

THE 1997–98 ASIAN CRISIS: A PROPERTY RIGHTS PERSPECTIVE

Sinclair Davidson

In 1997 the “Asian miracle” came to a sudden and dramatic end. A group of East Asian economies that had performed remarkably well over the previous two decades suddenly found their currencies under intense speculative pressure, their stock markets fell dramatically, and their economic growth rapidly declined. The Asian crisis spread to other emerging market economies, notably in Latin America and Russia. Speculation on the causes of the 1997–98 crisis varies from an old-fashioned financial panic (Radelet and Sachs 1998), to poor regulatory environments and conspiracy theories (Krugman 1999). Events such as this call for policy responses and for a reformation of the international “financial architecture,” which McKinnon (1996) refers to as “the rules of the game.” Irrespective of what the precise rules are, they have common objectives: To foster efficiency in trade of goods and assets; to provide stability; and to provide an equitable, socially acceptable distribution of income and wealth (Swoboda 1999:2).

Free markets appear capable of meeting all of these objectives. F. A. Hayek (1979) argues, for example, that free markets produce lower prices than any other economic system, while Herbert Grubel (1998) provides evidence that market-orientated economies have better human welfare along several categories (unemployment, human development, life expectancy, literacy, poverty, and income distributions). Dani Rodrik (1999) provides evidence that democracies (which are more likely to have market-based economies) pay higher wages, and have lower income inequalities, than nondemocracies. Proponents of altering the financial architecture, however, are not

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Sinclair Davidson is Associate Professor of Economics at RMIT University in Melbourne, Australia. He thanks Jonathan Boymal, Robert Brooks, Keith Jakee, Stephen Kirchner, Dan Leach, Heather Mitchell, Mike Rieber, and two anonymous referees for valuable comments and Vikash Ramiah for research assistance.

usually known to be free-market economists. Indeed, Alan Walters (1998: 304) has argued that “the most egregious errors . . . were due to the neglect of the most simple principles of economics.” Given that the underlying basis of all capital formation and economic growth is a well-specified system of property rights, it seems appropriate to investigate the crisis in terms of property rights.

The importance of property rights has long been paid lip service. The theoretical literature has included contributions by Coase (1960) and North (1981, 1990). In recent years, empirical evidence has contributed to our understanding of the interrelationship between property rights and economic development. In this respect, and important for our purposes, Johnson et al. (2000) find that investor protection and enforcement of property rights explain the 1997–98 decline in emerging markets better than standard macroeconomic explanations.

Governments have incentives to involve themselves in economic activity. In order to reduce competition and increase the scope for opportunism, governments often establish an inefficient set of property rights. The set of property rights, however, that maximizes the utility of those in power also exposes the economy to higher risks and penalties in unfavorable states of nature.¹ These property rights structures are proxied by economic, political, and civil freedoms, and by the exchange rate regime. In particular, an inefficient set of property rights will manifest itself as a mismatch between economic, political, and civil rights. This article presents empirical evidence consistent with this expected behavior. Using stock market returns for the 1997–98 crisis as a proxy for performance, the data show that those economies with mismatched economic, political, and civil rights performed poorly. Similarly, those economies with pegged and managed exchange rate regimes performed worse than those with floating exchange rate regimes.

The Grabbing-Hand State, Property Rights, and Exchange Rate Regimes

Neoinstitutional economics posits a “grabbing hand” theory of the state (Shleifer and Vishny 1998). The objective of the state in this type of model is to maximize revenue and influence—and, for those individuals who control the state, to stay in office. The state, however,

¹The model set out here, however, does not “predict” when an unfavorable state of nature will occur.

faces constraints: Internal rivals may attempt to control it, and external rivals may undermine its power and authority. The state does not simply carry out the wishes of a particular elite, nor does it act as an impartial umpire and practice benign neglect once property rights are specified. Rather, the state provides the “internal rules of the game” by establishing property rights that allow individuals to undertake economic activity; it adjudicates disputes but is also a self-interested player of the game.

