Introduction

Yet another book on 'liberal democracy'?

I wrote this book to present an original argument, an argument that is aimed at a better understanding of why and to what extent 'liberal democracy' is a good system that delivers 'economic development': Does democracy really cause development? How tight is the connection? How does it do so? What *really* is the connection? What are the limits of that connection?

In other words, in this book I ask a series of questions that few people seem to be asking any more. By examining how 'liberal democracy' can or cannot contribute to 'economic development', I challenge readers to think about what 'liberal democracy' really is, what it can be, and especially what it can do – how, and under what circumstances.

These are important and long-overdue questions. Since the late 1980s and throughout the 1990s to now, 'liberal democracy' has been celebrated and 'democratisation' seemed 'the only game in town'. The universal *goodness* of 'liberal democracy' is almost always assumed: it will bring economic development, social harmony, enhancement of human rights, etc. In this atmosphere of triumphalism, there is little critical reflection on the concept of 'liberal democracy' itself.

The original argument presented in this book is constructed around a '$2 \times 3 + 1$' axis: the first set of three concepts are 'economic' liberalism, 'civil' liberalism and 'political' liberalism (achieved by 'decomposing liberal democracy', in chapter 2); the second set of three concepts are 'security', 'stability' and 'information and openness' (achieved via a top-down overview of liberal democratic theories, rendered in chapter 5). These six concepts interact together and are embedded in a particular 'institutional matrix', the seventh concept, which I use to explain the democracy–development connection in Japan and the Asian newly industrialising countries (NICs) (chapter 6).

In the course of examining and questioning this assumed connection between 'liberal democracy' and economic development, therefore, I use a set of cases to underscore some of the points. These countries have not strictly followed the path of 'democratisation' but have at the same time achieved the 'economic development'[1] that Western 'liberal democracies' are often said to bring (some call this the 'Asian miracle'). It is common to explain this success by some variants of 'authoritarianism', 'state autonomy','strong government', whether these were culturally predisposed or not ('Asian values', Confucianism, etc.). This type of *authoritarianism-was-responsible-for-the-economic-development-of-the-Asian-NICs* argument, I assert, needs to be unravelled; at the same time the *'liberal democracy'-goes-hand-in-hand-with-economic-development* argument needs also to be unravelled. Having set up the three-fold framework of 'liberal democracy', and then having unravelled some of the theories that purported to explain democracy–development, I ask the questions that really need to be asked about Japan and the Asian NICs: in what way and to what extent were 'liberal' and 'democratic' elements involved (or not involved) in their economic development, and what may this in itself say about 'liberal democracy' and about theories that connect it with economic development?

My concern in this book is not so much to describe the Asian success story as to bring into focus the theoretically interesting things the Asian success story reveals about 'liberal democracy' – its historical and theoretical underpinnings and the inter-connections as well as the contradictions amongst some of these. That is its relevance, and its ambitions.

The conclusions, I believe, are important and interesting: first, that the 'economic' and 'civil' dimensions of 'liberal democracy' impact on economic development in a different way and to different levels than the 'political' dimension does; second, that a proper understanding of the democracy–development connection requires an understanding not only of the different ways in which those three dimensions of 'liberal democracy' impact on economic development, but also of how the manifestation of those differences depends on the particular 'institutional matrix' of the particular states and how that institutional matrix furnishes and builds 'security', 'stability' and 'information and openness'. These conclusions, I believe, should be heeded by scholars and policy-makers alike.

The materials presented in this book cross boundaries of three fields: political theory (including globalisation), development studies and East Asian studies. The story told here makes unexpected use of elements within Western liberal democratic theory to construct an explanation

[1] The definition of 'economic development' is of course a contested one; one need only look at the debate over the recent 2000 *World Development Report*. My position on this is stated in chapter 1, note 1.

of the political economy of a set of non-Western countries (but not necessarily to reach an unexpected conclusion). I hope thereby that it will help practitioners and academics understand Western theory better (its tensions, inconsistencies, pretensions, etc.).

Isn't it true anyway that the financial crisis of 1997–8 put an end to the 'Asian miracle'?

The reader may well ask: what is the relevance of your argument in the light of the Asian 'financial crisis' of 1997–8? Does the 1997–8 Asian financial crisis affect what is presented in chapters 1 to 6? To what extent does it either strengthen or weaken the argument presented?

I want to note six points.

First, the countries most directly affected by the 'crisis' are not the ones I discuss in this book. The only exception is South Korea. Japan and Taiwan (as well as Hong Kong and Singapore, the other two NICs) were not significantly hit by the crisis.

