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1

Crises, Adjustment, and Transitions

Two Countries, Two Trajectories

On the morning of July 14, 1997, citizens of Jakarta and Kuala Lumpur awoke to a new world. The difference from the previous day was seemingly minor and distant – several hundred miles to the north, the government of Thailand had abandoned its long-standing informal currency peg of the baht to the American dollar. Few would have believed that this decision was the first in a chain of events that would fundamentally remake the political economy of Southeast Asia. Even as foreign investors turned their eyes toward other Asian countries, reconsidering the health of their financial systems, political and economic upheaval seemed unlikely. Indonesia and Malaysia had long embraced the world economy. They were competently run economies with popular leaders who had engineered decades of impressive economic growth. Despite their excesses, authoritarian rule in each country bred stability, prosperity, and development.

A year later, Indonesia and Malaysia were in turmoil. Sustained capital outflows and currency speculation had led to massive depreciation of the rupiah and ringgit and heavy losses in each country's stock market. Economic growth, which for a decade had been among the highest in the world, became economic collapse – GDP contracted nearly 8 percent in Malaysia and more than 13 percent in Indonesia during 1998. In each country, thousands of borrowers in the business community were unable to service their debts. Financial upheaval forced both countries to seek emergency funds from foreign donors to keep their once-buoyant economies afloat. In Indonesia, simmering ethnic animosity that overlay

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long-standing economic inequality had boiled over into violence. In Malaysia, the prospect of such violence once again appeared.

Despite sharp economic contraction in each country, policies and politics varied widely between them. Previously one of the world's most durable authoritarian regimes, Indonesia was almost unrecognizable in July 1998. For ten months, the regime's adjustment policies shifted wildly: tight monetary policy followed by loose monetary policy, promises of fiscal and trade reform made and then broken, subsidies protected and then cut, bailouts offered and then denounced. President Soeharto resigned from office amid mass urban violence that drove many of his ethnic Chinese cronies overseas and divided his military backers. His successor, B. J. Habibie, had no natural constituency and presided over a largely peaceful transition to democracy while quietly accepting a deeply unpopular adjustment package from the International Monetary Fund.

Malaysia, by contrast, was in July 1998 preparing for one of the most controversial economic policy choices taken by an emerging market economy in the post–Bretton Woods era. A brash critic of the International Monetary Fund's recommendations for Asia, Malaysia's Prime Minister Mahathir Mohamad consistently resisted tight monetary policies and subsidy cuts for poor Malaysians and allowed crony interests to use public funds to forestall their own bankruptcy. In early September, Malaysia imposed extensive capital account restrictions, loosened monetary policies still further, and expanded public spending. At the same time, with the country's security forces firmly behind him, Mahathir ousted his popular deputy prime minister and finance minister Anwar Ibrahim and crushed Malaysia's first truly panethnic democracy movement. Coercion and economic recovery allowed Mahathir and his regime to survive Malaysia's worst-ever economic crisis relatively unscathed.

This book is about the struggles of authoritarian regimes to contain economic crises. The questions that inspire it arise from the diverging experiences of Indonesia and Malaysia during these tumultuous years. Why do authoritarian regimes respond to crises with different policies? Why do adjustment policies within one country vacillate so wildly? What drives protestors into the streets during economic crises? When can authoritarian regimes successfully crack down on their opponents? When do economic crises lead to authoritarian breakdowns?

I answer all of these questions by focusing on political coalitions and their economic interests. I show that during economic crises, authoritarian regimes face powerful pressures from their supporters to enact

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policies that minimize the burden of adjustment that they face. Regimes enact policies that shift the costs of adjustment away from their political supporters. Across countries, different coalitions of regime supporters therefore produce different political trajectories, both in the adjustment policies that regimes adopt and in the nature of political conflict that the regime faces. When supporters have mutually incompatible preferences over adjustment policies, adjustment policies appear incoherent, and political coalitions are fundamentally unsustainable. When preferences are compatible, regimes adopt their supporters' favored policies, crush their opponents, and survive.

