1 Mixed Blessing: Expectations about Foreign Capital Flows and Democracy in Emerging Markets[1]

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Ever tighter and more rapid cross-border financial links gird the globe. High-powered international finance reaches deeply into the same developing countries in which basic local phone service works only sporadically. Many of these countries, moreover, are newly democratic or democratizing, with the attendant explosion in citizen demands of governments for improved jobs, educational opportunities, and better lives. Is the result – large and often volatile foreign capital inflows into democratizing 'emerging market' countries – a fortuitous coincidence of need and supply? Or is it, instead, a perversion of justified popular hopes for accountable government, as public policies become skewed toward the orthodox macroeconomic policies global investors are well-known to favor? Furthermore, do large foreign capital inflows, other things being equal, tend to promote or inhibit democratic transitions and the consolidation of electoral norms?

The forms of cross-border capital flows have altered in recent decades. In the 1950s through the mid-1960s, foreign aid provided more than half of all capital flows between advanced industrial and developing countries. In 1965, for example, foreign aid constituted 64 per cent of net resource flows to developing countries (McCulloch and Petri, 1994). In the 1970s the share of medium and long-term bank loans increased dramatically, supplying about half of net resource flows by the end of the decade. Meanwhile, between 1970 to 1980, total net inflows to developing countries almost doubled, to just under 4 per cent of their combined economies (see Table 1 of the Introduction).[2] Long-term bank lending disappeared abruptly in 1982, in response to Mexico's near default on its external debt. By 1988, foreign aid was again the largest single category of net resource flows (43 per cent), followed by direct investment (25 per cent), and medium and long-term bank loans and trade credit (14 per cent).[3] Total flows plummeted to a little over half of their pre-debt crisis high. Moreover, net transfers (net resource flows

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minus interest payments on past debt) from advanced industrial to developing countries as a group in the 1980s were approximately nil.[4]

Meanwhile, international financial markets evolved dramatically in the 1980s. Jointly known as 'financial globalization,' these changes meant that more money, both absolutely and as a share of world economic output, was more mobile across borders than ever before. The total stock of financial assets traded in global capital markets, the so-called 'eurocurrency assets,' rose from about \$5 trillion in 1980 to \$35 trillion in 1992. In 1994 the McKinsey Global Institute projected they would reach almost \$83 trillion by 2000, about three times the combined gross domestic product of the advanced industrial countries (Woodall, 1995, p. 10). Some commentators argued that, if measured properly, the total stock of outstanding global financial assets was no more overwhelming, as compared to either global output or world trade, than during the turn of the century epoch of British financial hegemony and the gold standard (Bradsher, 1995). However, the volatility of world capital markets in the last decade of the twentieth century unquestionably has had no precedent.[5] In 1973 daily foreign exchange trading was about \$10 to \$20 billion; by 1992, it was \$900 billion; and by mid-1995 it had reached around \$1.3 trillion of 'hot money,' backstopped only by the combined foreign currency reserves of government's of the advanced industrial countries, an apparently inadequate \$640 billion. Similarly, the ratio of global trade to foreign exchange transactions was about 1:10 in 1982, but as much as 1:60 a decade later (Woodall, 1995, p. 10).

What did these changes mean for developing countries? The largest share of globally mobile capital, of course, flowed among advanced industrial countries, and the largest single destination was the United States, which by mid-1996 owed around \$800 billion abroad (Prestowitz, 1996). Nonetheless, after the hiatus of most of the 1980s, large flows again began to go to developing countries. Beginning in the late 1980s, Mexico and other erstwhile pariahs suddenly found themselves again receiving net private voluntary capital inflows again – but this time the forms had altered dramatically. In 1980, portfolio capital flows (defined here to include portfolio equity, bonds, and short-term debt) were only 3 per cent of flows to developing countries, but by 1988 they were 17 per cent and by 1994 had become the largest single category of flows, with 39 per cent. Foreign direct investment, also enjoying a revival, comprised 34 per cent (Table 1). Total net flows, meanwhile, had shot up to 4.6 per cent of developing countries' GDP. The particular profile of the 'new' cross-border capital flows continues to be subject to change: although the figures are not available yet, the consequence of the East Asian financial crises of 1997 will almost certainly be reduced capital flows to emerging markets. What is unlikely to go away is the much larger share, as compared to the other post World War Two decades, of the new (or old, dating back to the late nineteenth and early twentieth century) form of cross-border investments: portfolio flows.

The risks of portfolio capital flows were illustrated by the dramatic events of Mexico's 'peso crisis' in December 1994, when close to a billion dollars exited the Mexican economy in a single day. As had happened with the 1982 debt crisis, in early 1995 the home governments of Mexico's major private creditors, in the interests of preventing a global financial crisis, stepped in with a rescue plan. One consequence of the peso crisis was that the rich countries had to begin thinking about which countries they would bail out should they be threatened with a financial crisis, and whom they would let crash. Presumably most emerging market countries would fall in the latter category – so long, that is, as their troubles did not threaten financial markets in the advanced industrial democracies.[6] Although the potential economic costs of these new, highly liquid, capital flows have been widely discussed (Calvo, Leiderman, and Reinhart, 1993; Fernandez-Arias, 1995; French-Davis and Griffith-Jones, 1995; Folkerts-Landau and Ito, 1995; Nunnenkampt and Gundlach, 1996; Rojas-Suarez and Weisbrod, 1995),[7] the political implications for emerging market countries have been less debated.

This chapter tries to think through the implications of these recent shifts in the institutional form of international financial flows for another global trend of the 1980s and 1990s: the turn from authoritarian to democratic rule in developing and post-Communist countries around the world. Is the relative decline of official development assistance, for example, on the whole 'good' or 'bad' for new democracies like South Africa or the Czech Republic? Why? The second issue of 'financial globalization,' the recent increase in net resource flows as a share of the total economies of developing countries, and the potential for further increases as financial investments become ever more mobile across national borders, I leave for another discussion.

The essay's first major section sets out definitions, first of 'democracy,' then of six ideal types of international capital flows.[8] The second section deductively considers the likely impacts of each of the six broad types of financial instruments on four intermediate variables: (1) the rate of economic growth, (2) the fortunes of four players in the national game of politics in most emerging market countries (foreign governments, the host country government, foreign business, and local big business), (3) the risk of a balance of payments crisis arising sometime in the future, and (4) pressure for neoliberal economic reforms. Section three then links the four intermediate variables with some possible consequences for democratic development.

VARIABLES DEFINED: DEMOCRACY AND INTERNATIONAL FINANCIAL FLOWS

The effects of foreign capital inflows on democracy in emerging market countries are what I hope to explain or predict. This section briefly defines the dependent variable, democracy, and distinguishes a hitherto relatively underexamined source of variation in the independent dimension, foreign capital flows.

