Global Economic Governance in Asia: Through the Looking Glass of the European Sovereign Debt Crisis

Working Paper

Is Liberal Democracy the best form of Government to produce Public Goods?

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Summary: This paper considers the impact of the on-going financial crisis on liberal democracy and its ability to produce public goods, with particular reference to the situation in the European Union (EU). After reviewing the pros and cons of liberal democracy, the paper then covers the reasons that led to the current crisis, including inadequate governance, greed, short-termism, the credit rating agencies and the role of lobbyists. The paper examines the damaging impact of the crisis on Europe and the response of the Eurozone countries. It concludes that despite many negative factors, liberal democracy has shown itself capable of revision. Greed and incompetence have been exposed and tempered. The banking system on both sides of the Atlantic is being re-shaped with tighter regulation. The crisis is also propelling the Eurozone countries to much closer integration than anyone could have imagined just a few years ago. Liberal democracy will thus emerge both chastened and stronger than before. The ‘end of history’, however, is not in sight.

Introduction
Before the crisis there was a widespread conviction that democracies were not only morally superior to authoritarian forms of government, but were also better positioned to deal with economic and financial turmoil. The recent financial crisis, however, has called this assumption into question, especially as some authoritarian states such as China have apparently weathered the storm better than Europe or the US. Most economists and political scientists still agree, as does the author of this paper, that liberal democracy is indeed a better system of government than all others in producing long-term public goods. It is argued here that liberal democracy offers greater resilience and stability, especially in times of crisis. Some would disagree, suggesting that democracy might be part of the problem, with a frequent electoral cycle and giving too much deference to special interests that wield disproportionate influence. This is discussed later but suffice it to say that special interests exist in all political systems.

Authoritarian modernisation has become increasingly fashionable in the wake of the financial crisis. For many observers, the crisis was, above all, a crisis of the West, one whose impact extended beyond the economic recession in the United States and Europe to shake the very foundations of Western liberal values. In sounding the death-knell of the Washington consensus or the ‘Anglo-Saxon’ model of capitalism, some believe that it opened up the field to authoritarian modernisation where a one party regime takes a dominant stake in the economy and forces through economic policies without any real public debate. But far from being a new model based on new thinking, authoritarian modernisation is an illusion – and an old one at that. Paradoxically, the record of reform in Russia and China demonstrates this. In Russia, a significant increase in authoritarian control has brought not modernisation, but increasing signs of decay. By contrast, China has experienced a remarkable transformation, yet one that is driven largely by economic liberalisation and devolution, not authoritarian centralism.
Authoritarian forms of government might be just as good if not better than liberal democracies in promoting financial stability. But such goals are not the only measure of a free and stable society. Liberal democracies provide a more informed environment for policy decisions. Cabinets and parliaments are exposed to many competing views. In authoritarian systems there is an understandable desire not to be the bearer of bad tidings to the leadership. Space for a reasoned public debate is thus a key mechanism through which democracies usually achieve better outcomes than authoritarian regimes which usually rely on a mix of fear, successful economic performance or subsidies to the poor for legitimacy. When economic problems arise, popular support for the regime can quickly fade. Without the release valve provided by democracy, autocracies, from Russia to Iran, are forced to quell unrest with increasingly heavy-handed tactics, often making the survival of the regime ever more precarious.

There were a number of early prophets of doom about democracy as a result of the financial crisis. The Economist, for example, warned that ‘the recession could turn the recent halt in democratisation...into a retreat.’ Larry Diamond wrote concerning democracy that ‘thanks to the global economic crisis ... things may get worse before it gets better.’ Now that four years have passed, what does the record show? Although the economic crisis has certainly caused widespread economic suffering, it appears that democracies, even struggling ones, are demonstrating more resilience to the crisis than many predicted. It should be stressed, however, that the crisis is far from over in many countries and could still take a turn for the worse.

Incumbent governments have often suffered as a result of the crisis. Frustrated citizens have voted to remove the party in power in more than 50 per cent of the elections in the past three years, including long-term ruling parties in France, Iceland, Spain, Ireland, Greece, Japan, and (very likely) South Korea. The crisis has also led to widespread public anger and distrust of governments in many if not most countries.

