of veto authority and what I call policy risk for investors. I then provide thumbnail

4. A further reason for this more general approach is that even were one so motivated, it is not obvious what an optimal policy response would have been given the ongoing divisions among even mainstream economists on the appropriateness of orthodox stabilization measures, major structural reforms, and capital controls, and the absence of any clear pattern connecting specific policies and outcomes across the region.

sketches of the political frameworks of the four cases, locating them on this notional U-shaped curve and highlighting the correlation between this distribution and the variation in investment. I next set out condensed accounts of the four cases, focusing on their policy behavior and the connection between this and the institutional framework of politics. In the concluding section I reflect on both the limitations and the wider application of this institutional lens for examining political economy questions.

The Economic Consequences of Political Institutions

Two broad strands of theorizing in the institutionalist literature are helpful for understanding the connections among political institutions, investment, and, more broadly, economic growth. The first strand deals with the credibility of government commitments and the importance of policy stability for investors. The second deals with governmental adaptability and the importance of policy flexibility for the purposes of economic reform. Both strands have important implications for our understanding of governments' policy responses to the financial crisis and investors' calculations about these responses.

The literature on policy credibility has been built upon the work of Douglass North about the importance of stable and secure property rights regimes for investment and growth in the economic development of Europe. The introduction of new political institutions was critical to constraining the power of the political executive, which in turn provided for a more stable and secure environment in which investors were less discouraged by the risk of capricious policy action. Investors could have greater confidence that sovereigns or political executives would adhere to their proclaimed policies because there were other political institutions that checked their ability to alter course.[5] A modern variant in advanced industrial democracies is politicians tying their own hands by delegating management of a special area of policy to a credibly nonpartisan third party, such as an independent central bank, that provides an additional check on arbitrary executive action.[6] These core ideas have been deployed to help explain the rapid rise of investment and growth globally, in emerging markets, in particular parts of Asia, and cross-nationally in the telecommunications and electricity sec-

5. See North and Thomas 1973; North and Weingast 1989; Root 1989; and Weingast 1995.

6. But note that the credibility of such independent agents is itself connected to the wider political framework, since an institutional configuration that disperses veto authority reduces the likelihood of the agent being overturned or captured. More broadly, the credibility of such agents is likely to be sensitive to the strength and depth of democracy. It is not coincidental that delegation of this sort is rare in developing countries where there are often powerful political executives who are unwilling to tie their own hands and weak legal systems that increase the risk of miscellaneous cooptation and corruption. For statistical support regarding the significance of the institutional environment for the effectiveness of central bank delegation, see Keefer and Stasavage 1999, 35.

tors.[7] Common to much of this research is the proposition that when government is institutionally constrained, a more stable and predictable policy environment exists for investors. Unconstrained governments cannot be trusted, for no matter what they promise—on issues ranging from contracts to inflation rates—nothing prevents them from reversing themselves and undermining investors' plans and eroding or eliminating their profits. At a time of heightened investor uncertainty and nervousness, we could expect these considerations to be brought sharply into focus.

The literature dealing in various ways with the impact of policy flexibility has moved in the opposite direction. A quite diverse collection of writers has emphasized the importance for investment and growth of governments that are adaptable or nimble in responding to changing circumstances in a timely fashion. The macro-institutionalist literature on state autonomy and state strength is one exemplar of this.[8] Much of this literature has explored the ability of different state structures to respond to economic shocks and to promote rapid investment and growth. A distinct but logically parallel micro-institutionalist literature has focused not so much on the character of the state as a whole, but on the configuration of its components and the policy consequences of different institutional designs. Here the key variables have been electoral systems, the institutional division of governmental powers, the nature of the party system, and the nature of bureaucratic delegation.[9] Countries in which, for instance, the electoral system produces weak or incoherent parties or the structure of government produces fragmented authority among multiple decision-making bodies are likely to be slow to reform and have difficulty responding to policy challenges that demand prompt, focused action. Running through this broad second strand of literature is, on the one hand, attention to the institutional features that promote or hinder timely policy adjustment by governments, and, on the other hand, the significance of this for economic outcomes. A logical implication—given explicit emphasis in some of this work—is that flexibility in policymaking and economic reform can be crucial to making an unattractive investment environment more attractive and preventing an attractive one from losing its appeal.

To summarize, if we look across the main currents of the institutionalist literature dealing with political economy questions, there are substantial bodies of empirical evidence and robust logics supporting arguments about the importance of credible commitments and policy stability, on the one hand, and adaptability and policy

7. For global quantitative studies, see Henisz 1999 and 2000. On emerging markets, see Borner, Brunetti, and Weder 1995. On Asia, see Montinola, Qian, and Weingast 1995; and Root 1996. On the telecommunications sector, see Cowhey 1993; Levy and Spiller 1996; and Henisz and Zelner 1999. On electricity, see Bergara, Henisz, and Spiller 1998.

8. See Katzenstein 1978; Johnson 1982; Haggard 1990; Wade 1990; Woo-Cummings 1991; Doner 1992; and MacIntyre 1994.

9. Among others, see Weaver and Rockman 1993; Steinmo 1989; Moe and Caldwell 1994; Kiewiet and McCubbins 1991; Shugart and Carey 1992; Haggard and Kaufman 1995; Tsebelis 1995; Shugart 1999; and Haggard and McCubbins 2000.

flexibility, on the other. Yet there is a powerful tension here, since the arguments pull in opposite directions. The practical and conceptual problem is that the institutional underpinnings for these two conditions are antithetical. Other things being equal, policy stability will be maximized by an institutional framework in which control over policy is dispersed so that the likelihood of arbitrary policy action is reduced; flexibility in policymaking will be maximized by an institutional framework in which control over policy is concentrated so that the likelihood of delay and logjam is reduced.

Both matter. Investors require stability and predictability in some areas, such as macroeconomic settings. But in other areas a premium is placed on flexibility and change in a timely fashion—for instance, the removal of sector-specific obstacles to competitiveness and profitability. How are we to resolve this tension? Consider the full spectrum of political systems arrayed along a continuum ranging from those in which there are no effective institutional checks on executive action to those in which there are very many. Either extreme is likely to carry serious potential policy risks for investors. A political framework that heavily favors policy stability carries the latent risk that it may prove incapable of responding quickly enough in circumstances where timeliness is critical. Conversely, a political framework that heavily favors policy flexibility carries the latent risk that it may prove incapable of taking believable policy actions in circumstances where credibility and constancy are critical. These two extremes correspond to the two basic policy syndromes identified earlier: rigidity and volatility. I seek to operationalize this insight by building on George Tsebelis' veto player framework.[10]

A veto player framework is helpful because it enables us to compare and calibrate diverse systems of government. In essence it differentiates political systems by the number of actors who can block—or veto—a change in policy. A veto player is an individual or collective actor whose agreement is formally required for policy change—or, more strictly, legislative change—to proceed. The higher the number of veto players and the further apart their policy preferences, the more difficult policy change becomes—and thus the more stable and predictable the policy environment—because more separate actors must agree for change to occur. Figure 2 illustrates this linear relationship between the number of veto players and policy stability.

In Tsebelis' model the dependent variable is policy stability. My concern, however, is with the implications of the policy environment for investors—that is, whether the policy environment is sufficiently inhospitable or risk-laden to cause investors to withhold investment or even to transfer capital offshore.[11] Recast to capture what I will call policy risk, the question becomes, what is the relationship between policy risk for investors and the degree of centralization of veto authority? I argue that this relationship, rather than being linear, is best thought of as a

10. Tsebelis 1995 and forthcoming.

11. There are, of course, many factors in overall risk calculations; the concern here, however, is just with the policy environment.

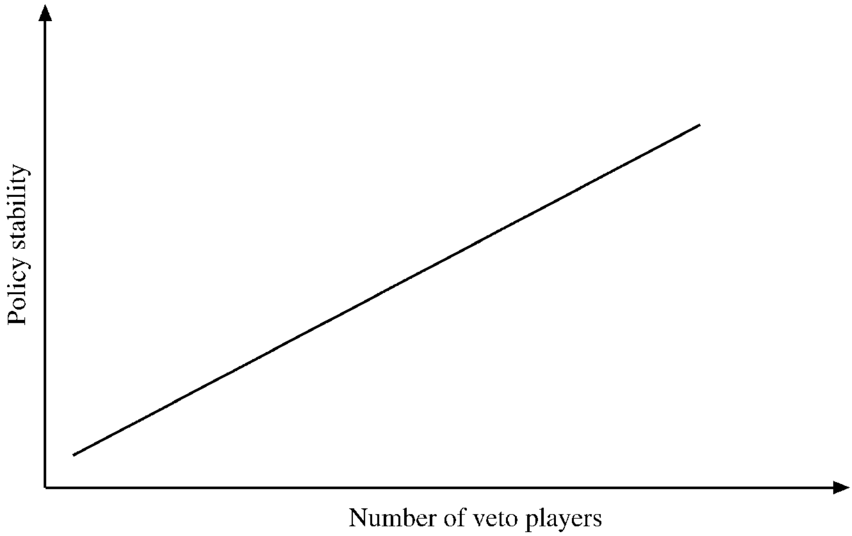


FIGURE 2. *Relationship between number of veto players and policy stability*

U-shaped curve, or more simply as a relationship that passes through a minimum value. That is, having more than one veto player helps to reduce the likelihood of policy volatility, but there is some point of inflexion after which additional veto players become unwelcome, serving only to increase the likelihood of policy rigidity. Figure 3 describes this in stylized fashion: the fewer the veto players, the greater the risk to investors of policy volatility; the greater the number of veto players, the greater the risk to investors of policy rigidity. For investors, the institutional extremes carry increased dangers, which are likely to be felt very keenly during a time of crisis. I argue that this simple model has much to tell us about the way in which governments in the four Southeast Asian countries handled the unfolding crisis and, in turn, why investment reversals in some were more severe than in others.