Notwithstanding this, discussions about the crisis have centred around several themes: what were the forces driving (shaping) the incidence, timing, nature and extent of severity of the crisis? In particular, the arguments centred around the question of whether it was predominantly domestic factors – such as the inadequacies of the domestic financial system, 'cronyism', etc. – or whether it was more factors to do with the inadequacies in the international financial system – such as the lack of a powerful international financial regulatory agency, the internationally widespread trend of financial liberalisation, etc. – that were responsible for the way the crisis emerged and developed ('endogenous' versus 'exogenous' causes).[2] Identifying the causes of the crisis is important not only because it directly links with the proposed steps for the future (or 'lessons' from the crisis), but also because it has relevance for the broader questions about the nature and future of capitalism, 'liberal democracy' and 'globalisation'. More specifically, what does the incidence of this crisis mean for 'neo-liberalism', the doctrine of liberalisation and de-regulation? What does it mean for the 'Asian model' – would the aftermath of the crisis create more pressure in Asia towards a convergence with American-style capitalism?

[2] One important collection of scholarly work on the Asian crisis is the *Cambridge Journal of Economics*, 22:6, November 1998, Special Issue on the Asian Crisis. One interesting thing to note is how a report from the Japanese government issued just before the crisis was already producing some very pertinent analyses; see IDE Spot Survey (1997). For some official after-the-event analyses, see World Bank (1998b) and IMF (1998a and 1998b).

This leads us to the second and third points, which are in answer to those who argue for the end of the 'miracle'[3] and/or that this is the end of the 'Asian model'. Usually the argument proceeds as follows: first, the 'Asian miracle' is now doomed; second, it was 'Asian cronyism' that was responsible for the crisis (the obverse of this is that democratic countries have been better able to 'weather the storm'); and third, because the 'Asian miracle' is doomed therefore the 'Asian model' is doomed. Then there are those who argue that the crisis confirms a link between political regime-type and the incidence and/or seriousness of the crisis. In other words, to put it crudely, the argument in this book is considered irrelevant because, first, there are question marks over whether there really was an unusually successful 'economic development' in the Asian NICs, and second the incidence of the crisis itself proves the necessity of 'liberal democracy' for 'economic development'.

We need therefore to answer two questions. The first is: does the incidence of the crisis show that the 'miracle' has ended? The second is two-fold and relates to the cause of the crisis: is the 'Asian model' the cause of the crisis (is there a direct link from the institutional underpinnings of the 'miracle' to the crisis), and is regime-type itself related to the incidence and/or seriousness of the crisis?

The question whether the 'miracle' has ended is easier to answer than that about the causes of the crisis. The short answer to the question whether the Asian 'miracle' ended in 1997 is no. 'Asian doom' is an over-reaction to short-term events; although a significant setback, it is hard to imagine the current crisis undoing the gains of the past quarter century. The answer to the question whether the 'Asian model' is doomed (even if there is no 'Asian doom') is: not necessarily, and probably no.

This latter answer requires some explanation. As the crisis unfolded, explanations of it became more sophisticated. It is now generally agreed, in explaining why the crisis took place, and why it happened the way it did (in terms of nature of the crisis, its timing, its magnitude, its regional spread, the differential level of severity within the region), that it was a combination of several factors, both international and domestic, both macro and micro, against a series of background factors,

[3] Some dispute the so-called 'miracle': Paul Krugman and Alwyn Young's work claimed that the Asian economic growth rate was not so special after all, and definitely not a 'miracle' (simply a result of high levels of input). My counter to this is: one still needs to ask *what were the conditions for* these high levels of input? See Krugman (1994), also note 188 in chapter 3.

longue durée developments, that a potent mix obtained. I would argue that 'fundamentals' played a role, while 'panic' and 'over-reaction' also played a role. I would also argue that the significance of these factors differs depending on whether one is trying to explain the timing and the onset of the crisis, or whether one is trying to explain the way it spread, or whether it is the differential level of severity within the region that one is interested in (see my unpublished paper, 1998, University of London). A causal analysis of the crisis would have to include elements like the heavy borrowing encouraged by twin liberalisation, the enthusiasm of the international investor community, as well as the particular corporate governance structure which seemed to offer implicit government guarantees.[4] An explanation of the severity and the regionalised character of the crisis would also have to include systemic factors, such as herding and panic.

