Creative Destruction? After the Crisis: Neo-Liberal 'Remodeling' in Emerging Financial Markets

Introduction [1]

From the mid-1990s forward, an array of states already exposed to the mixed blessings of financial globalization have been buffeted by a new threat to their economic security, viz. "twin" financial crises: comprising bank sector insolvency *and* balance of payments problems.[2] Under the permissive condition of high capital mobility and rapid reversals of short-term investment inflows—touched off by sizable oscillations in investor confidence and punctured asset market bubbles—have afflicted an array of states with contagion.[3] This arguably novel phenomenon has been correlated with numerous factors and the focus of a robust debate as to its precise cause; somewhat less in contention are its consequences.[4]

Although few states are wholly immune to contagion, be its effect direct or more circuitous, emerging financial market states (EFMs) have proved the most vulnerable.[5] The 1997-99 East Asian financial crisis was a marquee exhibit of this phenomenon, whose contagion spread as far away as Russia and Argentina and stretched out its time frame until 2002. The so-called East Asian Five (Malaysia, Thailand, Korea, the Philippines, and Indonesia) bore the brunt of its effects, including sharply declining currencies, asset prices, and stock markets, as well as spiking unemployment, recession, and serious economic contraction *inter alia*—even riots on the island of Java. From the perspective of the middle and lower classes in particular, the hardship

1 I would like to thank David Andrews, Leslie Armijo, Benjamin Cohen, Christina Davis, John Echeverri-Ghent, Jeffry Frieden, Patrick Leblond, Helen Milner, Shanker Satyanath, and Mark Vail for their insightful comments on an earlier draft.

2 Kaminsky and Reinhart, 1998.

3 contagion: the spread of speculative currency attacks, short-term capital flight, declining equity markets, and deterioration in capital market borrowing terms, triggered by macroeconomic imprudence of other states and/or attacks on their currencies.

4 For scholars who view highly mobile capital as constricting, cf. Andrews, 1994; Armijo, 1999; Cerny, 1993 and 1995; Garrett and Lange, 1986; Kurzer, 1993; Matthews, 1997; Pauly, 1997; Przeworski and Wallerstein, 1988; Ruggie, 1993; Schrecker, 1997; Strange, 1986 and 1997; Underhill, 1997; etc. For the dissenters, cf. Berger and Dore, 1996 (esp. Wade); Garrett, 1995, 1998a, 1998b; Garrett and Lange, 1991 and 1995; Rodrik, 1997; Swank, 1998.

5 EFMs go by other labels such as Newly Industrialized Countries (NICs) or Economies (NIEs) or Middle Income States (MISs). They are more advanced developing states with higher growth rates and greater economic potential than typical Less Developed Countries (LDCs) and are found mostly in East Asia, Latin America, and East-Central Europe.

wrought by contagion was quite literally disastrous. According to the IMF, "[t]he magnitude of the recessions in the affected Asian countries has exceeded all initial expectations."[6]

As the crisis receded in 1999, most observers expected a fresh round of capital account closure akin to Malaysia's behavior midway through the crisis. However, the Five uniformly resisted this temptation and opted for continued openness in lieu of capital controls—due primarily to their more pressing need for banking sector recapitalization. Once this was accomplished, chiefs of government (COGs) could contemplate how to prevent a recurrence. But would macroeconomic reform alone suffice for the prevention of this unprecedented form of economic threat? Because their banking sectors were involved, standard fixes like bringing inflation under control would be insufficient. Indeed, in classic Washington consensus terms, the Five confronted clarion calls by finance experts from all quarters to make deeper institutional reforms related to effective banking sector supervision.[7]

Though COGs throughout the region laid plans for new reform efforts, the results were mixed. As with other financial crises in recent history, post-crisis reform efforts in certain EFMs succeeded but failed in others. In light of the dramatic scale of destruction wrought by contagion, not to mention its alacrity in metastasizing, any failure to make the changes necessary to avert a new round of contagion amounts to a puzzle. In more general terms, what explains varied responses to twin financial crises when the stakes are so high? With a subsequent absence of manifest changes to the structure of international capital markets—i.e. the so-called international financial architecture—there is little reason to believe that poorly performing EFMs

[6] Indeed, economic crisis quickly transmogrified into a humanitarian crisis for wide swaths of the affected states, with household wealth plummeting by as much as 70%. For example, in the early stages of the crisis, Indonesia experienced a currency depreciation of 80%, economic contraction of 14%, and an increase in inflation of 80%. The sizable spike in unemployment that resulted contributed to substantially worsened conditions, which in turn led to various forms of social unrest. See "The IMF's Response to the Asian Crisis—Factsheet," http://imf.org/External/np/esr/facts/asia.html, January 17, 1999.

[7] The Washington Consensus, a term coined by John Williamson, refers to the agenda of what Jagdish Bhagwati has deemed the Wall Street-Treasury Complex, whose actors include *inter alia* Wall Street financial firms, the Treasury Department, the State Department, the IMF, and the World Bank. In this perspective, such actors agree on and incessantly advocate an agenda of economic liberalization writ large, what Williamson has enumerated as fiscal discipline, financial liberalization, privatization, deregulation, trade liberalization, tax reform, secure property rights, etc. Staunchly opposed are central planning, over-regulation, and state intervention in the economy under most circumstances. Accordingly, what is good for Wall Street is viewed as being good for the world. See Williamson, 1990 and 1994; and Bhagwati, 1998.

will be able to inoculate themselves once the malady of contagion reappears in global financial markets.

The explanation for varied reform outcomes is found in each EFM's body politic. I argue that a combination of regime type and quality of governance determines whether a given EFM succeeds or fails in its post-crisis reform efforts. Associating good governance with low corruption, the rule of law, high social capital, and low corporate ownership concentration—the so-called "antecedents of good governance"—a given EFM will experience at least a semblance of reform success where these antecedents are evident. On the other hand, if the antecedents of good governance are lacking then the EFM in question will experience a modicum of difficulty, if not out and out failure.

By combining regime type with governance, further explanation of the variance outcome can be achieved. If a given EFM's antecedents of good governance are positive and it is autocratic, it will achieve "success"; whereas if it is democratic it will achieve only "relative success." On the contrary, if a given EFM's antecedents of governance are negative and it is autocratic, its efforts will result in "failure"; whereas if it is democratic its efforts will result in only "relative failure." Thus, despite the obvious irony, there can be advantages in authoritarianism. See below for a deeper theoretical grounding of the argument, as well as justification for how success and failure are operationalized and measured.

Background

The severe economic and other consequences transmitted into widespread demand for protection from individuals and groups alike—even from some liberal international quarters.[8]

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[8] Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs* 77, 3 (May-June, 1998); *The Economist*, "Keeping the Hot Money Out," January 24, 1998, "Capital Controversies," May 23, 1998, and "Of Take-Offs and Tempests," March 14, 1998; Barry Eichengreen, 1999; Paul Krugman, "Whatever Happened to the Asian Miracle?" *Fortune*, August 18, 1997, "Curfews on Capital Flight: What Are the Options?" Krugman web page, October 12, 1998, and "An Open Letter to Prime Minister Mahathir," Krugman web page, September 1, 1998; *Los Angeles Times*, "Los Angeles Times Interview: Stanley Fischer," October 8, 1998; and Dani Rodrik, 1997, and "Should the IMF Pursue Capital-Account Convertibility?" Essay in International Finance, No. 207, Princeton University.

Instead of typical calls for trade protectionism, the desire of societal actors to be inoculated against future crises generated substantial pressure for cutting off volatile capital inflows, i.e. financial protectionism in the form of capital controls. In spite of this, when the crisis receded and markets stabilized, more immediately COGs were conscious of the acute need to revitalize their capital-starved banking sectors; lobbied extensively by business elites and cronies alike, they chose largely to maintain their previous level of current and capital account openness, and in certain cases increase it.[9]

Fortunately for them recovery soon commenced, marked by an impressive return of GDP growth and significantly strengthened currencies. By the end of the 90s numerous prognosticators updated their 1997-8 predictions of ongoing EFM economic despondency with expectations of a return of unmitigated growth, effectively going from one extreme to the other. However, looking toward the longer term the economic, political, and social damage among the Five also engendered a critical new national interest across them, viz. a shared understanding that a recurrence of this type of crisis was to be avoided, practically at all costs.