The internal rules give rise to an economy’s “structural production frontier” that defines legal economic activity. Eggertsson (1990) refers to the neoclassical production frontier as the “technical frontier.” Technology, technical progress, factor endowments, and the division of labor are direct determinants of the technical frontier. In addition, the structural frontier has an indirect impact on the technical frontier. As is well known, growth (and the structural frontier) is affected by the extent to which social and private cost-benefit ratios converge (North 1981, 1990). Both social and private cost-benefit ratios are determined largely by the economic and political-civil freedoms within an economy, which suggests that, on average, the technical frontier will converge to the structural frontier.² In neoclassical theory the structural and technical frontiers always coincide. However, with positive transaction costs, this need not be the case.

Economic and political-civil rights are key determinants of the structural frontier. Indeed, an argument can be made that these two categories of rights are merely two sides of the same coin and are mutually reinforcing (Hayek 1944; Friedman 1962; Barro 1997, 1999). The connection between economic freedom and political freedom, however, is considered to be controversial. At a theoretical level, the relationship is unclear (Barro 1997). The Lipset (1959) hypothesis maintains that political freedom requires a minimum level of prosperity to survive. An alternative interpretation is that political freedom is a luxury for the rich.³ Under this alternative view a driving force for developing economies is a benevolent dictatorship, which allows for development while restraining interest group politics and inefficient redistributive policies.⁴ There are some *ex post* examples of

²Individuals will either illegally export their financial capital and their human capital. In order to prevent contraction of the technical frontier the state may introduce capital controls or prohibit emigration by skilled individuals. This type of activity was common among Soviet-style economies.

³Sen (1999) refers to this view as the “Lee hypothesis.”

⁴A common argument is that, in the development stage, the electorate will vote for inefficient redistributive policies (Barro 1999). Brenner (1999), however, finds no evidence in favor of this view.

this type of state: Hong Kong and Singapore are immediately obvious. It is difficult, if not impossible, to establish *ex ante* conditions for this type of state. Empirical evidence does support the Lipset (1959) hypothesis. Barro (1997) provides evidence using cross-section panel data. In addition, Farr, Lord, and Wolfenbarger (1998) report that economic freedom Granger-causes economic growth, which in turn Granger-causes political freedom. Specifically, they segment their data into industrial and nonindustrial economies and find no difference in the relationships, undermining the “political rights as a luxury good” view. A benevolent dictatorship is a risky investment because the possibility of nonbenevolent rivals is high. Such a strategy for growth must be unstable in the long run.

A strong grabbing-hand state can follow one of two strategies: It can either establish a Soviet-type economy or a “corporate state.” The first strategy has been shown to fail, whereas, the second strategy has been viewed as being successful. Indeed, the World Bank (1993) provided some respectability to corporate states. In corporate mode, the state establishes high levels of economic freedom but low levels of political freedom. Barro (1997: 50), for example, argues, “nothing in principle prevents nondemocratic governments from maintaining economic freedom and private property.” As a short-run strategy, this approach to economic development can assist in mobilizing resources (see Krugman 1994), but it also allows the government to be somewhat arbitrary and unaccountable. Moreover, it is likely that technical efficiency and structural efficiency will be inconsistent with long-run growth.

A strong grabbing-hand state would also want to limit access to international financial markets. Indeed, Friedman (1962: 57) writes, “There is much experience to suggest that the most effective way to convert a market economy into an authoritarian economic society is to start by imposing direct controls on foreign exchange.” In this regard, he echoes Hayek (1944: 92, fn. 2) who indicates that most states could establish control over the exchange rate with little controversy and “complete indifference.” The international foreign markets are massive relative to any state. It is difficult for any state to control a market-orientated exchange rate regime—either a freely floating currency or a currency board (see Friedman 1962, Hanke 1999). Not only is the free market hard to control, it also “allows” private individuals to circumvent state controls. By mandating a nonmarket exchange rate regime, the state can appear to be assisting growth opportunities by reducing business costs and also “insulate” the economy from what the rulers see as “irrational and irresponsible” markets. Most important, exchange controls allow governments to

allocate favors and to make policy mistakes with impunity. But such behavior cannot last forever. At some point, the currency (and stock market, if there is one) will experience a speculative attack.

