

Financial Crises, Capital Controls, and Authoritarian Breakdowns

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1. Introduction

Economists disagree about the welfare consequences of capital mobility. Whereas many argue that any barrier to the movement of foreign capital across borders constitutes a politically-induced market imperfection (Dornbusch 1998), others argue that in a second-best world with imperfect information, temporary barriers to the unimpeded flow of capital across borders can in certain instances can shield vulnerable economies from the vagaries of international financial volatility (Bhagwati 1998; Rodrik 1998; Tobin 1978). The logic is straightforward. Hot money often flows out of countries with little regard to their macroeconomic fundamentals, and sudden reversals in the flow of capital have serious consequences for countries' financial systems. By selectively restricting the ability of capital to flow in or out of a country, therefore, emerging market economies can protect themselves from the more deleterious aspects of global financial integration.

Much of the evidence for the latter claim—that capital controls can be welfare-enhancing or at least that capital account liberalization is not always and everywhere socially optimal—comes from the experiences of several countries that experienced severe economic contractions in the early 1980s and late 1990s. Countries such as Chile in the 1980s and Malaysia in the 1990s imposed selective capital controls as parts of economic adjustment measures during financial crises. Various accounts argue that these measures were instrumental in giving governments autonomy to enact expansionary monetary and fiscal policies that stimulated economic recovery, and which would have been impossible without cutting the link between a fragile domestic financial sector and global capital flows (see e.g. Kaplan and Rodrik 2001). If

these accounts are true, then governments should consider selective capital controls as a useful tool for combating financial sector crises.

I argue in this paper that while capital controls may spur economic recovery during financial crises, they also have a much more unpleasant result of prolonging the life of authoritarian regimes. Based on the experiences of the same countries held as models of successful crisis management using capital controls, I argue that their authoritarian regimes are less likely to succumb to popular pressure for democratization during financial crises when they impose capital controls. The findings are consistent across a larger sample of countries that have experienced financial crises, and controlling for alternative explanations for authoritarian regime survival. Capital controls not only shield authoritarian governments from the volatility of international markets, they also shield authoritarian governments from pressures for regime change. The literature on capital mobility and economic adjustment has neglected this important political story, but in order to grasp the welfare consequences of capital controls as a solution to financial market crises, analysts must take into account their economic *and* political implications.

The paper proceeds in five sections. The next section describes the theoretical literature on capital mobility and financial crises. The goal of the review is not to exhaustively survey the literature on the causes and consequences of financial crises, but rather to draw attention to the neglected role of politics in assessing the consequences of capital controls as an adjustment measure. Next, I flesh out several causal pathways that link capital controls to authoritarian durability. Capital controls can enable expansionary policies that decrease incentives for protest and rebellion among citizens, they can shield domestic markets from negative international reactions to crackdowns against dissidents and political opponents, and they can placate the demands of industrial groups allied with the regime. I then discuss two paired comparisons of

emerging market economies that faced financial crises—Chile and Argentina in the early 1980s, and Indonesia and Malaysia in the late 1990s—contrasting regimes that impose capital controls to their counterparts that do not. The qualitative investigation of these four cases allows a close inspection of causal pathways between capital controls and authoritarian breakdowns, showing how they actually work to enhance regime durability during financial crises as well as the consequences of their absence. Turning to a broader sample of countries, I demonstrate that, controlling for confounding political and economic factors, both existing capital controls and increases in capital controls after the onset of a financial crisis decrease the probability that an authoritarian regime breaks down during or immediately following that crisis. This quantitative analysis demonstrates the cross-national applicability of insights gleaned from the four cases, and allows for a more direct test of the role of capital controls against alternative explanations for authoritarian breakdowns. The concluding section discusses the consequences of this research for the study of regime durability and financial politics, as well as the policy implications of this argument.

2. Capital Mobility and National Welfare

Economists and political scientists have long recognized that cross-border capital movements have important consequences for economic management. The benefits of financial internationalization are clear. Capital flows into countries in order to provide economic actors with investment funds that are otherwise unavailable from domestic sources. The inflow of investment capital rewards governments and sound economic management with the resources to pay for infrastructural investments, and gives firms the resources to expand and upgrade. Conversely, capital flows out of countries as domestic capital holders seek higher rates of return in foreign markets, or to hedge their investment risks by diversifying between foreign and

domestic markets with varying degrees of investment risk. Capital also flows out of countries when multinational firms to repatriate their profits to domestic shareholders, and when institutional investors reallocate their investments to other markets.

In short, along with trade in goods and services, capital flows are the engine of international economic integration. But economists have long recognized a downside to unimpeded capital flows that has no analogue in trade. This is the problem of hot money and speculative investment. Foreign investors often allocate their resources not only in long term fixed investments, but also directly into portfolio investments in stock and bond markets or in private firms and financial institutions through loans. Such capital investments can be quickly withdrawn, in particular money markets investments which can be liquidated and repatriated almost instantaneously. Whereas the flow of foreign funds into equity and bond markets can help to prompt economic growth, a sudden stop or reversal of the inflow of capital can swiftly lead to a financial crunch and an economic crisis. Sometimes such crises can be attributed to an unsustainable currency peg (Calvo 1995; Krugman 1979) or poor regulation of a domestic financial sector (McKinnon 1993; McKinnon and Pill 1997, 1998). Yet a particular problem of sudden capital account reversals is that they often cannot be attributed to clear macroeconomic policy or regulatory mistakes, but instead appear to occur as the result of self-fulfilling dynamics such as informational cascades or herding (Chari and Kehoe 2003; Obstfeld 1986, 1996). To the extent that foreign investors react to aspects of a country's economy beyond the control of governments, sudden reversals may punish emerging markets and their citizens seemingly unjustly, or to an extent far beyond that warranted by relatively minor policy errors (among others, see Díaz-Alejandro 1985; Winters 1999).

Capital flows also influence domestic economic management through the well-known Mundell-Fleming trilemma, whereby small economies cannot simultaneously maintain free capital mobility, a fixed exchange rate, and independent macroeconomic policy (Cohen 2006; Frieden 1991b; Mundell 1963). Under a fixed exchange rate regime with an open capital account, expansionary monetary policies lead to capital flight (investors seek higher global interest rates), upsetting the fixed exchange rate unless the government intervenes by tightening monetary policy again. The end result is that discretionary monetary policy is ineffective with a fixed exchange rate. By abandoning the currency peg, the government can induce monetary expansion, but the consequence of monetary expansion is currency depreciation. Only by restricting short-term capital movements across its borders can the government simultaneously stimulate the economy through expansionary macroeconomic policies and maintain a desired exchange rate. Governments may have good reasons to desire both a stable and predictable exchange rate and a monetary stimulus, especially in the short term, as tools for steering out of an economic crisis originating in the financial sector. In such cases, retreating from international financial integration can be less costly for medium-term recovery than the alternatives.

There are thus at least two reasons why restrictions on the movement of short-term financial capital across borders can be desirable from an economic perspective. First, by preventing sudden capital account reversals, capital controls minimize the risks that come from the inflow and outflow of hot money. Second, by breaking the link between interest rates and exchange rates, capital controls give governments the flexibility to adopt adjustment policies that are otherwise technically unfeasible. In essence, these two justifications for limits on short-term capital mobility reflect a single underlying concern, that hot money can cause financial market crises and make it more difficult for countries to overcome these crises once they occur. In the

economist James Tobin's words, these risks make it clear that, in order to reduce financial volatility, national governments and international financial institutions should put "sand in the market's gears."¹

The debate about the effectiveness and welfare consequences of capital controls remains unsettled (for a recent review, see Cohen 2006). The breakdown of Bretton-Woods meant the end of decades of restricted capital mobility and the new rise of global finance as a powerful political actor (Helleiner 1994). Since then capital flows have surged, and both emerging markets and OECD economies alike have embraced them. Nevertheless, economists continue to disagree whether on balance, capital account liberalization promotes sustained economic growth (see the debates in Chinn and Ito 2006; Dooley 1996; Forbes 2005; Obstfeld 1998; Rodrik 1998; Satyanath and Berger 2005), or whether capital controls facilitate economic recovery during economic crises (Edwards 1999a, 2005; Eichengreen and Leblang 2003).

3. Capital Controls and Authoritarian Breakdowns

Neglected in this debate are the political consequences of capital controls. This is curious, as the literature on capital mobility has emphasized the importance of political calculations in determining their imposition, and on political factors supporting capital account liberalization.² Anecdotal evidence certainly suggests that authoritarian regimes have used capital controls for purposes other than neutral economic recovery. Paul Krugman, the first mainstream economist to endorse capital controls during Asia's financial crisis, was later quite critical of Mahathir's "habit of putting inconvenient people in jail."³ Krugman's statements

¹ James Tobin, "Why We Need Sand in the Market's Gears," *Washington Post*, December 21, 1997.

² On the determinants of financial liberalization, see Brooks (2004), Cohen (1996), Goodman and Pauley (1993), Haggard and Maxfield (1996), Helleiner (1994), Leblang (1997), and Quinn (1997).

³ Paul Krugman, "Capital Control Freaks: How Malaysia Got Away With Economic Heresy." Available online at <http://slate.msn.com/id/35534/>.

capture the unsettling view that capital controls enabled Mahathir Mohamad, Malaysia's authoritarian Prime Minister, to crack down against domestic political opponents. If so, capital controls had a political consequence in Malaysia that many proponents of capital restrictions may not have anticipated, in prolonging the life of authoritarian regime.

