

***To what extent was crony capitalism to blame for the 1997 – 98 financial crisis in Southeast Asia?
(Choose any 2 countries covered in this course for your focus).***

“In nearly every economic crisis, the root cause is political, not economic.”

Lee Kuan Yew¹

The Asian financial crisis in 1997 had been analysed widely by academics, policy-makers and economists. The unexpectedness of the crisis and its magnitude that hit countries long regarded as “*economic miracles*” steered up much interest in the subject. Perhaps the apprehension is due to the potential spread of contagious effects to the rest of the world. Before discussing about the causes of the crisis, one needs to understand how political action is being demonstrated in Southeast Asia. In an attempt to analyse the economic and political action in Southeast Asia, anthropologists have developed the *patron-client model of association*.² Western political scientists have relied on these two models of association and conflict:

1) The horizontal, class model of conflict represented most notably by Marxist thoughts.

It explains conflict within the more modern sector of colonial nations and it analyses cases where rural changes have been so cataclysmic as to grind out a dispossessed, revolutionary agrarian mass.

This model helps explain the recurrent agrarian movements in Central Luzon although it does not enable us to understand the competition among the political parties in the Philippines.

¹ Senior Minister Lee Kuan Yew’s address in October 1997 at the Fortune 500 Forum in Boston in Jeffrey A. Winters, “*The Determinant of Financial Crisis in Asia*” in T.J. Pempel, ed. *The Politics of the Asian Economic Crisis*, Ithaca : Cornell University Press, 1999, p.87

² James C. Scott, “Political Clientelism and Political Change in Southeast Asia” in Steffen Schmidt, James Scott, Carl Lande and Laura Guasti, eds., *Friends, Followers and Factions : A Reader in Political Clientelism*, Berkeley : University of California Press, 1977.

2) *The primordial model that emphasises primordial sentiments such as ethnicity, language and religion rather than horizontal class ties.*

The model is reflective of self-identification. It helps to explain the tension and conflict that increasingly occur as these ascriptive, isolated groups come into contact and compete for power. For instance, the primordial model explains the racial hostilities and conflicts that exist in Malaysia as well as helps us understand the basis dissident movements in North and Northeast Thailand. It does not however, enlighten us about the intra-Malay politics.

Besides the realm of communalism and class conflict, the political process in Southeast Asian model can be characterised through a realm of informal power groups, leadership-centred cliques and factions such as ad-hoc groupings. The patron-client relationship best describes such groupings. The basic pattern is an informal cluster consisting of a very powerful figure who is in a position to give either security or inducement or both. In return, his personal followers will contribute loyalty and personal assistance to the patron's designs. The patron-client ties may or may not be corrupt but when a patron occupies a public position or extracts favours from those in public positions, patronage and corruption overlaps³. These patron-client linkages represent an important structural principle of Southeast Asian politics.

Causes and Effects of the Asian financial crisis

Economists have argued that the main elements of the crisis are not new or not unprecedented. The bursting bubble (real estate and stock markets) has been a common feature in

³ Paul Hutchcroft, "The Politics of Privilege : Assessing the Impact of Rents, Corruption and Clientelism in Third World Development", in Paul Heywood, ed., **Political Corruption**, Malden : Blackwell Publishers, 1997, p. 229

economic history.⁴ For the past decade before the crisis, export-led growth, extensive foreign borrowing and the favouring of short-term investments by financial sectors contributed not only to construction and property booms, but also to stock market bubbles. In Thailand, the asset bubbles were created by “*moral hazard*”. Financial intermediaries were unregulated and they were prone to excessive risky lending, leading to inflation of asset prices. Once the property bubble had burst, many real-estate companies found it impossible to pay their short-term debts. Many finance houses that had lent heavily to property developers went bankrupt. As the Thai baht fell in value, Thai companies began to default on loan payments and the cost in baht of their dollar loan soared. By July 1997, total external indebtedness exceeded 50% of Gross Domestic Product (GDP) in Thailand, Philippines and Indonesia.⁵ Sharp falls in currency resulted in a reevaluation of all foreign debts, triggering off a steep rise in private debt, placing great pressure on the banking system that led to the escalation of the proportion of their non-performing loans. Capital flight out of Thailand and the collapse of the baht had made investors nervous about the region causing panic as a whole. The panic contributed to a downward spiral process whereby once the value of financial assets and real estate declined, agents were encouraged to sell more, thus further depressing asset prices and inflicting tremendous damage.

