The Institutional Basis of East Asia's Economic Crises

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Abstract

Restructuring and modernization of basic political institutions is the crucial key for long-term recovery of East Asia's crisis economies. These steps are necessary to restore confidence and allow for their economies to stabilize as the first step towards recovery. Then they must recapture or reengineer their respective competitive positions in the global economy. Long-term competitiveness will require gains in overall productivity embodied in advanced technical systems and greater investments in human capital. Unfortunately, East Asia is lagging in these areas. High prestige projects have given a false impression of widespread adoption of new technology that has actually been quite low for most of the region.

The Economic Crises Afflicting East Asia

The analysis of the East Asian crises offered herein departs from an understanding of the nature of the interaction of economic and political institutions with market processes. A link is drawn between the underlying political culture and a set of institutional arrangements that it engenders. In turn, this institutional infrastructure defines a set of incentives within which economic decisions are made. Faulty institutions will send misguided signals such that decisions that appear to be *rational* when judged upon internal criteria are proved to be irrational and inefficient when compared to external standards. A number of propositions or observations will be outlined and then explored.

First, the economic crises afflicting East Asia after July 1997 can be considered to have been self-inflicted in that they reflect a general failure of governance. In effect, the turmoil resulted from systematic politicization of domestic financial markets. Policies of directed-development were followed in most of the countries in the region. As such, investments for development were directed through banks while domestic capital markets were suppressed.

Second, it follows then that global capital flows were not the cause of the crises. These footloose flows merely transmitted the message that the institutional framework of the East Asian economies would no longer be considered to be compatible with the demands of the international marketplace. Overall conditions of competition changed the rules of the game. Political and economic institutions that were once thought to help promote growth in the region began to serve as a drag. Judging from the resignation of former Indonesian President Suharto, global capital can now be seen as a liberating force that displaces dictators and inept rulers.

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Third, East Asia's problems are deep-seated and arise from elements of political culture and similar development policies that are evident throughout the region. As such, resolution of the crises requires radical changes that must include the introduction of greater political accountability and increased financial transparency. Participation in the global marketplace will induce reluctant leaders to embrace modernization of their political and economic institutions.

Fourth, before these economies can recover, they must first stabilize. Stabilization can only begin after they reach bottom. Japan's state of arrested collapse that began at the end of the 1980s inspires little confidence that its neighbors can act more quickly or more resolutely. There are no good estimates of how much longer Indonesia will experience economic decline. Even though there are some encouraging signs of progress in South Korea and Thailand, the crises are in the early stages of Malaysia and Singapore.

Fifth, recovery from the crises involves a long-term, structural adjustment. These problems are *not* merely a brief, cyclical downturn. Restoration of confidence in Asia's economic future, and with it the return of foreign capital will depend upon a willingness to abandon culturally-imbedded institutions. This may require decades or even generations.

Sixth, there is a widespread misunderstanding of the modernizing process brought about by the global economy. An oft-repeated confusion is that modernization is linked to Westernization or even Americanization. Such suggestions are misplaced and smack of an inappropriate sense of cultural triumphalism. Modernization is a universal process and is best interpreted as the implementation and evolution of individualist-based institutions.

Why (Free) Institutions Matter

Institutions are systems of rules, conventions, laws or customs that serve as enabling mechanisms discovered through the process of human interaction. Such arrangements emerge and endure inasmuch as they reinforce stability within a community or facilitate change by reducing uncertainty. The rule structure of institutions provides an aspect of predictability in the course of social interplay. This predictability arises from the incentive structures embodied in the institutions that guide individual choices and shape the social impacts of these decisions.

Since institutions define incentives and impact upon choice, the overall institutional arrangements have considerable economic import. In particular, markets both depend upon and set the stage for the emergence of a contract culture and commercial morality. In turn, institutional frameworks will evolve to reinforce and reward or punish actions in reference to the agreements and the legal institutions that support them.

Virtually every country in the world has undertaken a voluntary path to participate in the international market economy. Therefore success as measured by sustainable growth will require an environment compatible with markets.