**Defining Liberal Democracy**

Liberal democracy traces its origins to the Enlightenment of the 18th century. Until then kings and emperors were the accepted norm. There was a belief that democracies would be inherently unstable as the government would have to pander to the whims of the ordinary people who were manifestly unfit to make reasoned choices. Hobbes and Rousseau challenged these assumptions with their vision of a social contract. The Enlightenment promoted the concepts of reason, liberty and equality. The American and French revolutions were based on the principle that all people are created equal and that governments should exist to serve the people and not vice versa. Although European monarchies fought a defensive action for much of the 19th century, liberal democratic ideals took root amongst the general population. In the 20th century liberal democracy was challenged more by communism than monarchies. By the end of the Cold War in 1991 there were few communist states left. The Soviet Union had collapsed and China was fast moving away from any kind of communism that Karl Marx would
have recognised. Francis Fukuyama proclaimed the end of history, arguing that liberal democracy had achieved a dominant position among theories of government and was now endorsed by the vast majority of states in the world.

There is no one definition of liberal democracy but political scientists usually ascribe it with a number of features including universal suffrage and a constitution which provides for the separation of powers between the executive, the judiciary and the legislature. The rule of law, a strong middle class and a flourishing civil society are also features of most liberal democracies. Another important feature is an acceptance of opposition parties who will one day form the government. The concept of a loyal opposition is important in that it gives political parties, old and new, the hope if not the expectation that the voters will ‘throw out the rascals’ and they will have an opportunity to take office. There is thus a broad consensus on the basic principles of the state. The rise of the German Greens from a minor extra-parliamentary opposition to be a partner in government is a classic example. Today there are many new populist parties rising quickly (e.g. in Greece, the Netherlands, Hungary, Finland) as a result of the euro-crisis. But all are seeking to bring about change through the democratic system.

**Pros and Cons of Liberal Democracy**

Most political systems suffer from corruption but liberal democracies less than others. Freedom of information and a free media are among the most effective counters to corruption (although again there are examples of private media groupings serving their own partisan agendas – Murdoch empire, Berlusconi, etc.). There is also considerable evidence, pace the past few years, of a correlation between economic prosperity and freedom and democracy. There are inevitable exceptions such as oil rich Qatar or Kuwait. According to the World Bank, of the 80 worst financial catastrophes during the last 40 years, only five were in democracies. It is also worth noting that no functioning democracy has ever suffered a large scale famine; and refugee crises almost always occur in non-democracies. Democracies also tend to manage resources and public goods better than authoritarian systems. Russia, for example, wastes as much gas each year as France consumes as there is no incentive to apply strict rules on energy efficiency.

One of the most common criticisms of liberal democracy is their short-term focus as a result of the frequent elections that indeed characterise democracies. One former British cabinet minister once described to this author the time horizon of most ministers as follows. The short term was next week; the medium term was next month; and the long-term was the next election. With such thoughts in their minds, how does one expect politicians in a liberal democracy to take necessary but unpopular decisions even though they know these decisions would have a genuinely long-term benefit for the population? How does one compare, for example, the spot oil price of the West against Russia or Kazakhstan negotiating 15 year oil barter arrangements with China over land routes that lock in stable cash flows that justify huge infrastructural investment programmes with minimal risk, that aficionados of the free trade model look askance upon but which makes eminent financial and geopolitical sense? Politicians in
the UK have been debating building a third runway at Heathrow or a fourth airport in southeast England for more than a quarter of a century. The public debt crisis in most countries was caused by politicians outbidding each other to offer ‘goodies’ to the electorate. Francois Hollande’s promise to reintroduce the 35 hour week in France is one example. The failure of successive Greek (and Spanish, Portuguese, Irish) governments to tell the truth about the state of public finances, and introduce a much needed austerity programme, is another albeit slightly different example (although the EU was a willing partner in this legerdemain).