Applying a Veto Player Framework

One of the great advantages of a veto player framework is the ease with which it can be applied to diverse constitutional and party configurations to highlight the ease or difficulty, on average, of affecting policy change. Scholars have applied a number of variants of this framework since the early work of Ellen M. Immergut and Evelyne Huber, Charles Ragin, and John D. Stephens.[12] Tsebelis has played the key role in formalizing and developing the approach and making it more sensitive to preferences, with spatial modeling of the impact of ideological distance. Subsequent empirical

12. See Immergut 1990; and Huber, Ragin, and Stephens 1993. See also Birchfield and Crepaz 1998.

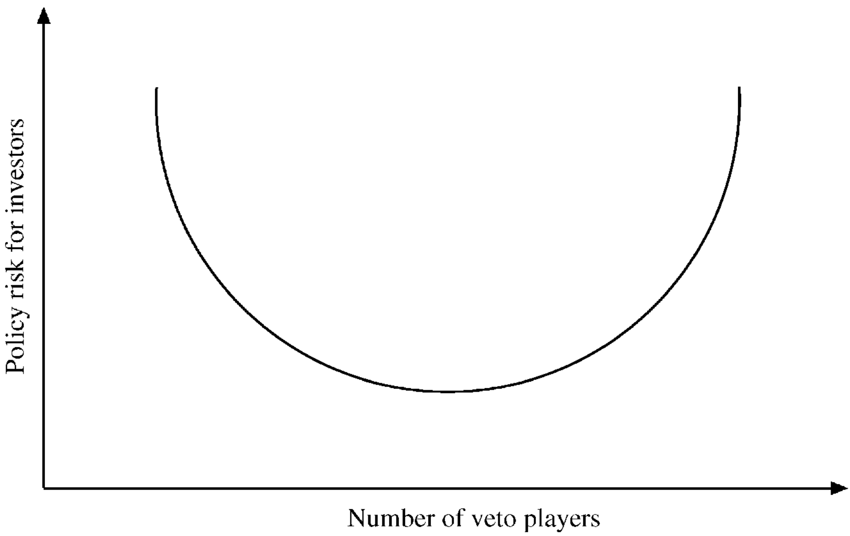


FIGURE 3. *Relationship between number of veto players and policy risk for investors*

studies have provided large-*n* statistical analysis to support arguments about the impact of the number of veto players on the frequency of legislative change.[13] All are drawn from Organization of Economic Cooperation and Development (OECD) cases. I hope to show that the approach has wider application beyond the methodologically comfortable world of OECD-based research. In other words, it can also embrace more slippery polities in developing countries that may be semidemocratic or even nondemocratic and, more broadly, that have more fluid party systems and party competition that is often based not on ideology but on regional differences, personal followings, and patronage distribution.[14]

I do not attempt to calibrate ideological distance between veto players along any single issue dimension. Apart from the fact that ideological distance is less relevant when party competition is not based on ideological differentiation, my purposes are broader. I aim to specify the distribution of veto authority in a generalized fashion, thereby implicitly accepting the reality of logrolling across multiple policy dimensions. With this qualification in mind, I follow Tsebelis in identifying veto players as provided for by both constitutional structure and party system and consider whether to discount any players that are, for analytical purposes, rendered mute or redundant because their aggregate preferences are subsumed by the aggregate preference of other players.[15]

13. See Kreppel 1997; Hallerberg and Basinger 1998; and Bawn 1999.
14. On party systems in developing countries, see Haggard and Kaufman 1995, 166–68.
15. Tsebelis forthcoming, 12.

The beauty of a veto player analysis is its adaptability and parsimony. But is it too reductionist? Is this tight analytic focus liable to miss other important political factors, such as unilateral executive action that does not involve the formal legislative process or, more fundamentally, the impact of other actors, such as economic groups, student movements, or even militaries? Certainly unilateral executive action is an important phenomenon in some polities, but accounting for the number of veto players captures this reasonably well, since systems with very few veto players are typically those in which the scope for such action is the greatest (that is, when the executive controls the legislative process). More contentious is the issue of other private and public actors who are not part of the formal institutional framework of law making. Should we think of actors such as big business groups and student demonstrators as extra-institutional or informal veto players and include them in the analysis? After all, not only is it plainly the case in many polities that powerful private actors can mobilize to kill an unwelcome policy action, one could also reasonably argue that this is likely to be particularly the case in semidemocratic and even more authoritarian polities where informal political actors can be especially potent.[16]

While recognizing this, I nonetheless seek to make a case for a strict focus on formal institutions. In part this is because to do otherwise is to open the door to post hoc analytical fudging: how are we to specify informal veto players in advance of their flexing their alleged muscles? But more fundamentally, I wish to resist a widening of the analytic focus, because doing so would blur the basic distinction between institutions and interests. All institutional frameworks are surrounded by seas of contending interests, but the configuration of the institutional framework is not without consequence. If actors occupying institutions endowed with formal veto power are equated with politically influential private actors, our ability to see the effect of institutions is reduced. In the four cases here the spectrum of interests struggling over policy is remarkably similar, ranging from well-connected bankers seeking protection to urban poor protestors hit by fiscal cutbacks. But these contending interests were ultimately mediated through formal veto structures that differed fundamentally.[17] And it is precisely these differences and their consequences that I seek to highlight. Of course interests are important and the tight institutional focus does carry real limitations, as I discuss later. But for the purposes of trying to illuminate the connections among political institutions, overall policy posture, and investor reactions to the unfolding crisis, the parsimony is both reasonable and helpful.

16. Shirk offers a good illustration of this from leadership selection processes in China. Shirk 1993. More generally, see Dittmer, Fukui, and Lee 1999.

17. A seeming exception to this is when the institutional framework itself comes under challenge, something illustrated best in the Indonesian case when the economic decline in the final weeks of Suharto's rule became so severe that mass protesting broke out. But in such situations we are talking about opposition to an entire regime, not merely opposition to a policy.

With this in mind, let us explore the application of a veto player analysis to the cases. We begin with the country where the crisis first emerged. Under the framework then in place, Thailand had a parliamentary system, and although there were two houses of Parliament, the upper house only had powers of delay rather than actual veto. Also, during this period there was effectively no scope for judicial review. Accordingly, only the House of Representatives carried veto power. However, because Thailand also had multiple weak parties—due in substantial measure to its electoral system[18]—the situation was in practice much more complicated. With some ten to twelve parties being represented in the Parliament, coalition government was inevitable, typically compromising six or more parties. This meant that there were typically at least six (collective) veto players, since the prime minister risked coalitional collapse if he attempted to override serious opposition to a policy change by one or more members of the coalition. Further, depending on the particular parties sitting in the coalition, the effective number of veto players could be much higher, since some parties had little coherence or internal discipline, thus opening the possibility of different factions voting differently on a particular policy proposal.

Importantly, while there was little significant ideological difference among the parties, we cannot discount any of them as veto players. As is widely recognized among observers of Thai politics, competition among parties is over pork and other particularistic benefits. All parties therefore have a powerful incentive to assume positions that are distinct in some way from one another—on whatever happens to be the policy issue of the day—to ensure necessary leverage in capturing side payments. The underlying game inside the coalition was not so much negotiation over diverging policy preferences as it was zero-sum bargaining over the distribution of pork. In short, all members of the coalition were effectively veto players. With at least six veto players, the political framework at the time provided for fragmented control over policy.[19]

The framework of government in the Philippines is quite different both in institutional design and the number of veto players. The Philippines has a presidential system of government with a bicameral legislature, in which both the House of Representatives and the Senate have full veto power over legislation. Like Thailand, the Philippines has a multiparty system, with roughly six incohesive parties gaining representation in the Congress in recent times. This points to the need for a multiparty coalition in each chamber for the president to get legislation passed. Given that parties, as in Thailand, are institutionally weak, at first glance this might suggest that the Philippines would have a high number of veto players like Thailand, but this is not the case in practice. Unlike a parliamentary system, the political executive—the president—is separately elected and not beholden to the parties for tenure. The president does require the consent of a majority of each chamber for

18. The pioneering work to open up systematic institutional analysis of Thailand's party system and electoral system is Hicken 1998 and 1999.

19. See Hicken 1998; Anusorn 1998; and Hewison 1997.

legislation to pass, but as long as a majority is achieved, its precise size and party composition do not matter. Because there is no stable majority of disciplined parties, presidents construct any coalition they can. Accordingly, we should view each legislative chamber as a single (collective) veto player.[20]

The fact that the Philippine presidency has a range of potent formal and informal discretionary powers at its disposal—high by comparison with presidential systems in many other nations—has greatly facilitated the task of building legislative coalitions.[21] After elections, many legislators migrate to the party of the new president. Legislators remaining in other parties have strong incentives to join with the administration coalition for the purposes of legislating because of the president's formidable patronage-dispensing powers, both on and off budget. During the Ramos administration, this became a finely oiled (if costly) machine.[22] The net effect here is that where on average Thailand had a minimum of six veto players during the period in question, for the Philippines the figure was three: the president, the House, and the Senate. In addition, the Philippine Supreme Court enjoys and exercises powers of judicial review. Alone among the cases dealt with here, the judiciary in the Philippines occasionally serves as a veto player, overturning actions approved by the president and the Congress.

Malaysia presents a striking contrast to both Thailand and the Philippines, being very much more centralized. Like Thailand, Malaysia has a multiparty system and only the lower house of Parliament has veto power. But the dynamics of the two systems are utterly different. Unlike the familiar Thai pattern of volatile coalitions formed after elections by rival parties, Malaysia's longstanding and greatly oversized coalition—Barisan Nasional (Barisan)—is made up of parties that divide the electoral map among themselves before each election to avoid competing with each other. The absence of significant electoral competition or policy conflict among parties in Barisan, together with its history of stability (in effect, ruling Malaysia since independence), means that Barisan is best understood as a unitary actor or single party.[23] Internally, the huge Malay party, the United Malays National Organization (UMNO), completely overshadows the other dozen much smaller ethnic and regional parties in Barisan and controls all the key cabinet posts. Indeed, the smaller parties depend on UMNO for financial resources to campaign against opposition parties at election time. Observers widely recognize that the crucial political battles in Malaysia are fought not among the parties in the coalition but within UMNO.[24]

20. Tsebelis forthcoming, 8.

21. On the international comparison, see Shugart and Carey 1992, 156. More generally, see the promising work by Yuko Kasuya and Gabriella Montinola that is casting new light on the linkage between the presidency and the weak party system in the Philippines. Kasuya 1999; and Montinola 1999.