There are two generally accepted speculative attack models (Eichengreen 1999, Appendix C). The first-generation model posits that speculative attacks arise due to inconsistent macroeconomic fundamentals. In this instance the market is simply a messenger, and the blame can be attributed to the particular government concerned. The second generation model posits that speculative attacks are self-fulfilling, and even with sound macroeconomic fundamentals they can, and do, occur. In this view, market participants are not benign messengers but active participants in creating and subsequently benefiting from the crisis. Related to this approach is the idea that some sound economies may become targets for speculative attacks on their currency due to a “contagion effect.” Certainly, the idea of contagion has become widely accepted as a cause of speculative attacks in otherwise sound economies and is, to some extent, the basis for reforming the world financial architecture.

Pericoli and Sbracia (2001) provide an accessible review of contagion. They indicate there is no generally accepted definition of contagion and offer five potential definitions. One of the definitions is that contagion occurs when market “co-movements cannot be explained by fundamentals” (p. 10). Definitions such as this presuppose known and generally accepted fundamentals. David DeRosa (2001: 113) indicates “contagion is a term that derives from medical science.” The implication being that a perfectly healthy economy is struck down by a highly contagious “disease”—a view apparently taken by former Malaysian Prime Minister Mahathir Mohamed. Anna Schwartz (1998), however, is unconvinced by contagion type arguments. She clearly believes that floating exchange rates should insulate different economies from “contagion effects.”

If contagion is not a cause of international crises, then bailouts sponsored by the International Monetary Fund lose any justification. Similarly, if contagion is not a cause of crises, then modifying the international financial architecture is rendered meaningless. What such a “reform” would achieve, however, is to insulate governments and policymakers from the consequences of their chosen unsustainable policies. In terms of the grabbing-hand model, those economies with inconsistent economic and political rights—giving rise to a conflict between structural and technical efficiency—should be susceptible to “contagion.”

This hypothesis is tested by considering the stock market returns of economies over the period of the crisis. The grabbing-hand

hypothesis would indicate that those economies with low levels of economic and political and civil freedoms, and also those economies with a mismatch between freedoms, would perform worse over the period of the crisis. Similarly, those economies that do not have market-orientated foreign exchange rate regimes would perform poorly over the period of the crisis.

Empirical Analysis

The empirical analysis is conducted on the basis of data collected from various sources, using the largest possible data set in each instance. Stock market data are from DataStream. Monthly market indexes, in U.S. dollars, are for the period December 1996 to December 1998. MSCI and IFC indexes are drawn from as many markets as possible. Continuously compounded returns were calculated over the period and averaged for each market. MSCI and IFC data were pooled to create a cross-section of returns. When the MSCI provides data for any particular market that data are used. When the MSCI, however, does not provide any data IFC data are used. In total, data are provided for 65 markets.

Economic freedom data from Gwartney and Lawson (2004) for 1995 are used in the analysis. Data for that year were chosen to approximate the economic freedom prevailing in each economy at the time of the 1997–98 crisis. The data are ranked from 1 (lowest) to 10 (highest). Data on political and civil rights are from Freedom House, which provides both cross-section and time series data.⁵ Again, 1995 data are used to proxy the levels of political and civil rights prevailing in each economy at the time of the crisis. The data are ranked from 1 (highest) to 7 (lowest). In order to reduce confusion and enhance interpretation of results, the data are transformed to a scale from 7 (highest) to 1 (lowest). Similar to Freedom House's practice, the two scores are averaged to provide a single ranking for both political and civil rights. Barro (1997, 1999) has predicted democracy scores (Freedom House's political rights score), given economic conditions in the economy, and compared them with actual scores. The differences between actual and projected scores (the "gap scores") are also taken from Barro (1999).⁶ The classification of the exchange rate regime operating within countries at the time of the crisis is from the December 1996 edition of *International Financial Statistics* (IMF 1996).

⁵The entire data set 1972–2003 can be downloaded from www.freedomhouse.com.

⁶The correlation between the gap scores in Barro (1997) and Barro (1999) is 0.9034. Results using the 1999 data are reported.

The data are categorized into five groups: pegged, flexible, adjusted to indicators, managed floating, and floating. Taiwan is not a member of the IMF; consequently, it is excluded from the analysis involving exchange rate regimes.

The median score for economic freedom is 6.4, while the median score for political and civil rights is 6. Economies with scores below either median are considered to have either low economic freedom or low political and civil rights. Economies at or above the median were considered to have high economic freedom or high political and civil rights.