Observers also emphasized prospects for EFM "lesson learning," speculating that the Asian crisis could ultimately prove to possess a silver lining—functioning as the impetus for some overdue reform à la "creative destruction," sort of Schumpeter at the macro level.[10]

> The main lesson is that prevention is still by far the best option. Sound macroeconomic policies are a key aspect of prevention in this regard. Another is sound banking: effective supervision of financial institutions.[11]

In this vein Goh Chok Tong, Singapore's Prime Minister at the time, inveighed that the crisis generated four potentially positive outcomes: greater economic opening-up, greater awareness

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[9] Nearly all EFMs retained their pre-crisis degree of financial sector openness despite widespread pressure for reverting to financial closure (i.e. capital controls, etc.). Malaysia was the lone exception, introducing controls in September, 1998 and lessening them somewhat in February, 1999 (and eventually fully).

[10] Some contend that, if post-contagion lessons are learned and EFMs engage in proper reforms, the Asian financial crisis and its aftermath would be an exemplar of Schumpeter's "creative destruction." Yet, to be precise, when Schumpeter coined this term and deemed it "the essential fact about capitalism," he was referring to capitalism's incessant cycles of industrial production, involving destruction of the old and creation of the new—essentially, business cycles. Certainly these involve unemployment (also cyclical) as well as firm failures, but nothing of the sort and scale as was recently experienced by contagion-ridden EFMs. See Schumpeter, 1942.

[11] "The IMF's Response to the Asian Crisis—Factsheet," http://imf.org/External/np/esr/facts/asia.html, January 17, 1999.

of the need for corporate governance, greater concentration on actual competitive strengths, and greater understanding of the tribulations of globalization.[12]

Nonetheless, even on the back of stock market and GDP resurgence, EFMs afflicted by the Asian financial flu have struggled to digest these lessons and reconstitute their economies in structural terms. For once the crisis abated, responses to the contagion stimuli began to diverge. While the Five achieved surprisingly rapid macroeconomic convalescence, only certain states achieved marked internal reconstitution in terms of advanced neoliberal reform. Indeed, certain EFMs have fared better at this task than others, despite an array of shared economic and political characteristics.

This paper seeks to explain why states with numerous characteristics in common are responding differently to highly similar external conditions. More specifically, it asks why, in the wake of the Asian crisis, certain EFMs have proved more proficient at implementing advanced neoliberal reforms—particularly prudential reforms in their banking and corporate sectors—than others, despite similar crisis experiences, similar stages of economic development, similar demands being leveled at them by various external actors—from political actors like the IMF, the U.S., and other G-7 states, to market actors such as institutional and portfolio investors—and even similar recovery experiences.[13]

The fact that certain EFMs are managing to implement so-called "second generation" neoliberal reform while others are not, despite an amalgam of similarities, is puzzling. Some contend that any EFM reform at all is puzzling, given long-standing proclivities for Asian values, cronyism, and rent-seeking in the region. But the spate of recent twin crises, particularly those in Latin America and East Asia, has leveled the playing field of market actors' perceptions—whether individual investors, institutional investors, or G-7 finance officials. EFMs now are not

[12] "A Survey of South-East Asia," The Economist, February 12, 2000.

[13] I focus specifically on the Asian crisis (and its aftershocks) because it constitutes a new more virulent form of crisis, not only of the aforementioned twin variety, but also because of three novel developments: the more rapid rate of diffusion, the greater propensity for contagion compared to the Tequila crisis, and the fact that even economically viable countries were implicated (cf.

only expected to achieve a deeper, more fundamental package of reforms, but they also face similar incentives for doing so, from the degree to which EFMs and their firms are currently in competition with each other for foreign short-term capital, to the widely perceived necessity to avoid a second round of crises.

Nonetheless, similar incentive structures are not translating into similar outcomes. Indeed, the similarities extend still further, including recent democratization experiences, increasingly democratic elections, reasonable macroeconomic governance, sound macroeconomic policy, relatively stable macroeconomic conditions, acceptance of a significant role for markets in resource allocation, deep integration into the international economy (in terms of both current and capital accounts), the self-reinforcing character of internationally-oriented growth, high savings and investment rates, and a strong societal emphasis on education. In terms of common economic factors which contributed to their proclivity for being inflicted by contagion, a lack of transparency about corporate financial affairs, ineffective or non-enforced prudential supervision of banks, and the presence of implicit guarantees on exchange rates, bank safety, and certain other business practices, have each been widely prevalent.

Thus, the East Asian EFMs are not for nothing continually grouped together by journalists and academics. What significant differences there are among EFMs recently buffeted by financial crises—differences in political and economic institutions—are largely captured by my dependent and independent variables, and relate directly to covariance in the theoretical framework. Yet, notwithstanding this cluster of similar characteristics, similar reformist outcomes are not being achieved.

The reforms alluded to are not so-called "first generation" reforms, which economists place in the reform category of "macroeconomic stabilization."[14] Reforms of this type constitute

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Paul Krugman , "What Happened to Asia?," 1998 mimeo). Nonetheless, looking at different crises/responses over time does have appeal.

[14] I do not equate reforms with policies; however, it is must be noted that the desirable achievement of a consistent, favorable policy outcome over time (contrasted with a history of failure in a specific policy area) *is* tantamount to reform. For example, after a history of high inflation a given government may choose to adopt a low inflation *policy* using the instrument of high

the consistent achievement over time of low interest rates, current account surpluses (or minimal deficits), low inflation, positive fiscal balances, stable exchange rates (or strengthened currencies), high savings rates, etc.—standards by which, for the most part, the Five have made impressive recoveries post crisis-alleviation (up until their very recent imported slowdown).

Rather, this paper is concerned with "second generation" neoliberal reforms, what in the financial sector are referred to as prudential reforms—i.e. supervisory laws and regulations involving the regulatory rules for banking / financial sectors, corporate sectors, labor markets, property rights regimes, privatization, and deregulation in general, which meet international standards (here the focus in on the banking and corporate sectors).[15] This reform type constitutes a deeper level of structural change involving the alteration or creation of economic institutions. This endogenization of institutions constitutes the next generation of reform. While first generation reforms contribute to short-term GDP growth, their second generation counterparts function as antecedents of greater productivity rates and thus long-term growth; in light of the need to alter deep-seated institutions, they are also more difficult to achieve.

For example, throughout 1999-00 largely positive first generation achievements have given rise to impressive output figures as well as marked reversals in investment climates and capital flows—from rising bond prices/falling yields to significantly increased levels of equity, portfolio, and direct investment. Longer-term growth, however, will depend on whether EFMs can underpin their national political economies with neoliberal economic institutions, i.e. second generation reforms.[16] Without these deep-seated structural reforms, GDP rates of 3-5% during upturns will be expected to stagnate, shy of the 6 – 8% rates necessary to reduce high unemployment rates and poverty levels leftover from the 1990s, not to mention put into place

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interest rates. The actual achievement of low inflation is a *policy outcome*. The sustained achievement of low inflation over time, given historical difficulty in this policy area, constitutes a *reform*. Reforms are never permanent, although policy reforms (first generation) are more easily reversed than institutional reforms (second generation) See Introductions in the following for discussions of macroeconomic stabilization reforms: Williamson, 1994, and Sturzenegger and Tommasi, 1998.

[15] Examples of prudential regulations can be found among banking sector regulations, e.g. capital adequacy ratios, loan provisioning and classification rules, removal of credit and interest rate controls, openness to foreign bank competition, and rules governing market risk, exchange risk, large exposures, connected lending, etc.

[16] Claessens, Djankov, and Klingebiel, 1999, p. 25.

safety nets that many COGs now espouse.[17] COGs are thus playing the game of how to change (and to what degree) in order to augment the initial recovery, meet the higher expectations of citizens, *and* prevent the recurrence of crisis in particular (in large part by pleasing investors).

With respect to how the credibility issue is tied to being vulnerable to twin crises, the reform task is imperative. According to a recent study of the Asian Development Bank (ADB), second generation reform gives rise to market confidence, which in turn gives rise to greater GDP growth than there otherwise would be.[18] Staunch pressures to engage in serious structural reform stem from three primary sources: 1) *market actors* (rating agencies and different classes of investors—firm-based, institutional, and portfolio—all of whom "vote" via exit/return), 2) external *political actors* (international organizations—the UN, the World Bank, and the ADB—and foreign governments—the U.S., the G7, and ASEAN), and 3) *internal groups* and *individuals* (agencies and policy-makers who perceive the national interest of preventing a twin crisis recurrence). Although COGs and their governments continue to pursue reform in response to these pressures, the outcomes of these efforts are far from uniform.