22. See Coronel 1998; de Dios and Esfahani forthcoming; and Leones and Moraleda 1998.

23. Lijphart 1999, 69–71. My thinking on this point has benefited from discussions with Matthew Shugart.

24. See Gomez 1998; Milne and Mauzy 1999; Case 1996; Crouch 1996; and Rais 1995.

Viewed through the lens of a veto player framework, Malaysia has just one collective veto player, Barisan, with it being centered in the cabinet. And with the cabinet overwhelmingly dominated by UMNO, for most purposes the effective locus of veto power is within the UMNO leadership. If UMNO leaders favor a policy change, it easily obtains cabinet approval and passes quickly into law since there are no other veto players to be reckoned with. Stated simply, Malaysia's framework functions much more like Britain's disciplined two-party system (without the party turnover) than Thailand's volatile multiparty system. And by comparison with Britain, the position of the Malaysian executive has been strengthened further through creeping encroachments (such as the decline of judicial independence) on democracy since the mid-1980s.

More centralized still is the unambiguously authoritarian case of Indonesia under Suharto. Under the constitution, both the president and the House of Representatives had veto power over legislation. However, because the president's party so dominated the legislature and his own party, we can quickly discount the legislature as a veto player with preferences distinguishable from the presidency.[25] There was no question of judicial review powers. In practice, then, only one institution in this system had veto power: the presidency. In Malaysia the UMNO leadership was, de facto, the single collective veto player; in Indonesia it was the single person of the president. In Malaysia's parliamentary framework the party did constrain its leader; in Indonesia's presidential framework Suharto's party had little independent life and imposed no policy constraints on him. In relative terms Suharto was thus even less constrained than Mahathir with regard to control of the policy process. And, of course, in the background was the reality that a resort to coercion was a ready option for Suharto.

These thumbnail sketches of the institutional framework of government in the four countries highlight the degree of dispersal or concentration of control over the policy process by identifying formal political actors with the routine ability to block change. If we look across the diverse institutional frameworks of the four cases and calibrate, we have Indonesia as the most centralized system (even more so than Malaysia because the single veto player was an individual rather than a collective and because of the more authoritarian context), Malaysia also with a very centralized system featuring just a single veto player, followed by the Philippines with three veto players, and then Thailand much further along the continuum with a very decentralized system featuring at least six veto players. These calibrations are only crude indicators, but they do point to basic and highly consequential differences among the political systems. In terms of Tsebelis' model of the relationship between the number of veto players and the extent of bias toward the policy status quo, we would expect Indonesia closely followed by Malaysia to be the cases in which policy change was least difficult. The Philippines should be an intermediate case, and change in Thailand should be most difficult. In

25. See MacIntyre 1999; and Juoro 1998.

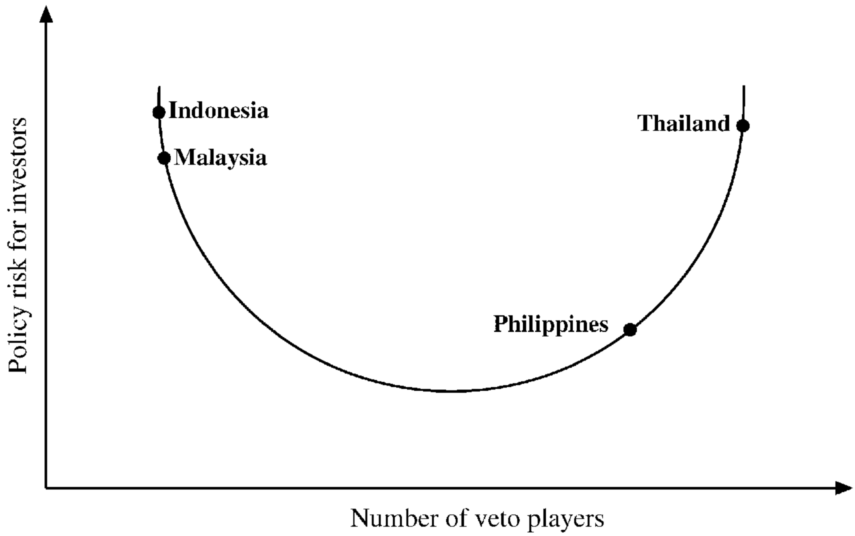


FIGURE 4. *Locating the cases—veto players and policy risk*

terms of the model I have outlined of a U-shaped relationship between the number of veto players and policy risk for investors, Indonesia, followed by Malaysia, would be up the left arm of the notional curve (reflecting the risk of policy volatility), the Philippines would be toward the center, and Thailand would be up the right arm (reflecting the risk of policy rigidity). Figure 4 depicts this in stylized fashion.

It is not coincidental that this distribution on the independent variable roughly mirrors the distribution of outcomes on the dependent variable. (Recall the overall pattern across the four countries in Figure 1.) Moreover, as we shall see, the generic policy syndromes expected under the model proposed here were indeed the ones experienced. With their heavy centralization of veto authority, Malaysia and even more so Indonesia exhibited severe problems of policy volatility. With its wide dispersal of veto authority, Thailand exhibited severe problems of policy rigidity. And the Philippines, with its intermediate distribution of veto authority, avoided either extreme, exhibiting a sticky but not inflexible policy environment. Institutional configuration had a direct bearing on overall policy posture, and this had consequences for investors. In the next section I illustrate this by presenting an overview of the policy behavior of the four governments as they grappled with the economic crisis.

The Cases

Before becoming immersed in the cases, it will be helpful to revisit the issue of comparability and initial conditions. As Table 1 (drawn from a major study by the

TABLE 1. *Selected indicators of initial conditions, end of 1996*

	Thailand	*Philippines*	*Malaysia*	*Indonesia*
Inflation > 5%	Yes	Yes	No	Yes
Fiscal deficit > 2% of GDP	No	No	No	No
Public debt > 50% of GDP	No	Yes	No	No
Current account deficit > 5% of GDP	Yes	No	No	No
Ratio of short term debt to international reserves > 1	Yes	No	No	Yes
Credit to private sector > 100% of GDP	Yes	No	Yes	No
Credit to private sector, real growth > 20%	No	Yes	Yes	No
Euromoney rating, Sept. 1996 (0–100)	77	62	80	71

Source: Balino et al. 1999, 14; *Euromoney* data from Hill 1998, 266.

International Monetary Fund [IMF]) indicates, on the recognized threshold indicators no single case was strikingly more vulnerable than the others. Certainly, there was open concern about Thailand's growing trade deficit; but based on purely macroeconomic indicators, if any of the four cases could be tagged as a candidate for trouble, it would probably be the Philippines with its continued high public debt and rapid credit growth. Indeed, in late 1996 *Euromoney's* credit rating pegged the Philippines as the weakest of the four.[26] On the macroeconomic indicators, Indonesia and Malaysia looked good. On the issue of short-term foreign borrowing, Indonesia and Thailand were more exposed, but particularly in the case of Indonesia, nothing suggested that this was unsustainable. In short, even in retrospect no tell-tale signs identify the three hardest-hit cases as being clearly more vulnerable than the case that experienced the least-severe investment reversal. And all four shared the risky combination of a de facto pegged exchange rate with an open capital account. I am not suggesting that initial conditions were irrelevant but merely that there is no obvious basis for predicting the varied outcomes from initial conditions. This strengthens the case for believing that the actions of government through the crisis had a significant bearing on the behavior of investors.

26. Hal Hill, the respected economist of Southeast Asia, notes that the Philippine's low savings rate was another source of concern and also comments that if any country in Southeast Asia looked economically troubled in the period prior to the crisis, it was the Philippines (and Vietnam). Hill 1998, 266.

We turn now to the cases themselves. I treat the countries in the order in which they were hit by currency instability: Thailand, the Philippines, Malaysia, and Indonesia.

Thailand

Thailand was experiencing economic problems for some time prior to the fall of the baht on 2 July 1997.[27] The economy was slowing by late 1996 (growth eased from 8.8 percent in 1995 to 5.5 percent in 1996). Export growth, which had been strong in 1994 and 1995, fell sharply in 1996, with total exports actually contracting. The current account deficit was sitting at 8 percent of GNP. Alongside these problems in the real sector, problems in the financial sector were also coming to light. Having grown very rapidly, Thailand's banks and particularly its finance companies became hostage to a prolonged property market boom, which was failing by late 1996, raising concern about the soundness of a number of nonbank financial institutions. Adding to this concern was the fact that much lending had been funded through short-term foreign borrowing.[28]

By late 1996, there was no doubt that Thailand was facing economic difficulty, and its currency was already a target of speculation. These problems rapidly mounted and metastasized during the first half of 1997. The collapse of the pegged exchange rate on 2 July 1997 did not mark the beginning of Thailand's crisis but rather the failure of the first round of crisis-management tactics and the inauguration of an even more volatile state of affairs.

Institutionally rooted policy rigidity was central to the mounting problems in Thailand and its subsequent failure to contain the situation more effectively once the baht began to depreciate. Much blame has been heaped on the short-lived government of Chavalit Yonchaiyudh that had stewardship of the country through the critical months from December 1996 until November 1997 when the economy rapidly unraveled. But this government was no more beset by divisions, paralysis, or even corruption than any of the other short-lived elected governments that preceded it. Indeed, Chavalit's government looked stronger, more economically competent, and more promising than its three elected predecessors, as least in the beginning. But like all its predecessors, Chavalit's government was profoundly constrained and soon broken by the inherent fragility of the multiparty coalition upon which it was founded. The institutional configuration made it extremely difficult for any government to introduce major policy change because veto power was so dispersed. For a prime minister to attempt to override serious opposition from a member of the coalition was to invite defection and possible coalitional collapse.