Countries with institutions that provide strong protections of property rights along with relatively low costs for innovations can be expected to have economies that perform better. An effective system of property rights invests ownership and control of productive properties and means of distribution in private hands. These rights require a firm legal underpinning that include constitutional guarantees, effective laws, and an independent judicial system with the will and ability for enforcement. Qualities of innovation and receptivity to change are not limited to the economic realm and should include politics. In this latter regard, valuable lessons might be learned about political and corporate accountability associated with the rise and decline of the East Asian economies.

Cultural change and economic growth reflect the speed of learning expressed through the learning process. Entrepreneurial action is the search and application of new knowledge that occurs when there are adequate payoffs from the expense of their quests. As such, institutional arrangements based upon openness and that encourage competition will offer greater opportunities for entrepreneurial innovation. In contrast, the presence and enforcement of monopoly imposed by government mandate will retard learning and put a brake on economic growth. Consequently, a strong case can be made for the linkage between economic liberty, as seen in institutional arrangements that promote free markets, and high growth.

Through the Past, Brightly

While the pace of material advance in East Asia over the past three decades has been admirable, the idea of an ascendant *Asian Century* has proven to be fraught with difficulty. One crucial flaw was that it was based upon an understanding that expanding international trade is a zero-sum game with Asia portrayed as a *winner* at the expense of *losers.* Second, continued success with high economic growth has proved to be more difficult than those that assumed that it would arise from a simple extrapolation of past performance.

A fruitful approach to understanding the past and anticipating the future for East Asia lies in an examination of the institutional arrangements and development strategies common to much of East Asia. This requires a long view combined with an understanding of the requirements for market-driven growth to be sustainable. Following this line of reasoning, there is good reason to doubt rapid return to stability and a recovery in the high growth rates once enjoyed by the economies in the region.

Inherent conservatism and inflexibility of East Asia's economic and political institutions were once widely seen as the basis of high growth in the region. However, it has become clear that the institutional arrangements were incompatible with the demands of an increasingly efficient global market.

In particular, the boom period for many East Asian economies was coincidental with a form of *corporatism* as a guiding paradigm for economic development. This framework involves a close cooperative relationship between politicians, technocratic bureaucrats, and an established business elite, often with the collusion of trade unions. The German and French economies have operated along these lines where *insiders* oversee policies to protect their special interests that often serve to disadvantage *outsiders*. In general, *outsiders* are consumers who pay higher prices and have less choice or workers not covered by the arrangements or small or medium sized firms that are or would be new market entrants.

Asian traditions upon economic and political structures to create a regional variant, identified here as *Confucian corporatism*, that reflects corporate practices familiar elsewhere. For example, key elements of Confucianism like *filial piety*, *saving face*, and *society above self* serve to reinforce the hegemony and hierarchical political structures of Asian corporatist arrangements. In Japan, this arrangement became known as an *iron triangle* wherein bureaucrats, businesses, and politicians work together under conditions of close consultation.

Corporatist arrangements are credited with increasing harmony and cooperation in the work place but they might simply have been coincidental with initial high rates of economic growth. Corporatism was also associated with the original *miracle* economy in postwar Germany. However, it is likely that the current economic malaise in both countries arises from rigidities associated with their institutional arrangements.

Historical experience suggests that corporatist institutions suffer from internal contradictions in that they spawn rigidities in economic relations that retard economic growth rates. Ironically, the institutional arrangements previously said to be part of the winning formula for many East Asian regimes continue to undermine stabilization and inhibit recovery of their economies.

For example, the growth strategy of most East Asian countries included a substantial involvement by governments. This included government-directed investment that was funded through taxes and forced savings. In addition, governments often guided bank lending to promote export-oriented industries by offering subsidies and tax incentives to multinationals. This was combined with capital friendly policies to encourage foreign direct investments and technology transfers.

But most of these policies can only be part of a short-run strategy. In the face of economic fundamentals, subsidies are unnecessary. Indeed, they are economically irrational since they will have no positive net impact on jobs. Such attempts to protect employment in one sector generate price distortions and misallocation of resources in other sectors that lead to offsetting job losses.

In sum, most governments in the region overlooked the necessary development of their infrastructure for their modernization. While prudent actions were often undertaken to provide *physical* infrastructure (roads and railways, communications, seaport and airport facilities), there was a neglect of the intangible infrastructure expenditures and human capital investments. In general, this meant that the institutional arrangements were not in place that would make their economies compatible with the changing demands of the global capital market.