Numerous definitions of *democracy* each have their defenders. The most used, and most achievable, is procedural political democracy. Here democracy is defined by wide access (all adult citizens have the vote, with no restrictions on either citizenship or voting imposed by property ownership, race or ethnicity, literacy, or other demographic or economic criteria) and specified, universalistic procedures, including freedom of speech and organization, multiple political parties and candidates, secret ballots, fixed terms of office, and limited authority of elected officials, who themselves are subject to the law of the land. Robert Dahl (1971) aptly suggested defining degrees of democracy along two dimensions: 'participation,' or breadth of inclusion of the population in the franchise and the group of those with potential to lead, and 'contestation,' or degree to which elections offer voters genuine alternatives between viable candidates with differing public policy preferences. Another crucial component of procedural political democracy is a guarantee of basic civil and civic rights, including freedom of expression, association, and religion, equal protection under the law, the right to be charged with a specific crime if arrested and to have an impartial trial within a reasonable time period, and the right to retain one's life and property, except under carefully specified circumstances, as in, for example, the military draft or the government's limited right to seize property for a compelling public purpose under the rule of 'eminent domain.' Finally, it must be true that in a procedural political democracy the elected leaders, assisted often by both appointed advisors and career civil servants, control the major public policy decisions in society; civilian leaders, that is, are not mere figureheads for military authoritarian rulers who exercise the real power.[9]

It should be noted that what the above definition lacks is any limits or comment whatever on the economic conditions that must or should obtain in a 'democracy.' It presumes that neither minimums of economic security nor economic equality are either necessary or sufficient for democratic government. Implicitly, the definition assumes that the one person, one vote rule, combined with the legal imperative of equality before the law, is sufficient to ensure justice in society. Procedural political democracy thus explicitly is a minimalist definition of democracy, requiring only that major conflicts among persons and groups are settled peaceably and through the political process, in theory open to all. All of the advanced capitalist countries, and increasing numbers of developing and postcommunist countries, meet these minimum requirements, at least most of the time. Procedural political democracy thus seems to be an achievable goal. Furthermore, it also serves as an essential, necessary although not sufficient, component of most contemporary definitions of economic democracy.[10] This chapter focuses the bulk of its attention on exploring the possible consequences of foreign capital flows for procedural political democracy.

At this point a further dimension must be introduced. Thus far, democracy has been considered only as a static condition. Yet for the vast majority of emerging market countries, the crucial question is not how certain conditions might affect a long-standing and well-established democracy, but rather how they might shape a new or fragile democracy, or influence the possible transition of an existing authoritarian regime in the direction of becoming a future democracy. Reasonably stable and enduring democracies in developing countries, such as those in India, Jamaica, or Costa Rica, have been few. It should be important to review briefly some of what is known about conditions for successful transitions to democracy.

Three observations about transitions to democracy are relevant. First, it is harder for a country to become democratic than to maintain a preexisting democracy. Above all, procedural political democracy requires the consent of all essential political actors – defined as those individuals and groups that can exercise effective veto power over the outcome of democratic decision-making – to abide by the outcomes of elections, parliamentary debates and lawmaking, and like democratic procedures. Adam Przeworski (1991) usefully has formalized these conditions by noting that the rational calculations made by all relevant political actors must suggest to them that the payoffs expected from playing the democratic game, over the medium run, will be greater than those to be anticipated from subverting democracy, even though, and by definition, most players will not achieve their most preferred policy outcomes most of the time. Democracy is about institutionalized uncertainty and continuous compromise; each player's rational calculation must lead to the conclusion that mutual compromise is superior to no-holds-barred conflict, which holds out the possibility of total victory, but also of total defeat (see also O'Donnell and Schmitter, 1986). Once democracy has functioned for awhile, people typically began to attach a positive normative significance to it, and also to see it as the 'normal' state of affairs. After these points have passed, maintaining stable democracy becomes much easier.

Second, heightened economic insecurity usually is not auspicious for a successful democratic transition (Haggard and Kaufman, 1995). It is true that conditions of economic crisis can erode support for authoritarian incumbents. However, in and of itself, there is no reason to believe that a crisis will favor democratic successors over another authoritarian government with a change of personnel. Furthermore, feelings of personal vulnerability are likely to make many key political players more defensive, and thus less willing to compromise, that is, less willing to settle for the second best solutions inherent in the democratic process, than they would be if economic conditions were more settled or promising. Political liberalization that occurs in conjunction with significant economic liberalization, as has happened in Latin America, Eastern Europe, and elsewhere in the 1980s and 1990s, also poses particular problems beyond those associated with making a political transition separately (Armijo, Biersteker, and Lowenthal, 1994). Since new forms of foreign capital inflows to developing countries often are associated with a larger program of market-oriented economic reforms, these problems of transitional incompatibility between political and economic reform can make democratization significantly more difficult. For example, even scholars who believe that economic liberalization ultimately will improve both overall economic growth and increased economic opportunities for all sectors, including the poorest, recognize that the short-term effects of market reforms are likely to involve increased unemployment, structural dislocation, and, quite often, heightened income inequality, whether among quintiles of income earners or diverse geographic regions. Increased insecurity and/or inequality, even if policymakers plausibly expect it to be temporary, easily can provoke societal responses from groups that perceive themselves as losers, ranging from diffuse anti-system radicalism and even violence, to focused xenophobia, nationalist chauvinism, exaggerated protectionism, and religious fundamentalism. The ideas of a Patrick Buchanan or a Jean-Marie Le Pen pose little to threat to an established democracy as in the US or France. It was harder to be quite so confident about, for example, the election of a Vladimir Zhirinovsky or Gennady Zyuganov in Russia in mid-1996, both of whom attacked the incumbent, Boris Yeltsin, for being excessively neoliberal and insufficiently Russian nationalist.

Third, the process of democratization may be conceived of as typically including three stages (O'Donnell and Schmitter, 1986; Przeworksi, 1991). The first, political liberalization, signifies a loosening of overt authoritarian controls on the exercise of basic civil and civic liberties, such as freedom of expression, association, worship, and travel, and perhaps greater tolerance of criticism by the regime, but stops short of formalizing full democratic procedures. The second stage, formal transition to democracy, occurs when a country adopts new laws and procedures marking an official, legal transition to democratic rules of the game. The third stage is that of democratic consolidation, which implies internalization and normative acceptance of the new democratic procedures by all of the major political actors. One of the problems of some democratic transitions, not surprisingly, is that they get 'stuck.' Brazil, for example, spent at least a decade, more or less from the mid-1970s to the mid-1980s, moving from political liberalization to the formal transition to democratic rules. Russia in mid-1997 clearly was somewhere between stages two and three, but probably closer to the former than the later. Transitional political leaders in the Philippines and South Africa, Corazon Aquino and Nelson Mandela respectively, have tried hard to lodge their polities firmly in stage three before the leaders had to leave office. These leaders recognized the overriding importance of creating a shared normative commitment to the politics of institutionalized compromise.