Authoritarian regimes also face the same problem. The ruling elites in Russia, for example, are keen to maximise their short-term rent-seeking gains as there are too many uncertainties about the future. As soon as any Russian accumulates wealth he seeks to transfer as much as possible overseas – and send his children abroad for schooling. The vast outflows of Chinese capital to the West in the past year would indicate that many of the nouveau riche are also seeking to hedge their bets against possible negative developments in China.

Another criticism is that liberal democracies are too much beholden to special interest groups such as farmers who may use their lobbying power to gain subsidies beneficial to them but harmful to society. However, special interest groups may be equally or more influential in non-democracies. The influences of the SOEs in China, Gazprom in Russia or the military-industrial complex in the US are obvious examples.

The Nature of the Global Financial Crisis
The current financial crisis is not the first and will not be the last such crisis. Indeed ever since financial capitalism emerged there have been crises caused by excessive credit expansion, financial speculation and asset price bubbles. But this crisis is exceptional in the number of economies that have been affected on both sides of the Atlantic. This was largely due to a regulatory breakdown caused by a political indifference as well as deregulation caused by the occult doings of partisan political interests and lobbyists short circuiting the open political process. There was also a dramatic expansion in leverage before the crisis. It was also the first major crisis that has predominantly been a household debt crisis (households assumed rising property values would never end and bought the story). It is also exceptional because of the nature of the modern financial system – that is to say, the high degree of international integration and the complexities of the securities market added extra volatility to the cocktail.

The crisis has affected the reputation and standing of academic and policy pundits writing about economics who continued to think within the classic envelope. The crisis demonstrated that the pre-crisis orthodoxy – both ‘new Keynesian’ and ‘neo-liberal’ views – on how the economy worked was wrong. In addition the crisis has raised serious problems, to which no one has the answers, about the likely duration and extent of the damage caused by the mistakes of politicians and bankers. Nor is there any consensus about what set of policies, domestically and globally, should be implemented to secure a sustainable, growth-led recovery. Politicians and economists argue over
what is the right monetary policy, the right fiscal policy, and the right policy on dealing with debt overhangs.

Another major policy challenge is reconstructing the world's monetary and financial order at a time when the transition in global economic power is changing the geopolitical as well as the geo-economic landscape. The rise of the BRICS vis-à-vis the EU and US mirrors the rise of the US vis-à-vis Europe in the 1920s and 1930s, and may offer some historic parallels.

Alternatives to capitalism have not gained much traction but there is debate about unbridled capitalism that leaves non-financially quantifiable costs un-factored into the equation. Many countries are trying to strengthen their regulatory systems, some are allowing a greater role for the state, but they are not throwing out capitalism altogether. Strengthening these regulatory systems however is highly complex, as for every solution there is a usually a clever way around it. The behaviour of corporate giants such as Amazon, Google and Starbucks avoiding tax in the UK is one example of clever tax lawyers beating the system. There is increasing evidence of citizen anger against politicians and bankers who appear to conduct their affairs on the basis of pure greed and selfishness without any apparent consideration for society as a whole.

As the crisis continues, the full effect of the crisis on liberal democracy remains to be seen. Economic inequality and government corruption tend to become more evident in the public eye during recessions, and both tend to fan the flames of populist and anti-democratic elements. The increased popular dissatisfaction with democracy in Eastern Europe is an example of the long-term trouble the recession may exacerbate. In Ukraine, Hungary, and Bulgaria, less than a quarter of the population is satisfied with the way democracy is working in their country, with more than 70 per cent in each country naming corruption as a significant problem. Polls reveal a similar level of dissatisfaction with corruption in Russia and China.

The crisis is also testing the commitment to European integration. Elected heads of government have been resigning to be replaced by technocratic prime ministers. When the elected prime minister of Greece declared that he would hold a referendum on a necessary package of austerity measures, he was warned by France and Germany the following day to withdraw his referendum decision. What happened in Greece demonstrates the dilemma of popular democracy. Could one really expect the Greek population to vote for stringent austerity in a referendum?