There are at least three causal pathways through which capital controls during financial crises can benefit incumbent authoritarian regimes. They can enable governments to implement macroeconomic stimuli that protect employment, and thereby increase the opportunity costs of protest and rebellion; they can allow government to reward connected firms with favorable policies; and they can shield regimes from market punishments for cracking down on domestic protest. I describe each of these pathways in greater detail below.

3.1. The Opportunity Costs of Rebellion

As noted above, the Mundell-Fleming conditions show that purposive macroeconomic expansion with a targeted exchange rate is technically unfeasible without controls on capital outflows. Particularly when countries face significant currency depreciation alongside economic contraction, a major concern is to stabilize the currency while engineering an economic expansion. The function of capital controls during such a situation is to allow countries to reach these goals simultaneously. In a context of an economic crisis that threatens an authoritarian regime, expansions that forestall mass retrenchment can prevent an economic crisis from leading to mass opposition. They can do so by decreasing the opportunity costs of protest and rebellion.

Consider the example of poor urban wage laborers. Under an authoritarian regime, these laborers face the question of whether or not to engage in protest or rebellion that can spur democratic opening. Unemployment for any one individual decreases the opportunity cost of her protest, and mass unemployment decreases the collective action costs facing a large subset of

poor laborers. So preventing mass unemployment is one way that an authoritarian regime can decrease pressures for democratization. It is possible to embed this intuition in most formal models of protest, revolution, and regime collapse. In economic models of regime change such as Acemoglu and Robinson (2006), as well as in models of insurrections such as Roemer (1985) and Grossman (1991), the “demand for transition” and “the value of rebellion,” however modeled, is determined largely through economic hardship or inequality. But if governments can manipulate the demand for transition by, for example, preventing layoffs of urban wage laborers, then they can increase the effective costs—and hence decrease the likelihood—of this mass protest which drives regime change.⁴

Capital controls are a policy tool that enables governments to enact an economic expansion that protect mass employment. This is the precise economic logic that motivates the use of capital controls as a tool for economic adjustment. In cases where authoritarian regimes face economic crises that threaten mass employment, they may therefore choose capital controls as an adjustment strategy to insulate their rule from popular protest and rebellion. And given that authoritarian regimes in many parts of the world derive legitimacy from economic performance, capital controls can allow such regimes to protect their reputation of competent economic management in the face of economic turmoil. In the case of Malaysia, discussed below, reflationary policies specifically targeting the country’s poor became prevalent after the imposition of capital controls.

3.2. Placating Connected Interests

A related pathway to regime survival via capital controls given financial sector turmoil focuses on the corporate interests of regime supporters. In emerging market economies, both

⁴ On this link between mass protest and democratization, see e.g. Haggard and Kaufman (1995: 60-74). On labor and democratization, see Collier and Mahoney (1997) and Valenzuela (1989).

authoritarian and democratic, tight links frequently exist between political leaders and business elites, industrial enterprises, and trade organizations. These linkages can be formal or informal, through direct government ownership of industrial firms, politicians serving as company directors or majority shareholders, entrepreneurs trading money for political protection, or through networks of patronage or “old boys” clubs. The consequences of such relationships are that business groups demand policies that shield them from financial turmoil, with the implicit threat that business groups will push for regime change absent favorable policies. Corporate welfare of connected interests, therefore, directly enters the utility calculations of an authoritarian ruler.

To placate the demands of connected business groups during periods of financial turmoil, regimes may offer a number of blandishments. The most obvious is expansionary monetary policy: by relaxing interest rates to facilitate economic expansion, governments can encourage spending and investment, easing business conditions throughout the country and loosening tight credit markets. More technical financial policies such as relaxations of reserve requirements, or more coarse policies such as bailouts and emergency liquidity support, have the same effect of easing tight credit markets and inducing expansion. Yet the Mundell-Fleming model again demonstrates that such expansion will be ineffective with full capital mobility, unless countries are willing to abandon managed exchange rates. If rapid currency depreciation itself wreaks havoc on domestic economic conditions, then firms may demand exchange rate protection in addition to expansionary bailouts.

For these reasons, capital controls emerge as an indirect but vital policy tool that allows regimes to create policies that benefit connected firms. Protected from the threat of capital outflows and currency depreciation, governments can implement expansionary policies that save

connected firms, without the fear of capital outflows negating their impact of these policies. Evidence of this causal pathway at work is apparent in all four countries. In each, business groups lobbied incumbent regimes to retreat from international financial integration in order to facilitate economic expansion and to protect their business interests. In two, Chile and Malaysia, business groups obtained their desired policies and continued to support incumbents; in the other two, Argentina and Indonesia, dissatisfied business groups ultimately turned against incumbent regimes out of their frustration with continued economic decline.

3.3. Shielding Regimes from Market Punishments

The final pathway between capital controls and regime survival during financial crises deals with market punishments for controversial policies. Beyond rendering expansionary macroeconomic policies incompatible with managed exchange rates, free capital convertibility entails that currency traders and stock speculators can punish governments that enact policies that they consider imprudent, economically harmful, rash, or otherwise improper. They do so by divesting from these governments' economies, reallocating their investments to other, potentially safer locations. Such decisions punish incumbent regimes by furthering exchange rate deterioration, deepening share market collapses, and erasing foreign demand for government bonds, thereby prolonging financial crises. In a famous example of how international speculators can raise the ire of recalcitrant authoritarian regimes, George Soros became a lightning rod for leaders who complained of the discipline that his currency transactions exacted upon them during late 1990s financial crises in Asia and elsewhere.⁵

Divestment can take place as a consequence of a number of policy actions that a vulnerable authoritarian regime may take to secure its rule. Crackdowns on protest organizations, repression of nascent opposition movements, and other related policies increase

⁵ "George Soros's Image Problem: Nobody Loves a Cop," *Asian Wall Street Journal*, August 5, 1997.

perceived levels of economic uncertainty during financial crises. By the same token, targeted bailouts of crony controlled business groups can reinforce international perceptions that regimes are not serious about corporate or financial reform, thereby generating new uncertainties about minority shareholder protection. Regimes that backslide on international commitments to prudent financial management may be perceived as indifferent to the consequences of bad policies, or more broadly as incompetent economic managers. Each of these can drive capital outflows that deepen financial sector crises, despite their obvious attraction as tactics for protecting authoritarian rule.

To simultaneously engage in these policies, regimes require a policy intervention that prevents markets from exacting punishments. Capital controls—in particular, restrictions on capital outflows, or on overseas or cross-border currency trading—are one such tool. Without the ability to divest, foreign and domestic capital investors must allocate their “trapped” capital within that country’s economic system. Capital controls thereby ensure that regardless of subsequent crackdowns against domestic opponents or heterodox adjustment policy choices, capital stocks cannot further decline, and that foreign currency traders cannot continue to bet against vulnerable exchange rates. Capital controls therefore allow vulnerable regimes the latitude to adopt regime-preserving policies without the fear of market punishments.

All four cases discussed below show evidence of market punishments for internationally unpopular policies. In both Chile and Malaysia, investors reacted negatively to a wide range of policy decisions before the imposition of capital controls, and crackdowns against domestic opponents and opposition demonstrators followed immediately in the wake of their imposition. In Argentina and Indonesia, where regimes refrained from imposing capital account restrictions, widely internationally condemned decisions—in the former, an ill-conceived war, in the latter,

extensive bailouts of cronies and evasion of IMF loan conditions—sent already fragile exchange rates and capital markets into further downward spirals.

3.4. *Why Not Capital Controls?*

The three considerations above illustrate how capital controls can serve as a policy tool that authoritarian governments can strategically employ in order to fend off pressures for regime change and political reform. Why, then, would any regime not opt to restrict capital flows during a financial crisis? Several factors may constrain the ability of regimes to respond to financial crises with capital controls. Most obviously, authoritarian regimes may receive crucial political support from owners of mobile assets who demand the ability to move capital in and out of a country. If regimes have constructed political coalitions that cement alliances between capital-rich but mobile investors and domestic industrial groups, capital controls may be politically unpalatable for a large subset of the regime's closest allies—mobile financiers. In fact, high office holders within the regime who have substantial liquid assets may prefer an open capital account, which allows them to convert domestic currency holdings into foreign currency as a hedge against a domestic economic meltdown. Facing the People's Power movement in the Philippines that accompanied dramatic financial turmoil, Ferdinand Marcos sent millions of U.S. dollars overseas.⁶ As we shall see, in somewhat different ways, distinct subsets of political and business elites in Argentina and Indonesia had used capital openness to their advantage during more stable periods that preceded economic crises. When crises struck, these powerful elites lobbied hard for capital openness to protect their own interests.

Another possible influence may be the impact of neo-liberal ideas in policy preferences. Increasingly throughout the 1990s, the so-called “Washington consensus” of neo-liberal

⁶ “How Hot Money has Beggared the Third World,” *Globe and Mail*, August 30, 1985; “Marcos ships in fortune in pesos,” *The Times*, March 1, 1986.

development policies had powerful impacts on policy formation in many emerging markets. Western-oriented technocrats on policy planning boards can shape policy dialogues in authoritarian regimes, and international lending institutions such as the World Bank and the IMF can place conditions on structural adjustment loans that stipulate neo-liberal reforms. Capital controls, viewed as a politically-induced market imperfection, are just one of many policies that run counter to orthodox economic principles. We see below that the political expediency of capital controls overcame the ideational pull of influential orthodox technocrats in Chile, but in other cases such the case of Mexico during the tequila crisis of the 1990s, economic policy authorities appear to have remained faithful to the principle of capital openness for ideational reasons.