27. For more detailed accounts of Thailand through the financial crisis, see the Nukul Commission Report 1998; Bhanupong 1998; Ammar 1997; Pasuk 1999; Warr 1998; and Lauridsen 1998.
28. See Bhanupong 1998; Warr 1998; and Ammar 1997.

Chavalit's government came to power after campaigning on a platform of tough new policy leadership to tackle the country's economic malaise. Chavalit installed Amnuay Virawan as finance minister and leader of the nonelected technocrats he placed in key economic posts in the cabinet. Amnuay's declared policy priorities were hacking back government spending and tackling the systemic problems in the financial sector. The primary obstacle in each case was the need to obtain the agreement of the various veto players represented in the cabinet. On the fiscal front Amnuay succeeded initially in obtaining cabinet approval for substantial spending cuts in an effort to reimpose some budgetary discipline and ease the current account pressures. A tighter fiscal stance was also aimed at allowing the government to loosen monetary policy, in an effort to help rekindle economic growth. However, big spending reductions in capital works programs for roadworks and infrastructure projects created intense opposition within the cabinet because they threatened to eliminate prized pieces of legislative pork. And as deteriorating economic circumstances in the first half of 1997 forced Amnuay to return to his cabinet colleagues to seek approval for additional cuts in outlays, opposition to his proposals rapidly hardened within the coalition and ultimately became a catalyst for his fall.[29]

If the government made at least some initial progress with its policy goals on the fiscal front, the situation in the financial sector was considerably worse. It was widely suspected that there were problems in the financial sector, particularly among the country's ninety-one finance companies. Prior governments had conspicuously failed to tackle the emerging problems in the financial sector. The new government's initial signals suggested it might reverse this trend. But as it was put to the test in 1997, it too proved incapable of effective remedial action.

By February 1997 the situation in the financial sector was beginning to unravel with the first default on a foreign loan followed by an announcement that the country's largest finance company was seeking a merger to avoid collapse. In the face of widespread fears of an impending financial implosion and the beginnings of hurried depositor withdrawals, all attention focused on the government's response to the situation. In a joint move on 3 March, Finance Minister Amnuay and central bank governor Rerngchai Marakanond suspended trading of financial shares 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 ten of the weakest financial companies would have to raise their capital base within sixty days.

These measures did little to reassure markets; and when trading resumed, 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

29. *Economist Intelligence Unit (EIU)*, Thailand, first quarter 1997, 15–16; second quarter 1997, 16–17; third quarter 1997, 17.

sooner had Amnuay and Rerngchai targeted the ten ailing finance companies in their "get tough" campaign, than determined opposition emerged from within the government. Several senior members of the government had interests in some of the ten targeted institutions and used their leverage within the coalition to veto the actual implementation of the tough measures outlined by Amnuay and Rerngchai. Further, not only was no action taken against the ten finance companies, but 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.[30]

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 baht was coming under mounting pressure, with currency market players sensing exchange-rate vulnerability. Amnuay and Rerngchai did not dare pursue the strict path favored 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 unattainable. These initiatives failed not because they were blocked by popular outcry or parliamentary opposition, but because they were vetoed by members of the ruling coalition. Rather than risking the collapse of his new government, Chavalit preferred to gamble on further 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 investors. The government was not only failing to deliver reform plans the market was apparently calling for but also failing to deliver the reforms it itself had publicly announced. As one minister lamented, "To solve economic problems we cannot simply announce economic measures, we have to follow up on their progress."[31] Further, the compromise and delaying measures that did eventuate only worsened matters. A side effect of not closing the ten finance companies and just injecting them with large-scale emergency funding was the rapid expansion in the money supply (by 10 percent in 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.[32]

30. See *The Nation,* 18 April 1997 and 13 March 1997; *The Bangkok Post* (*BP*), 19 August 1997; and Pasuk and Baker 1998, 105–10.

31. *Far Eastern Economic Review* (*FEER*), 29 May 1997, 15.

32. See Ammar 1997, 2; and Fane and McLeod 1999, 4.

As 1997 progressed, there was rapid turnover in personnel in key government positions, but the same basic policy dynamic continued as the country descended further into economic disarray. With a 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 were 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.

In mid-June Amnuay resigned, frustrated by his inability to persuade the coalition's leaders in cabinet to move on more extensive financial sector reforms and being blocked on further specific budgetary cuts. His successor, Thanong Bidaya, fared little better. Seeking to seize the initiative, on 27 June he announced the suspension of sixteen finance companies (including seven of the original ten), giving them thirty days to implement merger plans. At the same time, however, the central bank was nearing the end of its rope in the doomed attempt to continue propping up the baht through currency market intervention. With its reserves effectively exhausted, on 2 July the central bank announced that the baht was being cut loose. In a move that would quickly reverberate around the region, the baht immediately fell very sharply, depreciating by 17 percent.

Thanong's priority remained the struggle to avoid widespread collapse in the financial sector. But although he had won approval for the announcement of the suspension of the finance companies, leaders of Chart Pattana, the second largest party in the coalition, were able to block the implementation of the initiative. Chart Pattana not only succeeded in preventing the closure or forced merger of the sixteen finance companies but 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 emergency loans to the sixteen 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 percent of GDP.) The government naturally sought to downplay its own direct involvement in this scandal and instead forced the resignation of recently appointed central bank governor Rerngchai.[33]

A week later, on 5 August, in an effort to regain the initiative and to satisfy IMF demands for commitment to policy reform, Thanong announced that a further forty-two finance companies would be suspended because of the scale of their loan problems and imminent insolvency. A total of fifty-eight, or two-thirds of the country's finance companies, had now been suspended. Like the earlier sixteen, 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.[34] Again, however, there

33. *BP,* 14 August 1997.

34. 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.

were questions about the government's determination to deliver on these threats and persistent rumors of irregularities in the committee established to vet rescue plans of the suspended finance companies. In an effort to rectify this problem a new committee leader was appointed, Amaret Sila-on, the respected head of the Thai Stock Exchange.[35]

But as one section of the government was trying to overhaul the financial sector, others were 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."[36] 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 in an effort to have the criteria for their rehabilitation relaxed. The IMF responded by publicly expressing concern that the independence of Amaret's screening committee not be undermined. Nevertheless, a week later Amaret resigned after only a short tenure, declaring that he was being undercut by forces within the government.[37] Yet again policy adjustment was being stifled.

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 targeted institutions, Thanong also revealed that the deadline for their restructuring would now be extended (without a new date being set) and that loans provided earlier 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.[38] And in another successful rearguard move, Chart Pattana succeeded in holding up cabinet approval of plans for the two new agencies announced by Thanong until text was inserted in the decrees specifically reversing the agencies' independence from the government.[39]

By this stage, however, the political situation was collapsing. On 19 October Thanong resigned as finance minister over the reversal of a petrol tax a mere three days after it had been announced as part of the government's long-awaited policy response to the IMF bailout. And on 3 November, 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 own resignation.

35. *BP,* 26 August 1997.
36. *BP,* 15 October 1997.
37. *BP,* 12 October 1997.
38. *BP,* 14 October 1997.
39. *EIU,* Thailand, 1998, 13.

Thailand had fallen into deep trouble. Investor confidence had been routed: the exchange rate had fallen continuously (losing 25 percent of its value by the time of Chavalit's fall), capital was flowing out of the country rapidly, and lending had dried up. Central to this was the chronic inability of government to deliver necessary policy adjustment. Like its predecessors, Chavalit's government became stymied by internal coalitional disagreement; but with an institutional framework producing so many veto players, this was scarcely surprising. This striking inability to launch effective reform measures sent powerful signals to the investment community: the government—any government operating under this institutional framework—would be incapable of delivering desperately needed reform.

The Philippines

The Philippines presents a stark contrast to Thailand, both in terms of the extent of the investment reversal and the underlying institutional configuration of government.[40] Although there was significant dispersal of veto power—such that rapid policy change was difficult—the status quo bias was markedly weaker than in Thailand. In terms of the central argument of this article, the Philippines is an intermediate case in which there were institutional checks against policy volatility but sufficient scope for flexible executive action on pressing issues.

The crisis struck the Philippines during the final twelve months of Fidel Ramos' term as president, when his authority was declining both because of a standard lame duck effect and because of criticism stemming from a futile attempt by his supporters to circumvent his constitutional term limit. In spite of this, when he brought the full weight of the presidency to bear on the task of persuading legislators to cooperate with various measures integral to handling the crisis, he was successful. Also relevant here was the differential ability of the political executive in the Philippines and Thailand to take executive action. A number of policy adjustments relevant to the economic crisis—most obviously, exchange-rate and monetary policy issues—were typically the province of executive agencies or central banks and thus did not directly involve the legislature. This proved advantageous in the Philippines with its presidential framework, but it was of no advantage in Thailand with its multiparty parliamentary coalition government. Presidentialism implies that executive decision-making authority is ultimately concentrated in a single individual. In Thailand, however, executive authority is much more fraught because the executive—the cabinet—is a collective body containing all the veto players.

In the prelude to the crisis, unlike Thailand, the Philippine economy was not slowing, its export sector was not sagging, and it had not built up heavy short-term foreign debt in the private sector. In part this was a function of the growth spurt in the Philippines having occurred much more recently than elsewhere and, relatedly,

40. For more detailed discussion of the Philippines through the financial crisis, see Hutchcroft 1999; Mijares 1999; Intal et al. 1998; Sicat 1998; Lim 1998; and Montes 1999.

that it had only reentered international capital markets in 1993. From this perspective, as others have noted, the Philippines did indeed seem a less likely candidate than Thailand for a major investment reversal.[41] Nevertheless, it was by no means without problems. We saw earlier that there were real difficulties in some macroeconomic areas: persistently low savings and persistently high public debt paired with rapid credit growth. And as a number of economists have pointed out, questions were emerging about the competitiveness of Philippine industries, and in the period immediately prior to the onset of the crisis unhealthy trends were emerging in the financial sector, with the proportion of foreign borrowing and the proportion of lending to real estate and other nontradables beginning to rise quickly.[42]

How did policymakers in the Philippines respond to the crisis? Although there were certainly political obstacles to adjustment, we do not see the crippling pattern of systemic policy rigidity exhibited by Thailand. After a brief and costly effort to defend the currency, on 11 July the peso was allowed to depreciate sharply. From this point, by comparison with what other countries in the region were doing, the Philippines followed a reasonably consistent orthodox approach. The key elements were adjusting monetary policy, enhancing bank regulation, and tightening fiscal policy. All were important. The country's institutional framework facilitated relatively smooth policy adjustment on the first two fronts, but it rendered the politics of fiscal management much more complex. Even here, however, despite messiness and delay, a tolerably timely and coherent outcome was achieved. The Philippines exhibited neither of the extreme policy syndromes outlined earlier, and this was consistent with the distribution of veto authority inherent in its institutional framework.