The argument therefore focuses tightly on the causal role of coalitions and economic interests in shaping the dynamics of economic reform and political survival in authoritarian regimes. During economic crises, struggles over adjustment policy and regime survival are fundamentally intertwined. This framework illuminates how the economic shock of the Asian Financial Crisis produced such dramatically different political outcomes in Indonesia and Malaysia. For reasons that I detail in this book, the coalition of supporters that backed Soeharto's New Order regime – ethnic Chinese business groups with extensive holdings of mobile capital, and military-linked firms and a new class of indigenous entrepreneurs whose capital assets were rooted in Indonesia – had contradictory preferences over adjustment. Both sought bailouts from the regime, but the latter demanded that Soeharto close the capital account, whereas the former demanded continual capital account openness as a condition for supporting the regime. Sharp vacillations in adjustment policy during 1997–98 reflect these struggles. This political conflict amid financial meltdown ultimately brought down the regime, leading to a political collapse marked by anti-Chinese violence and the mass exodus of ethnic Chinese Indonesians.

Malaysia's regime, supported by a coalition of the ethnic Malay masses and a newly ascendant coterie of Malay entrepreneurs with fixed investments, faced no such contradictory demands over adjustment policy. Neither group had substantial mobile assets to redeploy overseas, so both demanded that Mahathir ban capital outflows to enable expansionary policies. The seemingly idiosyncratic nature of Malaysia's adjustment measures – consistently resisting austere stabilization policies and maintaining extensive redistributive programs – reflects the demands of this coalition of supporters. Without a fundamental cleavage in its supporters' preferences, the Malaysian regime was able to steer through financial meltdown by adopting its supporters' preferred policies, ensuring that

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only the regime's opponents bore the costs of adjustment and allowing the regime to survive intact. Differing coalitions therefore explain different adjustment policies and regime outcomes in Indonesia and Malaysia.

The coalitional approach, by examining trajectories of adjustment policy and regime survival in Indonesia and Malaysia, brings a fresh perspective to a topic that has been well studied by area specialists. To be sure, many have noted political resistance to economic reform in both countries, as well as the role of economic crises in motivating antiincumbent protest in the face of recalcitrant authoritarians. But these accounts are incomplete. Studies of resistance to reform in each country, and of regime collapse in Indonesia and regime survival in Malaysia, have neglected the critical interrelationship of antiregime protest and pressures for economic reform. Actors protest against regimes *because* they do not receive favorable policies. The coalitional theory not only provides a unified account of how interest groups pressure regimes for favorable policies but also considers the impact of these pressures on subsequent political trajectories.

Understanding Adjustment and Authoritarian Breakdowns

My theory of crises, adjustment, and regime survival rests on the analytical tools of positive political economy and open economy macroeconomics. By carefully examining the nature of the economic meltdown in each country, I uncover the consequences of different economic policy choices, detailing how these choices spread the costs of adjustment across different citizens in an economy. Assuming a simple behavioral strategy, that actors pressure regimes to enact policies that fulfill their interests, I then derive predictions of policy choices given different kinds of constituencies. I assume here that no policy is "off the table": clients will turn on their patrons if their patrons do not supply them with favorable policies, and regimes will adopt policies that are deeply unpopular to regime opponents and the international community if it is in their supporters' interests to do so. With these tools in hand, I am able to understand policy choices that can seem illogical or irrational (as in Indonesia) or radical (as in Malaysia). This approach also allows me to make wider generalizations on the basis of the experiences of these two countries. Across the world, when authoritarian regimes face economic crises, coalitional pressures dominate struggles over adjustment policy and regime survival.