Who is to blame?
The financial crisis exposed numerous flaws in the system including regulatory gaps; inadequate supervision; poor corporate governance and short-termism in financial institutions; opaque markets; and overly-complex products, especially derivatives. The main culprits are clearly national governments who borrowed too much and consistently under-estimated their borrowing needs. According a recent IMF study, total public debt in the major OECD countries was 32% higher, as a share of GDP, in 2010 than governments had forecast back in 2007, in part due to the compounding
interest and credit rating agencies adding fuel to the fire. Of course, the financial crisis explains this massive forecasting error, but the IMF found that relatively little was due to fiscal stimulus programmes in response to the downturn. About a quarter of the debt overshoot in the OECD countries was due to ‘an incomplete understanding of the country’s underlying fiscal position on the eve of the crisis.’ More important were exogenous factors like the unexpected fall in national output in the recession, and the unexpected need to bail out banks. The IMF suggests that governments - and the IMF - need to better understand their 'contingent' liabilities as well as the liabilities they can see right now, especially in the financial sector. This became blindingly apparent in the US in the autumn of 2008, when it became clear that the US government was ultimately responsible for all of the liabilities of Fannie Mae and Freddie Mac, two government-sponsored mortgage institutions which had not previously been formally included in the federal government’s accounts. These two alone increased the government deficit in 2008 by 2% of GDP - or nearly $300bn. In considering the fiscal position, governments need to consider not just what will happen if the economy continues broadly on track, but also if it gets into trouble. That sounds like the most obvious advice imaginable. But - looking back through history – it is the advice that governments almost never follow.

The finger can be pointed rightly at those politicians and officials in the Western world for allowing the credit boom to take place. Top of the culprit list is Alan Greenspan whose habit of lowering interest rates at the first sign of trouble during the pre-crunch era was indeed a major contributory factor. The theory was that since the US Federal Reserve would always ride to the rescue, it made sense to take big risks. Fear was numbed and greed left untrammelled. Central bankers do have a role in mitigating the extremes of the economic cycle. But it is vital that in doing so, they do not just stoke up more trouble. They need to have the expertise to recognise bubbles and the courage to prick them — an idea that has, thankfully, gained currency in the post-Greenspan era.

The second malady was caused by an excessive willingness to bail out bankrupt banks. In a well-functioning free market, investors would bear the consequences of poor decisions. If a bank failed, shareholders and bondholders would suffer. But with the exception of Lehman Brothers and a few much smaller cases, investors were bailed out. This was understandable, given the fear of indirect effects. But a healthy body has old cells dying and new ones being born. A well-functioning financial system also has to allow for death and renewal. Propping up failed banks debilitates the whole economy and sends the wrong message that foolish risk-taking will not be punished. The third problem was caused by the ‘heads-I-win-tails-you-lose’ bets that financiers and traders were able to enjoy during the upswing. If everything went well, they made a fortune; if everything collapsed, taxpayers picked up the pieces. Not surprisingly, they spun the roulette wheel. Such privatisation of gains and socialisation of losses is not healthy capitalism. It is a caricature of the free market.

The past 30 years have brought the rise of the ‘greed is good’ culture, epitomised by the Thatcherite ‘get rich quick’ years and Gordon Gekko in the film ‘Wall Street.’ Greed can have some healthy aspects but it does need to be balanced by other motivations. The most important of these is the concept of service. Businesses need to be asking
always: how are we adding value to our customers and society at large? Most successful companies do this. But many financial institutions failed to think through whether their products were socially valuable. Merely relying on the theory that the market’s invisible hand will reconcile private greed with the greater good has been proven insufficient.

Ultimately any economic system rests on the consent of the people. As years of economic austerity take their toll, the challenge is to show that capitalism can be healthy. That requires changes in both structures and mind-set. On both sides of the Atlantic there is a growing consensus that the major financial institutions have become too big and complex to manage. Regulators have begun to articulate what needs to be done. Banks should be smaller with many proposing that there should be a clear separation between retail and investment banking. More broadly, we have lost sight of what banking is supposed to do. Banks play an essential role in all modern economies, but that role is not to assume a huge amount of risk, with the downside losses covered by society.