A final possible influence—again, perhaps at play during Mexico’s tequila crisis—is issue linkage in the international arena, where regimes have entered into valuable international agreements that link capital account policy to other issue areas, such as trade and investment policies. One key difference, between Mexico in the early 1980s—where the regime imposed strict capital controls during a financial crisis—and Mexico in the 1990s was the existence of NAFTA. Such agreements raise the costs of capital controls, discouraging governments from constraining capital flight during financial meltdowns.

4. Case Study Evidence

As a first step towards examining the impact of capital controls on authoritarian regime survival, we can examine several well-known cases of “successful” capital account restrictions during financial crises. Two stand out: Chile in the early 1980s, and Malaysia in the late 1990s. In both of these countries, an authoritarian regime implemented capital controls as a part of an extraordinary mix of policies designed to jumpstart economic recovery in the midst of a severe

financial crisis. We can compare these countries to others that did not impose such capital controls during financial sector crises, and see how their regimes fared. For Chile, a convenient comparison is Argentina at the same time. For Malaysia, a natural comparison is Indonesia in the same period. These four cases yield two focused comparisons that vary across time and space both in the imposition of controls. They also vary with regard to regime survival: regimes in Chile and Malaysia each survived their financial crises, while crises in Argentina and Indonesia contributed directly to the collapse of authoritarian regimes.

The cases also vary in a number of other dimensions that could potentially determine regime survival, allowing us preliminarily to check the role of other factors that might mediate the link between crises and transitions. Some crises led to greater economic distress as measured by real GDP contraction than others, from the low single digits (Argentina) to almost fourteen percent in Chile and Indonesia. Three countries sought IMF loans, but Malaysia did not. Three cases featured open military participation in politics (Chile, Argentina, and Indonesia), while two featured strong institutional structures (Indonesia and Malaysia). The cases vary in the age of the incumbent authoritarian regime, from just five years at crisis onset (Argentina) to thirty-two years under one ruler (Indonesia). They also vary in their procedures for executive turnover, from three regimes led by strong authoritarian personalities (Mahathir Mohamad in Malaysia, Soeharto in Indonesia, and Augusto Pinochet in Chile) to Argentina's series of junta leaders. Finally, the countries vary in the "depth" or "hardness" of authoritarianism, from a competitive authoritarian regime in Malaysia to more repressive regimes in the Southern Cone and Indonesia. We quickly lose degrees of freedom in noting the other factors that could determine transitions during economic meltdowns, but none vary as cleanly with regime survival as do restrictions on capital convertibility (Table 1).

-- TABLE 1 about here --

As a hard, loosely institutionalized military regime, Chile under Pinochet matches Argentina and Indonesia, yet unlike them it survived the crisis. Instead, Chile parallels Malaysia, a highly institutionalized competitive authoritarian regime that also survived its crisis. A closer examination of political developments in each country reveals the dynamics of capital account restrictions amidst financial panic, and the links between capital movements and regime durability.

4.1. Chile and Argentina

Economic policy making under Pinochet prior to the Latin American debt crisis embraced many of the tenets of orthodox economics. By 1980, General Augusto Pinochet had consolidated his rule over a regime that was openly hostile to labor, and in particular, to organized labor (see e.g. Barrera and Valenzuela 1986; Cortázar 1985; Drake 1996: 117-148; French-Davis 2002: 183-211; Fortin 1985: 160-164; Leiva and Petras 1986; Silva 1988; Vergara 1986: 96-106; Winn 2004; Zahler 1983: 540-545). In the coup of 1973 that ousted Salvador Allende, Pinochet's greatest support lay in the business community, with additional support from conservative and middle class Chileans frustrated with Allende's economic mismanagement. Within months of the coup, Pinochet and his advisors had abolished price controls, and begun to sell off enterprises previously nationalized under the Allende regime. After two years of unsatisfactory recovery, the regime stepped up the pace of economic adjustment, launching a new set of radical monetarist economic policies under the consultation of the so-called Chicago Boys, a group of technocrats educated at the University of Chicago under the tutelage of the monetary economists Milton Friedman and Arnold Harberger (see Foxley 1983; Valdés 1995). The Chicago Boys directed further rounds of privatization, this time of the country's domestic

financial sector, in order to encourage foreign capital investment and more efficient allocation of credit to the domestic market. By 1980, Chile had seen the rise of an important new group of conglomerates, or *grupos*, based around new financial institutions in the country's newly deregulated financial sector. Many of these *grupos* diversified into areas such as property speculation as well as into the more traditional export-oriented sectors (Foxley 1986; Frieden 1991a: 166-167; Galvez and Tybout 1985; García Hurtado 1983: 10-11; Valdés 1995: 218-240; Vergara 1986: 93-96).

Despite the rising prominence of the *grupos* and the wide latitude given the Chicago Boys in domestic economic management, capital account restrictions remained in place during this period of stabilization and expansion. From the period from 1979 until 1982, at the very height of the Chicago Boys' influence, the Chilean government banned all inflows of capital with maturities of less than twenty-four months. For capital inflows with maturities of between twenty-four and fifty-five months, the regime imposed an effective tax on inflows by requiring owners to deposit a variable percentage—from ten to twenty-five percent, depending on size and length of maturity—of that inflow in non-interest bearing accounts known as *encaje* at Banco Central de Chile (Edwards 1999b). Thus, while the regime quickly opened itself to trade, openness to capital flows was much lower throughout the 1970s and early 1980s (see also Meller 1993: 130-131; Ramos 1986: 140-141; Zahler 1983: 529-537).

The antecedents to Chile's financial crisis were the same policies that the Chicago Boys had employed to spur economic expansion. Chile had since 1979 maintained a fixed peso-dollar exchange rate regime designed to anchor expectations over future prices. With a largely open capital account, despite short-term restrictions on inflows, this meant that macroeconomic policy was ineffective; and indeed, the reliance on an economy's "automatic stabilizer" was part of the

Chicago Boys' economic management strategy. As noted above, there had been great strides in financial sector deregulation, but export performance lagged, leading to a current account deficit financed by capital inflows—again, despite policies that discouraged them. With capital inflows came a boom in the domestic financial sector, now woefully underregulated rather than repressed. Buoyed by easy access to foreign capital, speculative activities from foreign investors and domestic actors alike contributed to an unsustainable financial bubble. When the price of copper, Chile's main export commodity, tumbled in 1981 along with an increase in global interest rates, capital inflows slowed. When this decrease in the availability of foreign funds exposed financial sector weaknesses, capital inflows nearly ceased, leading to a domestic banking crunch and increasing downward pressure on the Chilean peso (Edwards and Cox Edwards 1987: 196-203; French-Davis 2002: 29-146; Foxley 1986: 27-30; Frieden 1991a: 164-165; Meller 2000: 88-109; Whitehead 1987: 125-130).

Initially, the regime made little attempt to use policy levers at its disposal to minimize the impact of capital outflows on domestic macroeconomic conditions. With a fixed exchange rate and capital outflows, domestic interest rates rose sharply. But predictably, the ensuing credit crunch led to protests from the domestic business community. Chilean labor suffered as well through retrenchment from cash-strapped businesses. The Chicago Boys' commitment to non-intervention notwithstanding, after several months of hands-off economic management under the Chicago Boys, domestic business pressures began to bear fruit (on this period, see Meller 2000: 102-129). Throughout January, the Central Bank allowed a series of devaluations of the peso, from 39 to the US dollar in January to 74.4 at the end of the year. The effects were clear for the indebted *grupos*, and especially their in-house *financieras* (lightly regulated non-bank financial institutions), who found that their effective debt burden had nearly doubled. In September 1982,

in a major break with Chicago Boys, the government announced that it had imposed selective bans on capital outflows as it simultaneously began actively to target domestic interest rates. Exchange controls included strict quotas on currency held by domestic travelers, forcing speedy import payments, and lowering the limit on foreign exchange held by exporters (Corbo and Fischer 1993: 14; Meller 2000: 128).

The retreat from monetarism and the imposition of capital account restrictions were indicative of the Pinochet regime's strategy of protecting the interests of export-oriented domestic business, the group upon which it had relied for political support since 1973. However non-interventionist the regime had been previously, this was no longer the case (Biglaiser 2002: 28-29; Constable and Valenzuela 1991: 195-217; Fortin 1985: 193-194; Frieden 1991a: 173-174; García Hurtado 1983: 35-36; Kurtz 1999: 420-422; Martínez and Díaz 1996: 94-100; Meller 2000: 129-141; Muñoz Goma 1989: 179-180; Ramos 1986: 22-23; Silva 1992-1993: 81-94; 1996: 151-182; Silva 1991: 397-398; Stallings 1989: 186-190; Whitehead 1987: 147-148). Expansionary monetary policies helped to ease the impact of the previous banking crunch for domestic business, the government took possession of troubled financial institutions, nationalized their debt while dismantling the corporate empires based around them. Meanwhile, the previously vaunted Chicago Boys became something of a pariah. Owing to agitation from the domestic business community, between 1982 and 1986, the country saw six different Ministers of Finance, with the Chicago Boys increasingly marginalized. In choosing expanding the economy, the regime returned to its traditional support base of export-oriented industrial capitalists, domestic business, and landowners. Newly wealthy business groups suffered, as the regime went as far as to imprison Javier Vial (head of the *grupo* Vial) and Rolf Lüders (a former Bi-Minister of Finance and the Economy) for financial crimes. Observers called this marked

change towards active political intervention in the economy the “Chicago Road to Socialism,” recalling the earlier dictum that Salvador Allende’s nationalization of private enterprises constituted “Chile’s Road to Socialism.”