On the monetary front, the central bank, Bangko Sentral ng Pilipinas (BSP), worked closely with the government to drain liquidity from financial markets through the second half of 1997. A number of tools were used: open market operations, ratcheting up the liquidity reserve requirements and loan-loss provisions, and pushing up BSP's own overnight rates and occasionally even closing BSP's overnight window. With the exception of urgent attempts to force rates sharply higher for short periods (in the face of a new wave of currency uncertainty), the rise in rates was fairly gentle. The peso reached its low point in the first week of January 1998. From roughly the beginning of 1998 BSP moved steadily to ease rates as pressure on the peso seemed to be subsiding and the alternate danger of keeping monetary policy too tight came increasingly into focus.

Compared with Thailand, the policy rhetoric and policy action of the Philippine government were much more closely correlated. Through the first phase of the crisis in the second and third quarters of 1997, BSP (working closely with the adminis-

41. See Hutchcroft 1999; and Sicat 1998.
42. See de Dios et al. 1997; and Intal et al. 1998.

tration) sent steady signals about its intentions to keep monetary policy tight; and when circumstances appeared to warrant an easing in early 1998, it moved steadily to bring this about. This was not a frictionless process; indeed, lowering interest rates proved to be more difficult than raising them. A range of inducements, together with threats from BSP Governor Singson through the first quarter of 1998 to reintroduce lending rate controls and allow in more foreign competitors if banks failed to narrow their lending spreads, was needed before lending rates subsided.[43] Nevertheless, compared with what we observe elsewhere, BSP moved in a coherent and steady fashion, and, critically, it was not undercut by contradictory signals from other branches of the administration.

Enhanced prudential and oversight arrangements for the banking sector were a second key policy focus. The Philippines had undergone a long-running reform process in the banking sector in the wake of a major financial crisis in the early 1980s.[44] Prior to the outbreak of the financial crisis in 1997, BSP had moved preemptively to limit bank exposure to the property sector and increase cover against foreign exchange volatility. Once the crisis erupted, it took additional steps in this direction: lending to the property sector was further tightened, the classification and reporting requirements of nonperforming loans were tightened, a hedging facility (nondeliverable forward contracts) to limit foreign exchange risk was brought in, minimum capitalization and provisioning for bad loan requirements were strengthened, and stricter eligibility rules for investors in banks and bank presidents were introduced.[45]

Institutionally, these measures were relatively easy to introduce. On issues that fell within the purview of the specific powers delegated to it by the legislature (and underwritten by the constitution) BSP could act executively to affect regulatory change in the banking sector. In these areas, then, BSP—in coordination with the administration—could and did act in a timely fashion to introduce measures to reduce the risk of bank failure and thereby boost wider investment confidence in the stability of the Philippine economy. As a result bank failures were minimal in the Philippines. Several minor institutions closed, but their combined deposits amounted to barely 0.25 percent of total deposits in the banking system.[46]

The third key policy front—fiscal management—was no less important, but much more complex politically. The fiscal picture deteriorated rapidly over the course of 1997; a surplus of P6.26 billion (US$240 million) had been achieved in 1996, and the original target for 1997 was P12.96 billion, which in practice shriveled to just P1.56 billion. The outlook for 1998 was bleaker, not least because of the government's rapidly increasing interest obligations arising from the intensified open market monetary policy operations. The deteriorating fiscal situation quickly became a key concern, with the government struggling to prevent this from exacer-

43. *EIU,* The Philippines, second quarter 1998, 18.
44. See Hutchcroft 1998, chaps. 8–9; and Intal et al. 1998, 146–48.
45. Singson 1998a.
46. Singson 1998b.

bating investor nervousness and driving the currency down further. Its response was broadly consistent with its monetary policy operations: it took a stiff orthodox position, persevering with the conservative fiscal posture assumed in the last few years. But where the administration, in conjunction with the central bank, enjoyed a high degree of operational autonomy on monetary and bank supervisory issues, in the fiscal arena the political situation was much more complex. Institutional arrangements were central to this. Simply put, on some key issues the administration's plans were confounded by other branches of government, whereas on others the path to policy action was much clearer.

The key illustration of the latter was the relative ease with which the administration could cut expenditures. Although the president needed congressional consent to spend more than the approved budget, no obstacles kept him from spending less. Ramos could thus unilaterally order a 25 percent across-the-board cut in all nonpersonnel departmental spending. Contrast this with the Thai situation where the multiparty collective executive structure of the government meant that Finance Minister Amnuay (and his successors) had to fight hard against all the parties in the cabinet for every budget adjustment.

Serious problems did arise for Ramos, however, in two key fiscally related policy areas that came to assume bellwether significance in the context of the wider economic nervousness: income tax and oil deregulation. Both had powerful budgetary implications as well as symbolic importance for the government's credibility in the area of economic reform. Both were also required for the Philippines to "graduate" from the preexisting IMF Extended Fund Facility (EFF), but they had been held up by opposition in Congress. And as the crisis erupted in the second half of 1997, they assumed even greater significance for financial markets as the IMF made fresh lines of capital conditional on satisfactory legislative closure.

Reforming income tax laws had been a long-running political battle in the Philippines. A comprehensive reform of tax laws was central to the EFF agreement the Ramos administration established with the IMF in 1994. Income tax was the last remaining component, having been the subject of protracted debate within Congress, and between Congress and the administration. By early 1997 pressure for resolution was mounting since the EFF was scheduled to expire at the end of June. But with elections looming in 1998, legislators were naturally keen to champion the cause of higher tax-free thresholds against the more austere fiscal plans of the government. Despite presidential pleas for cooperation, one target date after another passed, until the administration was forced to request an extension of the EFF to October 1997. Meanwhile, the regional financial crisis was growing and the peso was tumbling. With increasingly desperate presidential pressure behind the scenes and intense bargaining within both the House and the Senate, and then between the two in a bicameral conference committee, congressional agreement was finally reached on 8 December and signed into law three days later by Ramos. Although much delayed, the final outcome satisfied both the government's and the IMF's essential needs for a more effective tax system and increased revenue.[47] The outcome was late but apparently not too late.

Just as the protracted income tax saga was approaching its legislative conclusion, another problem with potentially important implications for investor confidence was breaking out in the oil sector. The liberalization in February 1997 of the previously heavily regulated and subsidized oil industry had been a significant milestone in the economic reform drive of the Ramos administration. However, public opposition to the new policy framework flared up as local oil prices rose rapidly in response to both rising world oil prices and the falling value of the peso.[48] Sensitive to the implications of this for voters with an election drawing near, several members of Congress filed suits before the Supreme Court challenging the constitutionality of the deregulation law. The administration and many foreign investors were shocked when the Supreme Court did indeed overturn the law on 5 November. The ruling was surprising for several reasons. First, it threw oil industry pricing and administration into confusion. Second, it raised potentially serious fiscal problems for the government if, as critics were demanding, some form of subsidization on key oil products were to be reintroduced. And, finally, as with the income tax legislation, the deregulation of the oil industry was an explicit part of the government's reform obligations to the IMF under the EFF agreement, and failure to deliver a (constitutionally acceptable) bill could jeopardize fresh flows and financial support to battle the economic instability.

From the viewpoint of an administration nearing the end of its term and desperately struggling to prevent a more extensive investment collapse, this setback could not have come at a worse time. The administration promptly set about redrafting the legislation and renegotiating its passage with the Congress, but it was unable to secure an agreement before the Christmas break. Intense bargaining finally produced a workable compromise early in 1998, before Congress closed for the electoral campaign. The compromise outcome, together with falling international oil prices in 1998, effectively got the government close enough to where it had been prior to the Supreme Court ruling to enable the whole issue to subside.[49] Again, although the process was messy and belated, the administration had succeeded in overcoming institutional vetoes to its legislative agenda and thereby salvaging what would otherwise have been a very damaging situation at a time of widespread investor nervousness.

To summarize, even if we allow for differences in Thailand's and the Philippines' initial conditions, it is hard not to conclude that the more steady and coherent policy response of the Philippine government helped it to avoid a substantially worse investment reversal. This is not to suggest that the policy response of the govern-

47. *EIU,* the Philippines, fourth quarter 1997, 18–19; first quarter 1998, 13–15.
48. The Philippines is dependent on imports for 95 percent of its oil.
49. *EIU,* The Philippines, first quarter, 15–16; second quarter 1998, 14–17.

ment was in some sense optimal; inevitably there is scope for debate about whether monetary policy settings could have been more finely tuned and so forth. Nevertheless, the striking point about this case is the relative coherence and consistency of policy management, even in the face of substantial policy setbacks for the administration. Unlike Thailand, there were not so many veto players in the Philippines as to induce a profound status quo bias: timely policy adjustment was indeed possible if the administration was willing to fight hard. And, viewed from the other side, the constraints on executive action from the legislature and the judiciary were sufficient to preclude the possibility of radical policy volatility—the syndrome we observe in Malaysia and Indonesia. Alone among the four cases, the Philippines did not see its credit rating fall sharply during the crisis—its rating, instead, held steady.[50]

Malaysia

Like Thailand, Malaysia was hit hard by the crisis.[51] Paralleling the radical reversal of investment, the exchange rate fell by nearly 50 percent, the stock market suffered the biggest fall of any of the afflicted countries, dropping by more than 65 percent, and overall growth plummeted from 8.6 percent in 1986 to −6.2 percent in 1998. On the basis of Malaysia's initial economic conditions, this situation was quite unexpected. Malaysia appeared in good economic shape: growth was strong, inflation was modest, there was no heavy reliance on short-term foreign borrowing (indeed, Malaysia enjoyed strong inflows of long-term foreign direct investment), and the banking system looked relatively healthy with very low rates of nonperforming loans and high capital-adequacy rates.[52] However, as in the Philippines, Malaysia was not without problems. Bank credit had expanded rapidly through the 1990s; by mid-1997 it was higher than in any of the other cases, and, as elsewhere, much bank lending had gone to the property sector and the stock market.