The presumed successes of an *Asian model* provided a cover for the dysfunctional democracy of one-party or one-family regimes. In most East Asian regimes, political longevity was seldom a function of a true and unshakeable approval of their citizens. More often than not, electoral success reflected a grip on power based upon either the carrot of cronyism or wielding the stick of fear. More benign methods involved co-opting key elements of the civil society through trade unions guided by supporters of the regime or filling key university posts with sycophants or concocting laws that could be used to tame the media.

An underlying element of the crises emerged from the politicization of the domestic financial markets throughout the region. Their policy of directed development involved a purposeful weakening of capital markets so that commercial and industrial investments were directed through the banking system. Bank managers are much easier to control than are the millions of individual investors who would participate in open markets for equities and bonds. Government-directed investments and subsidized interest rates resulted in massive conglomerates like the Japanese *keiretsu* and Korean *chaebol* that diverted vast amounts of funds into non-economic activities.

On the one hand, stunting the growth of long-term debt markets supported the policy objectives of the government but encouraged domestic capital to be used inefficiently. On the other hand, in absence of an active domestic bond market, foreign portfolio funds went into the stock market. But heavy reliance of corporate enterprises upon bank financing meant that equities were thinly-traded and have proved to be vulnerable to fickle foreign capital flows.

Economic Growth: Inspiration; Perspiration; Luck…?

A key element of the catch-up process in much of East Asia was the shift of labor and other resources from agrarian production toward industrial output, especially evident in Japan, Korea, and Taiwan. As these economies modernized, labor resources were released from farming and were combined with increasing numbers of women seeking employment. This massive mobilization of the overall labor force allowed a substantial boost in production when combined with new capital investment.

The consequence of this input-driven approach to growth became the object of an interesting and lively debate stimulated by Paul Krugman in an article in *Foreign Affairs*. Professor Krugman pointed out similarities of East Asian experience with early stages of development in the USSR. Although many of the East Asian economies have made large expenditures on physical and human capital, these actions are non-repeatable.

In this context, economic growth in much of East Asia has arisen from massive increases in inputs that will unavoidably boost output, at least initially. Growth may continue to increase, but it will increase at a decreasing rate. Without gains in productivity, rates of growth will eventually decline. An economy with high rates of investment will eventually attain a higher level of income than one with lower rates of investment, but income gains will experience diminishing returns. Furthermore, since investment involves the sacrifice of current consumption excessive levels of saving and investment reduce economic welfare.

Maintaining increases in productivity became more difficult as operating costs rose rapidly in most of the high growth regions of East Asia. With rising costs exceeding productivity gains, production facilities began to migrate to areas with lower costs and greater profit opportunities.

This problem may become more acute in China. In early 1996, the Beijing regime rescinded tax breaks previously offered as a lure for new foreign investments. At the same time, costs of housing for expatriates in controlled property markets are soaring, and there is continued interference and financial impositions from corrupt officials. Also, there is a scarcity of skilled labor and management talent. Delivery costs are rising due to regulations in the transport industry. There will have to be substantial increases in productivity gains or growth will begin to slow dramatically.

While the economic logic in the Krugman logic is intact, the crises afflicting East Asia did not stem from this process. In this sense, Krugman was right about the fact that growth would slow in East Asia, but for the wrong reason. Problems with returns to scale would not likely to have arisen until well into the next millennium.

Indeed, the *miracle* growth of the East and Southeast Asian economies may be no different from the high-growth record exhibited by other countries during the early stages of development. Most East Asian economies relied heavily upon off-the-shelf technology and access to markets in the mature economies to fuel their growth. Without developing their own domestic entrepreneurial talent and self-generated technological advance, East Asian economies will be followers, instead of world-class leaders. Like Germany and America prior to World War I, East Asian economies benefited as much from expanding product and resource markets as they have from their own development strategies.

The sustainability of economic growth was also undermined in those countries with a heavy dependence exploitation of non-renewable resources. Whereas these limits occurred in the Philippines during the 1970s, they are becoming apparent in Indonesia and Thailand. The obsessive drive for adding to material wealth in the short run may lead to a serious deterioration in the environment for living generations in many of the Asian countries. In many cases, these problems arise out of government action that leads to overzealous exploitation as politicians and bureaucrats scramble to cut themselves in on sweetheart deals.