The above definition of *democracy* as procedural political democracy is reasonably well-accepted. That is, the analytical concept is clear, although cross-national measurement is more tricky. The other component to be defined is *foreign capital flows*. Inquiries as to the effects of more or less foreign capital, or its presence or absence in an economy, are fairly standard in the political economy literature. By contrast, the premise of this chapter and this book is that the institutional form of cross-border financial flows makes a difference for political and policy outcomes in the capital-recipient emerging market country – that is, that the *form or quality of the capital flow may be as important in some cases as its sheer quantity*. I define six types of capital flows based on the answers to three questions: Is the source of the capital in the advanced industrial country the public or the private sector? Is the recipient of the foreign capital in the emerging market country the public or the private sector? Third and finally, how intrinsically volatile is the financial instrument employed? Table 1.1 provides a summary description of these six ideal types of international capital flows.

Foreign aid flows from the foreign public to the recipient country public sector and has comparatively low volatility. The category includes both grants and low-interest loans offered by developed country governments – either bilaterally or through a multilateral financial institution such as the World Bank or Inter-American Development Bank – to less-developed countries, almost always directly to their governments.[11] The numbers reported in the book's introduction consider credit from the International

Table 1.1 International investment instruments: ideal types

Financial instrument	*Investor*	*In-country recipient of funds*	*Volatility*
Foreign aid	Public sector	Public sector	Low
Foreign direct investment	Private sector	Private sector	Low
Bank loans to government	Private sector	Public sector	Medium
Bank loans to private firms	Private sector	Private sector	Medium
Portfolio investments w/government	Private sector	Public sector	High
Portfolio investments in private firms	Private sector	Private sector	High

Monetary Fund to be multilateral foreign aid. *Foreign direct investment* (FDI) flows from the foreign private sector to the private sector within the emerging market country in which the multinational corporation becomes, de facto, a local player. FDI also has low volatility. Through FDI multinational corporations set up new businesses or purchase existing firms located in the recipient country. The defining feature of direct investment is that the foreign owner assumes a long-term managerial commitment to the business in which he or she invests. Direct investment need not always mean majority ownership, which developing countries frequently have prohibited; foreign control can be exercised via a plurality of shares. Purchase by foreigners of a dominant interest in a privatized state-owned enterprise, for example, thus constitutes direct investment. The investor is a private corporation based in an advanced industrial country. The in-country recipient of funds is the subsidiary or affiliate of a multinational corporation (MNC), and thus also a private sector entity.[12]

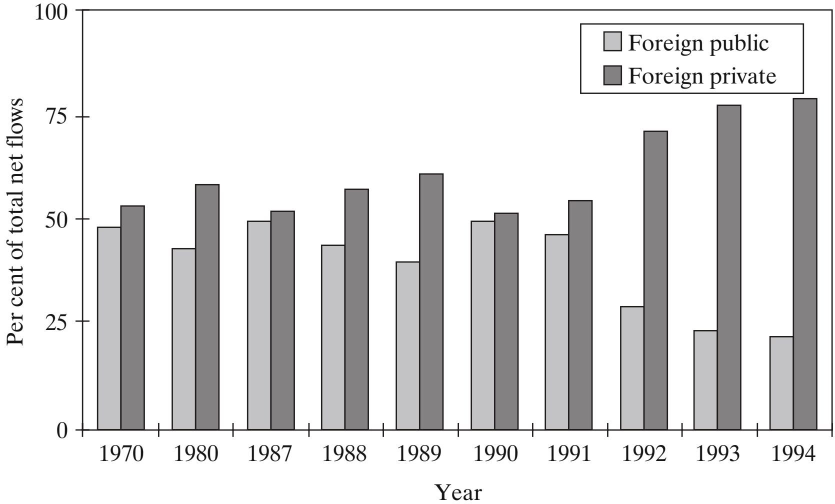
Commercial bank loans to the incumbent government come from the foreign private to the emerging market country public sector, whether directly to the central bank or finance ministry, or to state-owned enterprises, ostensibly operated at some remove from national budgetary accounts, but nonetheless ultimately responsible to the political authorities.[13] Medium and long-term loans should have medium volatility. *Commercial bank loans to local big businesses* originate with the foreign private sector and are spent by the local private sector. In category four, loan recipients are creditworthy large private firms with a high enough international profile to borrow long-term funds directly from multinational banks. Typically, although not invariably, these firms are exporters, thus providing some assurance to the lender that they will have access to the foreign exchange needed to repay the loans.

Portfolio investments in securities of the incumbent government move funds from foreign private investors[14] to the recipient country public sector, as with foreign investment in treasury bonds of the emerging market goverment or minority shareholding in public sector firms. These securities may be sold directly in international financial markets or to foreign investors who buy them in the capital markets of the capital-importing country. Their defining characteristic is that the funds raised become the responsibility of the emerging market country's government. The sixth and final category, *portfolio investments in securities of local businesses*, refers to the transfer of resources from the foreign private to the local private sector. Securities in this group include both those traded only within the emerging market country and those floated directly in global markets, as with corporate equities or debentures of private firms of developing countries sold on European exchanges in the form of global depository receipts (GDRs) or traded in the US through American depository receipts (ADRs). I include short-term debt with portfolio investments in the local private sector.[15] Portfolio investments with either the public or private sector have the highest potential volatility.[16]

The six ideal types of cross-border capital flows to developing countries just specified have been constructed based on three types of distinctions: the identity of foreign investors (public or private sector), of in-country borrowers (public or private sector), and the hypothesized volatility of the financial instrument or modality (low, medium, or high).[17] In recent years there have been substantial shifts in aggregate flows on all three dimensions. From 1950 through the mid-1960s, foreign aid flows, originating in the public sector of the advanced industrial countries, were substantially larger than flows originating with private investors. By 1970, as shown in Figure 1.1, public and private *sources of foreign funds* were of approximately equal importance. In 1980, which represents the profile of the 1973–81 peak years of multinational commercial bank lending, the foreign private sector contributed about 25 per cent more funds than did foreign aid. Following the 1982 debt crisis, the share of bilateral and multilateral foreign aid again rose, as shown in the data for 1987. However, by 1992 private flows of all types dwarfed official flows, a trend that continued through this writing in late 1997. Figure 1.2 shows an equally pronounced shift in the *recipient sector of capital flows*, as the share of net flows coming to the in-country public sector dropped toward the end of the 1980s, while that of the in-country private sector rose. Figure 1.3's trends in *predicted volatility* reflect, first, the sharp decline in medium and long-term commercial bank lending, second, the recent sharp growth in portfolio flows, now exceeding the magnitude of official loans and grants, and, third, a recent recovery of foreign direct investment in the early 1990s. As compared to earlier postwar decades, that is, trends in the 1990s revealed dramatic movement in the direction of private sector to private sector flows, at least a third of which was in a highly liquid form.