How did capital controls allow Chile to withstand domestic pressure for regime change? At the most basic level, they allowed Chilean policy makers to adopt expansionary economic policies that would have been unfeasible with free capital convertibility. Expansionary policies such as those adopted to save the Chilean business community would have prompted outflows (or currency depreciation) absent exchange controls. These business interests, a key political ally, therefore retreated from their previous stance of open protest at the regime’s handling of the economy. The regime also was able to move decisively against opposition protestors, putting down violently mass demonstrations that many observers believed would bring the regime (Arriagada 1988: 56-66; Chavkin 1989: 248-278; Constable and Valenzuela 1991: 261-267; Martínez and Díaz 1996: 18-19; Oppenheim 1993: 183-188; Spooner 1994: 183-204). Absent restrictions on capital convertibility, such crackdowns would have surely generated massive capital flight. Secure in the expansionary policies of the Chicago Boys’ successors, Pinochet’s supporters in the business community continued to support the regime, allowing it to survive the crisis.

In contrast to the case of Chile, the experience of Argentina during the Latin American debt crisis illuminates the consequences of a regime refusing to control capital outflows amidst financial panic. Like Pinochet’s Chile, by 1980 Argentina was a rightist, military-led dictatorship that oppressed labor. Substantial inflows of foreign capital during the five years preceding the country’s economic collapse led to reckless and ultimately unsustainable financial expansion.

But unlike Chile, Argentina's regime did not contain the popular discontent that its financial crisis unleashed.

Argentina's military regime under General Jorge Videla had close links to both mobile financial capital and domestic heavy industry. Videla seized power in the wake of the disastrous second Peronist government (1973-1976), which espoused populist ideologies but was never stable amidst factional infighting among Peronist camps. Under the military regime, labor faced restrictions on collective bargaining, the right to strike, and the right to participate in politics; the regime also appointed military overseers of existing unions and maintained wage controls despite deregulating prices (Decker 1983: 55-66, 75-81; Drake 1996: 149-180; Flichman 1990: 14-16; Munck 1998: 65-93; Munck 1985: 66-67; Nogués 1986: 10-13; Peralta-Ramos 1987: 48; Pozzi 1988). Orthodox structural adjustment measures in the 1970s caused a sharp rise in unemployment and "self-employment," along with stagnating real wages, both to the detriment of labor (Decker 1983: 103-106; Ferrer 1985: 50-52; Munck 1985: 62-65).

So far, the Argentine regime's hostility to labor matches the Chilean case. But while observers normally consider Pinochet's Chile to have been the ultimate expression of monetarist economic principles in Latin America, liberalization did not extend to international capital transactions. In Argentina, foreign and domestic capital faced almost no restrictions on cross-border movements. Under Minister of the Economy José Martínez de Hoz, most restrictions on capital flows were abolished by 1977, and all were dismantled by 1980 (Calvo 1986: 518-519; Nogués 1986: 16-18; Ramos 1986: 41). Like the Chicago Boys, Martínez de Hoz had a clear affinity with orthodox monetarism (Manzetti 1991: 94-98). Like Chile, the financial boom amidst orthodox stabilization policies encouraged the growth of *financieras*, but in Argentina they forged close links with the highest levels of the regime's leadership, allowing short-term

capital inflows to grow to unprecedented sums (Calvo 1986: 514-518; Flichman 1990: 19-20; Frieden 1991a: 207-209; Manzetti 1991: 105; Munck 1985: 58-60; 1989: 51-52; Peralta-Ramos 1987: 50-51; Ramos 1986: 41-42).

This partially was the result of the economic climate that the military regime in Argentina inherited, one already marked by heavy annual inflation. The challenge facing the Argentinian regime was to encourage investment, and abolishing controls on capital movements along with orthodox stabilization measures was the chosen policy. Inflows of foreign capital helped to finance the country's budget deficit, while open borders allowed domestic holders of liquid assets to protect themselves against peso inflation by converting assets into foreign currency as a store of value. Significant appreciation of the exchange rate despite a goal of nominal *depreciation* under a system of pre-announced devaluations (*tablita*) only encouraged the conversion of pesos to dollars (Calvo 1986: 520-529; Dornbusch 1989: 294-296; Fanelli and Frenkel 1989: 10-13; Fernandez 1985; Fischer et al. 1985: 42-56; Frieden 1991a: 212; Nogués 1986: 18-19; Sjaastad 1989: 265-267). In addition to large outflows of capital owned by politically connected figures, large inflows of hot money led to skyrocketing foreign debt. Domestic borrowers sought dollar loans, and then directed these loans toward short term domestic deposits with high interest rates, or towards the rapidly growing stock market.⁷ Importantly, a number of active and retired military figures in the Videla regime used their positions as leverage to obtain loans, in order that they themselves could engage in these activities (Dabat and Lorenzano 1984: 69-70; Lewis 1990: 462-463; Peralta-Ramos 1987: 54; Petrei and Tybout 1985). The use of foreign loans to speculate in the domestic market during

⁷ Private sector "financial debt" increased from US\$2,413 million to US\$13,099 million from 1975 to 1982, while public sector debt jumped from US\$4,021 million to US\$28,616 million in the same period (World Bank 1987: 94).

this period became known as the “bicycle” (*bicicleta*), which would remain upright so long as one kept pedaling.

Argentina’s debt crisis began in March 1980 with the collapse of Banco Intercambio Regional, heavily leveraged with extensive domestic and foreign liabilities. The collapse of Banco Intercambio signaled to domestic deposit holders and foreign currency traders alike that the *bicicleta* had finally tipped, and in the ensuing banking panic most of the big *financieras* that had risen under the military regime collapsed as well (Lewis 1990: 462-469; Munck 1985: 60; Pion-Berlin 1985: 60). Shortly thereafter, capital outflows commenced, growing continually throughout the remainder of the year and through 1981 and 1982. These were driven by annual inflation rates of still over 100 percent per year as well as the perception that domestic financial institutions were no longer safe (Frieden 1989: 31; Ramos 1986: 43).

With continued downward currency pressure and systemic banking fragility, political conflict over adjustment worsened (on the political dimensions of the crisis, see especially Munck 1998; Pion-Berlin 1985). Indebted industrial groups, many linked to the military, who found that tight monetary policies designed to draw capital back into the country had eroded their profitability, demanded bailouts from the regime. When these were not forthcoming, they eventually turned against it (Maxfield 1989: 82-83). Likewise, within the military, prominent figures such as General Armando Lambruschini (Commander-in-Chief of the Argentine Navy) claimed publicly that “speculation [is] the greatest enemy of economic freedom in the realm of production” (quoted in Pion-Berlin 1985: 61). General Videla extricated himself from active politics by resigning in March of 1981, as he had long claimed was his intention. The new government under General Roberto Viola backtracked to a degree on the earlier policy of macroeconomic tightening, and then attempted to re-peg the peso with two parallel exchange

rates—a full float for financial transactions and a crawling peg for commercial transactions. At the same time, the regime guaranteed all foreign currency debt held in the domestic financial sector, and guaranteed support for insolvent banks—contributing to an over looser macroeconomic stance (Fernandez 1985: 887-888; Fischer et al. 1985: 12; Frieden 1991a: 224-225; Lewis 1993: 174-175; Peralta-Ramos 1987: 58; Pion-Berlin 1985: 64-66).

With no end to the crisis in sight and amidst hotly contested adjustment measures, Viola himself was ousted by General Leopoldo Galtieri. The new government abolished Viola's dual exchange rate system and adopted a "dirty" float of the peso, which continued to depreciate due to free capital convertibility (Canitrot and Junco 1993: 46; Fischer et al. 1985: 12; Frieden 1991a: 226; Pion-Berlin 1985: 67-69). Galtieri's Minister of the Economy Roberto Alemann was a fierce proponent of orthodox adjustment measures (Biglaiser 2002: 36; Munck 1985: 68). Yet orthodox adjustment measures could not placate the demands of industrialists, and the effects of the crisis on Argentine labor and the middle class continued to worsen. Still deeply unpopular, and in a dramatic bid to unite the populace, Galtieri launched the disastrous Falklands/Malvinas War against the United Kingdom. The war succeeded in uniting the populace behind the war effort, but economic management remained critically divisive (Dabat and Lorenzano 1984: 83-109). The war led to still more changes in the exchange rate regime, ultimately leading to still more depreciation, which increased the debt burden of the domestic financial sector still further and led to grumblings within the military about the costs of orthodox policies (Fischer et al. 1985: 12-13; Pion-Berlin 1985: 70). Moreover, the war frightened foreign investors, making them even less willing to invest in the economy (Sjaastad 1989: 267).

Galtieri's regime did not survive its defeat in the Malvinas. After General Reynaldo Bignone assumed the presidency, there were new steps to reform the financial sector through

interest rate regulations. These were ineffective, and mass conversions of liquid peso assets to fixed assets and foreign currency continued. In the face of mass opposition and a political coalition that had crumbled, the military leadership agreed to hold elections in October 1983. Anticipating a future victory by populist/nationalist political groups, the regime near by mid-1983 began to adopt a host of exchange controls and protectionist policies to shield domestic business from international markets (Fernandez 1985: 888; Fischer et al. 1985: 20-32; Peralta-Ramos 1987: 60).