Authoritarianism, Collectivism and Economic Growth…?

The East Asian crises have generated a number of casualties concerning views on the role of governments in economic development. The first is the myth that authoritarianism is good for growth. A corollary to this view stressed the importance of political connections as a necessary and sufficient condition for business success in the region. Another mistaken view was that collective decision making would provide superior results to reliance upon individualist-based institutions.

Many Asian cultures rely upon methodical deliberation towards reaching a voluntary or enforced consensus. This tendency reflects a belief that the imposition of order provides better results than does the messiness associated with the open discourse of competitive processes. However, a good case can be made for encouraging involvement of a large number of free thinkers when issues become increasingly complex. My own experience as a professor has revealed that uninitiated students ask the most interesting questions and answers because they do not know better!

Much of the now-dormant debate revolved around claims that an Asian version of democracy combined *positive* features of authoritarianism with popular rule. Authoritarian regimes invoked the notion of *Asian democracy* to hide behind a legitimizing veil while they restrained modernization and change that threatened to disrupt the political status quo.

One serious side-effect of the institutionalized collectivism common in parts of East Asia will be an accelerated *entrepreneurial brain drain.* The discouragement of institutions that promote individualism frustrates native entrepreneurs who are likely to seek a more hospitable environment outside the region. An entrepreneur does more than buy low and sell high. It is unlikely that ersatz entrepreneurs will be able to provide the innovative spark of *true* entrepreneurs who improve market efficiency by exploiting market share opportunities, or by instigating changes to the rigidified policy framework. The subsequent shortage of domestic entrepreneurial talent eviscerates one of the most important internal sources of innovation-based development. Consequently, these countries are likely to remain dependent upon foreigners for access to markets and creative invention.

Despite its potentially disruptive impact on one-party politics, high-growth Asian economies must allow increased flexibility and efficiency in information flows as a precondition for future production. Just as continued world economic growth depends upon a regime of expanding free trade in goods and services, the modern global economy requires access to, and production of, knowledge-based commodities. Social progress also depends upon open competition among political and cultural institutions regardless of their geographic origin. Unfortunately, many Asian authoritarian regimes have imposed a form of *cultural protectionism* designed to inoculate their citizens against modernizing influences that might encourage the liberalization of individual rights and freedoms. However, impediments to cultural and intellectual exchanges are likely to be as self-defeating as politically-inspired trade protectionism.

The daunting challenges of the ongoing crises are especially problematic for the authoritarian regimes in the region. This is because successful resolution will involve choices that are antithetical to one-party regimes. On the one hand, an inability or refusal to adapt to constantly changing realities of the globalized economy will postpone the process of stabilization and push recovery further into the future. This undoes the claim to deliver prosperity in return for popular support. On the other hand, relaxation of government economic controls will, per se, undermine the basis of political dominance. Furthermore, the increasingly complicated political relationships that inevitably accompany economic modernization will undermine the management and control capacity of authoritarian leadership. In the long run, East Asian authoritarian regimes must either adapt or die, a choice faced by all economies.

Government Failures and Currency Crises in East Asia: Overinvestment or Malinvestment…?

If Krugman was wrong about what went wrong, what is a better explanation of the business failures in East Asia? The surprise and confusion over the currency and financial crises sweeping through the region in late 1997 and early 1998 reflects the belief that the fundamentals were intact to promote economic growth. A report by the World Bank in 1994 praised the East Asia leadership for getting the *basics right*. This notion must have been in part wishful thinking, since there would be no discussion of a long-term crisis if the fundamentals were in place.

Following conventional wisdom, observers have interpreted the turmoil sweeping through Asian economies as evidence that markets are irrational and unstable. A common notion is that the East Asian economies were victims because they went too far and too fast in liberalizing their markets. It seems as if the discussion of the East Asian development has been locked into ideological confrontations between left and right in the West - with an ensuing loss of clarity and logic.

Most East Asian governments pursued a policy that provided government guarantees of subsidized loans to specific producers for expansion of their operations that exceeded market rationality. But it is not easy to see how these guarantees could lead to *most* companies overinvesting even when they have access to foreign savings. Government subsidy costs would simply be very high. Massive and unpopular conversions of domestic savings into taxes to pay the subsidies would then follow.