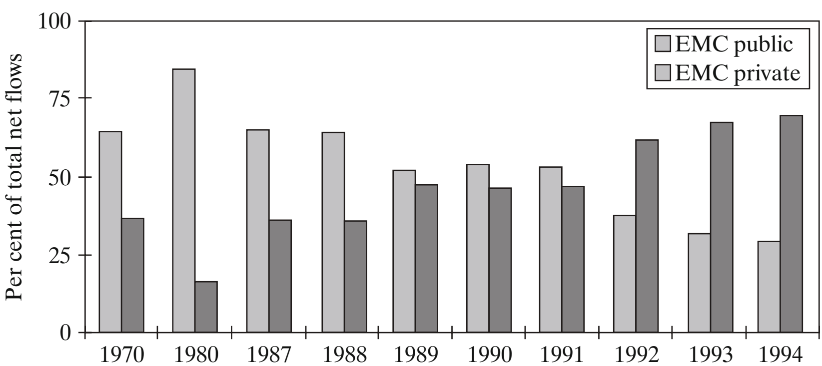
The argument thus far has specified an outcome, procedural political democracy, which I suggest may be affected by the composition of foreign capital flows from advanced industrial countries to emerging markets. I assume for purposes of argument that the sheer magnitude of capital inflows among different hypothetical cases does not differ greatly. Rather, the institutional form of its transfer is what shifts. It is difficult or impossible to suggest logic that would propose a direct link between, for example, foreign direct investment and the strengthening or weakening of democracy in a developing country. The next section, instead, looks at four intermediate dimensions to which the institutional form of cross-border capital flows may have a direct link.

Figure 1.1 Source sector of net foreign capital flows



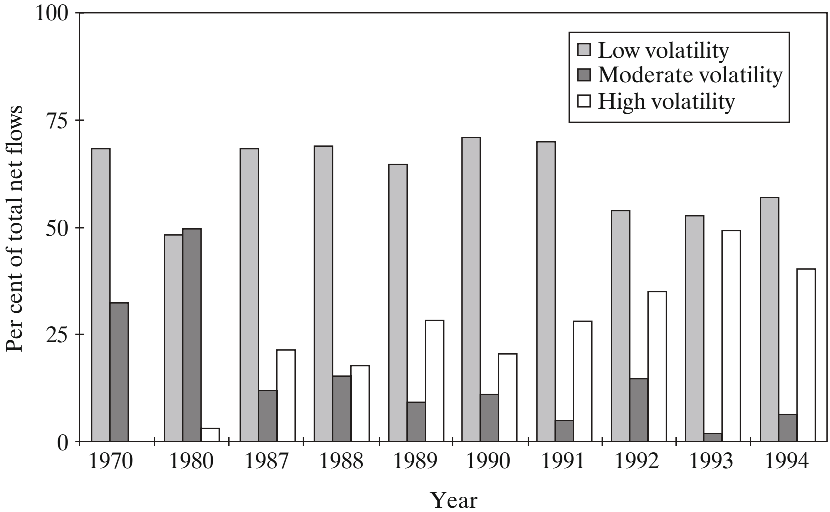
Source: See Table 1 of Introduction.

Figure 1.2 Recipient sector of net foreign flows



Source: See Table 1 of Introduction.

Figure 1.3 Flows separated by predicted volatility



Source See Table 1 of Introduction.

DIRECT CONSEQUENCES OF FOREIGN CAPITAL FLOWS: LIKELY EFFECTS ON GROWTH, POLITICAL RESOURCES, FINANCIAL CRISES, AND PRESSURE FOR NEOLIBERAL POLICIES

Deductive reasoning suggests likely differences among the six types of foreign capital flows in their effects on four important intermediate outcomes – economic growth, the balance of power among nationally relevant political actors, the risk of provoking a balance of payments crisis, and externally imposed pressure for the adoption of neoliberal public policies – each of which, in turn, plausibly is related to democracy. That is, this essay constructs a two-stage argument: first, from alternative instruments of foreign capital flows to the four intermediate variables just listed, and second, from each of these intermediate variables to supportive or inauspicious conditions for democracy. Table 1.2 summarizes the first set of hypothesized links.

The expected relationship between various cross-border financial instruments and *economic growth* turns on the point that the in-country recipients of foreign resources may be either the government or private firms. From a purely economic viewpoint, foreign resources that come directly to governments probably are less efficient in directly producing growth. There is no reason to doubt the conclusions of the extensive literature of the public choice

Table 1.2 International investment instruments: direct implications

Financial instrument	*Likely incremental stimulus to economic growth*	*Political actor whose influence increases (assuming no BOP crisis)*	*Increased risk of balance of payments (BOP) crisis*	*Pressure on govt. for neoliberal economic reforms (even if no BOP crisis)*
Foreign aid	Low	• Foreign government • Incumbent government	Low	Low
Foreign direct investment	High	• Foreign business	Low	Moderate
Bank loans to government	Low	• Incumbent government	Moderate	Low
Bank loans to private sector	High	• Local big business	Moderate	Low
Portfolio investment with government	Low	• Incumbent government	High	High
Portfolio investment in private firms	High	• Local big business	High	High

school, which argues that rational public sector bureaucrats and managers, as compared to private owners, have fewer incentives to maximize profits and thus efficient operations, but many more incentives and opportunities to reap monopoly rents at the general population's expense (see Bates, 1988; Bates and Krueger, 1993; Meier, 1991). Examples include awarding public sector procurement contracts not to the lowest bidder but rather for a consideration, charging illicit fees for government services that ostensibly are free, and so on. In addition, politicians and the bureaucrats who work for them may choose to allocate a portion of the investment resources that come under their control to alleviate social tensions such as those caused by interregional inequities within the country. That virtually all governments are at least at the margin influenced by political considerations in the allocation of public investment funds suggests that public sector disbursement of international resources is likely to be on average less efficient than private sector investment.

It is, of course, reasonable to counter that the private sector, though likely to run more microeconomically efficient firms, is much less well equipped than the central government to solve collective action problems (see Olsen, 1965). To the extent that society's economic problems are dominated by such typical collective action challenges as environmental degradation, or under-investment in future generations and in infrastructure, resource allocation by the central government may well be more macroeconomically efficient in the long run. Making this judgment about a particular society is an empirical task, and cannot be done on the general, analytical plane on which this essay operates. Possibly different countries have different likelihoods of encountering collective action problems.

Nonetheless, for our present purposes, the point is that resources that come directly to the central government tend to exhibit certain characteristics: in brief, the incumbents will employ resource allocation in ways that reflect their public policy priorities, which in turn will be both developmental and directly political. Some expenditures will be directed toward furthering economic growth. Other expenditures, however, are likely to go for other goals, from enhancing equity (arguably laudable, but in the short run less growth-enhancing than a single-minded focus on profits) to political patronage. On the other hand, private sector investors will tend to maximize profits, period. Thus, foreign aid, bank loans to the government, and portfolio investment in government securities all might be expected to be comparatively less efficacious with respect to yielding overall economic growth than foreign direct investment or bank loans or portfolio investments coming to the local non-financial private sector. The judgments in column 1 of Table 1.2 reflect these suppositions.