The loss of the Malvinas War directly foreshadowed the end of authoritarian rule in Argentina, yet the war itself was a symptom of the larger collapse of the coalition of capitalist interests in the midst of a financial crisis (Munck 1998: 139-144). Opposition mobilization became increasingly impossible to ignore as successive government desperately sought to contain the country's economic meltdown (Munck 1998: 133-161; Munck 1989: 102-105), and the regime broke down ultimately due to divergent interests between the regime's capitalist supporters amidst mass discontent with the regime's economic management (Dabat and Lorenzano 1984: 125-168; Pion-Berlin 1985). Successive military regimes' refusal to restrict capital outflows thus contributed to the regime's breakdown by allowing massive capital flight to prolong a domestic credit squeeze, which harmed business and industrial interests as well as pushing labor into the streets. In fact, popular preferences for adjustment became a cornerstone of the new democratic government under Raúl Alfonsín that came to power in December 1983 (Frieden 1991a: 224-227). Among its nationalist stabilization attempts was the ill-fated "Austral Plan" which froze wages and prices while fixing the exchange rate under a new currency, the Austral (Canitrot and Junco 1993: 48-55; Kaufman 1988: 26-48; Lewis 1990: 484-493; Manzetti 1991: 139-187; Manzetti and Dell'Aquila 1988; Smith 1990; World Bank 1987).

4.2. Indonesia and Malaysia

The military regimes in Chile and Argentina were relatively new when crises struck in the early 1980s. New Order Indonesia entered 1997 as one of the world's most secure authoritarian regimes. Under Soeharto, a former general who had led the country since late 1965, Indonesia had witnessed three decades of nearly consistent economic growth. Soeharto sat atop a steep hierarchy of exchange relationships that funneled rents from military-affiliated business ventures upwards, and protection and favorable political interventions downwards (see Crouch 1979; MacIntyre 2003; McLeod 2000). In a tight coalition with Soeharto and the military were a number of wealthy ethnic Chinese entrepreneurs who, in return for funneling their investments towards industries of strategic political or social importance, received monopoly privileges, tariff protection, closed-bid tenders, resource rents, and a vast array of other targeted benefits and inducements (see e.g. MacIntyre 1994: 246-247; Mackie 1992; Mackie and MacIntyre 1994: 32-33; McLeod 2000). Yet Indonesia also maintained a high degree of capital account openness throughout the New Order, giving these ethnic Chinese entrepreneurs and foreign firms alike an important check on the New Order's potential for expropriation (MacIntyre 2003; Winters 1996).

Indonesia's crisis followed on the heels of Thailand's surprise devaluation of the baht in July 1997 (Cerra and Saxena 2000: 236; McLeod 1997: 36; 1998: 916). In the ensuing reevaluation of regional financial markets, investors seized upon the large mismatch between foreign liabilities and domestic assets in Indonesia. Heavy borrowing from abroad was not itself problematic, but the government's implied exchange rate guarantee had encouraged firms not to hedge their foreign debts against currency fluctuations. Hill (1999: 59-60) estimates that by the eve of the crisis, in early 1997, only 30% of Indonesian foreign debtors had adequately hedged

their foreign currency borrowings. Further troubling was the pile-up of short-term debt (Hill 2000: 124; Ito 1999: 18; Sharma 2001: 84; Winters 1999: 84). Moreover, as in Argentina and Chile, credit had flowed largely to unproductive and speculative sectors that would not perform in the event of an economic contraction (Goldstein 1998: 7-9; Kartasasmita 2000: 10; Lindgren et al. 1999: 15; Nasution 1999: 76; Sharma 2001: 85-86). As currency contagion spread from Thailand to Indonesia, the government quickly abandoned the rupiah's peg, leading to a sustained rupiah collapse from around Rp2,500 to the dollar in August 1997 to more than Rp14,000 to the dollar in May 1998.

Facing sustained rupiah depreciation, Soeharto's regime embarked on a bewildering array of seemingly-contradictory adjustment policy decisions (see MacIntyre 2001: 111-116), all of which sought to contain the rupiah's decline and ease deteriorating macroeconomic conditions. It sought IMF loans to restore international confidence (Soesastro and Basri 1998: 10), but political resistance to conditionality led the regime to resist many of the IMF's reforms (Robison and Rosser 1998; Smith 2003). Throughout the crisis, high ranking officials in Bank Indonesia (Indonesia's Central Bank) and the Ministry of Finance came into open conflict with Soeharto and his relatives over finance and exchange rate policies. Because of their opposition to government policies of monetary loosening and corporate bailouts, in early 1998 Minister of Finance Mar'ie Muhammad and Bank Indonesia Governor Soedradjad Djiwandono were replaced by more pliable allies. Demands from the corporate and financial sectors for monetary loosening were constant during the crisis (see e.g. Soesastro and Basri 1998: 42). In responding with lower interest rates, the government both contradicted policies to restrain capital flight, and prompted inflation. At the sign of each policy reversal, the fragile rupiah plunged still further, as investors punished Indonesia for backtracking on its policy commitments. Bank Indonesia also

began to provide liquidity support to troubled banks in order to keep them afloat (Pincus and Ramli 1998: 726). These instructions came specifically from Soeharto in the form of several Presidential Instructions issued to Bank Indonesia in early September (Djiwandono 2004: 63). The great majority of liquidity support went to banks connected to Soeharto through his family, or to *konglomerat* connected to him through personal and business linkages (Haggard 2000: 67; Radelet and Woo 2000: 173). Meanwhile, inflation hit the poor hardest, especially in the prices of basic goods—already more expensive due to subsidy cuts (Booth 2000: 13-14; de Brouwer 2003).

The inability of Soeharto's regime to distance itself from domestic corporate and financial interests ultimately caused its breakdown (Smith 2003). Unwilling to accept orthodox adjustment policies, the New Order's decision makers pursued moderately expansionary policies that continued to drive capital flight. Industrialists and other holders of fixed capital accordingly clamored for capital controls, but ethnic Chinese cronies with highly mobile assets insisted on capital openness as a condition for their support of the regime (Pepinsky 2007). By May 1998, subsidy cuts for basic Indonesians—the one IMF condition that the regime faithfully implemented—along with retrenchment and inflation had spawned a mass opposition movement united under the banner of *reformasi* (reform) (O'Rourke 2002: 78-89; Pour 1998: 4). The deaths of four university protestors, murdered by security forces, spawned an orgy of anti-Chinese violence in Jakarta and several regional capitals (O'Rourke 2002: 91-117; Siegel 2001). In the wake of this violence, most of the New Order's ethnic Chinese supporters fled the country for their own safety (Wibowo 2001: 136). Without this previously loyal constituency, the New Order's coalition of supporters had fractured, and Soeharto resigned within a week.

Capital openness during Indonesia's financial crisis accordingly meant that the regime had little ability to maneuver among its powerful backers in the military and business communities. Tight money policies designed to reign in capital flight harmed domestic businesses, including the many regime-linked industrial firms. As in Argentina, labor suffered as well, with mass retrenchment prompting urban labor to join a loose coalition of students, activists, and housewives that directly challenged the Soeharto regime. Moreover, free capital convertibility allowed currency speculators to bet against the rupiah, especially in the wake of policy reversals at the behest of connected interests. Continued depreciation, in turn, tightened credit markets further by rendering domestic foreign-denominated debt yet more expensive. Finally and perhaps most importantly, the mass exodus of ethnic Chinese capital following riots in mid-May removed one of the fiscal pillars of the New Order regime, leaving it unsustainable.

The contrast with Malaysia is striking. Malaysia shared with Indonesia an urban-based *reformasi* movement that united students and regime critics in demanding reform and democratization. It also shared with Indonesia a highly open financial sector that guided funds to politically important business groups. But unlike Indonesia, Malaysia took the radical step of banning capital outflows in September 1998. This move proved critical in allowing the regime to survive the crisis.

Malaysia's authoritarian regime differs in important ways from military regimes in Argentina, Chile, and Indonesia. As a "competitive authoritarian" regime (Levitsky and Way 2002), it operates an ethnically-based cross-class coalition that relies on the politicization of the Malay identity. The dominant party in the ruling coalition is the United Malays National Organisation (UMNO), which has long championed pro-Malay social and economic policies, and under its rule the state has intervened extensively in the economy to redistribute wealth and

corporate ownership to *bumiputras* (Bowie 1991; Faaland et al. 2003; Gomez and Jomo 1999; Rasiah and Shari 2001).⁸ These interventions not only created a new Malay business class with tight links to UMNO (Gomez 1994, 2002), they also created a wide array of pro-Malay redistributive devices such as *bumiputra*-only unit trusts, entrepreneurship and investment corporations, smallholder development programs, educational institutions, and many others (Abdul Aziz 1994; Esman 1987: 410-411; Gale 1981: 45-56; Gomez and Jomo 1999: 34-38). In addition to its fidelity to the economic interests of its Malay constituents, the regime routinely violates democratic norms and procedures to restrict opposition criticism and ensure that it prevails overwhelmingly at the polls (Barraclough 1984; Election Watch 1995; Gomez 1996; Lim 2003; Muzaffar 1986). Under Prime Minister Mahathir Mohamad (1981-2003) in particular, executive authority grew to overwhelm all competitors within the regime (Slater 2003).