The problems confronting East Asia have arisen from a concentrated mass of distorted investments because government guarantees distorted incentives that encouraged investment based upon technocratic or political considerations instead of commercial viability and profitability. In absence of properly functioning domestic capital markets, funds were squandered on ill-conceived projects that exposed their economies to the non-compromising market logic of global capital.

Such malinvestment occurred directly through public spending or the promotion of government-favored businesses, like South Korea's *chaebol*. However, such misdirected investments are principally inspired by monetary or credit policies. In turn, illusory signals arise so that consumers and the business community misinterpret increased money and credit flows as real, permanent changes in the economy instead of mere monetary changes.

Unfortunately, government-guaranteed investments divert funds that might have been placed elsewhere in more economically rational applications. As rates of interest are forced down through credit expansion, there is an illusion that certain activities will be more profitable, especially in higher stages of production. In effect, production is misdirected by artificial changes in relative prices.

The extent of malinvestments depends on the vigor of the induced expansion. A vigorously manipulated expansion in East Asia that simply ran into a financial wall was the cause of the abrupt decline in production in the region. As investors began to understand that the boom was unsustainable, speculative pressures were brought to bear. Although condemned by governments in the region, the motivations behind the speculative actions were homegrown. Speculators were acting as countervailing forces to the counterfeit expansion and provided a force that burst speculative bubbles throughout the region.

Eventually every speculative bubble ends when consumers and producers realize that changes in activity are based upon an inflationary surge. Governments then must choose whether to curb the inflationary consequences of their own loose credit policies, or succumb to self-correcting forces triggered by inflation. Inflation will expose and restore the actual relations in the economy - prices will rise, relative prices will change and exchange rates will fall until a balance between the different parts of the economy has been reached.

Asia's problems have been heavily compounded by industry policies that have created their own malinvestments and have added to those created by inflation. Even in the absence of inflation these policy created malinvestment would have the effect of slowing down productivity growth. The logic of market economics suggests that when politicians and bureaucrats rather than the market allocate resources, there will be a decline in the rates of return on capital and productivity. Only markets allocate to generate conditions of the highest efficiency.

Much attention has been given to the degree of corruption in Asia and its role in recent financial events. While corruption has added to the turmoil, it has not created it. Even in the total absence of corruption the meltdown would have still happened. Interventionist policies that politicized financial markets made it inevitable. The blame for East Asia's crises lies with a failure of governance, not speculators nor irrational investors nor market imperfections.

Truth Hurts: Why the East Asian Crises Surprised So Many

It is interesting to consider why economic turmoil in the region was not better anticipated. There was no conspiracy of silence; however, there was a pattern of slinking away from the truth.

Many Asia watchers who were unable to anticipate what lay ahead apparently chose not to see. While some were bereft of an understanding of the economic fundamentals behind the operations of markets, still others suffered from conflicts of interests that kept them from an offering honest appraisal.

Rating agencies were of little help. As in the case of the Mexican peso crisis, their warnings lagged behind newspaper reports that are themselves both tardy and too often uncritical.

In fairness, few journalists have the training to sniff out theoretical or practical inconsistencies in economic policies. And custom or legal restraints thwart even those with the ability or an inclination to ask the sort of tough questions that might reveal such disharmonies. Many Asian countries require that questions be submitted in advance. In many other countries press restrictions or rough handling of *uncooperative* journalists runs the gamut of assassination to blatant censorship to limitation of circulation of periodicals or expulsion. Local media often face similar or even heavier constraints plus a lower level of investigative initiative based partially upon social conventions. For example, it was nosy foreign journalists that uncovered most of Japan's big political scandals while local coverage followed presentation in the international press.

Foreign diplomats assigned to the region or visiting politicians are congenitally loath to criticize or challenge conventional wisdom. Indeed, many people assigned to the region bought into the idea that an *Asian model* represented a third way between free market capitalism and socialism. Consequently, they were incapable of seeing the rot beneath the surface arising from fatal contradictions with the demands of the global economy.

