Crony Capitalism and the East Asian Currency and Financial ‘Crisis’

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The East Asian ‘crisis’ has been marked by a plethora of bad debts, including the, as yet, uncounted debts to Japanese banks. The figures quoted are running into billions. They suggest that a large proportion of the private flows of capital to East Asia in the 1990s were egregiously risky. They were not supported by project and sovereign risk analysis that shareholders and depositors have a right to expect from financial institutions. Much of the investment undertaken within East Asia in recent years was channelled into unproductive enterprises and projects. Much was stolen. It is deeply mystifying that these flows were not perceived as contributing to the weakness of the East Asian economies by the International Monetary Fund (IMF), the World Bank and the Asian Development Bank, all of which had responsibility for monitoring East Asian countries. In 1993, the World Bank (1993: v–vi), ignoring the extensive literature on monopoly and oligopoly, concluded that the East Asian countries were ‘... better able than most to allocate physical and human resources to highly productive investment and to acquire and master technology.’

A few perceptive observers (e.g. Lingle 1997) provided clearly argued early warnings, but these were ignored by most observers and the multilateral institutions that had surveillance responsibilities for East Asian countries. They were not undertaking appropriate analytical work and they were unwilling to embarrass their member governments by pointing out the cost of cronyism. Following the IMF’s half-century of persistently bailing out any country that ran into balance of payments difficulties, some private lenders suspended risk assessment, making ‘moral hazard’ a serious consequence of IMF operations.

Most analysts have focussed on the collapses of financial institutions and devaluations of exchange rates that became necessary once the hollowness of much of the unproductive investment and financial cronyism was exposed (Arndt and Hill 1999; Cleoed and Garnaut 1998; Montes and Popov 1999; Radelet and Sachs 1998). They have not explained why countries known for their prudent macroeconomic policies for some 30 years abandoned them in the mid-1990s. A more perceptive analysis indicates that the root cause of the crisis... was that financial intermediaries were not always free to use business criteria in allocating credit... and ‘well connected borrowers could not be refused credit...’ that ‘... was created by implicit or explicit government guarantees against failure’ (Moreno, Pasadilla, and Remolona 1998). That is, corporatist policies led to crony capitalism and hence to the 1997 collapse.

Leading East Asian market economies avoided following the Prebisch-Singer ‘development economics’ inward oriented model that was widely accepted by developing countries in the 1960s and 1970s (Lal 1983), recognising that an open market economy was more likely to bring progress than a dirigiste one. Liberalisation made considerable progress. Competition in international markets encouraged further reforms. Except in Hong Kong, Singapore and later in Taiwan, however, privileged local entrepreneurs originating in protected domestic industries were able to prevent the...
completion of liberal reforms that would have led to competitiveness in domestic markets.

In the middle of the 1990s, crony interests in Thailand, the Republic of Korea (Korea), Malaysia, and Indonesia, desiring to protect the dollar values of their assets, exerted pressure on Ministries of Finance and central banks to maintain exchange rates at overvalued levels. Short term loans were sought abroad to shore up the overvalued exchange rates. Current account deficits expanded. When acute foreign investors realised the weakness of the investments they had funded, they began to withdraw as much short-term capital as they could. Local investors fied to ‘safe’ currencies.

The evolution of dual economies

In the early post-war years, Hong Kong, under a British colonial regime, had a trade oriented economy, creating strong employment and economic growth. When Singapore left the Malaysian Federation, it turned sharply toward export-led growth. As city states, both were too small for protectionist illusions. The United States, dismayed by economic stagnation, inflation, dependence on aid and high levels of corruption in Taiwan, persuaded its government to allow liberal technocrats to stabilise and partially to liberalise the economy. Political opposition made it impossible to reduce tariffs, so export incentives were used to offset protection to production. Similar reforms followed in Korea, but the chaebol group of conglomerates was already strong enough to ensure that it continued to receive privileged access to capital and to prevent foreign direct investment inflows. In both countries, macroeconomic stability enabled agriculture and service sectors to develop, though dirigiste policies continued to distort manufacturing. But the Prebisch-Singer model retained a great deal of support in the domestic economy in Taiwan and Korea; the success of export orientation nevertheless made Taiwan and Korea as well as Hong Kong and Singapore the ‘tigers’ of economic development in the 1960s. Their dramatic rates of growth were marked by unprecedented poverty alleviation.

