

Asia's Political Lessons

*China has
important
political
lessons to
learn from
the East
Asian
economic
crisis*

Minxin Pei

The two-year-old East Asian financial crisis appears to be over. Many macroeconomic indicators, such as rising growth, falling interest rates, and stabilizing exchange rates suggest a recovery in progress.

Policymakers in China have patted themselves on the back for having avoided the brunt of the financial turmoil that plunged much of the region into recession. Judging from public discussion in the Chinese media, these same leaders have learned several—now familiar—economic lessons from the East Asian crisis, including the importance of a strong financial regulatory regime, well-capitalized banks, and the dangers of full capital-account convertibility. To their credit, Chinese reformers led by Premier Zhu Rongji have taken steps toward addressing these problems.

The same discussion, however, also suggests that many Chinese policymakers may not be sufficiently aware of the political and institutional roots of the Asian crisis and may not have learned its critical political lessons. Ignorance of the political origins and aftermath of the crisis could ultimately prove dangerous to China. Despite its luck and unique circumstances, the Chinese political economy shares the same underlying malaise that debilitated political and economic institutions in Indonesia, Malaysia, South Korea, and Thailand. This malaise raised these countries' systemic vulnerabilities to such high levels that an unanticipated adverse event was able to set off a chain reaction culminating in the collapse of the financial system or, in the case of Indonesia, the fall of the ruling regime.

At the moment, China's leaders are focused on solving the country's short-term economic difficulties: slowing growth, rising unemployment, deflation, weak banks, and poor export performance (see p.12). But it is unclear whether, should they overcome these economic difficulties, they will address the deeper institutional problems in China's political and economic spheres. It is, nonetheless, in the leadership's self-interest to recognize several political lessons from the East Asian crisis.

THE NECESSITY OF INSTITUTIONAL REFORM

Economic growth is not a substitute for institutional reform. If anything, economic growth may make a society's institutional flaws more entrenched and intractable, as growth-induced economic booms mask the severity of problems and minimize pressures for reform.

Although the development strategies adopted by individual East Asian countries may differ in detail, they share one central characteristic: an unshakable faith in the magic of growth. Implicit in the growth-oriented strategy is the hope that two developments will occur to make future reform easier. The first is that the tangible results of growth—particularly rising standards of living—will build up political capital and popular support, both of which are required to

*Minxin Pei is a senior
associate at the Carnegie
Endowment for
International Peace.*

address deeper problems in their country's political system and economy. The second is that growth's ability to improve the overall welfare of the populace will make for favorable conditions for reform. Under such conditions, it is hoped that some politically powerful groups will make sacrifices so that high rates of growth can translate into the resources needed to buy off unemployed state workers and other losers in the reform process.

In reality, however, these hopes have not panned out in East Asia. Although rapid growth has led to rising standards of living, political leaders throughout the region have found it hard to channel growth into lasting support. Rapid growth may produce more wealth, but it also creates new problems, such as socioeconomic dislocation. In China's case, growth has increased inequality and raised popular expectations. Some members of society find themselves losing out relative to others as the economy shifts, from agriculture to industry and from manufacturing to services, for example. Required institutional changes produce losers as well.

While a growing economy does provide opportunities, chiefly job opportunities in new sectors, governments tend to lack the ability to address new growth-created problems and meet rising expectations. This, in turn, typically reduces rather than increases their political capital. Governments thus have been unable to reform flawed political and economic institutions, from weak courts and corrupt bureaucracies to lax regulatory systems and cozy business-government relations.

Moreover, while structural shifts in the economy normally affect the most vulnerable members of society—such as the peasantry—first, institutional reform aimed at curbing bureaucratic power, increasing judicial independence, and making markets more transparent threatens the powerful—bureaucrats, politicians, and well-connected businesspeople. Unless the government is able to overcome the resistance of these groups, institutional reform cannot proceed even during the best of times.