The 65 economies under consideration are segmented into four separate groups shown in Table 1. The first group consists of 25 economies with high levels of both economic freedom and political-civil rights. This group had a positive average stock market return over the 1997–98 crisis period. However, this group does include South Korea, which was adversely affected by the crisis. But South Korea did have a managed exchange rate regime. The second group consists of 10 economies with high levels of economic freedom but low levels of political and civil rights. This group, which includes Thailand, Hong Kong, Indonesia, and Singapore, experienced an average negative stock market return over the 1997–98 period. The third group consists of 22 economies with low levels of economic freedom and low levels of political-civil rights. These economies experienced an average negative stock market return over the crisis period. The final group consists of 8 economies with low levels of economic freedom but high levels of political and civil rights. This group had a positive average stock market return over the crisis period.

Table 2 reports summary statistics for the full sample of 65 economies and the subgroupings. Two proxies for a mismatch between economic freedom and political and civil rights are employed. The first is the simple arithmetic difference between the two measures. This is rough measure, the two scores were not designed with this type of analysis in mind. Indeed, the scales of the two scores are very different. Nonetheless, this mismatch proxy (Free–P&C) appears to conform to a priori expectations. For example, the mismatch should be low for economies in group one, but higher for economies in groups two and four. Looking at the absolute magnitude of the proxy (i.e., ignoring the signs) in Table 2, that pattern can be seen. It is lowest for group one economies, and highest for economies in group two.

The second proxy for a mismatch is Barro's excess democracy score. A positive score implies that the economy has more democracy than could have been expected, while a negative score implies less

TABLE 1
COUNTRY ALLOCATION
ECONOMIC FREEDOM—POLITICAL AND CIVIL RIGHTS

High-High	High-Low	Low-Low	Low-High
Australia	Argentina	Bangladesh	Czech Rep.
Austria	Hong Kong	Brazil	Greece
Belgium	Indonesia	China	Hungary
Botswana	Jamaica	Colombia	Israel
Canada	Malaysia	Cote d'Ivoire	Lithuania
Chile	Mexico	Ecuador	Poland
Denmark	Philippines	Egypt	Slovenia
Finland	Singapore	Ghana	South Africa
France	Taiwan	India	
Germany	Thailand	Jordan	
Ireland		Kenya	
Italy		Morocco	
Japan		Nigeria	
Mauritius		Pakistan	
Netherlands		Peru	
New Zealand		Russia	
Norway		Slovak Rep.	
Portugal		Sri Lanka	
South Korea		Tunisia	
Spain		Turkey	
Sweden		Venezuela	
Switzerland		Zimbabwe	
Trinidad/Tobago			
United Kingdom			
United States			

democracy. The sign for the Barro score, by construction, is the reverse of the (Free-P&C) score. Barro's (1997, 1999) measure is far more sophisticated than the simple (Free-P&C) score. Nonetheless, the pattern of absolute scores follows the pattern of absolutes for (Free-P&C)—it is lowest for group one economies and highest for group two economies. The simple correlation between the two proxies is -0.8012 . Overall, the summary statistics indicate those economies with high levels of economic freedom and low levels of political and civil rights and those economies with low levels of both economic freedom and political and civil rights performed poorly during the crisis. Those economies with low economic freedom and high political and civil rights actually appear to have weathered the crisis fairly well.

Regression analysis can provide some insight into the marginal

impact economic freedom and political freedoms had on stock market returns during the crisis. The dependant variable is the 1997–98 stock market return, while the independent variables all precede the crisis.⁷ Results are shown in Table 3. There are some econometric considerations that need to be addressed. The potential for confounding results due to multicollinearity is addressed by calculating variance inflation factors for each equation. The maximum variance inflation factor was 1.46—well below levels of concern. White-adjusted standard errors (White 1980) are calculated, and associated p-values reported, to control for the effects of heteroskedasticity. Furthermore, each equation has been inspected for the effects of outliers. When outliers were detected they were removed from the equation.