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By the 1970s, the success of the outward oriented countries encouraged a second echelon of economies—Malaysia, Thailand and Indonesia—to follow export oriented reforms. But in these latter countries, as in Taiwan and Korea, monopolistic groups that had their start in protectionist policies, made it impossible to complete the reform process. Production for domestic markets remained regulated and protected. Large public sectors were fostered. Export incentives thus also had to be reintroduced to counter the high costs of inefficient production for domestic markets. They created new distortions. The ensuing combination of import substituting and export subsidies allowed favoured interests (cronies) to obtain monopolistic positions. Fiscal and financial policies were distorted to favour crony capitalists (Hughes 1995).

The Philippines was an exception to East Asian growth (Hughes 1995). It was strongly import substitution oriented from the 1950s, with accompanying other micro and macroeconomic policy distortions. Cronyism became entrenched. Economic reform was not possible until the collapse of the Marcos regime. The return of exiled entrepreneurs then helped to loosen crony structures. Lifting financial repression (i.e. the suppression of interest rates) in the 1990s has been the principal achievement, limiting the impact of the East Asian crisis on the Philippines.

Neither China nor Vietnam has advanced far along the transitional road to markets (Hughes 1995). They do not have competitive financial sectors. Entrepreneurship is stifled. Overseas Chinese-owned export sectors have provided China with comfortable external reserves, but their economic policies are still highly dirigiste. The close regulation of exchange rates has enabled exchange rate devaluation to be avoided, albeit at the cost of living standards. Both economies are extreme examples of distorted development, with Communist Party cadres dominating domestic and joint venture investment. Except in labour intensive, export-oriented production and some competitive township and village enterprises in China, both countries are following Latin American patterns of industrialisation. Investment in inappropriately capital and technology intensive processes and industries leads to low levels of urban employment formation and hence to poverty, notably in rural areas. Rural-urban migration is not only thwarted by regulation, but also by the lack of job growth.

Policies that create crony capitalism

As the strength of crony entrepreneurs, supported by authoritarian governments, overtook the liberal impetus, the ‘Japan Inc’ model replaced the Prebisch-Singer paradigms in East Asia. Inward orientation was succeeded by an
emphasis on exports, but, except in Hong Kong, Singapore and Taiwan, subsidies were needed to offset continuing protectionism. Support for public enterprises gave way to close relations between government and business, easing the expansion of cronies into public utilities. Policy frameworks remained essentially dirigiste.

Bureaucratic decision-making involved the granting of privileges, providing opportunities for ‘favoured’ applicants to ‘buy’ permission and for bureaucrats to ‘sell’ it (Bardhan 1997; Tanzi 1999). Cronies were those able to buy permission to engage in particular economic activities that were generally of a monopolistic nature. In this environment, projects that had low socio-economic returns and often failed in the long run despite the privileges they received, earned considerable benefits in the form of high management incomes, super profits and income in kind, such as the use of cars and housing.

The ‘Japan Inc’ model of crony government and business managed development appeared to work in the short to medium term, when developing countries were catching up with advanced industrial countries. Japan’s dismal performance in the 1990s and the East Asian collapses of 1997 indicate that dirigisme can only boost economies in the short run and at high cost. It breaks down in the long run (Lindsey and Lukas 1998).

The economic, social and political structures and institutions created by the ‘Japan Inc’ model severely distorted East Asian economies, including Japan’s, and had negative effects on political life. As monopolistic practices became entrenched, reform, as Japanese experience underlines, became extremely difficult.

Industry policies
The following section is based on research from Hughes (1999).

Industry policies, by preventing the emergence of competitive markets, were the core of the ‘Japan Inc’ model in East Asia. With the help of other distorted micro and macroeconomic economic policies, the power of large entrepreneurs spread from manufacturing to construction, real estate and banking. Enterprises in these fields became tightly linked into family held empires. Discrimination against medium and small businesses became rampant.

Import substitution policies built bureaucratic support for additional selective incentives for manufacturing enterprises. The principal function of Ministries of Industry was to structure monopolistic industrial development. Numbers of producers of each group of products were limited to avoid ‘excessive’ competition. Ministry bureaucrats, working with business, became the judges of appropriate levels of industrial capacity. In countries committed to protection, that is, to closed markets, there seemed to be a choice between one producer able to exploit economies of scale, and several firms producing inefficiently low levels of output. Bureaucrats believed that they had to opt either for economies of scale or internal competition. Inevitably they licensed several oligopolistic producers and thus achieved neither competitiveness nor economies of scale. Production licensing began in industries such as steel and chemicals, but came to be applied to all manufacturing and some service industries.