Since those who lose out in the process cannot imagine that they could possibly be better off after the implementation of reforms, they would view any "buy-out offers"—lump-sum payments for early retirement, managerial positions in semi-private firms, or

promises of future favors, for example—as inadequate and resist reform. This analysis helps explain why reform proposals to strengthen the banking systems in Indonesia, South Korea, and Thailand that aimed to prevent party-related lending failed before the crisis, and why suggestions for breaking up large conglomerates in these countries were scorned and resisted.

THE DANGERS OF A WEAK LEGAL SYSTEM AND CORRUPTION

Economic growth is unsustainable if deep institutional problems are left uncorrected. Although businesspeople and scholars often blame bad policies for economic inefficiency and poor performance, bad institutions are equally capable of destroying economic incentives and creating inefficiency and waste.

A typical example is a weak legal system, among the most common institutional deficiencies in emerging markets. Courts that lack autonomy and effectiveness are fundamentally products of the political system. Weak courts can increase the costs of economic activity enormously. Their ineffectiveness—most often exhibited through the failure to enforce contracts and protect property rights—raises uncertainty for investors and entrepreneurs; increases transaction costs as parties are forced to undertake additional hedges against breaches of contracts and unfair courts; and limits the size of the market when investors fear to venture into unfamiliar and unfriendly territories where they lack political ties to the courts.

Another costly product of flawed institutions is corruption. Bribery inevitably increases the costs of doing business and, eventually, the prices of goods and services for consumers. Bribes paid by inefficient and incompetent firms to secure government contracts and licenses create additional hazards by prolonging the lives of uncompetitive entities that produce shoddy and often dangerous goods.

Corruption also discourages private entrepreneurship, as rapacious government officials tend to impose arbitrary taxes and fees on these start-up companies to enrich themselves. Since income from corrupt activities is mostly consumed privately or salted away in offshore bank accounts, large-scale offi-

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cial corruption always results in the reduction of government-provided public goods and services such as education, environmental protection, and research and development. Finally, corruption increases the systemic risks of financial and fiscal systems when it results in falsification of information, financial fraud, capital flight, and poor tax collection.

Unfortunately, it is politically difficult to reform weak institutions during boom years because rising growth and investment rates conceal such institutions' negative effects on the economy. The corrosive effects of weak institutions become clear only after an unusually severe economic crisis exposes their underlying frailties. But at that point, the costs of improving poor institutions have already accumulated, and the economy and the government end up paying a steep price. Indonesia's collapse was all too vivid an illustration.

THE SUPERFICIALITY OF POLITICAL LEGITIMACY

The emphasis on growth in East Asia had a political origin: authoritarian regimes ruled in all high-performance East Asian economies except Japan when growth began to take off. Several regimes eventually made the transition to democracy. But during the authoritarian phases of these regimes and for the region's remaining authoritarian countries, maintaining high growth rates was and is regarded as essential for building not just industrial economies, but the political legitimacy of the ruling elites.

However, there are two serious problems with economic performance-

based political legitimacy. First, it is inherently superficial and unreliable. Although most citizens may accept authoritarian rule while their living standards improve, they do not develop an abiding affection or lasting support for unaccountable government or its leaders. The notion of maintaining legitimacy on the basis of growth becomes even more problematic when the gains from growth are unequally distributed. Disadvantaged groups given short shrift are especially unlikely to hold their governments and leaders in high esteem. Rulers counting on high growth to maintain popular support may also have unwittingly entered an impossible race: economic growth must be kept at an ever-increasing pace to meet people's rising expectations. Leaders risk erosion of political support if growth rates slip even slightly—country leaders from Indonesia to South Korea can testify to this.

The second problem with economic performance-based legitimacy is the difficulty of maintaining high growth rates. Obviously, corruption-related costs are likely to slow growth if the ruling elites fail to control graft. But in an increasingly globally integrated economy, many factors essential to keeping growth rates high are beyond these rulers' control. Capital today is extremely mobile, and can leave a country *en masse* at a moment's notice. Competition is also fierce at the low end of the market, where companies often resort to price wars. Comparative advantages, especially cheap labor, are now much less reliable or enduring than they have been in the past.