The Economic factors that contributed to the crisis include:

- 1) Over-reliance on foreign capital by the Asian emerging economies
- 2) Weakness of the financial system
- 3) Inappropriate macroeconomic policy responses to external problems and pressures
- 4) Sudden shift in foreign investors’ confidence and over-reactions in some cases which led to contagion

⁴ Eddy Lee, *The Asian Financial Crisis, The Challenge for Social policy*, Geneva, International Labour Office, 1998, p. 12

⁵ Uwe Johannsen, Jurgen Rudolph and James Gomez, eds. *The Political Dimensions of the Asian Crisis*, Singapore : Select Books, 2000, p.17

- 5) Vicious circle of the interactions between the banking crisis and weakening real economies which led to a deeper and deeper recession⁶

The Political causes of the crisis⁷ :

- 1) Non-democratic systems of government and weak democratic institutions
- 2) Corruption, Collusion and Nepotism
- 3) Inadequate Electoral Systems
- 4) A lack of Separation of Powers, Manipulation and Dependence of the Judiciary
- 5) The role of civil society and the media

Crony capitalism

Crony is another term for “close friend” while *capitalism* denotes “a distinct form of social organisation based on generalised commodity production, in which there is private ownership and / or control of the means of production.”⁸ Hence a key element of ***crony capitalism*** is widespread political interference with the market processes through give-away privatisations to relatives and cronies of the political leaders, the granting of artificial monopoly rights, government direction of credit towards political allies and government bail-outs of politically connected enterprises.⁹ All these practices amount to a supplanting of free and open competitive market process by corrupt rent-seeking behaviour; resulting in a misallocation of investment, falling returns to investment and growing fragility of the financial system.

Asian political systems are not transparent since power largely in the hands of the politico-economic elites. It is characterised by conglomerates that are very close to the government

⁶ William C. Hunter, George G. Kaufman, Thomas H. Krueger, eds., *The Asian Financial Crisis : Origins, Implications and Solutions*, Kluwer Academic Publishers, USA, 2000, p. 150

⁷ Uwe Johannsen, Jurgen Rudolph and James Gomez, eds., *Ibid.*, p.24

⁸ Iain McLean, *The Concise Oxford Dictionary of Politics*, Oxford University Press, 1996, p.54

⁹ Eddy Lee, *Ibid.*, p. 14

and the bureaucracy. A free press, an independent judiciary, powerful parliaments, tighter control and closer supervision of cartels and banks are perceived as threats to these ruling elites. Crony capitalism perverts the relationship between state and market and undermining the sound economic fundamentals of the Southeast Asia - “*Corruption has added 20 – 100% to the cost of procuring government goods and services in several Asian countries*”¹⁰

As argued by Senior Minister Lee Kuan Yew, the root cause of nearly every economic crisis is political and not economic. We can establish a nexus between economy and politics; between economic weakness and non-democratic systems of government. Corruption added to the lack of transparency due to controlled media will aggravate any economic crisis. This essay will discuss the extent of crony capitalism to blame for the 1997 – 98 financial crisis in the light of 2 case studies, that of Indonesia and Thailand. We will also discuss how the political structure in the two countries prolonged the crisis and intensified the economic destruction. The popular wisdom in both countries is that it was the incumbent governments that greatly exacerbated the underlying problem of investor’s confidence.¹¹

Indonesia

Indonesia under Suharto was the region’s most corrupt country. In fact, Indonesia is a kleptocratic state where corruption is a major means of capital accumulation. For decades, Indonesia was run like a family enterprise with former President Suharto watching over politics and his children running the economy. Five business groups were owned by the President’s children: *Bimantara* (Bambang Trihatmodjo), *Citra Lamboro Gung* (Siti Hardiyanti “Tutut” Rukmana),

¹⁰ “*Corruption had doubled Asian Costs*”, *The Straits Times*, 27 April 1999

¹¹ Andrew MacIntyre, “Political Institutions and the Economic Crisis in Thailand and Indonesia”, in T.J. Pempel, ed. *The Politics of the Asian Economic Crisis*, Ithaca : Cornell University Press, 1999, p. 144