Yet, prior to considering second generation reforms, the East Asian Five first had to manage the crises. This involved two steps. First, they had to stabilize the situation, which typically comprised speculative currency attacks, short-term capital withdrawals, declines in equity markets, and capital market borrowing terms deterioration, *inter alia*—all of considerable orders of magnitude. Stabilization efforts included preventing payments breakdowns, dealing with insolvent financial institutions, preventing further loss accumulation, and generally restoring financial system confidence. Second, the Five had to sustain the initial stabilization, largely by warding off currency attacks, recapitalizing weak but solvent banks, and eliminating non-performing loans; this step is part crisis management and part prevention.

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[17] "Reforms Promise Better Things to Come," Financial Times Survey, March 24, 2000.

[18] Zhuang, Edwards, Webb, and Capulong, 2000.

Only upon the sustaining of the initial stabilization have COGs been in a position to take the third and final step of responding to financial crises: implementing measures aimed at preventing recurrence. While their asset management companies are still dealing with non-performing loans, the Five have successfully recapitalized most of their banks and have commenced with prevention. This primarily consists of determining which measures are necessary to prevent the onset of an additional crisis, whether bank sector insolvency, balance of payments, or another twin crisis. In order to mollify external actors—particularly investors—this process involves upgrading or instituting prudential and supervisory reforms, primarily in their banking and corporate sectors, i.e. second generation reforms. The most salient of these in credibility terms, as indicated by a battery of interviews with IMF officials, comprise capital adequacy ratios, loan classification and provisioning rules, debt equity ratios, bankruptcy procedures, and transparency measures.

The Five have been engaged in post-crisis second generation reform efforts aimed at specific improvements—viz. international best practice benchmarks—in these six areas, which together comprise the dependent variable of this inquiry. Although they are in essence being judged by external actors according to best practice criteria, across the board progress in empirical terms has not been overwhelmingly impressive. Relative to one another, however, some of the Five are performing better than others. The overriding question is why, with several near miss crises since and not a single substantial change to the international financial architecture.

Theory and Argument

Variance in the dependent variable becomes all the more puzzling as time progresses without commensurate reform progress. Impediments to successful prevention will only be compounded by the following: increasing citizen backlash to early reforms, growing opposition

of vested interests, easing of the threat perception, and a weakening of reform momentum the longer the recovery is in evidence. Furthermore, each of these trends is likely to embolden the present quiescence of EFM veto players (see below). Thus, as EFM crisis management gave way to the need for cultivating long-term growth and an inoculation against further crises, why certain EFMs have achieved greater second generation success than others—given the common set of circumstances they face—calls for an explanation.

The theoretical framework rests on several assumptions, particularly the important baseline assumption that across emerging markets there is a shared perception of the necessity of significant "change." Just as EFMs, primarily in Latin America and Asia, achieved broad consensus in the wake of the 1982 debt crisis on the need to liberalize their economies—primarily with regard to the current account and first generation reforms—so too have they become acutely aware of the need for a new generation of reforms in the wake of the Tequila and Asian crises.[19]

These crises demonstrate that

> transitory capital account shocks can create major macroeconomic disturbances and that the contagion effect is real. These pose a major challenge for developing countries since large and highly mobile international capital flows are likely to be an important feature of the world financial landscape for the foreseeable future.[20]

Indeed, it is now a widely accepted premise that, in the aftermath of a particularly damaging crisis, aggrieved EFMs need to make some sort of clear break from the past and change their perceived profligacy.[21] Otherwise, they risk the recurrence of crisis, for the international conditions in which these crises occurred have not changed; nor are the likely to do so.

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[19] See, *interalia*, Sebastian Edwards, 1995, 41-66.

[20] Hadi Soeastro, "Long-term Implications for Developing Countries," in Garnaut and McLeod, 1999.

[21] After a financial crisis of unprecedented severity, it has been generally understood—by domestic and international elites alike—that in order to avoid a precipitous second round some fundamental reform measures must be instituted across emerging markets. This perspective was particularly impressed upon me by David O. Beim (conversation with the author, 2-22-00). It must be noted that one can in fact simultaneously hold this perspective and that which maintains that the prospect for serious reform is now dimmer given how soon the crisis came to an end ("A Survey of South-East Asia," The Economist, 2-12-00). Still, market actors' perceptions of profligacy/credibility on the part of EFMs are crucial.

Further impetus for this dramatic "need for change" stems from COGs' awareness that they will be judged at the ballot box by whether they can produce the same growth rates their citizens have grown accustomed to over the past decade-plus, i.e. 6 - 8 %.

Closely related, in addition to assuming that EFM COGs perceive the need to reform, I assume they make actual attempts to do so, understanding how costly further abortive attempts would be, e.g. a third round of twin crises. These two assumptions together comprise the baseline assumption. It is a fairly straightforward expectation to anticipate that EFM COGs will respond to their crises by taking reformist action, first and foremost to become credible in the eyes of foreign investors—whose own actions contributed to the crisis in terms of self-fulfilling prophecies, and who are needed to replenish capital starved banking systems; second, in order to reproduce output levels commensurate with voters' expectations; and third, large enough to deal with an assortment of social problems.[22] Whether this action leads to the implementation / enforcement of the recommended second generation economic reforms, i.e. success, is a different matter . . . a matter this paper seeks to explain.

Evidence is not required to buttress assumptions, yet there is ample evidence of related EFM attempts to enact post-crisis change. Soon after alleviation of the Asian crisis, ASEAN leaders began working anew at regional cooperation, not to mention reaching out to Japan, China, and North Korea. By early 2000 regional COGs had met to explore ways to be more self-reliant should crisis conditions return—in particular, an Asian lender of last resort—and also of more realistic prospects for creating a free trade area in the next five years.[23] Indeed, in December of 2005 progress materialized in the form of a landmark "ASEAN plus Three" (APT) summit—involving China, Japan, and Korea—that could culminate in a degree of trade and other types of regional integration by 2020.

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[22] "Latin American Finance," Financial Times Survey, March 24, 2000.
[23] "A Survey of South-East Asia," The Economist, February 12, 2000.

Aside from the baseline assumption, the paper makes several others that underpin the argument. First, it takes as given that all actors are rational and seek to maximize their utility. Second, it assumes that all COGs value political power and seek to retain it. Third, it further assumes that COGs' ability to retain power rests largely on how well they manage their economies. Finally, it is unconcerned that a few EFMs had already implemented a modicum of second generation reform prior to experiencing crisis, for their meager nature was not sufficient to stave off the crisis. The duration and severity of the Asian crisis has created a second generation tabula rasa.

The significance of this is inconsequential because the limited degree of reform in certain states did not prevent EFMs from nonetheless being perceived as profligate by the markets in the run up to the recent crisis. It thus bears reinforcing the point that the recent twin crisis was, more than anything else, a crisis of confidence. In the view of the financial markets, certain EFMs had not reformed sufficiently; no extrapolation from the recent crisis could be more manifest. This is to say that incomplete reform in some EFMs but not others did not preclude the onset and spread of contagion. Indications are that in certain cases where incipient reform had taken place, enforcement was lacking. Moreover, all among the Five behaved like potential targets of currency speculation and investment flight. Therefore, because meager, inconsistent, or ill-enforced reform did not render any EFM immune to the crisis, each is expected to try to enact reforms perceived as necessary for future crisis inoculation, irrespective of prior outcomes.

Beyond the assumptions of my theoretical framework lie the causal factors that I argue drive the outcome, potentially filling an important gap in the literature. Driven by real world events surrounding the ongoing integration of global financial markets and the concomitant upsurge in short-term capital mobility, since the mid-1990s IPE scholars have occasioned a burgeoning literature on the phenomenon of financial globalization—the ongoing integration of national capital markets. Most of this literature addresses one of two primary categories of globalization studies: the causes of financial globalization, with its higher levels of capital

mobility, and the effects. While the literature in the former category is much more extensive, this inquiry falls under the scope of the latter.