The fall of Suharto's regime proved just how unreliable growth-based legitimacy could be. The now-disgraced Indonesian leader spent most of his 31 years in politics transforming an impoverished and unstable society into a quickly modernizing one. Under his watch, the Indonesian economy maintained one of the highest rates of growth in the world in the post-WWII period. The level of poverty was cut dramatically, and the standard of living for almost all Indonesians improved substantially. Indonesians thus hailed Suharto as the "Father of Development."

But Suharto mistook popular recognition of his achievements as unconditional endorsement for a permanent hold on power and for his family to engage, unrestrained, in corrupt activi-

ties. The shakiness of his support became clear only when, barely eight months into Indonesia's worst economic crisis in three decades, angry citizens and the country's armed forces—supposedly the mainstay of the Suharto regime—forced the leader out of office.

DEMOCRACY LOWERS RISKS AND UNCERTAINTY

Established rules and procedures for resolving both state-society conflict and clashes among the elite can help reduce systemic risks and market uncertainty. Why did some countries in the region handle the crisis more effectively than others? A large number of Western politicians and observers point to the "success stories" of South Korea and Thailand and the "failure" of Indonesia as evidence that regimes with democratic characteristics are more capable of handling economic crisis than authoritarian regimes. But available scholarly research supporting this argument is scant and inconclusive, and the evidence from the recent East Asian financial crisis is mixed. While Indonesia, an authoritarian country, was a basket case, certain semi-democratic governments did not fare as poorly. Hong Kong, Singapore, and Malaysia seemed to have weathered the storm in relatively good shape, even though Malaysia experienced its most serious economic and political crisis since the 1969 race riots.

Democracies may have one notable advantage in handling crises, however. Although democratic countries all over the world differ in administrative capacity, party systems, electoral procedures, and legislative institutions, they all rely on a set of rules and procedures to help resolve conflicts among the political elite and between the state and society. Succession, for instance, rarely inspires uncertainty and anxiety in democratic systems.

Moreover, popular discontent with democratic governments is frequently vented through street demonstrations, strikes, and the ballot box but seldom culminates in massive social unrest. In fact, there is not a single instance in history in which a social revolution overthrew a democracy. Markets, cognizant of the benefits of such rules and procedures for conflict resolution, tend to price political risks accordingly. For democratic states, such political risks

are considered relatively low. For non-democratic states, risks are perceived as relatively high. Investor confidence may thus return sooner in democratic states than in authoritarian ones.

POLITICAL PLAYBOOK

The lessons of the Asian crisis should alert Chinese leaders to the risks of delaying crucial institutional reforms and the rewards of pursuing them. These leaders maintain that the current macroeconomic situation is too severe to contemplate dramatic reform measures. "Stability overrides everything" is the dominant official policy. Although this policy makes intuitive sense, it ignores the crucial fact that any institutional reform is difficult, even under the best of circumstances.

PRC leaders and policy advisors should start thinking more conceptually about the course of institutional reform once current economic difficulties are overcome. Strengthening state institutions and extricating the Communist Party from routine administrative functions of the government; accelerating the pace of legal reform and enhancing the independence and effectiveness of the courts; and encouraging the growth of civic organizations—which can help organize citizens and increase social cohesion in a time of rapid socioeconomic change—should top their agenda. The government should also mobilize the mass media against corruption, as scholarly research has demonstrated that there is an inverse relationship between civil liberties and corruption. Finally, Beijing needs to promote democratic participation at the grassroots level to increase the political accountability of local officials.

These measures may sound radical, but they are necessary both for China's continued modernization and for the survival of the Communist Party as the leading political force in the country. The East Asian crisis—and crises elsewhere in the world—have shown that governments forced to adopt reform measures in a position of weakness are seldom able to control the pace and direction of such measures. Deng Xiaoping, by initiating bold economic reforms in 1979, avoided Gorbachev's mistakes and resulting fall from power. Deng's successors should push political and institutional reform now to avoid Suharto's fate. 完