The second reasonably direct link is that between the institutional form of foreign investments and the *balance of resources and influence among nationally relevant political actors*. A definition may be helpful. National politics may be conceived of as a political 'game' in which various 'players' (social groups and occasionally individuals) jockey for position. Each group's goal is to use whatever politically relevant resources it has available (which may be guns, money, the ability to command votes, ideas, the ability to turn out masses into the street to demonstrate, specialized knowledge, inherited high status, and so on) in order to pursue its preferred public policy agenda (see Wynia, 1990). Thus, for example, organized industrial workers possess the resources of strikes, potential mass action, and a reasonably large bloc of votes; maintaining high wages is one of this group's most important policy goals. Capitalists possess the resources of control over funds, which may be channeled to candidates in democratic political systems, or invested abroad, if the business community becomes sufficiently disenchanted with local prospects. Their policy preferences run to lower wages and light government regulation. Interest groups, which may be constituted on the economic basis of class or occupation, or around other identities such as ethnicity or geographical origin, will have competing policy preferences in all political and economic systems. There is nothing *per se* that is insidious or abnormal about the existence of social groups competing to influence public policies, although many political ideologies (from Iberian or Latin American corporatism to Communism) prefer to pretend that society is intrinsically harmonious, and thus intergroup conflict nonexistent or at least illegitimate.

Social groups, or political players, compete over public policy within the framework of political institutions, including both the formal rules of the game (laws and constitutions) and its informal rules (well-understood although unwritten behaviors and practices, ranging from innocuous social conventions to the never-articulated but strictly enforced rule that the dictator-for-life is not to be contradicted on pain of imprisonment or death). Military authoritarianism is one set of rules, which of course exists in many variants, while procedural political democracy, which also has numerous specific incarnations, is another. Both formal and informal rules of the national political game may evolve gradually or instead shift dramatically because of some discrete event, such as a military coup. Circumstances that alter the balance of relative power among political actors constitute one important source of dynamism and change in national political rules, particularly informal ones.

There are *four main political actors* whose influence, overt or indirect, over local policymaking and political choices may be differentially enhanced by diverse forms of foreign capital inflows: foreign governments and international organizations, the incumbent government of the capital-recipient country, foreign business, and local big businesses sufficiently well-known to attract foreign private investors. These obviously are not the only politically relevant players, nor will their initial degree of influence be the same across all emerging market countries. (For example, as of the early 1990s local big business was a more powerful political player in most Latin American than most Eastern European countries, because capitalists had been deemed criminals under Communist rule.) The six types of cross-border financial instruments differentially apportion additional resources among these four political and policy players. Column 2 of Table 1.2 reflects my expectations of marginal increments to the resources controlled by locally relevant political actors. In all cases, I am discussing the pattern of political resources in the absence of a balance of payments crisis associated with the cross-border capital flows.

Foreign governments and multilateral financial institutions (whose policies wealthy foreign governments tend to dominate) enhance their direct influence in local politics through foreign aid. All foreign capital inflows to some extent bolster the *incumbent political 'regime'* (that is, type of political system, as in democratic or authoritarian) and the incumbent 'government' or 'administration' (that is, the set of politicians currently in power). Capital inflows signify the outside world's confidence in the economic management skills of the ruling team. *Foreign business* enhances its direct influence in an emerging market country only through foreign direct investment (FDI). The influence of MNCs is ostensibly strictly economic, but in practice includes the right to have an indirect input into public policy and regulatory decisions that affect them. Once installed within the country, MNCs become local political actors. Foreign investors with a majority stake in a local business enterprise are bound to have preferences on local issues, whether or not the formal rules of the game permit them to participate, as their profits and other legitimate interests will be strongly affected by national economic regulatory policies. Finally, *local big business firms* augment their politically relevant resources when they are able to attract foreign capital flows directly, as in commercial bank loans borrowed directly from multinational banks (category four) or portfolio flows (equity, bonds, or short-term debt) raised by private corporations directly. Where local big business firms have a sufficient international reputation to borrow on their own hook, this enhances their bargaining resources *vis-à-vis* their own governments, putting them in a position analogous to that of private sector entrepreneurs who account for a large share of a country's exports. (Often they are the same people.)

The comments just made apply to cross-border capital flows in the absence of a balance of payments crisis. Following such a crisis, however, the direct influence of all foreign actors in the emerging market country increases, including foreign investors or lenders, international financial institutions, and the home governments of foreign private investors and lenders.

The six types of cross-border capital flows also differ in their degree of potential volatility, that is, in the ease with which the foreign investor can turn around and repatriate his/her/its funds. Consequently these alternative financial instruments imply differing degrees of *balance of payments risk*, as shown in column 3 of Table 1.2. Foreign aid and foreign direct investment have low volatility; they are unlikely to be reversed overnight. Foreign aid flows largely respond to non-economic criteria in any case; it usually takes a very dramatic, and rare, political change within the recipient to have aid flows staunched suddenly. In contrast, the reasons that FDI is of low volatility largely are practical. Factory owners cannot sell out immediately without confronting large losses, particularly in the context of an economic or political crisis. They thus tend to remain in the host country, often attempting to influence public policy choices themselves, whether overtly or covertly.

However, although FDI is unlikely to be volatile in the sense of participating in overnight capital flight, political or economic crises in the capital-importing country can cause potential investors to delay or cancel long-planned inward FDI.[18]

Medium and long-term commercial bank loans (categories three and four) in principle are of intermediate volatility, and thus pose an intermediate risk of external payments crises. Loans for capital projects cannot be called in, barring gross violation by the lender of the terms of the contract, before they mature in six to ten years. Nonetheless, in practice, shorter-term loans, including medium-term trade credit, tend to become linked to the long-term debt. Within six months following Mexico's August 1982 admission of its inability to make its quarterly debt payments, the major commercial bank creditors had generalized the crisis to most other Latin American countries by refusing to renew entirely standard and customary forms of commercial credit, thus provoking liquidity crises and the borrower countries' consequent inability to meet their debt service payments on the longer-term loans.

Portfolio investments (categories five and six) pose the greatest risk of an external payments crisis. Stocks and bonds are designed to be traded regularly, even daily or hourly: this is the reason their prices fluctuate. If they also trade across national borders in sufficient quantities, then the price of a nation's currency can fluctuate with the fortunes of its domestic capital market. Short-term debt is extremely sensitive to interest and exchange rate movements. Thus, a serious balance of payments and currency crisis can accompany a market downturn. A crisis in one country in a region can be rapidly generalized to its neighbors. Finally, if foreign investors (and/or domestic investors intending to move their capital abroad – it makes no difference) also hold large chunks of the government's domestic public debt, then a fiscal crisis ensues as well. Thus Mexico's financial crisis in the months following December 1994 was both a balance-of-payments and a fiscal crisis, because exiting foreign investors held a large share of the public debt.

The final hypothesized direct effect of foreign capital flows, shown in column 4 of Table 1.2, is pressure for developing country policymakers to manage their economies to suit foreign investors, rather than local needs or preferences.[19] *Pressure for neoliberal economic policies* can be expected to vary dramatically according to the type of financial instrument.[20] Both foreign aid and commercial bank loans sometimes went to countries whose economic policy capacities were marginal; donor governments often didn't care, since their major goals were strategic, not economic, and multinational banks during the 1970s lending boom, in retrospect, did not vet their sovereign borrowers carefully (Devlin, 1989; Cohen, 1986). In fact, developing country governments often used aid and loans to delay or avoid painful economic reforms. The pressure for neoliberal economic reforms from these sources of capital inflow typically is low.