Within the category of "the effects of globalization," most contributions address either whether the globalization phenomenon is constricting the autonomy of the state or whether it is effecting a convergence of policies, institutions, etc. Only fairly recently, again in the wake of salient events, has the literature begun anew to deal with financial crises. However, the vast majority of these studies have been part of a veritable cottage industry on the *cause* of the Tequila and Asian financial crises (with economists having been even far more active than political scientists). As for its counterpart, a focus on the *effect* of contemporaneous financial crises, subject of the third debate, has been less visible.

A growing number of studies of the political economy of finance have emerged, some of whom deal primarily with the issue of financial globalization from a second image reversed perspective (Maxfield, 1990 and 1997; Woo, 1991; Frieden, 1991b; Haggard and Maxfield, 1993; Winters, 1996; Armijo, 1999). But very little has been produced on contemporary financial crises, and even less on the reform they engender (at least in the domestic sphere). This is auspicious in light of a gap that needs to be filled but unfavorable in terms of a dearth of material from which to draw. A trove of studies focused on the debt crisis of the 1980s, but few have focused their attention on balance of payments and banking crises in the 1990s (See *inter alia* Kahler, 1986; Nelson, 1990; Bates and Krueger, 1990; Haggard and Kaufman, 1992 and 1995).

Exceptions in this regard are both Eichengreen's important contribution to the burgeoning debate over a new "global financial architecture" (1999) and an edited volume by Kahler. The latter examines capital flows and financial crises, with significant contributions from Eichengreen and Fishlow on what is different about financial crises in the 1990s and Maxfield regarding the effects of portfolio flows on policy choice (1998). Haggard and

Maxfield run crises as an independent variable, positing balance of payment crises as the proximate cause for original decisions to liberalize economies in capital account terms (1996).

In a more recent exception germane to this inquiry, MacIntyre emphasizes the importance of domestic institutions—viz. veto players—in explaining government policy responses to the Asian crisis (2001). Bizarrely, however, he leaves out Korea, a crucial case to any account of EFM crisis recovery (the inclusion of which would appear to undermine the argument). Selection bias problems are compounded by a failure to consider alternative hypotheses, such as how the severity of crisis experience impacts the recovery effort. For example, the Philippines' recovery success is hardly surprising given how little it suffered compared to the rest of the East Asian Five; not to mention how Malaysia actually succeeded more in reality than it is given credit for in this piece, presumably in part because its experience was distinctly less severe than the three hardest hit EFMs. There are also problems in that a great deal is ascribed to extremely slight differences in number of veto players. Nonetheless MacIntyre's argument offers a compelling extension of the standard Tsebelis framework.

Rather than run balance of payment crises as an independent variable á la Haggard and Maxfield, and instead of looking exclusively at the initial phase of crisis recovery as MacIntyre does, I treat the experience of twin crises as an exogenous shock, a shock of such severity that EFMs are compelled to respond even well after stabilization is achieved. Once crisis conditions are alleviated and currencies in particular are stabilized, COGs are effectively forced to take pains to avoid adhering to the status quo and inviting crisis recurrence. They presumably must, therefore, grapple with the necessity of implementing an assortment of domestic reforms that could inoculate them against future twin crises.

As these reforms largely comprise adjusting policy levers and altering rules in the economic policy sphere—i.e. prudential and supervisory in the corporate and financial sectors—institutionalist theories are pertinent to this sort of inquiry. The institutionalist literature encompasses two particular schools of theory dealing with the effects of political institutions on

economic policy-making and performance. One of them focuses on the credibility of government commitments and investors' concern for policy stability, whereas the second emphasizes the nimbleness of government and how crucial policy flexibility is to economic reform. Both schools bear significantly on the understanding of how states deal with financial crises and their interplay with international investors, a critical question of the type motivating this inquiry.

The policy credibility school has been pioneered by Douglass North with the core proposition that secure and stable property rights regimes are conducive to investment and growth, which he and others have emphasized particularly with regard to economic development in Europe. As investors have always been wary of COG vacillations and policy volatility, the idea is that the development of political institutions to constrain COG executives reassures investors of a more stable environment for conducting commerce (North and Thomas, 1973; North and Weingast, 1989; North, 1990).

This literature's counterpart school cuts across this logic in its focus on the importance of policy flexibility. Less identifiable in terms of a single pioneering author, an array of scholars have emphasized how crucial the adaptability of governments to rapidly changing economic circumstances has been to economic development, i.e. how the flexible implementation of arduous economic reforms has directly facilitated investment and growth. Earlier contributions of this school are represented by literature on state autonomy and strength, much of it dealing the ability of different state structures to respond to economic shocks and promote investment and policy innovation (Johnson, 1982; Haggard, 1990; Wade, 1990; Nelson, 1990; Woo-Cummings, 1991; Haggard and Kaufman, 1995).

Somewhat more contemporary contributions emphasize the configuration of the state's domestic institutions, the relevant variables being party systems, electoral systems, bureaucratic delegation, and institutional division of powers (See *inter alia*, Steinmo 1989; Kiewiet and McCubbins, 1991; Moe and Caldwell, 1994; Haggard and Kaufman, 1995; Tsebelis, 1995;

Shugart, 1999; Haggard and McCubbins, 2000). These works highlight entities that allow / inhibit timely policy adjustments, the core proposition being that flexibility in policy-making and economic reform is consequential in terms of attracting investment.

Somewhat ironically, the logic of both schools' core propositions, and the compendium of evidence brought to bear in each, throw into stark relief the fundamental tension between them: their institutional underpinnings and basic arguments are in diametrical opposition to each other. Policy stability is augmented via institutional configurations in which policy-making authority is dispersed, thereby decreasing the likelihood of arbitrary actions; whereas flexibility is augmented via institutional configurations in which policy-making authority is concentrated, thereby decreasing the likelihood of delay. It would seem that both matter, for investors require stability and predictability in some areas and flexibility and adaptability in others. Both schools relate for more to democracies than autocracies.

Thus, if a regime is democratic there are theoretical reasons to expect mixed results for economic reform efforts: the higher number of veto players associated with democratic regimes (and the susceptibility of Westminster-style democracies to special interests) militates against successful reform outcomes; whereas the pressure on democratic COGs to achieve positive economic results (in order to get re-elected) militates in favor of successful reform.[24] The corollary is that after experiencing a twin crisis, democratic EFM COGs may succeed or fail in the short run, but are unlikely to fail over the long term.

Proposition 1: Democratic, representative regimes will achieve fair to poor economic results in the medium run; however, they will avoid prolonged periods of unsound economic policy-making.

> Corollary: Post twin financial crisis experience, emerging market governments of this regime type will achieve either relative success or relative failure in their reform efforts.

[24] While Tsebelis pitches the veto players variable as something that cuts across the regime type variable (1995), there is a strong theoretical and empirical association of large numbers of veto players and democracies (MacIntyre, 2001).

In standard macroeconomic terms technocratic, relatively non-corrupt, authoritarian regimes are likely to achieve the best economic results in the medium run, relative speaking. On some level even authoritarian regimes are accountable to their people, hence the Lee Kuan Yew "Singaporean type" autocrats who are less prone to rent-seeking behavior are expected to govern relatively in the interest of the populace. As long as reasonably benevolent dictators remain in power, with little domestic opposition and barring any malign international influences, it is more than likely that these COGs will be able to generate positive economic results, i.e. impressive GDP growth over the medium to long term, normal business cycles notwithstanding. The corollary is that after experiencing a twin crisis, EFM COGs of this regime type will have success achieving deeper institutional reforms necessary to appease investors.

Proposition 2: Technocratic, non-corrupt, authoritarian regimes will achieve positive economic results in the medium run (as long as reasonably benevolent dictators remain in power)

> Corollary: Post twin financial crisis experience, emerging market governments of this regime type will achieve second generation reformist *success.*[25]

Whereas less technocratic, corrupt authoritarian regimes are consistently likely to achieve dismal economic policy-making outcomes, the worst of all regime types. The Robert Mugabes and Joseph Mobutus of the world are almost invariably good at one thing: lining the pockets of themselves and their friends via the kickbacks associated with highly interventionist national economic policies. They do not perceive their own personal interests as tied up with that of the people they rule; hence, rent-seeking behavior even to the point of societal breakdown are to be expected. The corollary is that after experiencing a twin crisis, EFM COGs of this regime type broadly speaking will fail to achieve the reforms necessary to appease investors.