The question of how the organisation of politics and its institutional manifestation impacted on the trajectory of the crisis remains: to the extent there was a crisis, and to the extent there was agreement as to

[4] Some have commented that financial crises are often different from each other and therefore are hard to predict. Sachs (1997), for example, distinguishes the Asian financial crises from the fiscal-indiscipline-based debt crises of the 1980s – these sources are overvalued real exchange rates, weak and undersupervised banking sectors, and financial market liberalisation in the context of poor exchange rate and banking policies. Sachs, Tornell and Velasco (1996), based on a study of a set of twenty emerging markets in the year 1995, identified three factors that determine whether a country is more vulnerable to suffering a financial crisis: (i) a real exchange rate appreciation, (ii) a recent lending boom and (iii) low reserves. Other studies, notably Goldfahn and Valdes (1997), find that crises are largely unpredictable events (this looked at twenty-six countries in the past thirteen years and conclude that exchange rate crises are largely unpredictable events). Kaminsky and Reinhart (1996), for example, examined seventy-one balance-of-payments crises and twenty-five banking crises during the period 1970–95, concluding that financial liberalisation appears to play a significant role in explaining the probability of a banking crisis preceded by a private lending boom; in turn a banking crisis helps to predict a currency crisis. Berg and Pattillo (1998) pointed to vulnerabilities when domestic credit growth is high, bilateral real exchange rate overvalued relative to trend, and when reserves are low when measured as a ratio to broad money. (They also mentioned short-term external debt, political variables, degree of openness of capital account and structural factors such as the strength of regulatory frameworks and corporate governance). It is perhaps revealing that in Caprio and Klingebiel's study (1996) of eighty-six episodes of bank insolvency (1980–94), at least twenty featured 'cronyism', at least thirty featured overborrowing, 'panics' featured in the crises of the 1980s and in East Asia in the 1990s, but 'premature liberalisation' was cited in virtually all cases. The classic on 'panic' is of course Kindleberger (1978); see also Bordo (1986) on expectations, Mishkin (1991) or (1992) on 'information asymmetry' theories, and Griffith-Jones's (1998) comparison of the competition between professional investors to a 'beauty contest' – each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks most likely to catch the fancy of the other competitors.

what type of a crisis it was,[5] what role did the organisation of politics in these countries play in explaining the incidence of the crisis, how and why it became as deep and as widespread as it did, as well as the intra-regional differences? One could unpack by posing some counterfactuals: would the crisis not have occurred if (some of) these countries had 'liberal democracy' or a different constellation of 'liberal' and 'democratic' elements? The other possibility is: would the crisis, once it broke, have been much attenuated if the governments were 'liberal democratic', or 'liberal democratic' in a different way, resulting in a shorter and/or less severe, more limited crisis? Then there are the questions concerning intra-regional differences: did the crisis hit the more 'liberal' and more 'democratic' countries less than the others by virtue of the difference in political system? Are countries within the region with the more 'liberal' and more 'democratic' features recovering better than the others by virtue of their being more 'liberal' and more 'democratic'? And, which parts of their 'liberal democracies', if any – 'economic', 'civil' or 'political', and which particular interactions of which of these under which circumstances?

Furthermore, if the conceptual model of 'liberal democracy' I develop in this book – one that conceptualises 'liberal democracy' in terms of three dimensions of liberties, 'economic', 'civil' and 'political', interacting to provide economic development by virtue of providing 'stability', 'security' and 'openness and information' – has value, then it must help me answer these questions. Can a three-fold understanding of 'liberal democracy' help answer the question whether 'liberal democracy' eased or exacerbated the crisis? To what extent therefore did the levels and manifestations of 'liberties' in the affected countries help cause or exacerbate the crisis and/or hinder them from surviving it? More specifically, to what extent was the 'institutional matrix' explained in my $2 \times 3 + 1$ model correlated with the level of reserves (which enabled countries to weather the crisis better), the high capital inflows (the countries with the highest capital – especially short-term – inflows were hit most), 'twin-liberalisation' undertaken in the years before the crisis (which precipitated the crisis), and 'crony capitalism' (however badly specified the concept is)?[6]

[5] Hont (1994) has a historiographical discussion of the term 'crisis'; for a more extended treatment and a classification of 'crises', see Binder et al. (1971). In the current crisis, Jeffrey Sachs, as reported in the *Wall Street Journal* by Wessel (1997), asked at the Federal Reserve Bank of Kansas City weekend conference on 'financial stability in a global economy': 'what's the crisis?', 'that some people are going to lose money?' Sachs further made the point that 'the real crisis is in desperately poor countries like Malawi and Burkina Faso that wait years to get the aid they need'.

[6] Generally this refers to three things: regulatory inadequacies, close business–government links (which in Korea's case, are bound up with its high debt-to-equity model) and lack of transparency. Johnson (1998) has a good exploration of this.