Ministry of Industry staff were judged too slow in evaluating industrial investment proposals. The corruption associated with import substitution licensing was known to be widespread. New Boards of Investment were therefore established throughout the region to administer industry subsidy protocols, mainly for foreign but also for local investors. Efforts were made to link proposed subsidies to the capital to be invested, the proposed size of the work force and the types of new technology to be introduced to ‘pick’ foreign and local ‘winners’. Concepts of value added at international prices were ignored in favour of subjective points systems notorious for their double counting and arbitrariness.

The Boards of Investment were to be ‘one stop shops’ where foreign and local entrepreneurs could complete their negotiations quickly and efficiently. Several common features emerged. The proposals placed before Boards of Investment bore little resemblance to the actual investment, employment and technological inputs that could be discerned three, five or ten years after the starting date. Except in Singapore, reliable records were not kept, so that ex-post evaluations could not be undertaken even in the few cases where it was thought desirable to do so. Only Singapore’s Economic Development Board became a real ‘one stop shop’. Elsewhere investors not only had to negotiate with Boards of Investment, but also with Ministries of Industry, with Customs, with public utilities and with local governments. Except in Singapore, negotiations typically took months. Sometimes years elapsed before a satisfactory arrangement was made. The arrangements lacked transparency. In Thailand the initial negotiations with foreign investors
took place over lunch in air conditioned, candle-lit nightclubs. High level representatives of foreign firms and their local partners participated. Once the main outlines of an arrangement were settled, further negotiations could take place in the Board’s offices. Well-connected entrepreneurs, and those wishing to be well connected, were able to scoop the pool of monopolistic business opportunities.

Incentives to exports
Protection of domestic industry raises costs above international levels so that exports need subsidies to compete. Hence, incentives (subsidies) to exporters to offset the high costs of protectionism and thus be able to earn as much in export as in domestic markets, seemed to be a clever policy. Incentives to exports can take the form of direct subsidies, tariff exemptions and drawbacks, ‘wastage’ allowances, credit subsidies, tax holidays and so on. The bureaucrats who allocate such incentives earn ‘rents’ and so do the entrepreneurs who benefit from them. These rents do not add to national output (Krueger 1974). Deadweight rent seeking becomes a way of life. Protection offsets were particularly important in Korea where they made substantial contributions to chaebol profits while discriminating against other producers. Incentives to exports, and the regulatory regimes that necessitated them, were highly praised by dirigiste economists (Amsden 1989, 1991; Wade 1991a and b, 1992) and accepted by the World Bank (1993). The structural damage that the regulatory measures, including offsets to protection, imposed on the East Asian economies were thus condoned.

Tax holidays
The International Chamber of Commerce in the 1960s argued that to attract foreign investment to developing countries—predominantly for import substitution—multinational firms should be courted by special incentives. Tax holidays were the most frequent form of subsidy to be directed to foreign investors, but the Chamber also suggested privileged access to land and subsidies for utilities such as energy and water. On equity grounds, such subsidies had to be extended to domestic investors. They were adopted widely, even though they quickly became evident that they were not effective (United Nations 1968). As well as creating deadweight rents and opportunities for corruption, they undermined countries’ fiscal bases and the ability to finance social and physical infrastructures. Tax holidays did not benefit investors from countries that did not allow tax deduction for taxes ‘forgiven’ by tax holidays. Tax revenues were thus shifted from poor recipient countries to rich investing countries. Tax holidays, however, produced generous rents to domestic entrepreneurs and to bureaucrats. East Asian countries still bid against each other in extending tax holidays and other subsidies, particularly to foreign investors, despite the financial costs and corruption they engender.

Foreign investment flows into protected industries
The rule of law, a liberal, open policy regime, the absence of arbitrary regulations and associated corruption, and competitive public utility services are known to be effective incentives to domestic and foreign investment. An intensive debate in the 1960s and 1970s highlighted research findings that clearly indicated that the costs and benefits accruing from foreign investment flows were determined by recipient countries’ domestic policies. Incentives underline the economic settings that determine cost-benefit outcomes.