There are four equations shown in Table 3. The model is built up incrementally. In the first equation, the economic freedom coefficient is not significant. This result is inconsistent with the expectation that those economies with higher levels of economic freedom would outperform those with lower levels of economic freedom. Those economies with flexible exchange rates—namely, members of the European Union—outperformed those with floating exchange rate systems, while those with managed exchange rate systems underperformed floating exchange rate systems. In the second equation, the mismatch between economic freedom and political and civil rights is introduced. The mismatch coefficient is negative and highly significant. Those economies with a larger mismatch performed worse during the crisis period. In this equation, the coefficient on economic freedom is positive and significant. Those economies with higher levels of economic freedom weathered the crisis better than those with lower levels of economic freedom. On the other hand, the large negative coefficient on the mismatch variable (Free–P&C) is consistent with the grabbing-hand hypothesis. A Wald test fails to reject the hypothesis that the sum of the coefficients on economic freedom and the mismatch coefficient is zero. An indication of the economic significance of these two variables can be seen through a sensitivity analysis. Substituting the mean scores for economic freedom and political and civil rights into the second equation gives rise to a negative predicted stock market return. If the economic freedom score is increased by one standard deviation, but the (Free–P&C) left constant, then a positive stock return can be predicted. When both the mean scores are increased by one standard deviation, the predicted stock market return remains positive. Economically, it seems

⁷Mitton (2002) employs a similar empirical model. He uses firm level stock market returns during the crisis to test the impact of corporate governance.

TABLE 2
SUMMARY STATISTICS FOR WHOLE SAMPLE AND SUBGROUPS

	Returns	Economic Freedom	Political & Civil Rights	(Free-P&C)	Barro
Mean	-0.0064	6.5046	5.1846	1.3200	-0.0732
Median	-0.0100	6.4000	6.0000	1.0000	0.0000
Standard Deviation	0.0261	1.1591	1.7668	1.6211	0.1927
N	65	65	65	65	56
Economic Freedom/ Political & Civil Rights					
High-High Group One					
Returns	0.0119	Economic Freedom	Political & Civil Rights	(Free-P&C)	Barro
Mean	0.0200	7.4000	6.7200	0.6800	0.0104
Median	0.0170	7.5000	7.0000	0.5000	0.0000
Standard Deviation	0.0170	0.5972	0.3559	0.4830	0.0503
N	25	25	25	25	24

	Returns	Economic Freedom	Political & Civil Rights	(Free-P&C)	Barro
High-Low Group Two					
Mean	-0.0289	7.2800	4.1500	3.1300	-0.2480
Median	-0.0200	7.1000	4.2500	2.5000	-0.2900
Standard Deviation	0.0262	0.9543	1.2483	1.6853	0.1858
N	10	10	10	10	10
Low-Low Group Three					
Mean	-0.0200	5.4409	3.4773	1.9636	-0.1376
Median	-0.0200	5.6000	3.7500	2.2500	-0.1500
Standard Deviation	0.0215	0.6940	1.3316	1.5183	0.2424
N	22	22	22	22	17
Low-High Group Four					
Mean	0.0015	5.6625	6.3750	-0.7125	0.0940
Median	0.0000	5.7500	6.5000	-0.5000	0.0400
Standard Deviation	0.0205	0.5975	0.2315	0.7019	0.1117
N	8	8	8	8	5

TABLE 3
STOCK MARKET RETURNS AND ECONOMIC AND POLITICAL FREEDOMS

Dependent Variable: Average Monthly Stock Market Returns 1997-98
(White-adjusted p-values in parentheses)

	(1)	(2)	(3)	(4)
C	-1.3285 (0.3746)	-4.6402 (0.0010)	-1.8080 (0.2550)	-2.5831 (0.0749)
Free	0.2131 (0.3127)	0.7770 (0.0004)	0.3798 (0.1044)	0.4846 (0.0327)
(Free-P&C)		-0.6159 (0.0013)	-0.5396 (0.0052)	-0.5259 (0.0070)
Flex	1.5379 (0.0055)		1.0729 (0.0589)	0.1447 (0.0613)
Manage	-1.2024 (0.0518)		-1.2447 (0.0665)	-0.1810 (0.0848)
Pegged	-1.0199 (0.2698)		-0.6797 (0.4674)	-0.0976 (0.4977)
Adj-R ²	0.2215	0.2430	0.2904	0.2868
F	5.1264 (0.0014)	10.7887 (0.0001)	5.9932 (0.0002)	5.9061 (0.0002)
N	59	62	62	62
Outliers	Bangladesh Greece Indonesia Malaysia Zimbabwe Taiwan	Bangladesh Malaysia Zimbabwe	Bangladesh Zimbabwe	Bangladesh Zimbabwe
Missing Data			Taiwan	Taiwan

the positive coefficient on economic freedom dominates the negative coefficient on the mismatch variable. This result, however, is not robust to the inclusion of exchange rate regime variables.