As a consequence of the Malaysian government's heavy involvement in the economy for redistributive purposes, it has a strong interest in healthy economic performance. This interest became particularly acute during Malaysia's financial crisis. As in Indonesia, the financial crisis in Malaysia began on the heels of regional currency contagion from Thailand, which uncovered financial sector vulnerabilities that rapid growth had masked (Athukorala 2001: 31; Ong 1998: 239; Yap 2001: 46). Most important among these was the rapid growth of foreign debt, leading to the highest ratio of loans to GDP in Asia (Athukorala 2001: 71; Rasiah 2001: 69). Although relatively prudent financial regulations prevented the growth of *unhedged* foreign debt under Malaysia's fixed exchange rate, domestic banks intermediated foreign loans into the speculative property and equity sectors (see Athukorala 2001: 48-49; Haggard 2000: 59-60; Lindgren et al.

⁸ Most government policies officially target *bumiputras*—all non-Chinese and non-Indian “indigenous” inhabitants of Malaya and Malaysian Borneo—but the beneficiaries of such distribution are overwhelmingly Malays.

1999: 80-81; Ng 2001: 176). Additionally, by the middle of the 1990s capital inflows shifted in composition from primarily foreign direct investment to overwhelmingly portfolio investment (Athukorala 2001: 29; Chin and Jomo 2001: 112; Ong 1998: 222). So despite having contained unhedged bank debt, Malaysian authorities allowed foreign capital to pile up in speculative sectors that were uniquely vulnerable to secular changes in investor sentiment.

Adjustment policies in Malaysia were hotly contested, not only among the regime's supporters in the business community but within the regime itself. Deputy Prime Minister and Finance Minister Anwar Ibrahim oversaw a package in November 1997 known as "the IMF without the IMF," which mandated sharp spending decreases and delays in infrastructural investments (Haggard 2000: 61; Jomo 1998: 190; MacIntyre 2001: 108; Yap 2001: 50). The measures were designed to attract foreign investors back into the sagging Kuala Lumpur Stock Exchange by signaling the government's resolve to combat entrenched inefficiencies, but encountered fierce resistance from Mahathir and other members of the Malay business community. Likewise, interest rate hikes designed to encourage capital inflows were deeply unpopular with business groups, and were slowly reversed starting in February 1998. (Haggard 2000: 61-62; MacIntyre 2001: 111; Perkins and Woo 2000: 240). Facing such opposition to macroeconomic tightening and subsidy cuts, the regime actively sought an alternative adjustment strategy that would facilitate macroeconomic expansion without leading to further currency depreciation and capital outflows. The regime ultimately settled upon capital controls. The package implemented in early September 1998 restricted outflows of investment principal for one year in addition to banning overseas trade in ringgit and in Malaysian securities, but explicitly reaffirmed the regime's openness to portfolio inflows and foreign direct investment (Athukorala 2001: 76-78; Haggard 2000: 73-85; Mahani 2002: 117-121).

Following the imposition of capital controls, redistributive and expansionary spending increased, protecting the interests of struggling Malay firms and the Malay masses alike (Abdul Rahman 2002: 200-201; Athukorala 2001: 79; Case 2002: 248-249; Perkins and Woo 2000: 240; Toyoda 2001: 106-107). Moreover, with capital outflows restricted and the exchange rate re-pegged, the government was able to loosen monetary policies still further (Athukorala 2000: 173; Yap 2001: 55). Together with newly interventionist corporate and financial policies, these expansionary measures reinforced the fiscal expansion in the 1999 budget, and protected the interests of key allies within the Malay corporate world (Jomo 2003: 151, 186-190; Yap 2001). Johnson and Mitton (2003) find that, for instance, that in the wake of capital controls, firms associated with Mahathir and once-and-future Finance Minister Daim Zainuddin systematically outperformed unconnected firms. Meanwhile, the regime's *bumiputra*-only capital market investments managed to realize healthy dividends throughout the crisis, to the benefit of millions of small Malay shareholders and the consternation of non-Malay opposition parties (Lim 1998).

Capital controls in Malaysia hence played a key role in preventing mass retrenchment of the Malay masses and in safeguarding the corporate welfare of the regime's supporters in the business community. Capital controls also allowed shielded the regime from market punishments during its assault against domestic political opponents. Just days after imposing capital controls and announcing the ringgit's de-internationalization, Mahathir sacked Anwar on trumped-up charges of corruption and sexual impropriety. When Anwar refused to go quietly, launching a "*reformasi* roadshow" to seek support from opposition groups, Mahathir had him and other supporters arrested. Anwar and several others suffered beatings and humiliations in prison; while most were eventually freed, Anwar was eventually sentenced and served six years in prison (Case 2003; Hilley 2001: 154). Meanwhile, the regime's security arms cracked down

on mass opposition protests with an abundance of force (Case 2002: 134; Felker 2000; Hilley 2001: 228). Capital controls were instrumental in allowing the regime to engage in such oppressive tactics. Before their, financial markets had consistently punished the KLSE and the ringgit for Mahathir's frequent outbursts against rogue speculators, Western colonialists, and a Jewish conspiracy bent on undoing Malaysia's economic success (Jomo 1998: 185-186). With capital controls, Mahathir was able to avoid a similar fate during his assault against domestic opponents.

Absent the use of capital account restrictions to combat financial upheavals, there are few similarities between Mahathir Mohamad's Malaysia in 1997—a long-standing, party-based, ethnically-constituted, inclusionary authoritarian regime—and Pinochet's Chile in 1982—a recently constituted rightist military dictatorship. The cases of Chile and Malaysia, and their regional counterparts, demonstrate how in very different authoritarian regimes, capital controls during financial panics give authoritarian governments the same latitude to withstand demands for regime change. They do so by allowing governments to enact expansionary policies, and by shielding domestic markets from negative international reactions to offensives against opposition movements.

5. Quantitative Evidence

One might still ask whether the four cases above are idiosyncratic, and whether the relationship between capital account restrictions and regime survival during financial panics holds up around the world, controlling more systematically for alternative determinants of regime survival than the deterministic, mono-causal account summarized in Table 1. This section presents a quantitative test of this argument to demonstrate that it does.

5.1. Data Description

The criterion for case selection requires a set of economic characteristics which sets countries experiencing financial crises apart from those not. The concept of a “twin crisis”—a simultaneous currency and banking crisis—provides a straightforward coding criterion. Twin crises occur when a country’s exchange rates experience speculative pressure and the domestic financial system has either collapsed, or is at risk of collapsing (Edwards and Végh 1997; Glick and Hutchison 1999; Kaminsky and Reinhart 1999; Miller 1998). This is the type of financial crisis that should make capital controls useful adjustment policy option. Pure currency crises without serious domestic financial consequences should not require radical adjustment measures; pure banking crises that do not produce exchange rate pressures should not require adjustment of international monetary relations. Other types of economic crises—commodity crises, petroleum shocks—should not themselves require changes in capital account openness to mitigate their consequences, unless they themselves cause currency and banking crises. The four cases discussed above each experienced twin crises during the period under examination.

The sample of countries experiencing twin crises comes from Glick and Hutchison (1999). Their study collects data on all emerging markets, transition economies, and industrial economies between 1975 and 1997. The authors code countries as experiencing a currency crisis using a weighted average of changes in a country’s real exchange rate and percentage losses of foreign reserves, measured monthly. A country experiences a crisis if the change exceeds the country’s mean plus twice its standard deviation of currency changes. They code countries as having experienced a banking crisis if they fall into one of two datasets of financial crises, Calvio and Klingebiel (1996) or Demirgüç-Kunt and Detragiache (1998). To code twin crises, I choose all instances of a banking (currency) crisis followed within two years by a currency

(banking) crisis. This definition is consistent with the existing economic literature that explores the causal interrelationship between the two crises.

Because my argument focuses on the effects of capital controls on authoritarian regime survival, I focus on the subset of all twin crises that occur under authoritarian regimes as coded by Cheibub and Gandhi (2004). Table 2 includes the full sample of twin crises, as well as regime types and the transition outcomes of each country.

-- TABLE 2 about here --

The sample contains thirty-one twin crises in authoritarian regimes, with seven of them followed within two years by democratic transitions (Argentina 1982, Turkey 1983, Uruguay 1985, Philippines 1986, Nepal 1991, Kenya 1998, Indonesia 1998). These are the observations in the analysis, with the exception of the two observations from Laos, for which comparable data on economic development is unavailable. By contrast, the sample contains forty twin crises under democratic regimes, one of which was followed by a transition to autocracy (Peru 1990). These data suggest that transitions following twin crises are more likely in autocracies than in democracies, but that the crises themselves still only rarely lead to transition—in just over twenty percent of the cases.

The main independent variable of interest is restrictions on capital mobility. To measure this, I employ the dataset compiled by Chinn and Ito (2006) that measures legal restrictions on capital mobility using a variable entitled *KAOPEN*. I include two measures in the empirical estimations. The first is the value of *KAOPEN* at the onset of the currency or banking crisis that led to the twin crisis. This variable is called *KAOPENONS*. The second is the difference between *KAOPENONS* and the value of *KAOPEN* at the end of the twin crisis. I call this variable *DKAOPEN*. Because my theory argues that increases in capital account restrictions

during crises increase the likelihood of regime survival, *DKAOPEN* is the main theoretical variable. But including *KAOPENONS* in regressions allows me to control for the fact that countries that already have substantial capital account restrictions at the onset of the crisis have few additional restrictions that they can implement.

Other independent variables follow the literature on the determinants of regime breakdown during economic crises, and are summarized in Table 3.