Five years after the start of the world’s worst financial crisis in decades, many continue to denigrate capitalism. But what happened was not capitalism in the traditional sense. Capitalism is about wealth creation. What happened was ‘skimming’ in a zero sum game, and wealth destruction, where others were left holding the losses. This is a con-game. The system ran amok — leading to debt, unemployment and shrinking economies. But that is precisely why the world needs healthy capitalism. Health involves vigour, well-being and resilience. Capitalism — with its basis in free enterprise and private property — can have all those qualities, provided that warped incentives are corrected and the culture of greed is tempered. State socialism certainly cannot offer a better alternative. The practical alternative is to reform capitalism, not throw it away. But how should it be reformed? This is the crux of the on-going debate around the world.

**The Impact on the EU**

The crisis has had a major effect not just on the economics but also the politics of the EU. There are debates on how much austerity? How many banks should be saved? How much of the social model should be preserved? How will the EU be able to generate economic prosperity again? What will the impact be of the likely very low growth rates in the EU for the next years on the rest of the world? China and other Asian countries are already suffering a substantial drop in exports to the EU.

The answers to all these questions are unknown today as the EU is going through huge uncertainty regarding its future. The belief in the power of free markets has taken a serious blow. Zero-sum logic is also threatening the future of the EU. The whole construction of the EU was based on an effort to replace the ruinous and bloody rivalries of European history, with a win-win logic based around mutual economic interests. But in the aftermath of the financial crisis, huge austerity programmes in countries like Greece, Ireland, Portugal and Spain have increased tensions between EU
members and cast doubt on the future of one of the EU’s proudest achievements – the single European currency.

The European crisis was in fact a series of interlinked crises, with long term structural and political implications. The immediate catalyst was the 2008-09 financial/banking crises but this led into a public finance crisis, followed by an economic, social and political crisis. The European policy response has been a case of too little too late. It has set up new crisis mechanisms (ECB, EFSF, and ESM) and embarked on new forms of economic governance giving the EU institutions major new powers to oversee national budgets. The EU is making rapid progress towards a reform of the banking system involving a greater supervisory role for the ECB and new capital requirements for banks – the implementation of the global Basel III banking rules. The EU is also considering another piece of financial services legislation involving sweeping limits on financial transactions, including curbs on high-frequency trading and commodities transactions. These measures are aimed at protecting consumers and increasing transparency. It is worth recalling that the fledgling US had these crises until full monetary union and the creation of the Bank of the United States under Alexander Hamilton, and this was bitterly resisted.

A revived growth pact, general and targeted at specific countries, is also supposed to boost productivity. But much more still needs to be done. A full fiscal union will require a Eurozone budget. There are still threats to many banks in Spain, Greece and elsewhere. The overall situation remains uncertain and volatile. The global situation will influence what happens in the EU but also vice versa.

The ECB has also come into its own not only as the defender in chief against inflation but also the chief fire-fighter for the Eurozone. This has been a controversial move with some Germans complaining that Mr Draghi has overstepped his mandate. But what should central banks do when politicians seem incapable of acting? Draghi could hardly have let the house burn down. Like Lincoln being accused of violating the Constitution to call up the troops, he said he would bargain with the devil if it would save the Union. With its outright monetary transaction (OMT) programme, the ECB has offered to buy peripheral Eurozone countries’ sovereign bonds in the secondary market – provided that they sign up to agreed reforms. The logic is that conditionality will ensure that countries are solvent, while OMTs will restore trust to a market that has broken down because investors fear that the countries concerned will exit the Eurozone.

The EU is thus moving fast to respond to the crisis, also in conjunction with measures proposed at the G20 level. An agreed goal is that no financial operator, including hedge funds and rating agencies, no financial product, including derivatives, and no financial market should be exempt from effective and transparent regulation. This is a requirement for stability and sound growth.

Between 2008 and 2011, the aid and guarantees granted by Member States to banks amounted to 4,500 billion euros. In some countries, this has resulted in a loss of market confidence and a hike in interest rates. To break this vicious circle, the Eurozone countries have decided to recapitalise banks directly, under certain stringent
conditions, in particular effective implementation of the single system of banking supervision under the ECB.