In the third equation, economic freedom is not statistically significant, while (Free-P&C) remains negative and significant. The coefficient for having a managed exchange rate remains negative and significant. Overall, the results are consistent with the grabbing-hand scenario. Those economies with a mismatch between economic freedom and political-civil rights performed worse during the crisis. Similarly, those with a managed exchange rate regime performed worse during the crisis.

The impact of the exchange rate regime can be further investigated by employing an interactive dummy variable, instead of the simple slope dummies used in the first three equations. The coefficients for Flex, Manage, and Pegged in the fourth equation are from interactive dummies between the exchange rate regime and economic freedom. Again, it can be seen that having a managed exchange rate regime is associated with poor performance during the crisis.

Table 4 provides a robustness test of the results in Table 3. The Barro (1999) excess democracy score is used as a proxy for a mismatch between economic freedom and political-civil rights. Higher Barro scores indicate that the actual level of political rights in the economy is greater than predicted by economic conditions. The Barro coefficient is positive and significant in both equations. Those economies with positive excess political rights performed better during the crisis while those with negative excess political rights performed worse. This result is consistent with those in Table 3, and with the notion that suppressing political and civil rights in order to maximize economic growth was inappropriate. It is those economies that were adversely affected during the crisis. Having a managed or pegged exchange rate regime was also associated with poor performance, relative to a floating regime, during the crisis.

Conclusion

While various macroeconomic causes have been hypothesized for the 1997–98 Asian financial crisis, this article takes the view that inefficient and inconsistent property rights are partly to blame. The evidence presented is consistent with the following story: Strong grabbing-hand states have a set of policies, including nonmarket exchange rate regimes, and a nexus of economic, political, and civil freedoms that are inefficient in some states of nature. In 1997–98, such a state of nature occurred. To the extent that property rights

TABLE 4
STOCK MARKET RETURNS AND ECONOMIC AND POLITICAL
FREEDOMS ROBUSTNESS TEST

Dependent Variable: Average Monthly Stock Market Returns 1997–98 (White-adjusted p-values in parentheses)		
	(1)	(2)
C	0.0313 (0.9214)	0.2436 (0.6124)
Barro	4.3444 (0.0035)	2.7526 (0.0594)
Flex		1.5149 (0.0076)
Manage		-1.1920 (0.0841)
Pegged		-1.8440 (0.0841)
Adj-R ²	0.1235	0.2816
F	8.3283 (0.0057)	5.9981 (0.0006)
N	52	52
Outliers	Bangladesh Indonesia Zimbabwe	Bangladesh Indonesia Zimbabwe

form the basis of expectations (Demsetz 1967), economic agents formed their expectations on the basis of unsustainable policies. Governments had created inefficient “rules of the game” that in unfavorable states of nature exposed economies to substantial risks.

This argument is inconsistent with contagion, but is consistent with the notion that speculative attacks are related to government policy failures. Those failures, however, are not the ones (e.g., budget deficits) posited by first-generation speculative attack models. Instead, the failures stem from governments choosing an inefficient combination of economic, political, and civil rights as the basis for economic growth.

This article does not establish why an unfavorable state of nature occurred in 1997–98, nor why the crisis first manifested itself in East Asia. What the article does indicate is that a series of economies with similar characteristics—namely, inconsistent economic and political and civil freedoms—performed poorly in 1997–98. This result is inconsistent with *healthy* economies being struck down by a virulent

virus. As Anna Schwartz (1998: 4) indicates, “Capital flight from countries with similar unsustainable policies is not evidence of contagion.” The crisis, at least in part, can be explained by poor fundamentals. Ultimately, this article supports the view that economic and political freedoms are reinforcing, and highlights the risk associated with so-called benevolent dictatorship.

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