Given a currency crisis in Thailand, Malaysia might have been expected to experience a devaluation and an investment slowdown as it grappled with the task of easing the bank-lending bubble to the overheated property and equities markets. In practice, however, Malaysia experienced a severe reversal. It is not possible to make sense of this outcome without reference to the nature of Malaysia's policy response and the politics that lay behind this. Again, we see a strong connection among the configuration of veto authority, the government's overall policy posture in response to the unfolding crisis, and the severe investment reversal. With only one veto player, the UMNO leadership, Malaysia's political framework was conducive to flexible policy action but, of course, carried the attendant risk of

50. Grenville 1999, 8.

51. For a more detailed discussion of the Malaysian case, see Athukorala 1998; Jomo 1998a,b; and Haggard and Low 1999.

52. Athukorala 1998, 85–92.

destructive policy volatility. Unfortunately, this latent danger was fully realized as policy responses to the economic situation swung hard one way, then hard the other way, and then hard back again. Policy rigidity in Thailand had a powerful undermining effect on investment; in Malaysia the opposite syndrome, extreme policy volatility, had an equivalent effect.

Malaysia's policy action prior to the baht being floated was low key. The ringgit was subject to a bout of selling pressure in May 1997, triggered by the more serious attacks on the baht. The central bank, Bank Negara Malaysia (BNM), intervened forcefully in the currency market and briefly pushed up interest rates to bolster the exchange rate. However, in July the ringgit came under heavy pressure following the end of Bangkok's attempts in July to prop up the baht and Manila's decision to devalue the peso. After a short and intense defense of the ringgit involving a sharp upward spike in interest rates and the spending of an estimated US$2.9 billion in the currency market, BNM abandoned its attempts to prevent the ringgit from falling below M$2.525:US$1.

Following the decision to allow the ringgit to fall, interest rates were allowed to return to their earlier levels. There was no concerted effort to use monetary policy to support the currency and guard against inflation (indeed, interest rates in Malaysia were markedly lower than in the other countries). Higher interest rates were particularly unwelcome to local firms whose growth had been funded in large measure by local (ringgit) borrowing. Prime Minister Mahathir had championed the development of the local corporate sector and was unwilling to see this reversed, not least because many of those who had had access to the most extensive bank lending and were most heavily leveraged were closely allied with the UMNO party leadership and him in particular.[53]

At the same time, Mahathir began to expound publicly his argument that foreign investors and hedge fund operators in particular were to blame for roiling Southeast Asian currency markets. Backing up his rhetoric, on 28 July Mahathir declared that the government would take action to prevent speculation against the ringgit, and on 1 August BNM duly announced limited currency controls on foreigners, with ringgit sales for noncommercial purposes restricted to US$2 million per day. On 15 August Mahathir defiantly ruled out a more cautious fiscal stance, insisting that the government would push ahead with a series of controversial and large-scale import-dependent infrastructure projects. And then, in a still more dramatic move, it was announced that off-budget fiscal resources would be deployed in order to intervene in the stock market to hit at speculators and defend big Malaysian companies. To this end, on 27 August short-selling of shares in the top one hundred companies was prohibited, and a week later it was announced that the Employees Provident Fund (a national pension fund under the central bank) would be tapped to set up a M$60 billion (US$20 billion) fund to purchase shares from domestic investors at a premium above the market rate. As Prema-chandra Athukorala points

53. Gomez and Jomo 1997.

out, this extraordinary move favoring large (UMNO-connected) firms contributed to a rapid growth in the money supply.[54]

Mahathir's policy stance was clear, but far from reassuring investors it was accompanied by a sharp fall in the ringgit and the stock exchange through August. By 4 September the currency had fallen by 15 percent and the stock exchange was at a four-year low. Malaysia's declining economic situation had become serious, and its political significance was quickly becoming apparent. On the same day, in preparation for a meeting of the UMNO Supreme Council, both Finance Minister Anwar Ibrahim and UMNO economic godfather Daim Zainuddin met with Mahathir and urged adjustments to Mahathir's policy stance.[55] That Anwar—whose ambitions to replace Mahathir simmered just beneath the surface of Malaysian politics—should have divergent policy preferences was unsurprising. That he should be joined by Daim—a close confidant of Mahathir, the foremost figure in the UMNO-connected corporate world and no friend of Anwar—was much more significant. Mahathir's own supporters in the party were becoming anxious as their personal fortunes declined in tandem with the stock market. In good times, the prime minister's dominance of the cabinet and the party was far-reaching. But unified advice of party disquiet was a serious issue that no leader could take lightly. In a parliamentary framework of this sort the political survival of the leader as well as control of policy rested on the same thing: support within the party. Following the ensuing party meeting, Mahathir announced a tactical policy retreat from some unorthodox policy measures: he reversed the ban on short-selling he had launched the day before, and he reversed his earlier stance on the big infrastructure projects, conceding now that some of them would have to be delayed in the interests of reassuring nervous investors.

Markets rallied in response to this suggestion that the prime minister would take a less stridently unorthodox posture, but the uptick was short-lived.[56] In late September Mahathir began to renew his rhetorical attacks on foreign speculators for undermining the hard-won development achievements of countries like Malaysia and called for the introduction of international controls on capital flows. And with market indicators again falling rapidly, ratings agencies began to downgrade Malaysia's foreign and local debt risk, citing the government's failure to tighten monetary policy.[57] In late September there was a run on the country's largest finance company, MBf Finance, that only subsided when the central bank announced it would make funds available to cover all depositors. And the budget announced on 17 October received a negative market reception, with critics attacking it for not including any major new commitments to monetary or fiscal discipline while simultaneously handing out corporate tax cuts and for employing very optimistic growth projections. The only gesture in the direction of orthodoxy was the

54. Athukorala 1998, 97.
55. *FEER,* 18 September 1997, 65.
56. *EIU,* Malaysia, fourth quarter 1997, 23.
57. *EIU,* Malaysia, fourth quarter 1997, 23–24.

announcement of a requirement that banks increase provisions for bad loans by half a percentage point to 1.5 percent of total lending.

Mahathir remained undaunted by the persistently negative market reaction to his unorthodox policy stance. He continued periodically to attack foreigners and in November approved controversial bailout operations to selected corporate groups. Policy rhetoric and policy action were closely matched. He was, however, becoming increasingly frustrated and embattled. Under his direction policy was clear and coherent—it was determinedly expansionary and sought to restrict short-term foreign investors. But it was failing conspicuously to stem the slide in business confidence. Recognizing the seriousness of the situation, he reluctantly agreed that other policy options be explored. In operational terms this meant ceding more initiative to Finance Minister Anwar, who, armed with central bank and IMF advice, was urging the adoption of a much more orthodox policy response to the crisis. But as a political hedge against allowing his ambitious deputy to move toward economic center stage, in late November Mahathir also announced the formation of a new National Economic Action Council, placed under the leadership of his close party ally Daim Zainuddin, which was to be given unspecified emergency powers.

In early December, after receiving approval from the cabinet, Anwar unveiled a major set of strongly orthodox reforms that were widely viewed as the most important policy turning point in a decade.[58] Among the key elements were an 18 percent budget cut, an indefinite postponement of all big infrastructure projects still in the pipeline, a halt to new outbound Malaysian investment (previously a pet project of the prime minister), and an instruction to banks to limit lending only to "productive" undertakings and not to flinch from cutting support to nonviable firms. This was a stark swing in policy. The stock market surged on the news.

The sharp swing toward orthodoxy was infused with intense political implications, for it suggested that Anwar, who in the preceding months was limited to cleaning up after Mahathir's outbursts on restraining global capital, had now succeeded in prizing significant policy initiative away from the prime minister. Through December and the early part of 1998 Anwar pushed ahead with the orthodox agenda. To strengthen the financial sector, Anwar pushed for mergers among banks and finance companies and announced tighter prudential measures for banks and brokerage firms.[59] Particularly important were the deliberate moves to tighten monetary policy, with BNM pushing interest rates up through the first and second quarters of the year.

While Anwar's deflationary macroeconomic policies and tougher prudential arrangements in the financial sector were winning praise from the IMF, Mahathir, in conjunction with Daim, was working to ensure that the tighter financial environment did not undermine the corporate empires of key party supporters. Bailouts and assistance measures of various sorts were provided to a number of major firms, most

58. *FEER,* 18 December 1997, 14–15.
59. See Haggard and Low 1999, 14; and *FEER,* 15 January 1998, 52.

notably, the state oil company, which came to the aid of the prime minister's oldest son's business group.[60] The underlying tension between the two opposing policy strategies came to a head as 1998 progressed.

Anwar's position was weakened as official data and ratings agency assessments revealed that far from improving, Malaysia's economic conditions were deteriorating further. Despite Anwar's austerity measures and declarations about sound economic policies paving the way for recovery, the economy continued to slow, even contracting in the first quarter of 1998. And with this, nonperforming loans began to rise rapidly.[61] Anwar continued to call for patience and perseverance with tight monetary and fiscal settings and strict bank foreclosure on bad debtors. But with this approach failing to yield evident fruit and pointedly threatening the interests of key corporate allies, Mahathir and Daim began publicly contradicting his policy signals through the second quarter of the year. With growing force, they cast doubt on Anwar's orthodox efforts, publicly urging an easing of interest rates and a revival of public spending to support the previously shelved big infrastructure projects.[62]

What were investors to think? Where was policy now heading? Strong but highly capricious policy responses were coming from the government. Underlying this was the submerged rivalry between Mahathir and Anwar. With an important meeting of the party national assembly looming in June, both were taking stock of the implications of the country's economic malaise for their standing in the party. But instead of pursuing the policy rigidity occurring in Thailand, Mahathir and Anwar were both vigorously implementing their separate agendas. The net effect was severe policy volatility. Policy control was heavily centralized: whatever the cabinet wanted could be put into practice expeditiously. Beyond the need to avoid a showdown within the party, there were no institutional checks on executive action. In the second half of 1997 Malaysia had pulled strongly in an unorthodox and expansionary policy direction, and then in the first quarter of 1998 it had reversed direction and pulled strongly in an orthodox direction. And now, in the second quarter of 1998 it was pulling strongly in both directions at once, with the two ministers tugging at different policy levers.