Multinational corporations that invest directly in a developing country are more likely than aid donors or bank lenders to care about the host country policy environment. As local actors, however, as well as foreign investors, the policy preferences of multinationals are not likely to reflect a cookie-cutter, one size fits all orthodox mentality. Instead, they tend to prefer a stable regulatory environment. The pressure exerted by foreign direct investors on capital-importing country governments for orthodox economic reform is moderate.[21]

The portfolio investors in emerging markets of the late 1980s and the 1990s differ from their predecessors in two respects. First, the possibility of rapid movement of funds in and out of specific securities, and also in and out of countries and currencies, inspires investors to seek information that will enable them to make profits from rapid arbitrage. Meanwhile, each investor, whether as an individual or institution, must be prepared for rapid movement out of a multitude of idiosyncratic markets. It is very difficult, if not impossible, for investors to have good information on all of them. Thus, summary comparative measures – such as the government budget deficit, trade balance, public debt, growth rates, and inflation – tend to be seized on as a means of selecting among alternative investment venues. Furthermore, comparatively ignorant international investors tend to assume that countries that share similarities of geography, history, or culture (as in 'Latin America' or 'Eastern Europe') follow similar macroeconomic strategies with similar potential for success. Thus, the same herd mentality that caused multinational banks to react to Mexico's de facto default in August 1982 by pulling loans from all other Latin American borrowers was again in effect in Latin America in early 1995 and in East Asia in late 1997, but at an intensified level. From the viewpoint of investors, of course, such analytical shortcuts are entirely rational; it is better to rank possible investment destinations by imperfect data than to invest with no good information at all. From the viewpoint of emerging market countries, on the other hand, such investor behavior ties their hands very rigidly, forcing them into politically (and sometimes economically) risky behavior such as 30 to 50 per cent slashes in already low levels of social spending, often just as democratization finally is giving the poor a voice in politics.[22] This is the 'tyranny of the bond traders,' that moves exchange rates even in the advanced industrial countries.[23]

In addition, global capital markets today contain many decentralized investors, even if one notes the important leadership role of large international institutional investors, as Mary Ann Haley does in her chapter. In this situation, the lowest common denominator of information tends to prevail. Hypothetically, even if a given portfolio investor was aware that a country's heterodox stabilization program, for example, was appropriate given conditions in that economy, he or she might have to divest of that country's treasury securities if the investor suspected that less well-informed investors might flee and drive the value of the country's government debt down anyway. Even in the absence of direct, overt pressure from foreign institutional investors, that is, countries with large quantities of portfolio inflows find themselves under high implicit pressure to adopt neoliberal economic policies.

INDIRECT LINKS: CROSS-BORDER FINANCIAL FLOWS AND DEMOCRACY IN EMERGING MARKET COUNTRIES

The previous section suggested relatively straightforward links between the six types of capital flows and four important intermediate variables – economic growth, the relative power of four important political players, the likelihood of a balance of payments crisis, and external pressure for neoliberal economic policy choices. We now return to our core question: how might the institutional form of cross-border capital flow affect the prospects for a successful transition to, or consolidation of, procedural political democracy?

Let me first make an obvious point: the nature of the incumbent political regime (that is, the type of existing political system) is the most important influence on whether foreign capital inflows promote or retard democracy. *Ceteris paribus*, foreign investment in a democracy will strengthen democracy, while foreign financial resources flowing into a country governed by a dictator will tend to enhance his or her position. Similarly, balance-of-payments crises undermine the credibility of governing incumbents – even if the main borrowers have been private businesses or banks. It makes no sense to discuss the import, for democracy, of any of the six types of financial instruments without also considering the political status quo of the recipient country. The following discussion, summarized in Table 1.3, returns to this point frequently.

I am skeptical about a commonly posited relationship. In my view, forms of cross-border capital flows that *improve economic growth* don't necessarily aid in the promotion of democracy. There is no direct causal relationship between economic growth, on one hand, and the transition to or consolidation of procedural political democracy, on the other hand (see Table 3, row 1).

This is an old argument for political scientists. We can begin with the reason that so many observers have believed that economic growth and political democracy were complementary and mutually reinforcing (see Rostow, 1960). The majority of contemporary liberal democracies are wealthy, industrialized countries. Therefore, it is easy to conclude, changes that move countries in the direction of becoming wealthier or more powerful also help them democratize. However, as Guillermo O'Donnell (1973) conclusively demonstrated for Latin America in the 1950s through the 1970s, it also is possible that progress toward industrialization could lead away from democracy.[24] Many more recent treatments also argue that the relationship

Table 1.3 Intermediate variables: implications for democracy

Intermediate variable	*Implications for democracy* — *If incumbents are authoritarians:*	*If incumbents are democrats:*
High economic growth	May delay democratic transition by legitimating incumbents.	Good for democracy.
Foreign government's influence increased	Depends on goals of foreign government.	Depends on goals of foreign government.
Incumbent government's influence increased	Strengthens authoritarian regime.	Strengthens democratic regime.
Foreign business' influence increased	Promotes some political liberalization, but not full transition to democracy.	*Pessimistic hypothesis*: dangerous for weak democratic govts. with leftist policy goals. *Optimistic hypothesis*: protects foolish leftist govts. from policy mistakes that invite military coups.
Local business' influence increased	Promotes some political liberalization, but not full transition to democracy.	Depends on characteristics of local business.
Balance of payments crisis occurs	Discredits authoritarian incumbents with citizenry and international community.	Discredits democratic incumbents with citizenry and international community.
Neoliberal economic reforms occur	May delay democratic transition by weakening pro-democracy actors (organized labor, the poor).	Good in long run. In short/medium run may strain or reverse democratic transition.

between economic or industrial growth, on the one hand, and political democracy, on the other, is highly contingent at best, and may even be negative under some conditions (Haggard and Kaufman, 1992; Haggard and Kaufman, 1995; Armijo, Biersteker, and Lowenthal, 1994).

A comparison of India and South Korea, for example, which had roughly the same per capita income around 1950, suggests that Indian democracy since 1947 did not produce much in the way of rapid economic growth, at least before the 1980s, while Korea's admittedly successful economic strategy did not lead to democracy before the late 1980s (Varshney, 1984). In general, high economic growth under authoritarian political auspices has the effect of legitimating the incumbent non-democratic regime, and thus delaying the democratic transition in the short to medium run. Rapid growth in a democracy similarly validates the current political leaders and their economic policy team.

The second dimension explored in this essay's previous major section linked certain institutional forms of international financial investment to *shifts in the distribution of locally relevant political resources* controlled by key players in the game of national politics. We cannot plausibly argue that an increase in the resources available to player X will either create or destroy procedural political democracy. However, we may be able to assert that, all other things being equal, an increase in the resources available to player X heightens or diminishes the prospects for democracy, particularly under circumstances Y (see Table 1.3, rows 2 through 5).