The answer is a positive one. The crisis seems to support this $2 \times 3 + 1$ explanatory framework and my conclusions in chapter 7 well. First, on 'economic' liberties, the case seems clearest. The change in levels and mechanisms of control over economic flows – inadequacies and inattention to the policy of maintenance of high foreign currency reserves, a break from previous decades of carefully controlled capital inflows and reliance on high domestic savings – ultimately led to the perceived need to abandon the exchange-rate peg, setting off the spiral that resulted in the 'triple crisis'. Over-rapid and under-controlled liberalisation exposed the inadequacies in regulatory capabilities. When one focuses on the changes in the 'economic' dimension of liberties, therefore, one comes to the following conclusion: it was not the perpetuation of the 'Asian model', but in fact the beginning of the dismantling of this model, as for example in the turn to liberalisation, that led to the crisis.

The fourth point I want to make, therefore, is this: what an analysis of the crisis in fact shows is the importance of the quality of the economic liberties provided for in a society: what were they based on ('stability', 'security' and 'information'?), and what were they harnessed towards? Moreover, and related to this, the Asian crisis highlights the importance of distinguishing between 'economic' liberalisation, 'civil' liberalisation and 'political' liberalisation. It also highlights the importance of distinguishing between capital and trade liberalisation,[7] between liberalisation of

[7] Dani Rodrik, the Harvard economist, highlighted in three points how financial markets are different from markets for goods and services, with significant consequences: (1) asymmetric information combined with implicit insurance results in excessive lending for risky projects; (2) a mismatch between short-term liabilities and long-term assets leaves financial intermediaries vulnerable to bank runs and financial panic, a problem that is particularly severe in cross-border transactions where there is no international lender of last resort; (3) managers of money may exhibit herd behaviour. Robert Wade, in one of the earliest scholarly works on the crisis, also highlighted this same point: the pros and cons of trade liberalisation must be considered separately from the pros and cons of financial liberalisation, and not treated as if they were the same. James Tobin, the Nobel laureate in economics, made a critical comment to similar effect: 'South Korea and other Asian countries – like Mexico in 1994–95 – are . . . victims of a flawed international exchange rate system that, under US leadership, gives the mobility of capital priority over all other considerations'. See Rodrik (1998), Wade and Veneroso (1998) and Tobin (1997).

Jagdish Bhagwati takes this further, arguing that even if the case for free trade in goods and services may be unquestionable, the case for free trade in currencies must be considered separately and may not be so clear; indeed, Bhagwati attributed the pressure from institutions like the IMF on countries to undertake financial liberalisation to a powerful influence wielded on these institutions by 'the Wall Street–IMF complex'. Rodrik's 1998 study, mentioned above, concluded that the twenty-three developing countries that have experimented with lowered barriers to capital flows since 1973 did not enjoy faster growth or lower inflation than other countries. Based on this, Rodrik questioned the benefits of capital decontrols for economic growth when financial crises 'are the main story' and alerted us to the opposite situation in some other parts of the developing world: 'Will the African countries get the foreign capital they need [even] if they remove capital controls?' (p. 2). See Bhagwati (1998).

short-term capital flows (for short-term loans, equity portfolios, etc.) and liberalisation of long-term capital flows (for foreign direct investment (FDI), etc.).[8]

There is a fifth point. To what extent were there changes in the two other spheres of 'civil' liberties and 'political' liberties, and if so, to what extent were these changes connected to the changes in the economic sphere? Perhaps the most notable thing is that in terms of both 'civil' and 'political' liberties, the changes have not been noticeable. In fact, no serious breakdown of civil liberties occurred in the period leading up to or during the crisis, nor were the countries affected those with the worst provision of civil liberties in the region. In terms of political liberties, again one can discern few changes except in the positive direction; in fact, South Korea was moving towards more political liberties and a consolidation in the power of opposition parties, when in late 1997 the leader of the opposition party became President for the first time in Korea's history. Nonetheless, and interestingly, political leaders were also pursuing what a scholar has called 'fast-track capitalism',[9] pushing for rapid 'liberalisation' and growth, etc., in response to international pressure: the strong neo-liberal international agenda supported and encouraged by the international financial institutions.