International bureaucrats at the IMF and World Bank were no better than foreign service personnel. Even though they had or could have had access that should have alerted them to impending problems, e.g., the IMF and the governments of the affected countries were aware of the imbalances in the financial sectors of the crisis economies. In particular, the excessive accumulation of short-term debt was publicly accessible knowledge, but no steps were taken to rectify these problems.

Then there were the investment houses and brokers who were mostly mute or were irredeemably bullish on East Asia, especially those trying to sell the junk paper offered by many of the regimes. There was also a characteristic lack of independent analysis among the region's academics that was combined with weak political oppositions. The tendency for persistent dominance of a political party that often led to single-party states meant that parliamentary challenges were unheard of and inquiries into potential economic disorder were few and uncritical.

Behind much of the unwillingness to see was an abiding belief that political connections were sufficient to insure profitability. At the same time, there was a presumption that authoritarian regimes are inherently stable and that they contribute to economic growth. Based on these myths, political risks were underestimated and financial risk was simply set aside because with political support losses could be passed on to local taxpayers.

East Asia's economies exhibited a series of flaws that led to an avoidable doom. Unfortunately, there were few rewards for telling the truth and punishments were often outsized for those who were willing to be critical.

Global Capital as Liberator of the Masses

Global capital flows have become the vanguard of a new revolution. It has undermined despotism, revealed the unsustainable nature of corruption and motivated change in policies that curtailed domestic competition or imposed the high costs of protectionism. A key to understanding this process is that capital can no longer be thought of as having a specific national base. A world without national capital is one where attempts by governments to control or restrain capital will cause it to migrate. No hegemonic forces or small groups of financiers control capital markets. Migration of capital reflects the will of many, small individual savers in all countries who require that their funds are placed prudentially so that they balance risks against returns.

Although there will be substantial adjustment costs, in the future there will be rounds of vigorous institutional competition that will lead to the discovery of arrangements that best attract capital. This *race to the top* will mean that those countries with the most attractive arrangements for capital will be rewarded with the highest rates of economic growth and job creation.

Successful economic development in the future will depend upon a number of conditions that shape and define the so-called global economy. Perhaps the most important momentum behind the internationalization of economic activities arises from the high degree of capital mobility. The capacity of capital to migrate and reside more or less at will insures that the search for the gains from trade arising from comparative advantage is temporary, elusive, and increasingly contested.

It will be increasingly important that countries develop greater flexibility and responsiveness in their economic and political institutions. Otherwise the automatic adjustment mechanisms that contribute to stability and aid growth will be obstructed.

Countries wishing to be players in the global marketplace will have to face up to the implications of this simple observation. It will be as important to countries in early stages of development that might more likely pursue development through the promotion of export-oriented production as in more advanced economies that need to tease higher rates of growth to keep living standards high and unemployment low in order to maintain social harmony.

Aspirants in the global marketplace that wish to remain competitive and enjoy economic success will be guided toward policy mixes and institutional arrangements that are flexible and responsive. Otherwise, industrial and commercial aspirants will find market shares lost to competitors while national economies will experience an exodus of capital. In the future of a truly global economy, the institutions of every country will be affected by external shocks generated by repetitive waves of competition. Those countries with inadequate institutional flexibility will simply break down in face of these challenges. Indeed, this is what happened when the East Asian economies stumbled at the first hurdle beginning in July 1997.

From the micro side, small and medium sized enterprises will be well placed with nimble responses to exploit niche opportunities. This will imply that this will work best in situations where there is extensive domestic competition among firms, including allowing foreign producers in to contest local markets. From the macro side, capital friendly policies combined with a liberal trade regime will increase and enhance linkages with international markets that facilitate trade and capital flows.

There are risks and challenges associated with such arrangements. Not least of these is the upsetting of traditional relationships that may lead to some political instability. However, the political stability associated with the cozy relationships between many Asian governments and commercial interests has proved to be a recipe for disaster.

Unfortunately, there is impatience with certain aspects of progress in developing countries, whether with emerging economies or not. In essence there is a presumption that the institutional infrastructure required for long-term success in the global market can be implemented overnight. Optimists who wish good things for the region as well as apologists for *Asian values* tend to overlook several deficiencies in the institutional environment of the region. Many governments have embraced the voting rules associated with democracy (majority rule elections). However, the mere superimposition of such trappings upon a collectivist culture creates a number of internal, perhaps fatal, contradictions.