Increases in the leverage of foreign governments and international organizations, as through a country's acceptance of foreign aid, heighten the impact of the preferences of these foreign actors within the national political game of the emerging market country. Unfortunately, democratization or democratic consolidation is only infrequently a top priority of aid donors. Bilateral aid donors typically rank achievement of their other strategic objectives – such as access to military bases, cementing alliances, commercial reciprocity, or drug interdiction – above democratization. Multilateral financial organizations usually allocate resources according to overt macroeconomic criteria, and sometimes also according to the unacknowledged strategic criteria of their major donor countries, rather than as a reward for or inducement toward democracy. Increased influence in the politics of emerging market countries for foreign governments, even when they these governments are democratic at home, is, at best, a weak recipe for democratization.

Increased influence for the incumbent government promotes democracy only when the incumbents are democratic already. Monies coming directly to the incumbent government augment the resources (often in practice fungible across investment, consumption, and political patronage spending) that ruling politicians can deploy *vis-à-vis* their political opponents. New or weak democratic governments may have a particularly acute need for resources, since previously marginalized classes almost always expect a rapid improvement in their material circumstances, now that an oppressive government has gone. The 1990s shift toward private sector in-country recipients of funds, shown in Figure 1.2 above, thus may be particularly unfortunate for new democracies. However, as noted, all types of capital inflows strengthen governing incumbents to some degree – at least so long as they do not generate a balance-of-payments crisis.

What are the consequences of local political influence for multinational direct investors? This is, of course, a highly polemical topic on which much has been written (see Chase-Dunn and Bornschier, 1985). There are two contending expectations. We may call these contrasting predictions the 'pessimistic hypothesis' and the 'optimistic hypothesis.' The pessimistic hypothesis comes in two versions, which are not mutually exclusive. The first version suggests that transnational direct investors will have no patience with democratically elected leftist reformers. Left-leaning governments that promote policies like land reform or preferences for small-scale local production, thus may meet resistance from foreign direct investors in their midst. Foreign direct investment that originally entered the country during previous authoritarian and/or politically conservative times may be especially problematic for a new or weak democratic government in an emerging market country. Democratically arrived at (that is, politically popular) public policies might be excessively economically populist. The foreign businesspersons may feel that the regulatory environment suddenly – and from their viewpoint, unfairly – has been switched under their noses, thus justifying to themselves a decision to retaliate. The political activities of multinationals in host countries have ranged from the relatively innocuous, as in joining or sometimes organizing local chambers of commerce and or other business lobby groups, to the illegal but not unexpected, as in secretly contributing to the campaign funds of pro-business candidates, to the egregiously inappropriate, including involvements in coups and assassination attempts.

A second version of the pessimistic hypothesis reasons from the presence of transnational direct investors to the likely social class structure of a currently authoritarian or semidemocratic country, and concludes that the possibility for a future transition to full democracy has become less likely. Thus, some political sociologists have postulated that full electoral democracy with nearly universal adult participation is most likely to arise in societies that are at certain stages in their economic development, and possess specific sorts of class structures. If this hypothesis is correct, then certain alterations in groups' relative economic power that are non-threatening to an established democracy nonetheless may impede a full democratic transition. Rueschemeyer, Stephens, and Stephens (1992), for example, worry about the domestic political consequences of a developing economy in which multinational direct investors dominate core productive sectors.[25] The three believe a numerically strong and politically assertive industrial working class to be a necessary although insufficient condition for the successful transition to mass democracy. In the absence of effective lower class demands for political participation, they argue, political reform may cease with partial liberalization of overt authoritarian controls on middle class civil liberties, stopping well short of full democratization. For example, they suggest that the particular class characteristics of Latin American industrialization, whose leading actors for well over a century have been foreign direct investors, directly inhibited the formation of strong labor unions, and thus of stable democracies, in most countries there, at least prior to the late 1980s[26] (see also Karl, 1990; Moore, 1966).

Contrasted to these predictions is the 'optimistic hypothesis,'[27] which is the mirror image of the first pessimistic expectation above. Quite so, the optimists argue, foreign entrepreneurs might try to protect their property rights by pressing the government to restore a 'sane' investment climate. However, the intervention of foreign investors on the side of neoliberal policies could end up protecting, rather than undermining, formally democratic rules of the game. That is, foreign business leaders, often allied with local big business, could use their influence to push policymakers to adopt more macroeconomically sensible and sustainable policies. Society as a whole thus might avoid just the sort of economic breakdown that ends with a military coup and the installation of military-technocratic ('bureaucratic-authoritarian'[28]) political regime justifying their withdrawal of political freedoms in the name of restoring economic growth.

The sequences of events imagined in either the first variant of the pessimistic hypothesis, or the sole version of the optimistic hypothesis, of course, only come into play if the elected government wants to enact leftist, populist policies of economic redistribution, social spending, import-substituting industrialization, and the like – particularly if policy-makers are blithely unconcerned with how to pay for their plans. If, on the other hand, democratically chosen policymakers have conservative economic leanings, business actors typically will be more satisfied with the government and less likely to interfere. For reasons outside those analyzed in this essay, neoliberal economic ideas have made a worldwide ideological comeback in the 1980s and 1990s (Biersteker, 1995). If the elected government follows conservative economic policies, then both foreign and most local big businesses can support democracy without contravening their class interests and policy preferences.[29]

Finally, what can we expect if foreign capital inflows augment the resources available to local big capitalists? Emerging market countries differ greatly from one another: blanket predictions would be foolhardy. Nonetheless, deductive logic and a rational choice perspective suggests that big business should, in most developing countries, favor political liberalization but may be ambivalent about a full transition to competitive electoral democracy. A shift away from the arbitrariness of unrepresentative governance to the rule of law reduces the costs of doing business. Protection of individual freedoms protects businesspersons themselves. Press freedom is consistent with good access to timely business data. However, there are good structural reasons why the attitudes of business leaders toward democratic transitions may be ambivalent. On the one hand, entrepreneurs' personal experience of participation in global markets will tend to broaden the knowledge that they have of the larger world: cosmopolitan, educated, high status individuals tend to have been exposed to, and perhaps imbued with, democratic values.[30] On the other hand, successful local business leaders with a presence in global markets will, almost by definition, have been members of the privileged elite in their home countries. Similarly, multinational direct investors, once committed to a country, tend to become de facto members of the incumbent political regime's support coalition. If an emerging market country's current political regime is authoritarian, then the shift to mass electoral democracy almost inevitably will dilute the public policy influence of these same business elites. If we imagine that business leaders as a group are classic 'rational actors,' then their strictly selfish interests should lead them to favor a politically liberalized, semi-authoritarian regime – allowing, say, freedom of the print media but not of radio and television (because the masses don't read); freedom to travel abroad, but not to criticize the government openly at home; and well-codified corporate law, but not the right to strike.[31]

The previous section also ranked the six ideal types of cross-border capital flows according to their *risk of provoking an external payments crisis*. Table 1.3, row 6 suggests that the main consequence of a balance-of-payments crisis is to discredit governing incumbents. Two further observations seem irrefutable.