Proposition 3: Less technocratic, corrupt authoritarian regimes will consistently achieve meager economic policy-making outcomes.

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[25] I have benefited significantly from the work on these issues by Leslie E. Armijo as well as discussions with the author (Armijo, mimeos, 1999, 2000, and 2001).

Corollary: Post twin financial crisis experience, emerging market governments of this regime type will achieve thorough second generation reformist *failure*.

In contrast, democratic, representative regimes are likely to achieve little more than fair economic results in the medium term. Large numbers of veto points in political systems where powers are divided—or the susceptibility of governing parliamentarians to special interests in Westminster-style democracies—simply make it difficult for democratic governments to respond rapidly to changing economic circumstances. For example, in recent U.S. history the signing into law of economic stimulus packages tend to occur *after* economic recessions have already come to an end. However, the other side of the institutional checks and balances coin is that, due to potentially positive influence from certain veto players, democratic regimes may avoid prolonged periods of unsound economic policy-making; this is made even more likely due to the role that re-election prospects play, with their compelling incentives to enact growth enhancing policy.

Finally, antecedents of good government effectively act as proxies for a nebulous but nonetheless critically important type of political culture that is conducive to competent government performance. This part concept, part phenomenon has been memorably captured in Robert Putnam's recent work on social capital.[26] In essence, in states or other localities where good governance tendencies are rife, standard collective action problems are not as insuperable as in localities where rent-seeking free-riding tendencies are the norm; for example, plentiful social capital socializes COGs and other policy-makers to provide a steady flow of public goods, which in turn facilitate growth enhancing processes.

Thus, states exhibiting antecedents of good governance are likely to achieve sound economic policy-making results. This scenario is also engendered by the degree to which traditional impediments to sound policy-making tend to recede during crisis periods, making

[26] Putnam, 1993; Fukuyama, 1995.

barriers to reform more surmountable than under normal circumstances. In other words, if interest group demands wane in the wake of crisis and veto players become less likely actually to veto reform measures, then the absence of standard hindrances to COGs—and their legislative and bureaucratic counterparts—will open up the policy-making channels, leaving little else to stand in the way of necessary reforms that are likely to emanate from more primordial causal factors like the antecedents of good governance.

Proposition 4: The presence of "antecedents of good governance" lead governments to achieve sound economic policy-making.

> Corollary: Post twin financial crisis experience, emerging market governments exhibiting positive antecedents will achieve second generation reformist *success*; those whose antecedents of governance are negative will achieve reformist *failure.*

Moreover, the good governance causal factor helps compensate for the indeterminacy of the regime type variable, as not all (democratic) societies are fortunate to possess good governance endowments. Thus, the interaction of these causal factors helps to account for which democratic regimes achieve *relative success* and which ones achieve *relative failure*. Likewise, it helps to account for which autocratic regimes achieve *success* and which achieve *failure*, strictly speaking. The corollary is that after experiencing a twin crisis, EFMs exhibiting antecedents of good governance will achieve either *success* or *relative success* in their reform efforts, whereas those without will achieve either *failure* or *relative failure*—depending on their regime type.

Proposition 5: The presence of "antecedents of good governance" lead democratic governments to achieve relatively sound economic policy-making; the absence of antecedents of good governance lead democratic governments to achieve relatively unsound economic policy-making.

> Corollary: Post twin financial crisis experience, emerging market democracies exhibiting positive antecedents will achieve *relative success* in their efforts to enact second generation reforms; those exhibiting negative antecedents will achieve *relative failure.*

Proposition 6: The presence of "antecedents of good governance" lead autocratic governments to achieve thoroughly sound economic policy-making; the absence of antecedents of good governance lead autocratic governments to achieve thoroughly unsound economic policy-making.

> Corollary: Post twin financial crisis experience, emerging market autocracies exhibiting positive antecedents will achieve *success* in their efforts to enact second generation reforms; those exhibiting negative antecedents will achieve *failure*.

Much of the causal argument clearly rests on the notion of so-called "good governance." Not surprisingly, it is a disputed one. In more abstract terms the good governance concept encapsulates doing the direct will of the people vs. achieving outcomes in the best interest of the people. On one hand, governance in terms of acceding to the general wishes of the populace would reasonably qualify on political representation grounds—perhaps even when the longer term consequences of highly interventionist short-term economic policy are subsequently recognized as disastrous by erstwhile supporters. On the other hand, principled notions of achieving the greatest public good arguably suffice (however, such classic principles as equity/redistribution and efficiency/nonintervention inevitably clash). In a more applied sense, as popularized by the World Bank over the last decade or so, this multifarious concept may comprise either the government-related causes that allow a state to promote development, or their socioeconomic outcomes.[27]

Though economic history over the past several decades augurs toward the latter, by narrowing the good governance ambit I am on safer ground. In light of the severity of the Asian crisis—including the newfound poverty, dislocation, and social unrest that has persisted despite multiple years of economic growth—I treat "good governance" in the case of the East Asian Five merely as the implementation of policies designed and expected to prevent a recurrence of a twin economic crisis. This non-ideological objective conforms to the preferences of all political

[27] Kaufmann, Kraay, and Mastruzzi 2003.

actors involved, whether domestic or external. While the steps aimed at achieving this objective veer toward neoliberalism, leaving the means aside it constitutes an end adhering to national, group, and individual interests alike.

I therefore postulate that an EFM's post-crisis ability both to implement and enforce the key neoliberal reforms demanded by the markets, the IMF, the U.S., etc., hinges principally on the presence of antecedents of good governance in a given EFM—as indicated by its degree of corporate ownership concentration, level of corruption, rule of law, judicial efficiency, and level of social capital. Similarities notwithstanding, a given EFM will achieve success in the implementation / enforcement of specific second-generation reforms—capital adequacy requirements, loan classification / provisioning requirements, debt-equity ratios, transparency measures, and statutory bankruptcy procedures—if its antecedents of good governance are strong. Whereas, if its antecedents of good governance are weak, then the EFM will fail to achieve even a modicum of success, if not fail altogether.

Table 1

Reform Success		Good Governance: Strong	Good Governance: Weak	
	Yes	Malaysia Korea		Period:
	No		Thailand Philippines Indonesia	Jan ‘98 - Jan ‘02

In Table 1 the cases are classified in terms of the antecedents of good governance (whether they are positive or negative: *x* axis) and the dependent variable, banking and corporate sector reform efforts (whether they are successes or failures: *y* axis). Success based on the possession of positive governance antecedents is predicted for Malaysia and Korea; whereas failure based on the possession of negative governance antecedents is predicted for Thailand, the Philippines, and Indonesia. Yet, were the argument left at this stage, once the evidence is evaluated it could potentially be vulnerable to the criticism that there remains considerable variance in each reform outcome category, success and failure, to be explained. If this were the case, then omitted variable bias could be problematic.

Thus, this paper further postulates that if a given EFM’s antecedents of good governance are positive and it is autocratic, it will achieve “success”; if it is democratic, then it will merely achieve “relative success.” Whereas, if a given EFM’s antecedents of governance are negative and it is autocratic, its efforts will result in “failure”; if it is democratic, its efforts will result in only “relative failure.”

Table 2

Good Gov	Democracy: No	Democracy: Yes
Strong	Success	Relative Success
Weak	Failure	Relative Failure

Period:

Jan '98 - Jan '02

In Tables 2 and 3 the cases are classified in terms of regime type (whether they are democratic or autocratic: *x* axis) and the antecedents of good governance (whether they are strong or weak: *y* axis). Full-fledged success due to autocracy and the possession of strong governance antecedents is predicted for Malaysia, but only relative success due to democracy and strong governance antecedents is predicted for Korea; whereas relative failure is predicted for both Thailand and the Philippines due to democracy and the possession of weak governance antecedents, while full-fledged failure is predicted for Indonesia due to autocracy and weak governance antecedents.

In and of itself, hypotheses that either democracy or autocracy causes success are easily falsified. Indonesia gets classified as an autocracy, despite recent elections and the ouster of autocratic President Suharto, then his fellow crony President Habibie, and then President Wahid; the reason being that most of the government's reform efforts occurred first under autocrats and then under a regime that was and still is under transition, potentially to democracy. Malaysia under former Prime Minister Mahatir is a case of softer autocracy compared to Suharto's Indonesia, though both are considered autocracies.

