Asean's institutions still in poor shape:

By YASHENG HUANG and BERNARD YEUNG
2 September 2004
Financial Times

There is universal consensus among academic researchers that the main underlying cause of the 1997 Asian financial crisis was the poor quality of the afflicted countries' economic institutions. Yet seven years on, the overall institutional quality of the members of the Association of South-East Asian Nations - Brunei, Cambodia, Indonesia, Laos, Malaysia, Burma, the Philippines, Singapore, Thailand and Vietnam - has deteriorated. This is a worrying development.

Malaysia, which faced financial disaster in 1997, is a case in point. According to the Heritage Foundation, the US think-tank, Malaysia suffered the second biggest fall in economic freedom of all the countries covered by its global index of economic freedom (the first was Venezuela). On a scale of one (the best) to five (the worst), Malaysia scored 2.45 in 1995 but 3.16 in 2004. Rankings by other organisations point the same way. The "rule of law" index devised by the PRS Group's International Country Risk Guide shows a substantial decline for Malaysia since the late 1990s. Similarly, the World Bank's "governance indicators" for Malaysia showed decline in all six categories between 1997 and 2001.

But Malaysia is not alone. Between 2003 and 2004, Indonesia experienced one of the sharpest falls in economic freedom as measured by the Heritage Foundation's index. In the 1980s and 1990s, Suharto's regime epitomised crony capitalism. Yet Indonesia now appears to be doing even more badly. On the World Bank's "control of corruption" index - one of the six governance indicators - Indonesia's score declined from -0.8 in 1997 to -1 in 2001. Similarly, the Philippines, never a paragon of governance, has also put in a worse performance since 1997. Overall, on the economic freedom index the average for Indonesia, Malaysia, Myanmar, Thailand and the Philippines rose from 3.2 in 1997 to 3.5 in 2004. (Remember, the higher the worse.)

Asean suffered greatly in the 1997 crisis but it appears not to have heeded the advice to improve corporate governance and strengthen broad economic institutions. Its policy priorities have been regional integration in trade and efforts to encourage foreign direct investment.

According to the World Bank, Asean's average common effective preferential tariffs fell from about 13 per cent in 1993 to about 2.9 per cent in 2002. Within Asean, tariffs are even lower. About 90 per cent of intra-Asean trade now falls within the 0-5 per cent tariff range.

The prevailing view in the region is that free trade or greater market access - especially to China - is Asean's best hope for the future. President Gloria Macapagal-Arroyo of the Philippines has pointed out that combining the Asean and Chinese economies "would give birth to a market of 1.8bn consumers". Driven by this belief, the October 2003 summit of Asean countries concluded a series of agreements with China to allow preferential market access to China for Asean by 2010.

There is nothing wrong with trade liberalisation in and of itself. But the strategy of pursuing a trade liberalisation agenda in lieu or even at the expense of institutional reforms will backfire for several reasons. One is that these trade agreements and negotiations are easy hostages to often unpredictable geopolitical developments. China has already threatened to suspend negotiations to create a free trade zone with Singapore in retaliation for the visit to Taiwan by Lee Hsien Loong, a trip he made before he ascended to Singapore's premiership. Another reason is that the financial foundation for China's growth is extremely fragile. It is unwise for the region to tie its future so closely to a country struggling with its own, similar, institutional problems.

The most fundamental concern is that liberalisation of trade and FDI does not address the institutional deficiencies of the Asean countries. In the 1990s, Asean was already one of the regions most dependent on foreign trade and FDI. The crisis did not happen because the region lacked capital and export opportunities but because poor corporate governance and rampant corruption led to massive wastage of capital and inefficiencies in the corporate sector. Without institutional reforms, economic integration among Asean countries can only exacerbate those flaws. Singapore, the only Asean country whose institutional quality is among the best in the world, could easily be engulfed in a domino-like financial crisis.

In Asean countries, as elsewhere, fluctuations in market opportunities and capital supplies are a way of life. This is where strong institutions can really help: they serve as buffers that absorb the shocks that come from being integrated into the global economy. The best way forward for Asean is for it to combine its market expansion measures with deep and sustained institutional reforms. The question is whether the region's leaders have the necessary vision and courage. The record so far does not give much ground for optimism.

Yasheng Huang is a professor at MIT Sloan School of Management. Bernard Yeung is a professor at New York University's **Stern School of Business.**

--
Jessica Neville
Director of Communications
Office of Public Affairs
New York University Stern School of Business
Ph: 212-998-0666
E-mail: jneville@stern.nyu.edu