[8] This distinction – between short-term and long-term capital flows – is important because of the differential behaviour as well as impacts of the two types of flows. The Tobin-type tax proposal, of course, reflects this, and evidence is now emerging that patterns of long-term flows did not significantly change at all during or after the 'crisis' in Asia. Indeed, recent IMF figures show what it called the 'resilience of FDI in emerging markets' during and after the crisis period. A growing recognition of the difference is also reflected in suggestions that the weight that 'creditor' banks apply to short-term interbank lending be changed from the current 20 per cent to the 100 per cent applying to long-term interbank funding, or linking banks' capital requirements to the maturity structure of their interbank funding (the general point also being that existing capital adequacy requirements, especially the risk weightings, need revising). See IMF (1998a), p. 16; the IMF also noted some reasons for caution in interpreting the figures, especially the arbitrary way in which FDI is distinguished from equity flows. Note also that 'capital adequacy requirements' (CAR) and the system of risk weightings on the different types of borrowing instruments have been an important feature of many banks' risk assessment system as well as their profitability measurement in the past decade, especially spurred by the Bank of International Settlement's (BIS) 1988 stipulation under the so-called 'Basle Agreement'. Controversies have revolved around the way the weightings are assigned. The author has herself been involved in and witnessed strategic decision-making in banks based on calculating banks' profitability and risk-adjusted capital requirements in the mid-1990s. Attention on the issue of the 1988 weightings in need of being revised has been revived, at least partly due to the crisis.

[9] Bello (1998); Hirst and Thompson (1999). Indeed, Hirst and Thompson (1999) suggested that perhaps these countries should not push themselves too hard by seeking to grow at over 10 per cent p.a. The difficulty in controlling this, of course, is partly political and partly practical, and is a function of the capacity of the state.

The sixth point is this: the need to draw lessons about the quality of economic liberalisation and the particular institutional conditions under which particular versions of it may succeed or fail seems all the more important. An effective state is better able to recover from crises – it is of note that the country that has the most effective state amongst those affected, namely, South Korea, will recover most rapidly.

This book, therefore, serves as a first but important step towards enhancing our understanding of the democracy–development connection: an understanding of the way the $2 \times 3 + 1$ model is connected with economic development in the Asian NICs will enhance our understanding of how the presence or absence of 'liberal democracy' is connected with economic development or non-development.

What must finally be noted here is that there are some interesting questions about the institutional matrix in the East Asian NICs and its future that this book does not have the scope to discuss. These questions include: (a) whether, if what is emerging is a more truly competitive politics, it will in time not erode the 'inclusionary institutions' that have hitherto been so effective; (b) and if it will, whether now, at this stage of 'development', this will matter for 'security', 'stability', etc.; and (c) if it will, whether this will matter more for a poorer East Asian country, like Indonesia, than for a richer one, like Japan, South Korea or Taiwan. There are also other very interesting issues for further exploration, the foremost perhaps being the degree of applicability of this framework to other developing countries, which in itself will make another book.

1 The question: is 'liberal democracy' good for economic development?

What is the relevance of 'liberal democracy' to a developing country? How to think of the desirability, feasibility, conditions and possibilities of 'liberal democracy' for such a country, where there is an important need for 'economic development', a cultural and historical backdrop different from the West, and a state with different capacities? In exploring this question, this book goes back to the basic, big questions of what 'liberal democracy' actually consists in and why it is a good (as fact or idea, in its consequences or in itself). Can what 'liberal democracy' delivers (or is thought, perhaps uniquely, to deliver, most importantly for our purposes, 'economic development') be delivered by regimes of a distinctively different kind (how distinctively different?)? and different in what ways? and, enduringly different, or different only in their recent manifestations?

The focus of this book is therefore on the relationship between 'liberal democracy' and 'economic development'.[1] With the ending of the Cold

[1] Before one can look into the issue of the relationship between 'liberal democracy' and 'economic development', the two terms need to be defined. For 'economic development', I simply take it as a fact that the West and the East Asian NICs and Japan have been much more successful than other parts of the world (even counting in the recent financial crisis, which I discuss in the Introduction). What I am interested in is a broad comparative perspective. On 'liberal democracy', however, a definition is more difficult. There is in contemporary political theory a great controversy over the meaning of 'liberal democracy'. On the 'democratic' side, even restricting myself to modern representative democracy, there is a broad distinction within existing literature between formal/minimal and substantive democracy, or between a more 'minimalist' definition and a more 'maximalist' definition. The starting point of this present study is a core, minimalist definition, something along the lines of Dahl (1971), requiring the provision for participation of all adult members of a society, freedom to formulate and advocate political alternatives, and the credible availability of political alternatives. The concept of democracy may indeed be defined much more broadly (for example, Bowles and Gintis (1986)), but the assumption here is that the 'minimal' is a necessary condition of the 'maximal', that, to achieve a more substantive democracy, developing countries first need to develop a more 'minimalist' democracy, and, given that even the minimal condition for democratic rule presents difficulties for many countries, a more exhaustive set of criteria could make the issue of democratisation purely academic. On the 'liberal' side, I propose a three-fold categorisation of what are commonly called first-generation liberties, and distinguish