I am also careful, though, to ensure that theories and assumptions are borne out by the experiences of the two countries. Against the

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reductionist claim that economic interests alone condition policy responses, I emphasize that political coalitions are the key variable that explains why regimes favor particular interest groups. The adjustment story is inherently political. To show this, I bring a wealth of new data on regime behavior and interest group preferences to the large existing body of literature on crisis politics in each country. In doing so, I have attempted to combine the theoretical precision of positive political economy with the nuance and substance of the area specialist. The experiences of the two countries do reveal that many simple predictions from standard economic models do not obtain. For example, for various reasons that I detail later, rapid currency depreciation in each country did not lead to an export boom, despite the improvement of exporters' terms of trade. Deep study of the countries' economies and political systems was critical for allowing me to test such predictions against the experiences of each.

By linking international economic crises to political regime change through economic adjustment, this book spans two research paradigms in comparative politics and international political economy. The first is the politics of economic adjustment. Political scientists have recognized that economic adjustment has important distributional implications and, hence, that politicians enacting reform will tailor their reform packages to minimize the costs borne by their political supporters. In varying ways, authors ask why governments choose particular economic policies, or why governments fail to enact needed policy reforms, and answer these questions by looking at the preferences that actors within a country have over these policies and at the struggles between the winners and losers from economic reform.[1] Governments enact policies because they fulfill the demands of a politically influential group within the population. Failure to enact necessary reform packages is the result of entrenched opposition from some group with privileged links to the government. Within this positive political economy approach, governments do not arbitrate neutrally among possible reform choices, choosing policies that maximize collective welfare or future economic growth. Instead, governments fulfill particularistic demands for political purposes, with the result that in countries facing similar needs for economic adjustment, policies enacted will vary according to the profile of powerful interest groups within those countries.

[1] Alesina and Drazen 1991; Gourevitch 1986; Hellman 1998; Martinelli and Tommasi 1997; Rodrik 1996; Schamis 1999.

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A wide literature has asked, given this model of policy formation, what interest groups actually demand in terms of international and domestic economic policies. Interest group approaches have outlined how sectors with differing trade orientations will prefer different exchange rate settings given a world of highly mobile capital.[2] Different levels of asset mobility across sectors influenced the types of political conflicts that arose during Latin America's debt crisis of the early 1980s.[3] In industrialized economies, coalitions of different economic interests influence government responses to international economic crises.[4] A rich literature has followed these works, exploring how differing institutional configurations, collective action costs, and levels of intersectoral factor mobility shape the types of distributional conflicts that arise and the coalitions that form in open economies.[5]

While sharing this analytical tradition, my coalitional approach differs in important ways. Most broadly, economic interests are vital for my theory of adjustment and transition, for they illuminate the dimensions along which policy conflict unfolds during economic crises. But coalitions, not interests, are the decisive factor. Interests do not translate directly into political outcomes absent some organized method of articulation; in short, interests need politics to become policy. In authoritarian regimes, coalitions are the stuff of politics, and they determine which interest groups a regime will favor – given the same menu of interest groups in two countries, different coalitions will produce different policy outcomes. Systematic attention to the coalitional bases of authoritarian rule provides an intuitive framework for understanding the link between economic interests and political outcomes.[6] Other recent work has neglected coalitions, instead favoring reductive assumptions about the class basis of authoritarian rule or ignoring interests entirely.

I also uncover new axes of policy conflict. Building on work on the domestic politics of international monetary relations, I not only study preferences over both interest rates and exchange rates but examine when groups prefer capital account closure as an adjustment policy option. In addition, I focus on financial sector weaknesses, showing how the impact of international adjustment measures on financial sector viability gives

[2] Frieden 1991b.
[3] Frieden 1991a.
[4] Gourevitch 1986.
[5] See, e.g., Alt et al. 1996; Alt and Gilligan 1994; Broz and Frieden 2001; Hiscox 2002; Schambaugh 2004.
[6] Pepinsky 2008a.

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regimes an impetus to cut links between themselves and the international economy. Finally, I study preferences of three types of actors: labor, fixed capital, and mobile capital. I show that, when currency depreciation exposes banking sector fragility, the dominant cleavages are not among land, labor, and capital or between export-competitive and import-competitive sectors, but between factions of capital based on their cross-border asset specificity, with labor aligning with holders of fixed capital. By implication, I find that the level of conflict among sectors and factors varies according to economic conditions.