Humpuss (Hutumo “Tommy” Mandala Putra), *Arseto* (Sigit Harjojudanto) and *Datam/Maharani* (Siti Hediati “Titiek” Harijadi Prabowo).¹² Their lucrative businesses included the monopolies in the trading of cloves and the production of the urea fertiliser tablets; petrochemicals, construction, satellite communications, importing of cars etc. Among Suharto’s cronies included Liem Sioe Liong of the Salim conglomerate and Mohammad “Bob” Hassan who controlled the timber industry. The families that controlled the business groups placed unqualified relatives in top managerial positions thus preventing skilled individuals from gaining experience necessary to become successful entrepreneurs. At the same time, the conglomerates’ preferential access to government licenses and contracts worsened the distribution of wealth and detrimented the efforts to reduce poverty. These conglomerates enjoyed access to state funds and it was reported that in 1994, some four-fifths of all state’s bank credit, went to these business groups. Before the crash of 1997-98, Indonesia’s economy was dominated by the massive presence of these conglomerates that went into finance and real estate (the business sectors most likely to attract speculation and manipulation).

The contribution of the Indonesian business groups to the crisis of 1997 was apparent through the extent of their unhedged borrowing in foreign currency.¹³ They were motivated to contract debts due to the fact that the overseas lower interest rates and higher domestic rates made borrowing abroad attractive. They assumed that the government would continue to manage gradual depreciation of the exchange rate to facilitate reconvertibility. They also perceived that Indonesia’s foreign-exchange reserves were ample enough to deter attacks on the rupiah. However, the Thai currency crisis forced a reassessment of risk in Indonesia. The conglomerates had collectively

¹² Ahmad D. Habir, “*Conglomerates : All in the Family ?*” in Donald K. Emmerson, *Indonesia Beyond Suharto*, New York : M. E. Sharpe, 1999, p. 188

¹³ Ahmad D. Habir, *Ibid.*, p. 198

borrowed some \$80 - \$100 billion in foreign debts. They had difficulty paying back the loans as the rupiah weakened in value. Losing confidence in Indonesian banks, the international financial community refused to accept letters of credit. The lack of credit in turn contracted Indonesian exports and imports drastically and further undercut the rupiah causing it to depreciate 85%.

The core political problem in Indonesia was the increasingly unpredictable policy of the government. Indonesia's decision-making was centralised in the presidency. There were no checks and balances and no other institution or collection of political actors who had the ability to veto the implementation of Suharto's policy preferences or to initiate alternative policies.¹⁴ Hence, investors had no other option but to pull their capital out when the value of their assets plummeted. It was Suharto's autocratic regime that enabled cronyism to thrive. Even in the midst of the crisis, Suharto quietly signed a decree giving the green light to investment projects belonging to his cronies and relatives. 4 new power plants were allowed to be built in spite of the oversupply of power plants then. Despite Suharto accepting IMF's assistance package of US\$38 billion and agreeing to its terms and conditions (one of which was the prohibition for bailouts of banks), he did the contrary by allowing his second son to open a new bank. Crony capitalism thus further aggravated the financial crisis in Indonesia. It was the conglomerates and cronies owning billions in debt that caused the government to float the rupiah and ultimately caused the currency to plunge, leading to thousands of workers being laid off and accelerating inflation.

Thailand

Thailand, though far more democratic than Indonesia under Suharto, faced rampant corruption in the form of competitive clientelism. ***Competitive clientelism*** refers to the “*competition*