-- TABLE 3 about here --

The first set of variables is economic. The variable *GDPPC* measures per capita gross domestic product of each country at the onset of the currency or banking crisis that led to the twin crisis. This controls for the hypothesis that the higher a country's level of economic development, the more likely it will be to experience a democratic transition. The variable ΔGDP measures the greatest percentage change in GDP between the onset of the onset of the currency or banking crisis that led to the twin crisis and the end of the twin crisis. This captures the argument that more severe economic crises are more likely to lead to regime transitions. The second set of variables is political. Two dummy variables, *CIVILIAN* and *MILITARY*, from Cheibub and Gandhi (2004), test for the argument that military dictatorships are more likely to experience democratic transitions during economic crises than civilian authoritarian regimes or monarchies, the omitted category (Geddes 1999). Another variable The variable *POLITYONS* uses the Polity score for each regime at the onset of the currency or banking crisis that led to the twin crisis. It allows me to control for the possibility that more "democratic" authoritarian regimes are more likely to withstand pressures for democratization than their more dictatorial counterparts. I also include in some estimations a series of three dummy variables that code for the region of the

world in which each country is located (sub-Saharan Africa, the Middle East and North Africa, and Asia).⁹

5.2. Estimation Results

The functional form of the probit estimator employed through the analysis and estimated via maximum likelihood is given in (1).

$$\Pr(\text{TRANS} = 1 | \text{DKAOPEN}_i, \mathbf{x}_i) = \Phi(\gamma \text{DKAOPEN} + \mathbf{x}_i' \boldsymbol{\beta}) \quad (1)$$

In this model, *TRANS* is a binary variable coded 1 if the country experiences a transition during crisis *i*, and 0 otherwise. My theory predicts that the parameter γ is positive, implying a positive relationship between capital account openness and the probability of authoritarian regime breakdown (a decrease in capital account openness decreases the likelihood of transition). Control variables enter the equation in \mathbf{x}_i , with the associated vector of parameters $\boldsymbol{\beta}$.¹⁰

The results of the analysis appear in Table 4. In all specifications, the estimate of γ is positive and statistically significant at the $\alpha < .05$ level, and in Models 2-5, where I relax the assumption that errors are distributed independently across twin crises in the same countries, the significance is well beyond the $\alpha < .01$ level.

-- TABLE 4 about here --

These findings show that systematically across countries, authoritarian regimes that impose capital controls are more likely survive crises than those that do not. To fix the example in the real world, consider an increase in the change in capital account openness from -1 (approximately Cameroon from 1994-1996) to 1 (approximately the Philippines from 1983-1987). Using the techniques described in King et al. (2000), Model 1 estimates that such a

⁹ Regions enter sequentially rather than together, as a probit model with all does not converge. A linear probability model with all regional dummies gives substantively identical results.

¹⁰ All data and STATA code for reproducing the analysis are available from the author.

change leads to an increase in the expected probability of regime breakdown of 0.636 (standard error = 0.226).

Other variables perform roughly as expected. Across specifications, more “democratic” authoritarian regimes as measured in *POLITY* are less likely to succumb to regime change. In Models 2-5, civilian authoritarian regimes are more likely to survive crises than other kinds of authoritarian regimes. Also in Models 2-5, there is evidence that more developed authoritarian regimes are *less* likely to break down during financial crises. There is no consistent evidence that crisis severity or regime age has any impact on regime survival during financial crises.

5.3. Robustness and Substantive Effects

The robustness of the findings is a concern given the small sample size ($n = 29$). To check that these results do not follow from small sample properties, I report the results of two robustness tests, each based on a linear probability model which gives nearly identical results to Model 1.¹¹ The “Cook’s D” statistic measures the leverage that particular observations have on overall findings. The somewhat arbitrary but nevertheless standard critical value is $4/n$, where n is the number of observations (Bollen and Jackman 1990). Observations for which the statistic exceeds this value, in my case $4/29$ or .1397, are held to warrant further investigation. Based on this test, only one observation truly stands out: Botswana’s 1996 twin crisis in the linear probability model is associated with a Cook’s D of .882, which is over five times the critical value. To check if Botswana’s crisis exerts undue influence on the other observations, I re-estimated the linear probability model as well as Model 2, excluding the observation from Botswana. The results remain virtually unchanged. Three other observations have Cook’s D statistics that just barely exceed the critical value, but their serial exclusion also has no influence on the results. As a final robustness check, I estimated a bootstrap regression model that treats

¹¹ Estimation results for these robustness tests are available upon request from the author.

the sample of twenty-nine observations as the true population of cases, and samples with replacement from that population to create a virtual dataset. I then estimated a linear probability model on this simulated data. The results again remain substantively identical, although most parameters are estimated with less precision.

These robustness tests give us much greater confidence that the relationship between capital account restrictions and authoritarian regime survival holds across emerging markets. These consistent results demonstrate that the experiences of Chile and Malaysia are not idiosyncratic, but rather representative of the experiences of authoritarian regimes confronting financial crises. To see how varying levels of changes in capital account openness affect the expected probability of regime breakdown, I employ the software described in Imai et al. (2006), simulating the expected probability (with an associated confidence interval) of authoritarian breakdown given values of *DKAOPEN* ranging from -1.5 to 1.5, increasing at intervals of .1. In these simulations, the values of all other variables are held at their means.

-- FIGURE 1 about here --

I then simply plotted the expected probability of authoritarian breakdown and the 95% confidence interval of that estimate by the values of *DKAOPEN* (Figure 1). When the index of capital account openness decreases by more than .5, the probability of authoritarian breakdown is under 10%; when it increases by more than .9, it exceeds 50%.

6. The Political Costs of Capital Controls

This paper has argued that capital controls have a political cost that existing economic analyses have neglected. This cost comes from the politics that are possible given restrictions on capital mobility during financial crises. Authoritarian regimes can use the shield of capital controls to engage in behaviors that prolong their rule, while regimes which do not restrict

capital mobility place themselves at the mercy of international financial markets, and are consequently more likely to break down during crises. To be sure, opposition groups and foreign journalists lamented the political crackdowns by Pinochet and Mahathir that occurred following their retreat from financial openness. This is the first study, however, to uncover the common logic behind these policies, and moreover, to demonstrate that across time and space, authoritarian regimes have systematically employed such measures to protect their tenure in office.

The implications of this finding are unsettling for proponents of capital account restrictions as a strategy for combating financial sector turmoil. Evidence cited above points to capital controls having a positive impact on economic recovery during financial sector crises, yet in authoritarian regimes, this economic recovery can come at the expense of basic political rights and civil liberties, which may flourish in the wake of a crisis that unseats an entrenched authoritarian regime. The tradeoff is stark: controls may have a positive effect on economic welfare, but they have a negative effect on political freedoms. So in advocating an adjustment policy that may protect a country's short term economic fortunes, policy makers may be advocating policies that consign citizens of an authoritarian regime to further years of authoritarian rule.

The work of Satyanath and Berger (2005) may provide a partial way out of this dilemma. They find in a broad sample of countries that the long term welfare consequences of capital controls depend on a country's level of democracy. In established democracies, capital controls are associated with higher growth; in authoritarian regimes, capital controls are associated with lower growth. The combination of their findings about the economic consequences of capital controls in authoritarian regimes, with this paper's findings about the political consequences of capital controls in authoritarian regimes, yields a pair of powerful arguments against capital

controls in authoritarian contexts. Despite the manifest imperfections of international capital markets, and the populist arguments that support their imposition during periods of financial turmoil, capital controls in authoritarian regimes have real costs that policy planners must consider.

These findings also contribute to the theoretical literature on authoritarian breakdowns. There is surprisingly little systematic cross-national evidence that links economic crises to regime breakdowns (two notable articulations are Gasiorowski 1995; Smith 2004). Yet in cases such as Argentina in 1983 and Indonesia in 1998, economic crisis clearly hastened the breakdown of an authoritarian regime. How can we reconcile these seemingly disparate observations? The answer lies in additional sources of variation within authoritarian cases facing crises. Geddes (1999) argues that the institutional basis of the regime matters: party-based regimes survive crises, while military regimes succumb to coups. Smith (forthcoming) argues that the type of crisis matters: oil crises rarely lead to authoritarian breakdowns, and only do when regimes began to develop while receiving windfall oil rents rather than before receiving them. Gasiorowski (1995) argues also that the type of crisis (inflationary versus recessionary) matters, and also that the time period matters: inflationary crises led to authoritarian breakdowns in the 1980s, but not before. I argue in this paper that *endogenous policy* matters: some regimes adopt adjustment policies that decrease the likelihood of regime breakdown during financial crises, while others do not. I suggested several explanations for why some regimes do not adopt capital controls during financial crises, but these arguments should be considered preliminary. Future research can theorize more fully about the determinants of adjustment policy in authoritarian regimes to probe the conditions under which authoritarian regimes, facing economic meltdowns, can adopt self-preserving policies.

TABLE 1: *Hypothesized Determinants of Regime Durability in Chile, Argentina, Indonesia, and Malaysia*

Variable	Chile	Argentina	Indonesia	Malaysia
GDP contraction > 10%	+	–	+	–
IMF loans	+	+	+	–
Military	+	+	+	–
Party system	–	–	+	+
Regime age > 10 years	–	–	+	+
Authoritarian personality	+	–	+	+
“Hard” authoritarianism	+	–	+	–
Capital account restrictions	+	–	–	+
Regime survival	+	–	–	+

“+” means that the condition is present, “–” that the condition is absent.