In the conservative political culture seen in much of East Asia, vigorously contested, multiparty elections are far from the norm. One-party and one-family states dominate the civic landscape.

Similarly, most countries in the region pursued similar policies for growth whereby export-led *directed* development involved the politicization and underdevelopment of domestic capital markets. Not only did this provide opportunities for corruption and nepotism, it also led to substantial malinvestment whereby funds were directed towards projects with little or no economic merit or commercial viability. Indeed, the hundreds of billions of dollars in bad debt burdening the region arose principally from these homegrown circumstances.

As a matter of policy, industrial and commercial investments were funded principally through the banking system. This approach allowed for greater political control over investment flows since bank managers could more easily be influenced to direct funds toward activities or sectors favored by technocrats or politicians. While some investments were based upon technocratic inspiration, political considerations and cronyism drove many others. In all these cases, proper risk analysis was not seen as necessary since government support meant that profits would be privatized and losses would be nationalized and paid by taxpayers.

In contrast, controlling capital markets is similar to herding a room full of cats. Participants are independent and disconnected with disparate plans. What links them is a desire for some sufficiently high rates of return relative to associated risk by demanding that asset managers exercise due diligence in seeking adequate information.

At the same time, the inefficiency of the underdeveloped domestic financial markets meant that most of the economies in the region created a dependency upon international capital. In contrast to comments by Malaysian Prime Minister Mahathir, the exposure of East Asian economies to the whims of global capital reflects policy decisions by governments in the region. It reflects the outcome of their failure of governance and is not a neo-colonial conspiracy.

East Asian leaders did not seem to realize that by engaging the world trading system, they were riding a tiger. As in Indonesia, this tiger is global capital markets that dethrone autocratic or inept governments. It will come as a shock to Marxists that the greatest force for democratic change and freedom is global capital.

Modernization and Institutional Reform

Much of the high growth previously experienced by East Asian economies reflects the continuing process of the radical changes that Margaret Thatcher introduced to the world. The familiar core of her reform package included privatization of state-run enterprises and extensive deregulation to increase competition and opening up to international investments.

Many countries seeking to introduce Thatcherite reforms of their capital markets failed to understand that the most crucial contribution of the Thatcher Revolution was an accompanying requirement for supportive institutional arrangements. This oversight was not accidental since it would require a dramatic change in their respective political cultures. In sum, the full benefits of interacting in a market-based global economy require an ascendancy of individualist-based institutions. As such, there must be a shift from collective based decision-making and control towards arrangements wherein individuals play a decisive role in shaping political and economic outcomes.

In a macro context, this implies increased democratic involvement by citizens with greater accountability for politicians. At the same time, arbitrary rule by rulers or ruling parties is replaced by non-arbitrary outcomes governed by the rule of law. In a micro context, expanded individual and private property rights allow for greater self-ownership by each and all market participants. This will allow for entrepreneurial-driven growth and will provide greater corporate accountability.

There are few countries where Thatcher's wisdom has been completely implemented. However, it is in East Asia where the contradictions wrought by incomplete implementation are so fully and fatally exposed. Throughout most of East Asia, governments impose extensive interventions into the workings of the market. Political considerations too often reflect inept and inappropriate interference with the logic of the market and are motivated by a collectivist mentality. The resulting economic and political institutions tend to limit individualism. Political slogans like *society above self* and *the exposed nail is hammered down* express the collective instincts reflected in many of East Asia's institutions.

For many, it is counter-intuitive that individualist-based institutions can provide social harmony. The political philosophy in favor of *Asian values* has its deepest inspiration from the idea that individuals should transfer power and initiative to collective institutions. The fast growing economic change of East Asia has - after almost twenty years of phenomenal growth - reached the point of social development where it is clear that individualist-based institutions are the logical and necessary outcome of the process of modernization.

Civil society reflects the spontaneous emergence of voluntary associations of individuals in order to limit abuses of power by governments, groups or other individuals. These associations may support either special interests (such as trade unions or producers groups) or may seek to promote general interests (such as freedom of speech as advanced by a free, open media). These groups operate to offset the type of authoritarianism advocated in the *Asian values* concept and liberate individuals in a way that is implicitly criticized by the same philosophy.