¹⁴ Uwe Johannsen, Jürgen Rudolph and James Gomez, eds., *Ibid.*, p.30

*among political elites keeps barriers to entry low and thus fostering business competition” while Indonesia’s **monopolistic clientelism** or monopoly cronyism refers to the ways entrepreneurs “use their access to state machinery to enforce higher entry barriers and reduce competition.”*¹⁵ In Thailand, different portions of the business elite competed for patronage from different parts of the political elite. Patron-clients links had been a characteristic feature of business-government relations in Thailand for decades. Widespread corruption arose from the limited levels of organisational coherence and discipline in many parts of the Thai bureaucracy.¹⁶ There had been a decline in the scale of clientelism since the October 1973 student uprising leading to the collapse of Thailand’s longest military regime. The military-bureaucratic presence on the boards of business corporations declined thus reducing under-the-table dealings. However, in the 1980s and early 1990s, as electoral politics was in full gear, corruption went rampant. In order to win elections, vote buying was imperative. Funding for party activities and election campaigns came from covert donations instead of from public-acknowledged donations and legitimate government sources. In fact when the military junta overthrew the Chatichai’s administration in 1991, the principal justification for its actions had been to eradicate corruption. During the 1996 election campaign it was estimated that Thai politicians spent US\$800 million to buy votes.¹⁷ Thailand’s multimember electoral system also encouraged candidates to campaign on the basis of individualised strategies rather than as a party. Party discipline was weak and thus politicians and the nature of the electoral system made it impossible for economic reforms especially if such reforms would threaten the rent-seeking arrangements they had arranged between themselves and their key supporters.

¹⁵ Paul Hutchcroft, *Ibid.*, p. 235

¹⁶ Anek Laothamatas, “From Clientelism to Partnership : Business and Government Relations in Thailand”, in Andrew MacIntyre, ed., **Business and Government in Industrialising Asia**, Sydney : Allen and UnWin, 1994, p. 208

¹⁷ Uwe Johannsen, Jürgen Rudolph and James Gomez, eds., *Ibid.*, p.47

Thailand's biggest weakness was the liberalisation of financial market with inadequate oversight or prudential regulation. In the mid 1997, Thailand was beset with Bt1 trillion in bad debts by banks and finance companies with a Bt430 billion spent by government in propping up failing financial institutions.¹⁸ Thailand's combination of parliamentary structure with multiple weak parties (linked to electoral system) resulted in indecisive policy making. Under this political structure, party and faction leaders were compelled to work assiduously to generate resources to hold their members together. Prime ministers had to struggle to keep their coalitions intact. Hence, there were numerous veto players within the government and major policy initiatives were extremely difficult to implement. The constant turnover of key personnel in the highly fluid system did little to engender investor's confidence. The governments of Barnharn Silapa-archa, Chuan Leekpai and Chatichai Choonhavan were inflicted by serious and ongoing corruption scandals in addition to them resting on very shaky multiparty coalitions. Little economic reforms were implemented. In fact, Chavalit's government endured for 1 year with 3 cabinet reshuffles, 3 finance ministers and 2 central bank governors. Widespread public disillusionment with the system and its alarming impotence further accelerated the crisis.

In conclusion, the 1997 – 98 financial crisis in Southeast Asia was caused by a myriad of economic and political factors. In the case of Indonesia, crony capitalism contributed to the financial crisis and further caused massive violence, Sinophobia and Suharto's resignation. On the other hand, crony capitalism in Thailand merely aggravated the market process and caused further degradation of the financial crisis. Thailand's weakness lies in Chavalit's government indecisiveness and failure to respond effectively to the country's mounting economic problems and the weakness of the coalition government. According to MacIntyre, the failure of the parliamentary

¹⁸ Andrew MacIntyre, *Ibid.*, p. 148

politics in Thailand helped set the stage for crisis and contributed directly to the outbreak of investor loss of confidence.¹⁹ Therefore corruption increases vulnerability to crises and is an impediment to the implementation of appropriate responses to crises. As there is a high correlation between democracy and lower levels of corruption, democratisation may be the only solution that will reduce the chances of future crises.

The financial crisis has also paved a way for greater accountability and transparency. For example, Thailand's Prime Minister Chuan Leekpai has introduced an anti-corruption body where the every politician is obliged to disclose his financial circumstances.²⁰ The new Thai constitution also calls for greater civil rights and a more stable government. In Indonesia, however, with the transition from interim President Habibie to elected President Gus Dur, the democratisation process will take longer than usual as the Head of State grapples with increasing IMF loans, political unrest and corruption charges.

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¹⁹ Andrew MacIntyre, *Ibid.*,

²⁰ Uwe Johannsen, Jürgen Rudolph and James Gomez, eds., *Ibid.*, p.48

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