Of course, the coalitional approach to the politics of economic adjustment does not exist in isolation. Other explanations for adjustment policy include pressures from international lending institutions, ideology, institutional configurations, cognitive biases, political will, and technocratic competence, among others.[7] In this book, I treat each of these perspectives as alternative explanations, which I examine in light of events in Indonesia, Malaysia, and elsewhere. In revealing how each is incomplete, I demonstrate the power of my coalitional approach.

In the context of Asia's recent financial crises, institutions have received the most attention. Authors have argued that different institutional arrangements affected Asian countries' abilities to commit to creating good economic policies before and during the crisis,[8] and that institutional arrangements affect the course of postcrisis recovery and economic growth.[9] Although these authors do not address explicitly the choice of particular policies, they do suggest how institutions may have constrained the abilities of policy makers to enact policies. The coalitional story, which takes seriously preferences over adjustment policy, makes predictions that institutions alone cannot. Institutions are important, but as they are analytically secondary to an understanding of what groups within a society demand from the government, they alone are as incomplete as a purely economic explanation. Whereas Andrew MacIntyre's institutional approach allows him to study "broad patterns of policy management" in Southeast Asia,[10] coalitions tell us about specific policies and why they were enacted. Coalitions are the political link that mediates how economic interests translate into adjustment policies.

[7] Bates and Krueger 1993; Haggard 2000a; Haggard and Kaufman 1992; Haggard, Lafay, and Morrisson 1995; Haggard and Webb 1994; Krueger 1993; 2000; Manzetti 2003; Nelson 1989; 1990; Remmer 1986; Tommasi 2005; Vreeland 2003; Weyland 2002.
[8] Haggard 2000b; MacIntyre 2001; Satyanath 2006.
[9] Hicken, Satyanath, and Sergenti 2005; Montinola 2003; Pepinsky 2008b.
[10] MacIntyre 2003b, 55.

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This book, though, is about more than economic adjustment. It shows how political conflict over adjustment policy affects the ability of authoritarian regimes to survive economic crises. Departing from the usual practice of studying adjustment and regime survival in isolation, my argument links interest cleavages over adjustment policies directly to the question of authoritarian regime survival.

The literature on crises and authoritarian breakdowns has recently turned away from earlier arguments about preferences, coalitions, and elite factionalism in explaining authoritarian regime trajectories.[11] The new scholarship has focused instead on crisis severity and the institutional bases of authoritarian rule. There is some evidence that inflationary crises and recessionary crises have different impacts on the likelihood of democratic transitions.[12] Institutionalists have suggested that military regimes are more likely to break down during economic crises than party-based or civilian authoritarian regimes.[13] Alternatively, authoritarian regimes with political institutions such as elections, parties, and legislatures survive longer than other authoritarian regimes,[14] or just until their dominant parties are unable to marshal the resources that keep the masses supporting authoritarian rule.[15]

My argument challenges the ability of institutions and crisis severity to explain why and how authoritarian regimes break down during economic crises. Coalitional politics during crises is too rich to ignore. Regimes take steps to minimize the impact of crises on their supporters, meaning that crisis severity should not be treated as an exogenous causal variable in the study of authoritarian breakdowns. Institutional perspectives begin with the political structures in place and make predictions based on them, but they ignore how regime leaders and opponents alike assault the political institutions so often held to constrain leaders' authority and their opponents' mobilizational capacity. Adjustment policy and institutional manipulation are both endogenous responses by authoritarian regimes to economic crises. These responses matter; they reveal the contours of political conflict during economic crises, and they allow us to understand just why an economic crisis can unseat an authoritarian regime. It is here that coalitions and economic interests have a powerful story to tell,

[11] On these earlier statements, see Bratton and van de Walle 1994; Higley and Burton 1989; O'Donnell and Schmitter 1986.
[12] Gasiorowski 1995.
[13] Geddes 2003, 44–86.
[14] Brownlee 2007; Gandhi and Przeworski 2006.
[15] Greene 2007; Magaloni 2006.