The market acts as a civilizing force upon individuals because economic exchange becomes more impersonal. Primitive economic arrangements tend to be based upon personal relationships that limit the scope of exchange. Under these conditions there is little mutual trust outside of narrow groups defined by personal, ethnic, racial, regional or other characteristics. Those who do not possess these specific attributes are generally the objects of discrimination. The ethos of the group may even endorse cheating of others.

In more advanced markets, there is tendency to break down discrimination. Individuals expand their scope of trust and respect for others in order to expand their market reach to increase their wealth. Market processes also expose people to the need for compromise and provide greater confidence in surviving what may initially appear to be chaotic change.

The economies in East Asia have been characterized by communal, personalized institutions wherein individual attributes were not valued so they were sometimes discouraged. Herein lies an important development problem in the *Asian model*. Since entrepreneurs are the true engine of change and economic growth, they are the key for sustained economic growth. Their actions reveal that they are essentially individualists who aim to break up the economic or political status quo.

This type of activity initiated by individual entrepreneurs is often described as *creative destruction*. Economic innovations destroy older structures because of their higher productivity. An open economy introduces creative destruction through trade and capital flows even if domestic innovation is low. This process works against the cozy relationships and the ideal of social stability that have historically existed between most East Asian governments and corporations like the *keiretsu* in Japan and the *chaebol* in Korea.

Similarly, the high value of consensus evident in East Asian political culture is counter-productive to the modern market economy. The search for political harmony has often resulted in limits upon free speech and secretive protections of information flows in order to control or shape public opinion. These actions further restrain the entrepreneur by restraining access to information that would inspire them to create new products or services.

The East Asian crises can be interpreted as part of the ongoing struggle in the competition between modern, individualist-based institutions and conservative, collectivist institutions. Resolution of the economic crises in East Asia will occur only when there is deeper commitment to the lessons of Thatcher's grand experiment.

Into the Future, Darkly

The simple explanation for the decline of East Asia's *miracle* economies lies in the incompatibility of their political and commercial institutions with an increasingly efficient global capital market. While these arrangements worked under other conditions, they did not allow for a ready response to the external competitive shocks that visited their shores.

Ultimately, those countries with the most flexible and efficient institutions that support responsive economic arrangements will attract foreign capital. These conditions underlie innovation-driven growth, which differs from the sort of catch-up growth experienced of most East Asian economies. Innovation-driven growth is long-lived, because creative problem solving and invention constantly rejuvenate it.

In contrast, although catch-up growth may appear to be meteoric, it is short-lived because it only represents the belated incorporation of technology or ideas that were developed elsewhere. Thus, those governments characterized by strict and inflexible hierarchical rule will inadvertently hinder high rates of economic growth by stunting innovation. In the context of global mega-competition, such a politically self-serving approach is fatally flawed. Unless these governments can create the intellectual environment conducive to technological innovation, the *miracle* of Asia's stunning economic successes will be short-circuited. Unfortunately East Asian economies faced the same sort of catastrophic contradictions faced by communist economies. In the end, prospects for an *Asian Century* were no more likely than they were for a *Soviet Century*.

The next century might best be characterized as the beginning of a *Global Millennium* where competition among institutions and cultures that is as vigorous as any competition in goods and services. This new order of expanding international trade relations has been facilitated by the confluence of increased capital mobility and more ready access to information and technology. Economic success in this coming era will require further separation between economic and political spheres, greater tolerance of institutional innovation, and increased transparency and accountability of existing economic and political structures.

These conditions are as important for the mature Western economies as they are for developing economies, in Asia or elsewhere. Those regimes attempting to frustrate this marketplace of ideas will undermine their long-term survival. Just as economic protectionism leads to avoidable economic costs, cultural isolationism involves self-inflicted social and political costs. Neither wishful thinking, nor strong-armed authoritarian rule, will be able revive hopes for an *Asian Century* and neither can they hold back the positive forces of a *Global Millennium*.

While restoration of *stability* in East Asian economies will be a difficult road, the slow pace of institutional changes will make *recovery* an even longer one. Indeed, it may require a generation before some East Asian economies can replicate the required institutional infrastructure for sustainable economic growth that will be required by the increasingly efficient global capital market.