Table 3

Good Gov	Democracy: No	Democracy: Yes
Strong	Malaysia	Korea
Weak	Indonesia	Thailand Philippines

Period:
Jan '98 - Jan '02

In terms of defining success and failure, I operationalize second generation reformist *success* in terms of a given EFM's ability to meet and enforce "international best practice" standards for five of the six following indicators: non-performing loans (NPLs), capital adequacy ratios (CARs), loan classification / provision measures, debt / equity ratios, transparency measures, and bankruptcy procedures. These six indicators are only a few among myriad microprudential indicators, as related to EFM prudential and supervisory regulations—the technical terms for second generation reforms in finance and banking circles. Others include loan / deposit ratios, leverage ratios, interest coverage ratios, credit / GDP ratios, sectoral credit concentration, corporate debt levels, corporate profitability, gross debt standards, risk profile of assets, income recognition rules, banking sector profitability, interest accrual, etc.

They were selected largely on the basis of the following criterion: those indicators that are viewed by different classes of investors as the most indicative of the extent to which they can be confident in the overall quality of a given EFM's regime of prudential regulations. Based on a series of interviews with IFI finance officials, my six chosen indicators top the list of those most likely to determine investor confidence; for example, a given institutional investor tends to

examine a short list of microprudential indicators, in addition to macroeconomic and firm-level indicators, in assessing investment prospects (confirmed in a series of interviews with IMF and World Bank officials).[28] While these six indicators have much greater salience compared to others listed above, it is less apparent how salient they are vis-à-vis one another (IFI officials rank these six above the rest according to the above criterion, but appear not to have achieved consensus on a single rank order of the six themselves; CARs and NPL levels, however, appear highly salient).

International best practice standards for the six indicators, as stipulated by the Bank for International Settlements (BIS), involve the following: capital adequacy ratios of 8% or higher; loan classification measures in terms of 3 month classes (at least 3 - 6 months for "substandard"; 6 – 9 months for "doubtful"; and 9 – 12 months for "loss"); loan provision measures involving setting a standard minimum percentage for which provisioning occurs, ideally 3%, and progressing through three classifications; debt equity ratios with a growth rate no faster than the GDP growth rate, i.e. roughly 2.5%; transparency and disclosure measures (i.e. auditing and financial reporting standards) stipulating a supervising agency, specified compliance standards for firms, independent directors and external audit subcommittees, and substantial penalties for fraudulent reporting; and bankruptcy laws on the books comprising strong creditor rights with full procedures for insolvency, foreclosure, and liquidation. Success constitutes the achievement of 5 or 6 / 6; relative success constitutes the achievement of 4 / 6; relative failure constitutes achievement of 2 / 6; and failure constitutes achievement of 0 or 1 / 6.

Alternative Hypotheses

The most obvious alternative hypotheses involve actors and factors at the domestic and international levels, viz. regime type, number of veto players, IMF Program commitments, and several economic factors (vulnerability to crisis, severity of crisis, ability to withstand crisis, and

[28] I conducted 19 interviews of the IMF, World Bank, and IADB officials in Washington during the spring of 2003.

size of the economy). I will discuss each of these here, leaving a handful of others for my results tables below. Essentially, as the discussion of my dependent variable results will show, and as Table 3 predicted, efforts among the East Asian Five to implement reforms in their financial and corporate sectors have resulted in the following ranking, from best to worst: Malaysia succeeded; Korea achieved relative success; Thailand and Philippines did not succeed; and Indonesia was a thorough failure.

Taking the independent causal potential of regime type into consideration, falsification is clear based on how the two autocracies under consideration performed at opposite ends of the dependent variable spectrum. Thus, with the hypotheses attached to regime type falsified, the next reasonable candidate is the variable encompassing number of veto players in a given EFM. Under normal circumstances, it would be difficult to dismiss some sort of effect of this causal factor. But the Asian financial crisis and its aftermath do not qualify as "normal circumstances" or anything approaching *ceteris paribus*.

Akin to arguments in the East Central European context—where post-1989 governments and veto players of political persuasions across the board from left to right engaged in neoliberal economic reform programs[29]—I aver that veto players in East Asian EFMs have been largely responding in somewhat the same fashion to their own fairly cataclysmic experiences, in a context akin to what Leszek Balcerowicz has described as "extraordinary politics."[30] Whereas veto players in East Central European EFMs responded to the ravages of communism and command economic policy by seeking to tear down the old and replace it with the new, I posit that their East Asian counterparts have behaved similarly with regard to the ravages of their twin financial crisis experiences.

As such, I argue that the experience of the Asian crisis was so thoroughly and demonstrably negative from the perspective of domestic actors—across the ideological

[29] Hellman, 1998; Horowitz, 2000.
[30] Balcerowicz, 1994.

spectrum—that the landscape of preferences regarding economic policy and regulatory institutions was temporarily reconfigured in the wake of the crisis. According to this perspective, due to a radical instance of punctuated equilibrium, veto player preferences have been aligned, so that regulatory reform agendas have become aimed in the direction of second generation reform. The simple explanation for this is, as already discussed, the prospect of a recurring crisis unless significant reforms are enacted.

Thus, because preferences across veto players are posited to have been similarly recast and now broadly in alignment with regard to regulatory reform, the number of veto players becomes irrelevant so long as these conditions prevail. With preferences in favor of regulatory change shared by all veto players, their large number in Korea, Thailand, and the Philippines is transformed from a traditional hindrance into an actual facilitator of reform. As Balcerowicz states it in the Polish case,

> [t]he Polish program was prepared and launched under a double crisis: a long-term structural problem of low and falling efficiency and a macroeconomic catastrophe. It was the latter that gave the Polish situation a dramatic dimension. This crisis both required radical measures, especially with respect to stabilization, and increased the people's readiness to accept such measures . . . . Otherwise, the radical institutional program, especially privatization, would not have been possible. Liberalization and a massive Solidarity victory probably motivated people to accept the radical reforms. In this special situation of "extraordinary politics," there was a stronger-than-usual tendency among the political actors to act in terms of the common good. This and the government's speed of action explain the overwhelming acceptance of the economic program.[31]

Precisely via the mechanism of "extraordinary politics," democracies and quasi-democracies have not been impeded by the traditional obstacle from Tsebelis's well-known framework, which ordinarily proscribes states with multiple veto players from achieving significant reform (there are no Westminster type democracies among the Asian EFMs—nor among their Latin American counterparts).

This atypical, and certainly ultimately fleeting, alignment of preferences in favor of second generation regulatory reform is the key to understanding how the Tsebelis framework can be flipped on its head amid a set of special circumstances. On the rare occasions when sector

specific preferences of multiple political actors become aligned along essentially the same lines, due to a sizeable shock or stimulus as in this instance, the propensity of important political actors to preclude or "veto" the passing of regulatory reform thereby diminishes. If nearly all the veto players come to hold the same or fairly similar policy positions in this issue area, then attempts to obstruct COG-driven attempts at reform will not transpire. With an inflated win set, the COG's preferred policy is more realizable. *Ipso facto*, as long as this condition is maintained, a large number of veto players in a given political system actually serves to promote rather than hinder reform.

Clearly, such a set of circumstances is a deviation from the norm, which involves multiple players with differing preferences competing and, in states with a large number of veto points, generally obstructing reform attempts by COGs, as Tsebelis and others contend. The notion here is that something approximating a sword of Damocles is hanging over the heads of EFM veto players. Certainly, the "knock-on" crises in Russia, Brazil, Ecuador, and Argentina have kept up the pressure. With veto players broadly in alignment—and interest groups thereby impeded—COGs face few reform impediments outside of negative governance antecedents. Important political actors in EFMs face a plausible specter of recurrent crisis: if they fail to achieve significant progress in the area of second generation economic reforms, investors and foreign financial intermediaries are likely to swing their swords and exit. It goes almost without saying that the costs of non-action in this credibility game are extremely high.

In addition to testing these hypotheses, this inquiry tests three other alternative hypotheses. First, contrary to my argument, it may be that the driving force behind EFM policy responses to the Asian crisis is not related to regime type or the antecedents of good governance but the role played by the IMF instead. If, post-crisis alleviation, EFMs are subject to the dictates of IMF Support Programs, in which participating governments agree to policy reforms in exchange for financial assistance, then this alternative hypothesis would seriously undermine the

[31] Balecerowicz, 1994.

argument proffered here—particularly if none of the non-reformers have signed such IMF agreements. If one could observe that those EFMs with significant second generation reform progress have their hands held to the fire by the IMF, then this alternative hypothesis would *a fortiori* be confirmed. However, it is falsified in light of the evidence showing that Malaysia, which has not been on an IMF program over the past four years, is in fact the best performer of the Five; moreover, Indonesia, which has been tethered to such a program, has performed the worst.