A considerable, though unknown (Athukarola and Hill 1998) proportion of private foreign investment flows to East Asia have gone into protected and monopolistic enterprises. Their profits went into other uneconomic projects such as real estate bubbles that dissipated the benefits of foreign as well as local investment. Foreign investment, stimulated by subsidies and protective tariffs, led to high levels of oligopolistic excess capacity in some industries. East Asian countries have at least five and perhaps ten times the capacity of likely motor vehicle demand for decades to come. Inadequate scale of production makes exports only possible with subsidies. While the local associates in the East Asian countries benefit, the chief beneficiaries are the shareholders, mainly in the United States and Japan, of the parent motor-vehicle firms that earn protected monopolistic profits. The losers are the consumers who pay excessive prices for motor vehicles, the taxpayers who pay for the subsidies and those denied jobs in competitive industries.

Bureaucrats provide the chief support for incentive handouts even when they do not benefit from under-the-counter payments. When the issue of replacing tax holidays for exports by an across the board tax reduction was proposed in Singapore in the early 1990s, the reform was
strongly opposed by Economic Development Board staff. They argued that without ‘tax holidays’ as talking points, new firms coming to Singapore, or old firms expanding production there, would have no reasons to talk to them. Their jobs were at stake. The reform was defeated.

**Financial repression**

The suppression of interest rates below market levels for favoured borrowers, notoriously practiced in Japan and in most East Asian economies, prevented the emergence of sophisticated, competitive financial sectors. Financial liberalisation was too slow, too late and rarely accompanied by adequate prudential financial regulation (Suwandi 1995). Financial repression was a key concomitant of industry policies, magnifying the distortions they created. Credit rationing to favoured recipients by nationalised banks played a key role in building up the chaebol in Korea and restricting the growth of small and medium sized business. State-owned banks also made a major contribution to the emergence of crony capitalism in Indonesia. When, belatedly, Indonesian and Korean banks were denationalised, industry policies had created the family groupings that could play a dominant role in banking. Reasonably open Hong Kong, Singapore and Taiwan financial sectors were exceptions. The management of most East Asian banks did not adopt appropriate transparency and accountability measures. Internal financial transactions within crony groups led to a high proportion of non-performing loans. Foolish international firms were seduced by promises of high returns into lending on the basis of flimsy information about the banking institutions and the projects for which they were lending.

Paradoxically, growing democratisation of political processes played a counter-productive role in the events that led to the collapses of 1997.

**Fiscal policies**

It has been claimed, notably by the multilateral financial institutions, that fiscal policies were in good shape in the ‘crisis’ countries in the 1990s. But fiscal policy is not merely a question of budget surpluses or deficits. Fiscal policies cannot be regarded as prudent merely because budget deficits were contained until the mid-1990s. With the exception of Hong Kong, Singapore and Taiwan, taxation was highly regressive, inefficient, arbitrary, and inadequate for public expenditure needs. Tax avoidance and evasion by crony capitalists was rampant and others followed suit wherever they could.

Public services, swollen by armies of regulators, ate up a disproportionate share of revenues, leaving inadequate resources for infrastructure. By the mid-1990s it was becoming evident that high savings rates did not mean adequate private or public infrastructural investment. Infrastructure was lagging a long way behind the needs of most East Asian economies. The cronies stole, wasted or siphoned abroad a significant proportion of national savings. Infrastructure privatisation, far from easing the situation, has frequently exacerbated it. In the absence of appropriate policies and prudential regulation of utility sectors, inappropriate joint ventures between cronies and foreign investors are taking place. Multinational institutions are encouraging a climate of renewed reckless lending similar to that which underwrote the flow of private capital to East Asia in the 1990s.

Energy, telecommunications, highway and other potentially lucrative markets are being divided up among oligopolistic groups of local cronies and foreign investors. The public ownership and management of utilities is often highly inefficient, but it does not follow that private oligopolies will provide cost effective services. Evidence of the high costs of ill-conceived ‘build, own, operate, and transfer’ projects is already pressing for attention (Soonthonsipirong 1999). The next ‘crisis’ is in the making before the last one has been paid for.