TABLE 2: *Twin Crises, 1975-1997*

Country	Year	Regime Type	Transition (Type/Year)
Argentina	1982-1983, 1989-1990	Non-Democratic, Democratic	Yes (Aut Breakdown/1983), No
Bolivia	1986-1988	Democratic	No
Botswana	1996	Non-Democratic	No
Brazil	1990-1991, 1995-1997	Democratic	No, No
Burundi	1997	Non-Democratic	Yes (Dem Breakdown/1996)
Cameroon	1994-1996	Non-Democratic	No
Chile	1985	Non-Democratic	No
Colombia	1985-1987	Democratic	No
Ecuador	1982-1983	Democratic	No
Egypt	1980-1981, 1991-1993	Non-Democratic	No, No
El Salvador	1990	Democratic	No
Finland	1991-1994	Democratic	No
Ghana	1983-1989	Non-Democratic	Yes (Dem Breakdown/1981)
Guatemala	1991-1992	Democratic	No
Guinea-Bissau	1996-1997	Non-Democratic	No
Guyana	1993	Democratic	Yes (Aut Breakdown/1992)
Hungary	1991, 1994-1995	Democratic	Yes (Aut Breakdown/1990), No
Iceland	1985-1986, 1993	Democratic	No, No
India	1993-1997	Democratic	No
Indonesia	1997	Non-Democratic	Yes (Aut Breakdown/1998)
Italy	1992-1994, 1995	Democratic	No, No
Jamaica	1994	Democratic	No
Japan	1992	Democratic	No
Jordan	1989-1990, 1992	Non-Democratic	No, No
Kenya	1985-1987, 1993-1997	Non-Democratic	No, Yes (Aut Breakdown/1998)
Korea, South	1997	Democratic	No
Lao PDR	1995, 1997	Non-Democratic	No, No
Madagascar	1988	Non-Democratic	No
Malaysia	1986-1988, 1997	Non-Democratic	No, No
Mexico	1982-1987, 1995-1997	Non-Democratic	No, No
Mozambique	1993-1997	Non-Democratic	No
Nepal	1988, 1991-1995	Non-Democratic	No, Yes (Aut Breakdown/1991)
New Zealand	1987-1991	Democratic	No
Nicaragua	1993-1995	Democratic	No
Nigeria	1993-1994	Non-Democratic	No
Norway	1987-1988, 1992-1993	Democratic	No, No
Peru	1983-1990	Democratic	Yes (Dem Breakdown/1990)
Philippines	1983-1987, 1997	Non-Democratic, Democratic	Yes (Aut Breakdown/1986), No
Romania	1990-1993	Democratic	Yes (Aut Breakdown/1990)
Spain	1977-1979, 1982-1984	Democratic	Yes (Aut Breakdown/1977), No
Sweden	1992-1993	Democratic	No
Thailand	1983-1986, 1997	Non-Democratic, Democratic	Yes (Aut Breakdown/1983), No
Trinidad and Tobago	1985-1990, 1993	Democratic	No
Tunisia	1993-1995	Non-Democratic	No
Turkey	1982, 1994-1995	Non-Democratic, Democratic	Yes (Aut Breakdown/1983), No
United Kingdom	1976, 1984, 1986	Democratic	No, No, No
Uruguay	1982-1984	Non-Democratic	Yes (Aut Breakdown/1985)
Venezuela	1984-1986, 1994-1997	Democratic	No, No
Zambia	1995	Democratic	No
Zimbabwe	1995-1997	Non-Democratic	No

TABLE 3: Variable Sources and Descriptive Statistics

Name	Concept / Description	Source	Min.	Max.	Mean
<i>KAOPENONS</i>	Capital openness at the onset of the crisis	Chinn and Ito (2006)	-1.753	2.623	-0.56280
<i>DKAOPEN</i>	Change in <i>DKAOPEN</i>	Calculated from Chinn and Ito (2006)	-3.335	2.9960	-0.03157
<i>GDPPC</i>	Gross domestic product per capita	Penn World Tables	0.0097	4.044	0.4894
<i>DGDP</i>	Maximum percentage one-year change in GDP during the crisis	Penn World Tables	-15.7300	3.0480	-4.982
<i>MILITARY</i>	Dummy variable = 1 if a military authoritarian regime, 0 otherwise	Cheibub and Gandhi (2004)	0	1	0.516
<i>CIVILIAN</i>	Dummy variable = 1 if a civilian authoritarian regime, 0 otherwise	Cheibub and Gandhi (2004)	0	1	0.355
<i>AGE</i>	The age of the current regime, in years	Cheibub and Gandhi (2004)	1	44	22.42
<i>POLITYONS</i>	The Polity IV combined score	The Polity IV	-9	8	-3.677

TABLE 4: Financial Crises and Authoritarian Breakdowns^a

Variable	Model 1	Model 2	Model 3	Model 4	Model 5
C	2.392368 (2.571028)	2.392368 (2.567129)	3.071183 (2.478316)	1.96276 (2.573001)	2.482937 (2.480881)
GDPPC	-1.447093 (1.102444)	-1.447093 ** (0.7008362)	-1.861642 ** (0.7636934)	-1.278798 * (0.7343674)	-1.572378 *** (0.5816668)
ΔGDP	-0.0415109 (0.1037815)	-0.0415109 (0.081839)	-0.2003981 * (0.1048781)	-0.0354104 (0.08177)	-0.0374618 (0.0771907)
POLITY	-0.3256633 * (0.1770465)	-0.3256633 ** (0.1340324)	-0.2529068 ** (0.1152911)	-0.3200636 ** (0.1343999)	-0.3089249 ** (0.1246253)
MILITARY	-2.020433 (2.104905)	-2.020433 (2.064047)	-2.082078 (1.875201)	-1.624227 (2.022617)	-2.226362 (1.966205)
CIVILIAN	-2.809285 (1.90403)	-2.809285 ** (1.266858)	-2.732363 * (1.63225)	-2.620416 ** (1.156114)	-2.856681 ** (1.188277)
AGE	-0.0699793 (0.0605139)	-0.0699793 (0.0629849)	-0.1088697 * (0.0604928)	-0.0590304 (0.0651459)	-0.0734661 (0.0586874)
KAOPENONS	1.552917 ** (0.7343132)	1.552917 *** (0.4779372)	1.428779 *** (0.529001)	1.4661 *** (0.4970512)	1.466502 *** (0.4296338)
DKAOPEN	1.695943 ** (0.7767654)	1.695943 *** (0.5364337)	2.389392 *** (0.8714076)	1.738084 *** (0.5490029)	1.91162 *** (0.6713183)
AF			-2.787268 * (1.312115)		
ME				-0.4479585 (1.148581)	
LATAM					1.158414 (0.7601915)
EAS					
Residuals Clustered Within Country?	No	Yes	Yes	Yes	Yes

^a Cells contain parameter estimates and standard errors. * = statistically significant at $\alpha < .1$, ** = statistically significant at $\alpha < .05$. *** = statistically significant at $\alpha < .01$.

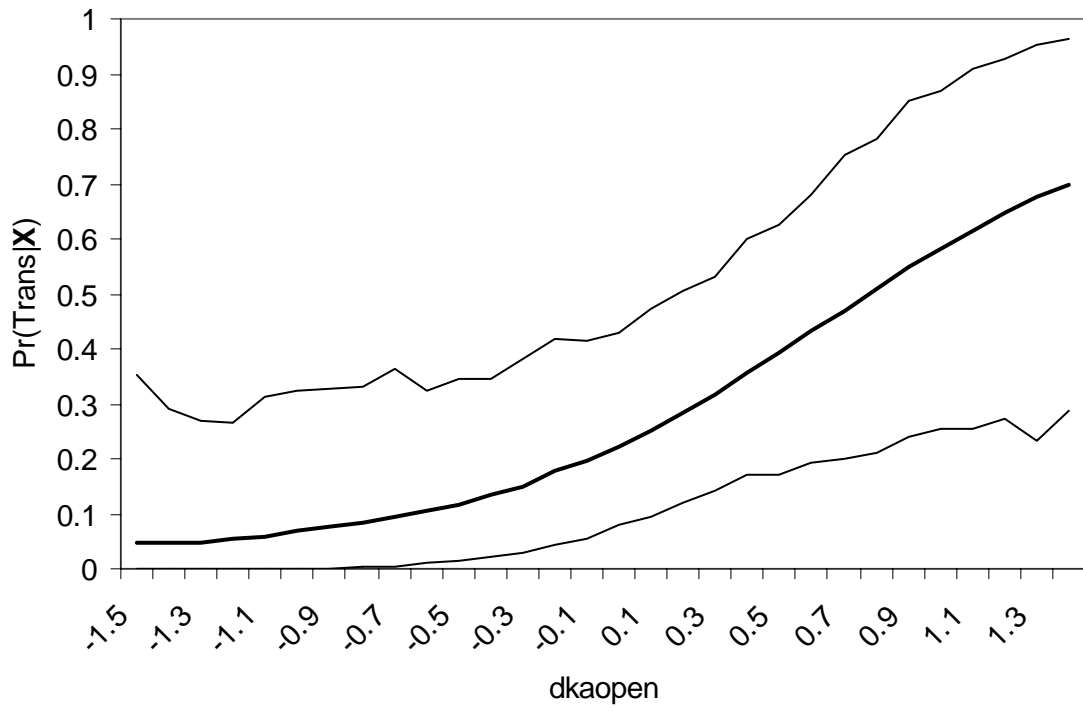


FIGURE 1: *Simulated Probabilities of Authoritarian Breakdown by Changes in Capital Account Openness*

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