A closely related alternative hypothesis posits that post-crisis EFM responses are driven by the Wall Street-Treasury Complex, i.e. that their continued liberalizing behavior has come specifically at the behest of pressure from the U.S. and/or other American influenced international organizations. While such influence attempts are difficult to measure, the U.S. and the IMF and World Bank have on different occasions, and in different ways, pressured all East Asian EFMs to implement prudential and supervisory reforms in their corporate and banking sectors; the slight but discernable differences in external pressures do not covary with the dependent variable results.

Also, it is not altogether implausible that EFM crisis responses are better accounted for by the degree to which a past history of consistent reformist success is in evidence in a given EFM. Which is to say that, in spite of the supposition of a newly crisis-leveled playing field alluded to earlier, it may be that the factor accounting for the greatest amount of outcome variance is the predilection of certain EFMs for reformism of whatever kind (or the fact that some of the Five were already ahead of others in certain aspects of second generation reform).

In other words, domestic conditions conducive to reform—other than those emphasized here—could exhibit clear covariance with regard to second generation liberalization. Such conditions might include things like legacies of colonization, influential domestic groups with neoliberal preferences, or ideational learning. For example, it may be that EFMs have learned the putative lesson over the course of the 1980s and 90s that economic or financial restrictions of

almost any kind are highly costly and therefore to be avoided. Akin to arguments about the idea of free trade driving states to remove trade protections, this alternative hypothesis could be confirmed if evidence can be found whereby each of the EFMs implementing neoliberal reforms can be observed undergoing some sort of learning process, while the causal factors that I emphasize here are varying and outcomes are not. Yet, prima facie evidence for each of these factors indicates that variation in them does not covary with EFM reform outcomes; as such, I consider them falsified.

Finally, it would be remiss not to consider evidence in pure economic form. Hypotheses that divergent reform outcomes are accounted for by degree of pre-crisis vulnerability (the less vulnerable one was pre-crisis, the more easily one can reform post-crisis), severity of crisis experience (the more severely one is affected, the more difficult recovery and reform become), ability to withstand crisis (the richer one is in income per capita terms, the more easily one can reform), and size of the economy (the bigger the economy, the less difficult reform becomes) display different degrees of plausibility, with the middle two hypotheses being the most plausible.

Nonetheless, although economists have made arguments along the lines of all four, particularly those working in the IMF and World Bank, the evidence shows that only one of the four exhibits any empirical traction (but plausibility here is suspect). The following comprise the order of each of the Five in terms of these four hypotheses: vulnerability to crisis (from least to most: Malaysia, Korea, Thailand, and Indonesia, with the Philippines not available), severity of crisis experience (from least affected to most severely affected: the Philippines, Malaysia, Korea, Thailand, and Indonesia), ability to withstand the crisis (from richest to poorest: Korea, Malaysia, Philippines, Thailand, and Indonesia), and size of the economy (from largest to smallest: Korea, Malaysia, Indonesia, the Philippines, and Thailand). The closest to covariance with the reform outcomes is the first, vulnerability to crisis, despite its being the least plausible in

causal mechanism terms.[32] Although I consider all four fairly falsified, I do not doubt that if there were enough cases to subject this inquiry to statistical analysis, then the second and third just might show statistical significance with small coefficients or marginal effects.

Results and Evidence

In light of the fact that including my case studies of all five East Asian EFMs would take up an inordinate amount of space, I refrain from including them in this paper and substitute tables of results for the dependent and independent variables and alternative hypotheses instead. The following sources contain Asian EFM crisis and post-crisis case studies, though confined largely to their initial crisis recovery efforts, as opposed to the reform efforts that are the subject of this inquiry (Haggard 2000; Nobel and Ravenhill 2000a; Emmerson 1999; Harymurtri 1999; Mo and Moon 1999; and Suchit 1999).

To reiterate, I operationalize second generation reformist *success* in terms of given EFM's ability to meet and enforce "international best practice" standards for at least five of my six indicators: non-performing loans, capital adequacy ratios, loan classification / provision measures, debt / equity ratios, transparency measures, and bankruptcy procedures. International best practice standards, as set out by the Bank for International Settlements (BIS), involve the following: capital adequacy ratios of 8% or higher; loan classification measures in terms of 3 month classes (at least 3 - 6 months for "substandard"; 6 – 9 months for "doubtful"; and 9 – 12 months for "loss"); loan provision measures involving setting a standard minimum percentage for which provisioning occurs, ideally 3%, and progressing through three classifications; debt equity ratios with a growth rate no faster than the GDP growth rate, i.e. roughly 2.5%; transparency and disclosure measures, including a supervising agency, specified compliance standards for firms, independent directors and external audit subcommittees, and substantial

[32] See Corbett and Vines for an extensive discussion of this issue, the different indicators of vulnerability, and the evidence (1999) Also, see Caprio for a pertinent discussion and presentation of evidence (1998).

penalties for fraudulent reporting; and bankruptcy laws on the books with strong creditor rights and full procedures for insolvency, foreclosure, and liquidation.

As previously stated, success constitutes either 5 or 6 / 6; relative success constitutes the achievement of 4 / 6; relative failure constitutes achievement of 2 / 6; and failure constitutes achievement of 0 or 1 / 6. Indeed, the evidence collected regarding the dependent variable outcomes reveal that Malaysia has achieved 5 / 6, i.e. “success”; that Korea has achieved 4 / 6, i.e. “relative success”; that Thailand has achieved 2 / 6, i.e. “relative failure”; that the Philippines has achieved 2 / 6 “relative failure”; and that Indonesia has achieved 1/ 6, i.e. “failure.” These results adhere fairly well with the hypothesis-generated predictions stemming from the argument laid out above, viz. that the what I refer to as the a given EFM’s “antecedents of good governance” (dependent also on its regime type) account for whether it either succeeds or fails in its post-financial crisis efforts to implement second generation economic reforms.

Table 5 below displays the evidence on my dependent variable—second generation reforms—with placement of the three indicators of banking/financial sector soundness in the first three columns and the three indicators of corporate sector soundness in the remaining columns. These six indicators were selected on the advice of IMF and World Bank officials interviewed in February and March of 2003. The primary selection criteria is whether or not a potential prudential indicator is viewed as important in the eyes of investors. There are myriad indicators, but certain of them have greater salience and are watched more closely by markets than others; these are the ones selected for measuring the extent of second generation reform among the East Asian Five.

By way of explanation, the indicators themselves require some minor fleshing out (more detail is provided in the case studies). NPLs are simply bank loans that debtors have defaulted on, hence their “non-performing” status; while some of the NPLs counted below have been transferred to Asset Management Companies set up by the Five in their crisis recovery efforts, these were counted if still held by the AMCs. CARs represent the percentage of a given bank’s

ratio of overall capital to its (risk weighted) assets, which the central bank requires it to have on hand at any given time, the aim being to ward of the danger of insolvency from any unexpected short-term shocks. Loan classification rules define when loans are officially considered "past due," while loan provisioning rules define how past due loans effectively get written off by banks in terms of asset valuation.

On the corporate side, debt / equity ratios literally are what they sound like, i.e. the amount of debt a firm has when measured against its equity holdings; this measure is useful in terms of evaluating how healthy firms are. Transparency and disclosure requirements are the rules encompassing auditing and financial reporting standards; if these are not up to international standards, then it is highly difficult for outsiders like market actors to independently assess the health of a given firm. And, finally, bankruptcy regimes consist of the law-based procedures that set out the process adhered to by indebted firms when they go bankrupt; without regimes representing strong rights for creditors, too many firms that are de facto failures get kept afloat, thereby absorbing resources that would be more efficiently allocated elsewhere in the real economy.