The policy volatility was becoming less and less tolerable for investors. As one businessman complained, "There's a lot of risk that's not quantifiable because of the flip-flops."[63] Both economically and politically, the situation was becoming unsustainable. A catalyst for change was provided by the stunning economic meltdown in neighboring Indonesia and the political fall of Suharto in late May. This strongly colored the situation in Malaysia and helped transform a debate over policy into a de facto shutdown of party leadership. Anwar's supporters seized this political opportunity and began drawing parallels between Mahathir and Suharto and openly

60. See Jomo 1998a, 186–89; and Haggard and Low 1999, 10–17.
61. *EIU,* Malaysia, third quarter 1998, 18, 23.
62. *FEER,* 18 June 1998, 18–21.
63. *FEER,* 21 May 1998, 24.

calling for an end to nepotism and corruption at the annual UMNO general assembly in mid-June. But despite the difficulties, Mahathir was in a stronger position than Anwar within the party. In the face of this all but openly declared challenge to his authority, Mahathir now acted swiftly to exploit the full institutional powers of the prime ministership and the party presidency to move against his opponents. In a party purge rolling through July and August, Mahathir forced the resignation of Anwar supporters from key posts, brought Daim formally into the cabinet and vested him with special economic powers, and squeezed out the governor and deputy governor of the central bank.

With Mahathir pushing Anwar to the margins, the ambiguity in economic policy was removed and the direction of economic policy swung hard around. Yet again. Monetary policy was relaxed, allowing interest rates to fall. Recently tightened bank statutory reserve requirements were again loosened. The government also signaled that public spending would again be pumped up and that measures would be introduced to assist firms in distress. And, in his most dramatic move, as international ratings agencies continued to downgrade Malaysia, at the end of August Mahathir ordered that all international trading in Malaysian stocks be halted, currency convertibility be suspended, and the exchange rate be lifted and pegged. Anwar's desperate efforts to backpedal and swear allegiance to Mahathir were in vain. A day after decoupling the economy from the international financial system, Mahathir fired Anwar and soon after had him arrested. Malaysia's sovereign rating fell to junk status; but with the economy already insulated from international financial markets, this no longer mattered.

There is a stark connection between Malaysia's political framework and its management of the financial crisis. Such strong surges in one policy direction and then the other and then back again would not have been possible in Thailand or even the Philippines. The existence of other veto players would have prevented this volatility in Thailand and substantially constrained it in the Philippines. Policy actions would have been neither so strong nor so varied. But Malaysia's institutional framework was much more permissive of flexible policy action—strong action in any direction. A complaint at the time captured the fundamental problem investors faced: "The political situation is highly unsatisfactory. We've seen constant U-turns and doubling back on policy in recent months. If the capital controls don't work, will he reverse himself again?"[64] Rapid and radical policy reversals—made possible by the institutional framework of politics—had turned what should have been a difficult but manageable economic adjustment into a disaster.

Indonesia

Simply put, Indonesia's experiences in the financial crisis provide an even more extreme version of Malaysia's story of policy volatility.[65] Indonesia was the fourth

64. *FEER,* 17 September 1998, 11.

65. For a more detailed discussion of Indonesia through the financial crisis, see McLeod 1998; Robison and Rosser 1998; Soesastro and Basri 1998; Pincus and Ramli 1998; and Hill 1999.

Southeast Asian economy to be drawn into the regional crisis and was the most extensively damaged. Reflecting the stunning investment reversal, growth contracted severely (–13 percent in 1998), and the corporate and banking sectors experienced a traumatic shakeout (about half of Indonesia's 128 banks closed). Like Malaysia and the Philippines, Indonesia was not thought to be an economic disaster waiting to happen in mid-1997; in fact its economy looked good. Observers regarded its key macroeconomic indicators as quite solid.[66] Inflation was moderate. The current account deficit to GDP ratio was lower than all of the other Southeast Asian cases (and half that of Thailand). Further, there was no sharp asset-price bubble, no indicators of capital flight, the stock market was not falling, and any pressure on the rupiah was in an upward rather than a downward direction. To be sure, like the others, Indonesia was not without economic problems. Observers recognized that serious weaknesses existed in the banking sector with nonperforming loans, but this had not become a focal point as it had in Thailand. Also, though not well recognized at the time, Indonesian firms were borrowing extensively from foreign lenders on a short-term basis. And, as elsewhere, the real value of the exchange rate had been kept stable for many years. But even more than its generally favorable economic condition prior to the onset of the crisis, the reason the Indonesian case is so interesting is that through the early stages of the crisis the government was widely celebrated for its handling of the situation—in marked contrast to Thailand and Malaysia. In spite of this, as time progressed the government's strong policy responses became increasingly changeable and destructive of investor confidence.

Once the baht depreciated, as elsewhere in the region, it was inevitable that the rupiah would have to adjust. The government responded swiftly to this situation. Despite the pervasiveness of corruption and rent-seeking activities, like its Malaysian counterpart, the Indonesian government enjoyed a reputation for generally sound macroeconomic management; and, further, in the face of major economic destabilization, it had repeatedly demonstrated itself capable of rapidly undertaking far-reaching structural forms. Even more so than in Malaysia, executive authority was centralized in Indonesia. As in Malaysia, there was only one veto player; but whereas this was a collective entity in Malaysia (the party leadership), in Indonesia it was a single individual, the president. To be sure, Mahathir was a very dominant figure in Malaysian politics, but unlike Suharto he did need to have close regard for his position in the party because of Malaysia's parliamentary structure. An additional consideration, of course, was that the more authoritarian nature of politics in Indonesia further heightened the president's personal dominance of the political system in an unmistakable if informal manner.

Where Malaysia initially pursued a determinedly nonorthodox policy approach, Indonesia did the opposite. In a preemptive move, on 11 July the central bank, Bank Indonesia, widened the daily trading band of the rupiah from 8 percent to 12 percent;

66. See Hill 1998; Radelet and Sachs 1998; World Bank 1998; and Hill 1999, 5–10.

once it became clear that this would be inadequate to contain the pressure created by firms with unhedged foreign borrowings rushing to buy dollars, on 14 August the rupiah was cut completely free. From this point the government's policy response quickly moved into high gear. The president set the tone with a sober assessment of the financial instability in his independence day speech on 17 August. Across the policy spectrum, strong response measures were unveiled in a bid to shore up confidence in the government's preparedness to tackle the situation frontally. The first and most important moves came with monetary and fiscal policy. In mid-August the government introduced a sharp liquidity squeeze in an effort to encourage investors to hold rupiah deposits. Following a strategy Jakarta had employed successfully in earlier years to deal with currency instability, the central bank moved to push up interest rates, and, separately, the finance minister ordered state enterprises to transfer deposits from commercial banks to the central bank. Going even further, the finance minister actually froze all government spending for two weeks.[67] Combined, these measures dramatically drained liquidity from the interbank market, sending interest rates extremely high.

On the fiscal front the government announced its plans to cut expenditures and to introduce new taxes on luxury goods to ensure a stable budgetary position. Importantly, it also signaled that a number of costly and controversial infrastructure projects would be postponed and that a second cluster would be reviewed. Its deferral of the big infrastructure projects was particularly welcome, since in addition to the fiscal implications this move suggested that the government was willing to rein in the excesses of the president's children and cronies who were involved in many of these projects. In the financial sector the government announced the lifting of restrictions on foreign ownership of shares for companies listed on the Jakarta stock exchange, and the central bank signaled that it would consider closing a number of struggling banks. Other flagged measures included a tariff cut on a range of industrial inputs with a view to assisting exporters.

The rupiah stabilized in September with market commentators celebrating the strong orthodox measures the government was unveiling.[68] However, when the rupiah again fell in early October, the government called for IMF assistance and by the end of the month had signed a sweeping agreement for up to $23 billion worth of financial support. Under the terms of the agreement, Indonesia committed itself to an intensification of the strategy it had already begun. Jakarta moved much faster than Bangkok or Manila in collaborating with the IMF. Almost immediately it began implementing measures for the closure of sixteen banks, the abolishment of several big import monopolies, the reduction of tariffs on industrial imports, a cost-cutting review of big-spending state-owned strategic industries, and the removal of entry barriers for foreigners to wholesale and distribution activities. Many of these measures promised to diminish the business privileges of Suharto's

67. Interview, Soedradjad Djiwandono (governor of the central bank during the crisis), 14 January 1999.

68. See *FEER,* 4 September 1997, 62; and *Asian Wall Street Journal*, 5 September 1997, 5.

relatives and key cronies. This was reminiscent of past episodes of severe external economic shock, such as when Suharto in the mid-1980s authorized sweeping reforms, including temporary but significant cutbacks to the business interests of relatives and cronies.[69]

By comparison with events elsewhere in the region, the speed and scope of Jakarta's adjustment measures were stunning. The massive centralization of authority in Indonesia made it possible to do this. Everything could be handled executively; and once Suharto gave his assent, there were no institutional actors capable of reviewing, much less vetoing, policy action. But as we saw in the Malaysian case, just as a heavily centralized veto authority makes possible strong action in one direction, so does it also enable rapid reversal. No sooner had the government begun unleashing these orthodox measures than it began pulling in precisely the opposite direction. In the flurry of activity implementing the terms of the IMF agreement, Suharto also signed a decree authorizing the initiation of eight of the big infrastructure projects postponed back in September and seven of the projects supposedly being held for review.