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broadening the causal story to explain when – and, more critically, *why* and *how* – economic shocks lead to authoritarian breakdowns.

Data and Methods

The coalitional theory explains policy choice and regime outcomes in terms of strategic interactions among regimes and interest groups. I approach the Indonesian and Malaysian cases, which form the backbone of the empirical work in this book, committed to an argument that is both *internally parsimonious* and *generalizable*. The internal parsimony of the account depends on how well it explains many different types of adjustment across policy domains and on how well it explains various features of regime survival in Malaysia and regime collapse in Indonesia. In assessing internal parsimony, I recognize that the topics of adjustment and regime survival in the two cases are well trodden. I judge my argument to be more internally parsimonious than its competitors when, in comparison with others, it leaves fewer aspects of adjustment and transition unexplained and, in particular, when pieces of evidence are consistent with my account but inconsistent with others.

The cases of Indonesia and Malaysia give some initial leverage for the coalitional argument, as they are similar on many other important dimensions. Both had very open economies dominated by exports and highly open to international financial flows, but with widespread government favoritism in the distribution of fiscal expenditures and extensive political influence in the allocation of credit. Fully convertible currencies made speculation against the rupiah and the ringgit feasible, and managed exchange rate regimes in each allowed speculators to bet against what they believed to be unsustainable currency targets. Both countries entered the crisis with relatively strong foreign reserves. Neither country had an independent central bank capable of vetoing adjustment policy decisions. Leaders in each country were avowed nationalists and maintained extensive personal control over the formation of economic policy. If economic characteristics or institutions alone drive outcomes, then variation between the countries is still more puzzling. Consideration of the political coalitions in both countries is needed to complete the story.

Studying coalitions requires deep, case-specific knowledge. I garnered this information through interviews, local and regional newspapers, opposition publications, reports from nongovernmental organizations (NGOs), national and international statistical sources, and a wide variety of published secondary sources. Newspapers and statistical sources

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together give a very accurate description of adjustment policy measures as they unfolded over time. Interviewees included key decision makers such as former government ministers and bureaucrats, opposition politicians, activists, local academics, journalists, and employees at international development institutions. Opposition publications and NGO reports give important context to the events and decisions.

It is important not to underestimate the sensitivity of this research, even today, ten years after the onset of the crisis. In both countries, the amounts of money at stake for key individuals reach occasionally into the billions of dollars. In Indonesia, thousands of people died as an indirect result of the political manipulation of that country's economy in 1997 to 1998, and many of the most important individuals have fled Indonesia and are today in hiding. Ongoing investigations mean that many ill-gotten fortunes are still at risk and that actions taken during the crisis may still have legal implications. In Malaysia, where the regime survived the crisis, many interested parties remain close to those in power and are reluctant to discuss their actions during the crisis. Moreover, in Malaysia, freedom of the press remains circumscribed, and many laws discourage open criticism of the regime. On several occasions in each country, I faced interviewees who openly lied about their actions during the crisis. For these reasons, my use of interview data is judicious: I corroborate all statements with other sources or other interviewees. Moreover, anonymity for many interviewees is a paramount concern. For some interviewees and on some topics I operate on strict journalistic "background" rules, where I do not attribute findings to particular individuals, even anonymously by reference to their profession or the date of the interview. When interviewees have explicitly consented, I include as much information as they view to be appropriate.

The drawback of a paired comparison of Indonesia and Malaysia is the potential that other influences on adjustment policy choice and regime survival outweigh the influences of coalitional preferences. I rely on two comparative methods to assess the plausibility of alternative hypotheses and to demonstrate the internal validity of my own theory. First, I examine explanatory variables both contemporaneously across countries and in the context of each country's political history. Second, I trace out the observable implications of several alternative explanations, finding that they misrepresent how the crises actually unfolded in each country.

The generalizability of my account depends on how well the argument explaining Indonesia and Malaysia in the 1990s can travel to other countries during other periods of time. Close attention to the historical record

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