Table 5: Dependent Variable Measures*

Non Perform Loans[33]	**Cap Adequacy Ratios**[34]	**Loan Classification/ Provisioning**[35]	**Transparency / Disclosure**[36]	**Debt / Equity Ratios**[37]	**Bankruptcy Regimes**[38]
% of total loans; Dec '98, Mar '01; < 2.5 % point change = success	Avg. set CAR; > 8.0% = success standard	Score scale 1-4; 4 equals best practice; 4 = success standard	Score scale 0-4; 4 equals best practice; 4 = success standard	selected listed co.s (weighted avg); < 2.5 = success standard	4 indicators of strong creditor rights (score of 0-4 possible); 3 = success standard
Mid-2001	End-2000	Mid-2000	Mid-1999	End-2000	Mid-2001

[33] Source: "Regional Overview," *East Asia Update*, October 2001 (World Bank, Washington).
[34] Sources: "Financial and Corporate Restructuring in East Asia—An Update," Bankground Paper, March 2001 (World Bank, Washington); *Asia Economic Monitor*, December 2001 (Asian Development Bank, Manila).
[35] Sources: Juzhong Zhuang, David Edwards, David Webb, and Ma. Virginita Capulong, "Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand," Vol I, 2000 (Asian Development Bank, Manila); Stijn Clasessens, Simeon Djankov, and Daniela Klingebiel, "Financial Restructuring in East Asia: Halfway There?", *Financial Discussion Paper* No. 3, September 1999 (World Bank, Washington); Carl-Johan Lindgren, Tomas J.T. Blino, Charles Enoch, Anne-Marie Gulde, Marc Quintyn, and Leslie

21.1; 23.2 M	12.4 M	2; 2 M	4 M	2.5 M	4 M
16.1; 16.2 K	10.3 K	3; 3 K	3 K	2.1 K	4 K
45.0; 26.7 T	11.4 T	3;2 T	2 T	6.3 T	3 T
10.4; 16.7 P	16.0 P	n.a.; n.a. P	1 P	2.1 P	0 P
n.a.; 54.4 I	8.0 (target) I	3;2 I	1 I	4.4 I	3 I

* Underscore indicates "success" and M = Malaysia, K = Korea, T = Thailand, P = the Philippines, and I = Indonesia

Table 6 presents evidence on the main alternative hypothesis discussed earlier in the paper. The evidence coheres with my view that none of the alternatives to the hypotheses related to my argument are able to be confirmed.

Table 6: Primary Alternative Hypotheses

	Dependent Variable Fin'l and Corp Sector Reform	**Regime Type** 1993 – 96 avg. 0 - 8 ; 0 – 10 Fr House; Polity III	**Veto Players** Number 1998 – 00 avg.	**IMF Program** Yes or No 1998 – 99	**COG Type** Crony or Not 1998 – 99
Malaysia	Success	4.5 ; 4.5	1	No	Crony
Korea	Relative Success	2.2 ; 9.0	4	Yes	Non-Crony

Teo, "Financial Sector Crisis and Restructuring: Lessons from Asia," IMF Ocasional Paper No. 188, 2000 (IMF, Washington); "Building Institutions for Markets," *World Development Report* 2001 (World Bank, Washinton).
[36] Source: ADB, 2000.
[37] Source: ADB, 2000.
[38] Sources: "Insolvency Law and Reforms in the Asian and Pacific Region," in *Law and Policy Reform*, Vol. I, April 2001 (Asian Development Bank, Manila); *Guide to Restructuring in Asia*, September 2001 (Asian Development Bank, Manila).

Thailand	Relative Failure	3.4 ; 9.0	6	Yes	Mixed
Philippines	Relative Failure	2.9 ; 9.0	3	No	Crony
Indonesia	Failure	7.5 ; 0.0	1	Yes	Mixed

Finally, Table 7 presents the evidence on the five indicators that together comprise my primary independent variable, the *antecedents of good governance*, along with the intervening variable of regime type. Together these particular indicators not only appear to account for variance in the outcomes of EFM reform efforts—meeting the causal standards of necessity and sufficiency in the process—but they also avoid some formidable problems with endogeneity and tautology that are associated with stock variables employed primarily by economists who study EFMs and financial crises. These include imprecise and often highly endogenous variables such as "governance," "government capacity," "bureaucratic quality," "institutional quality," "voice," "accountability," "regulatory quality," "current property rights regimes", "government expropriation risk," etc.

Table 7: Independent Variables

Regime Type	**Corruption** Avg. '95 - '97 TI, ICRG[39] 0 – 10; 10 = best	**Trust** WDR 1997[40] 0 – 7; 7 = best	**Ownership Concentration**[41] Top 10 families % of total market cap controlled	**Rule of Law** LLSV 1996[42] 0 – 10; 10 = best	**Judicial Efficiency** LLSV 1999[43] 0 - 10; 10 = best

[39] Sources: Transparency International; International Country Risk Group.
[40] Source: The World Bank's "World Development Report," 1997.
[41] Claessens, Djankov, and Lang, 1999.
[42] La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1996.
[43] La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998.

Non - Dem M	5.7 M	6.2 M	24.8 M	6.78 M	9.00 M
Dem K	4.9 K	6.5 K	26.8 K	5.35 K	6.00 K
Dem T	3.6 T	4.2 T	46.2 T	6.25 T	3.25 T
Dem P	2.6 P	n.a. P	52.5 P	2.73 P	4.75 P
Non - Dem I	2.2 I	n.a. I	57.7 I	3.98 I	2.50 I

The measures appear to line up well with my hypotheses and co-vary with the empirical outcome of my cases, thereby providing a seemingly convincing explanation of why some East Asian EFMs have made post-crisis reform progress and others have not, despite a shared and compelling structure of incentives for reform.

Given the desired luxury of having hundreds more cases, it would be interesting to use such econometric techniques as factor analysis to combine these indicators into a single measure to regress on my dependent variable. In any case, several passing caveats are necessary. First, although I could not collect enough trust data to independently verify my interviews, several country IMF experts claimed that the levels of trust in the Philippines and Indonesia are lower than the other three cases; second, I acknowledge that the present regimes in both Malaysia and Indonesia may be more appropriately labeled as “mixed”; and third, I acknowledge that Rule of Law and Judicial Efficiency are potentially endogenous, perhaps to Ownership Concentration (I have collected evidence on Legal Origin that may effectively deal with this potential problem).

Conclusion

This paper has demonstrated that an EFM's post-crisis ability both to implement and enforce the key neoliberal reforms demanded by external actors, hinges principally on the presence of antecedents of good governance in a given EFM—high social capital, low corruption, high judicial efficiency, strong rule of law, and low wealth concentration. In other words, similarities notwithstanding, EFMs achieve success in the implementation / enforcement of important crisis-inoculating banking and corporate sector reforms if their antecedents of good governance are positive. Whereas, those marked by negative antecedents of good governance do not achieve even a modicum of success, possibly failing altogether.

This paper further demonstrated that the regime type of EFMs represents an additional causal effect on the outcome in question, specifically via interacting with the governance antecedents variable so as to achieve both causal necessity and sufficiency. In light of evidence presented for the East Asian Five, the results of this study do indeed appear to confirm the aforementioned hypotheses. As predicted, autocratic cases with positive antecedents proved successful; autocratic cases with negative antecedents failed; democratic cases with positive antecedents proved relatively successful; and democratic cases with negative antecedents were relative failures (see Tables 5 and 7 above). In other words, Malaysia has succeeded in the post-crisis implementation of requisite banking and corporate sector reforms for staving off future rounds of twin financial crises; Korea has proved relatively successful; Thailand and the Philippines have been relative failures; and Indonesia has been a complete failure.

In terms of where to go from here, other EFMs in East Central Europe and particularly Latin America appear conducive for testing this paper's argument. Having experienced their own financial crises in recent years—most notably the 1994-95 Tequila twin crisis in Latin America, the 1998 twin crisis in Russia, and the 2002 debt default in Argentina—it remains to be seen whether the same causal framework can account for varying reform outcomes in those

EFMs. Prima facie indicators appear propitious; however, more extensive data collection is necessary to evaluate this project's hypotheses with a greater degree of certainty.

The potential policy relevance of this inquiry is apparent in that the importance of EFMs avoiding the new breed of twin financial crisis cannot be underscored enough. Unfortunately, given the lack of substantial, across the board success of second generation reform efforts, at least in East Asia—not to mention the abortive attempts to alter or upgrade the so-called international financial architecture—notwithstanding the sigh of relief over the lack of any serious Argentine default contagion, there appears to be plenty of tinder still strewn around the international economy merely waiting for a match to set it alight.

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