What were Suharto's true intentions? This was a stark reversal, and more was to follow. Shortly after having his bank closed, Suharto's second son was standing before the news cameras gloating that he had taken over another bank and was back in business. The next day, 21 November, the head of the chamber of commerce told the media that Suharto had agreed that some $5 billion provided by the Singaporean government for currency stabilization could now be used to bail out struggling Indonesian companies. This not only went against the intentions of the Singaporean government but also breached the whole spirit of the IMF agreement, which was pointedly against corporate and bank bailouts. The government subsequently issued a denial, but the damage had been done.

Policy signals were becoming increasingly volatile. As these various developments unfolded in the media through November, uncertainty about the policy environment mounted and the slide of the rupiah began to accelerate. But perhaps the most devastating reversal of all was what amounted to a 180-degree swing in monetary policy from November as a result of a desperate bailout of the banking sector. The banks were by now in dreadful shape, having been battered by an extremely tight liquidity squeeze, rising loan defaults, and withdrawals by panicked depositors after the closure of sixteen banks. As the banking sector slid toward insolvency, the president declared that there would be no more bank closures, and the central bank was forced to make special liquidity credit facilities available to keep distressed banks afloat. Even more so than the bailouts of well-connected Thai finance companies, this move proved to have disastrous macroeconomic consequences. Whatever the government's intentions, the result of this move was that banks rapidly lined up for assistance, with crony banks returning repeatedly and drawing vast sums. The largest such bank, Bank Central Asia, alone soaked up Rp

69. MacIntyre 1992.

35 trillion (roughly US$7 billion in late-1997 prices), amassing liquidity support equivalent to more than 500 percent of its capital.[70] As was later publicly confirmed, crony banks immediately misappropriated the liquidity credits, siphoning them out of the country and speculating against the rupiah. This massive expansion in the money supply from November onward had devastating consequences. Notwithstanding continued high bank lending rates, it led to a rapid upward revision of inflationary expectations, encouraging capital flight.

Policy signals had become hopelessly changeable. The government was taking strong policy steps, but they frequently represented a negation or outright reversal of earlier moves. This was an impossible situation for investors; the wild policy swings were completely destroying the investment environment for crony and noncrony firms alike.

Indonesia's economic situation began to deteriorate alarmingly through November and December. By the end of 1997 the currency had lost 54 percent of its pre-crisis value, already exceeding the low points of all other crisis-affected economies. And following the very negative local and international reception of the new budget presented on 6 January, outright panic set in and consumers began hoarding. As the currency went into free fall, investor confidence was utterly routed. The IMF rushed to draw up a still more radical reform package, but the situation had deteriorated too far. Indonesia's heavily centralized political structure allowed Suharto to cling to power for several more months until the economic dislocation set in motion by the earlier destruction of investor confidence eventually triggered mass protesting, elite fragmentation, and, finally, his fall in late May 1998.

As in Malaysia, the absence of institutional constraints on executive power meant that policy could be adjusted quickly. In Indonesia the government responded to the onset of currency instability by rapidly pursuing a strict orthodox policy path—even before the IMF arrived. Monetary and fiscal settings swung hard in a contractionary direction. Indeed, it seems likely that the initial liquidity squeeze was so severe that it triggered much of the ensuing difficulty in the banking sector and compounded the problems in the real sector.[71] But there was no institutional monitoring or coordinating—much less a veto—on any of the actions the executive took. And as the consequences of early powerful policy action began to work through the economy—reinforced, as elsewhere, by ongoing external buffeting—the problem became multidimensional. Like other governments, Jakarta was fighting fires on many fronts, struggling to cope with urgent and competing demands from diverse constituencies. But where Ramos, and even more so Chavalit, had to obtain agreement from other veto players for action to proceed on many issues—indeed, even Mahathir had to have some regard for his party colleagues—Suharto could unilaterally order strong and immediate action on any front. And so, by the fourth

70. *Jakarta Post*, 1 October 1998. It is unclear exactly how much money was released through this liquidity credit operation. According to the *official* figures, the total may have reached Rp 92 trillion, in which case BCA would have consumed more than a third of its own capital. McLeod 1998, fn 6.

71. See McLeod 1998; and Fane and McLeod 1999.

quarter of 1997, the overall policy picture had become increasingly conflicted and erratic. This was not a simple story of policy error or even venality (though both were certainly present); more fundamentally, it was an unconstrained presidency taking powerful but conflicting steps in response to the increasingly powerful and conflicting problems of diverse constituencies. The net effect was severe policy volatility. The institutional framework did not on its own cause this syndrome—we need to factor in other elements to get the complete story—but it could not have happened without it.

For investors the overall policy environment became intolerable. Promises made one day were, in effect, reversed the next. Projects were suspended and then reinstated. The currency was floated freely and then the central bank intervened heavily in currency markets. Banks were closed and then reopened under a new name. Monetary policy was severely contractionary, and then it was, in effect, radically expansionary. With policy signals fluctuating so wildly and with there being no institutional mechanism for the government to make credible policy commitments, it is scarcely surprising that there was rapid and total collapse in investment. Investors had no basis for predicting government policy nor for trusting government promises. Exit was the only reasonable option.

Conclusion

My primary aim has been to argue that by focusing on the institutional framework of politics we gain powerful insight into the differing responses of Southeast Asian governments to the unfolding crisis and, in turn, the severity of the fall in investment. I suggest that we can isolate a systematic relationship among the distribution of veto authority, the overall character of the policy environment, and the reaction of investors. Politics was integral to the economic crisis, and I offer an institutionalist theory to identify the key political variables.

Successive governments in Thailand suffered from policy rigidity and were simply unable to address the mounting problems in a timely fashion. Malaysia and Indonesia suffered from the opposite syndrome: powerful policy responses that vacillated wildly, creating profound uncertainty about the future investment environment. At either extreme, the management of the overall policy environment in Thailand, Malaysia, and Indonesia made matters much worse. Alone among our sample, the Philippines was able to maintain a steady course. Whether or not Manila's particular policy mix could have been better, it was at least steady, coherent, and timely in its delivery.

To argue in this way is not simply to follow Goldilocks in preferring one's economic porridge not too hot and not too cold. Policy rigidity and policy volatility are generic syndromes that create real problems for investors. Importantly, these generic syndromes can be directly linked to the institutional framework of politics. A heavy concentration of veto authority, especially in a weakly democratic or authoritarian context, produces an inherent risk of policy volatility. A wide dispersal of veto authority produces an inherent risk of policy rigidity. Intermediate configurations make policy sticky but leave some room for adjustment. It is certainly not the case that intermediate configurations prevent external shocks from hitting or ensure that governments will “get it right,” but they do reduce the likelihood of either of the extreme policy syndromes discussed here. More broadly, I am not claiming that the distribution of veto authority was the “key” to the crisis. The institutional framework alone is not a sufficient factor to explain the diverse outcomes, but it is a necessary factor. Institutions do not drive policy, but they do impose parameters on what is possible.

I have heavily emphasized the utility of an institutional lens, yet plainly it has its limits. The approach here has had little to say about preferences and even less about underlying interests. Unquestionably, a richer and fuller account could be achieved by layering in other factors. While recognizing these limitations, the virtue of this approach is that it provides an effective basis for systematic comparison across cases, including those in which electoral competition may be limited and party systems very fluid. This is a major boon for anyone dealing with developing countries.[72] In substantive terms the argument here reaches well beyond the Asian economic crisis in proposing a model in which, at least during a time of crisis, there is a U-shaped relationship—or more simply, a relationship that passes through a minimum—between political institutions (the distribution of veto authority) and investment (policy risk for investors). I have argued on an a priori basis that both policy flexibility and policy stability are important for investors and thus that a severe shortage of either is likely to produce an unsatisfactory environment for investors. In other words, having more than one veto player reduces the risk of policy volatility, but there is some point of inflexion after which additional veto players become a liability and serve only to promote policy rigidity.

In order to build this argument, I have presented in stark terms the relationship between institutions and investors and the trade-off between flexibility and stability. Plainly, a more nuanced analysis is needed to further develop the core ideas presented here. I have made little explicit allowance for interactive effects between changing economic conditions and the consequences of the overall policy environment for investors. Similarly, one might consider distinctions in regime character—for instance, a higher premium might be placed on stability and credibility in an authoritarian context. The exploration here is an initial case-driven foray into the connections linking institutions, policy, and investment. There is much room for further debate and research.

In reflecting upon the possible wider application of this argument, there is reason to believe that it will have most utility for developing country analysis. In many

72. The problem of handling imperfectly competitive or noncompetitive electoral processes has been a significant barrier to the extension of key parts of the institutionalist arsenal to weakly democratic or nondemocratic developing countries. Most notable in this context is the extensive theorizing about the implications of different electoral systems, resting as they do, on arguments about strategic voting. See Moser 1999.

ways, the cases illustrate institutional extremes—extreme concentration and extreme dispersal of veto authority. Most advanced industrial democracies are located near the center of the spectrum and thus are less susceptible to stark differentiation based solely on distribution of veto authority. (And those few cases that do have a heavy concentration of veto authority—such as Britain's Westminster framework—enjoy the countervailing effects of thick democracy, in which independent judiciaries, independent central banks, and a web of commitments to substantive international institutions help reduce the risk of policy volatility.) The opposite is the norm in developing countries. Developing countries are much more likely to be located near the extremes of the spectrum, either because democracy is weak or nonexistent and veto authority is therefore heavily centralized in the executive, or because, in those that are democratic, party systems are more likely to be fluid, fragmented, and weakly differentiated in policy terms, thereby increasing the probability of widely dispersed veto authority. And, of course, developing countries typically have only a thin veneer of social, economic, and other restraining institutions surrounding government.

These ideas must await further debate. But even if this tight analytic focus on the distribution of veto authority has greatest utility for developing countries, significant headway has still been made. For the foreseeable future it is likely that in the world's many developing countries—countries that are increasingly coming to the attention of students of international political economy—the distribution of veto authority will remain very consequential both for policy and for investors.

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