The fiscal consolidation efforts undertaken by Member States are bearing fruit. The average budget deficit of the euro area countries, which accounted for 6.2% of GDP in 2010, is expected to fall to 3.8% in 2012. In addition, 25 EU Member States have agreed a "fiscal compact" which will entail very strict budget deficit rules, in particular a limitation of the structural deficit to 0.5% of GDP.

Lastly, the EU agreed in June on a 120 billion euro ‘growth pact’, based on an increase in lending by the European Investment Bank, particularly for innovative SMEs, reorientation of structural funds and the launch of "project bonds" to finance infrastructure projects.

In addition, the European Commission has proposed a ‘Single Market Act II’ containing 12 new key measures selected for their rapid impact on growth and employment in four priority areas: European transport and energy networks, the mobility of citizens and businesses, the digital economy, and social cohesion.

The EU is also studying the Liikanen report that has proposed five new reforms of the financial sector. These are as follows. First, proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of a bank’s business. As a consequence, deposits, and the explicit and implicit guarantee they carry, would no longer directly support risky trading activities. Second, the need for banks to draw up and maintain effective and realistic recovery and resolution plans, as proposed in the Commission’s Bank Recovery and Resolution Directive (BRR). Third, banks should build up a sufficiently large layer of bail-inable debt that should be clearly defined, so that its position within the hierarchy of debt commitments in a bank’s balance sheet is clear and investors understand the eventual treatment in case of resolution. Fourth, the need to apply more robust risk weights in the determination of minimum capital standards and more consistent treatment of risk in internal models. Following the conclusion of the Basel Committee’s review of the trading book, the Commission should review whether the results would be sufficient to cover the risks of all types of European banks. Finally, it is necessary to augment existing corporate governance reforms by specific measures to 1) strengthen boards and management; 2) promote the risk management function; 3) rein in compensation for bank management and staff; 4) improve risk disclosure and 5) strengthen sanctioning powers.

**Conclusion**

The outlook for the global economy looks bleak in the aftermath of the financial crisis. But the past century has proved the resilience and creativity of liberal democracy and free-market economics. In 1989, Francis Fukuyama declared that democracy would eventually emerge as the universal form of human government. The intervening years have given ample ammunition to those who disagree. Indeed, the inexorable rise of China has led some to dismiss democracy’s messy compromises in favour of
authoritarian efficiency. People are prepared to sacrifice their freedoms, the argument runs, as long as the system under which they live can deliver economic growth. The Arab Spring would appear to undermine this view and many analysts are questioning how long the Chinese model can deliver sufficient public goods to keep the population satisfied.

Certainly the primacy of liberal thinking in the international system can no longer be taken for granted. The future of liberal democracy depends on performance, not on some inherited sense of moral entitlement. Its emergence as the dominant normative paradigm in the 20th century owed much to the fact – and perception – that it was instrumental in the rise of prosperity in Europe and the US. Leaders on both sides of the Atlantic need to prove this once again, both to their own disenchanted electorates and to a sceptical world. Finally, liberal democracies face a constant tension between allegiance to universal norms and the pursuit of national interests. It is not enough to issue glib statements along the lines of ‘values are interests’ or ‘human rights are universal.’ Western governments need to show that political morality is not some device to be applied selectively or suspended whenever convenient. For it is precisely exceptions made in the name of an often dubious national interest that have led to the current crisis of liberalism, and helped to rekindle belief in authoritarianism as a provider of public goods.

The world is facing a dual growth challenge – how to tackle the current crisis and how to ensure long-term sustainable growth taking into account the population explosion, the finite supply of natural resources and the growing dangers from climate change. It is too early to state with certainty that the measures which the EU has taken to date will resolve the current crisis. But if they fail then there will be inevitable implications for the euro. In some places, autocratic regimes may manage to remain in power. But from a global perspective, there is room for hope. When Mr Fukuyama gave his speech, the world contained 69 democracies. Today there are close to twice as many. The march of liberal democracy is not finished yet.