**International cronyism**

The UN agencies (ECOSOC,UNCTAD, UNIDO, ECLA, ESCAP, etc.) advocated dirigiste policies based on Prebisch-Singer import substitution to accelerate development. Most developing countries followed this
path with ensuing slow growth and little poverty alleviation. The United States Agency for International Development (AID), supported by the IMF and the World Bank, assisted East Asian countries to move toward stable macroeconomic and liberal trade policies as the base for outward oriented growth. But entrepreneurs who had their start in import substituting industries, resisted liberal reforms in favour of ‘Japan Inc’, re-labeled the ‘Asian Way’, to development. Liberal policies were denigrated as ‘Western’ and hence alien to Asia. The World Bank, funded by Japan, in a sharp change of development philosophy, attempted to make ‘Japan Inc’ acceptable by its promotion of The East Asian Miracle in 1993.

IMF economists in the late 1940s, 1950s and 1960s were influential in converting the economics profession to the thesis that most international disequilibria had domestic origins. The IMF, as the guardian of fixed exchange rates until the early 1970s, introduced country surveillance reports to urge policy changes that would enable countries to avoid undue exchange rate changes. Domestic policy reforms were the principal requirements for the granting of credits and loans. When the world moved to flexible exchange rates, the IMF continued its macroeconomic surveillance, funding countries with balance of payments difficulties, often repeatedly, because agreed reforms were not implemented. Such funding introduced substantial ‘moral hazard’ into international capital markets. Private lenders and developing country public and private borrowers became convinced that the IMF, backed by the World Bank, other regional banks and bilateral governments would provide perpetual credit to developing and transitional countries. Eventually developing country taxpayers would pay off such loans.

The World Bank management has for long been more concerned to achieve a high flow of lending than to ensure that its resources were efficiently allocated. At times floods of liquidity, the World Bank’s conditionality has become totally ineffective. Like the IMF, it poured resources into countries that had no intention of following prudent economic policies.

The analysis that was ignored before the currency collapses is still not being undertaken. There is little sense of urgency in seeking trade reforms that would put pressure on inefficient domestic producers. Industry policy continues to be implemented. No changes are being made in the motor vehicle industry and other attention grabbing foreign investments and local oligopolies. Progress in bankruptcy procedures has been minimal. The cronies are being amazingly successful in protecting their privileges.

The contribution of ‘Japan Inc’ to 10 years of recession in Japan and to the problems of the crony economies of East Asia is only rarely mentioned. Fiscal policy is still said to be fine. The aid funds now flowing into the crisis countries are not being used to facilitate reforms, but largely to rescue foreign lenders and domestic borrowers.

Because efficient export sectors continue to operate in dual East Asian economies, exchange rates have appreciated and confidence is returning, except, perhaps in Indonesia and Japan. Security prices are reviving with new inflows of foreign speculative and returning domestic funds. Foreign investment in inefficient motor vehicle production is being supported by large subsidies. National and international cronies are alive and well in East Asia.

Conclusions
Once dirigiste policies entrenched crony capitalists in East Asian economies, liberal reforms become increasingly difficult to initiate and carry through. Efficient corporate governance, transparency in government-business relations, and competition policy cannot be achieved until the dirigiste policies, and the institutional structures to which they have given rise, are changed. This will entail strengthening commercial law and accounting standards, dismantling protectionist policies and offsets to protection through export incentives, radically reforming fiscal and financial policies, and, above all, ending industry policies that pick winners. The Boards of Investment will have to go. At present there is no evidence that a start is being
made to reform these key policies that support crony capitalism.

The revelation of the depth of East Asia's financial problems took unduly long, partly because the greed and incompetence of some private international lenders overcame their commercial judgement, and partly because the principal multilateral financial institutions failed in their monitoring responsibilities. On the contrary, their support of foreign capital flows to East Asia, regardless of project or sovereign risk, exacerbated the ultimate depth of the financial collapses. When the excesses of imprudent capital transfers became evident, multilateral financial institutions sought to minimise the costs to international lenders and to local cronies through rescue packages. Ultimately, the taxpayers in developing countries, that is, low-income families who are already bearing most of the costs of the East Asian debacles, will have to repay those loans. The 'moral hazard' created by the IMF, the World Bank and the Asian Development Bank, undermined the competitiveness of international capital markets and was thus an important factor in the events of 1997 in East Asia. Putting an end to the multilateral institutions' underwriting of careless lending and borrowing is at least as urgent as policy reforms in East Asian countries.

**References**


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