First, if the political regime itself is weak or fragile, then such crises may also stimulate a political regime change. However, and second, while debt crises certainly are ominous for fragile democracies, it is not safe to conclude that balance of payments crises occurring under the auspices of authoritarian incumbents necessarily are good for democratic transitions.

When an incumbent military regime weakens and topples because political leaders cannot control the recessionary effects of an external financial crisis, then democracy, of course, may result. However, orthodox stabilization or structural adjustment, and the regressive social class and income shifts normally associated with them, may make it difficult for the successor regime to be a full mass democracy. The argument is as follows. Orthodox structural adjustment policies, implying deep recessions and much pain, seem an inevitable consequence of external payments crises in a contemporary emerging market countries. However, social groups whose political resources increase with a transition to political democracy – notably including organized labor and the poor[32] – may be precisely those that tend to lose out economically during standard neoliberal structural adjustments. For example, recessions mean that first private, then eventually public, sector workers lose their jobs – over the protests of their unions, typically, which then are delegitimized and weakened politically as an actor in constructing future political bargains. In addition, the poor, at least those whose livelihood depends on cash employment or casual earnings (as opposed to subsistence farmers), is the group that tends to suffer most during structural adjustment periods.[33] There are purely economic reasons why the poor should suffer more than organized labor, the middle class, or upper-class groups: they lack a diversified portfolio of assets going into the crisis, have little or no safety cushion, and cannot access good information about their options during the lean years.

Loss of relative economic power, however, breeds loss of politically relevant bargaining resources – particularly important during a period of political transition. It is during periods of political transition that the *de jure* and *de facto* 'rules' of the successor political game are being hammered out among all those groups that can, in effect, claim a place at the table. The bargaining weight of a political player is roughly equivalent to the importance and credibility of its threat to withdraw cooperation and sabotage the entire process of political compromise. If unions are discredited, and potentially mobilizable urban slumdwellers are busier than ever in begging and competing against one another for casual employment, then they (usually) become that much less likely to have the status, time, or energy to contest the rules of the successor political game. Therefore organized labor and the poor lose relative influence in the domestic political game.

Meanwhile, groups whose direct public policy influence would be undercut by the shift from policy-making by insider status to majority votes – such as foreign or local big business, as already discussed, or the military, or the urban middle class (particularly where this class is relatively small) – are unlikely to bear the brunt of structural adjustment cuts. That is, they still will be players of some heft during the transition bargaining. The relative balance of bargaining influence among alternative social and political actors that has been constructed during the time of political regime breakdown and renegotiation tends to be perpetuated into the future, at least until the next system-threatening crisis.[34] Of course, many other factors – prominently including the demonstration effect of Latin American and East Asian democratization in the 1980s, and the end of the Cold War and Eastern European democratization in the early 1990s – also play a crucial role in promoting democratic transitions. Nonetheless, the conclusion is that, even if the previous authoritarian regime has been discredited and overthrown, the experience of a balance of payments crisis in an emerging market country is not likely to be particularly conducive to the establishment of democracy.

The last dimension hypothesized to be directly affected by the form of international capital flows is external pressure on the borrowing country for *neoliberal economic reforms*, as shown in Table 1.3, row 7. As noted in this essay's previous section, I expect portfolio types of capital flows to generate the most pressure for preemptive neoliberal policy changes. Neoliberal reforms range from budget-cutting to structural/institutional changes such as shrinking the size of the federal bureaucracy, selling state-owned enterprises ('privatization'), and getting rid of trade barriers. The one-off reform of selling state assets, for example, brings money into the national treasury which can be used to balance the budget, thus attracting capital inflows. Furthermore, the language of market-oriented regulatory changes – 'free' markets, 'liberalization,' and so on – parallels that of democratization. It is no wonder that many thoughtful observers have assumed that free politics and free markets are entirely complementary – or even that they are acceptable substitutes for one another (see Bhalla, 1994).

However, this easy assumption of automatic complementarity appears to be false, except possibly in the long run. Even if we assume, for the sake of argument, that all such 'reforms' actually improve economic performance eventually, there is no linear, necessary connection between market-oriented economic liberalization and the transition to or consolidation of procedural political democracy. A reduction of the state's economic presence typically means not only an end to unnecessary red tape, but also cuts in social spending and the redistributive activities of the paternal state. These social structural shifts are unlikely to promote a transition from authoritarianism to democracy. Under preemptive neoliberal economic reforms we might expect labor unions and the poor to be relatively worse off, at least in the short to medium run, just as we argued they would be following a balance of payments crisis.[35] Moreover, authoritarian leaders, fearing political protests from recessionary reforms and cuts in state spending, may be particularly unlikely to risk political opening while implementing neoliberal economic reforms. Rapid neoliberal reform could make democratic transitions more difficult (Armijo, Biersteker, and Lowenthal, 1994).

At the same time, the consensus of economists, at least those practicing in advanced industrial countries, supports the belief that market-oriented reforms will improve economic growth prospects in the medium to long run (Williamson, 1990).[36] That is, there is also an 'optimistic' hypothesis about external pressure for preemptive neoliberal reforms. Market reforms are sorely needed to turn an authoritarian and inefficient economy around, say some observers, so much so that democracy cannot be safe until tough, and probably politically unpopular, measures are taken to dispossess a huge cadre of rent-seekers within the transitional state. Randall Stone's essay on Russia in this volume makes a strong version of this argument, and Jeffrey Winters' chapter at least raises the possibility that it could apply in Indonesia. If weak or venal domestic leaders are unable to undertake painful reforms, then skittish global portfolio managers (or wealthy locals with the know-how to move their money out through the black market) may, paradoxically, be the common people's best friends. In other words, the credible threat of a balance-of-payments crisis yields better macroeconomic policies, which is good for democratic transitions. In this case, aspects of both the pessimistic and optimistic expectations are both likely to be valid.

* * *

I have in this chapter adduced the following rough hypotheses, which the other contributors to the book address in various ways:

1. Economic growth, while desirable in many ways, does not directly bring political democracy, except possibly in the long run. Therefore, assertions that link economic growth with foreign capital flows say little about the consequences for democracy.
2. Foreign capital flows controlled by private, profit-seeking actors, will be allocated more efficiently, on average, than capital flows controlled by governments.
3. The direct beneficiaries of foreign capital inflows will be one or more of four actors: foreign governments, the incumbent government in the capital-importing country, local big business, and foreign direct investors. Different types of cross-border financial instruments add to the politically-relevant resources of those actors that control the flows. None of these actors, except incumbent governments that already are democratic, promotes democracy automatically.
4. Balance-of-payments crises, whatever their causes, are bad for political incumbents. If the political regime (overall political system) itself is fragile, it may be discredited along with the particular office holders.
5. Post-financial crisis periods of structural adjustment often generate socioeconomic changes that disadvantage just those political actors (organized labor and the poor) who can be expected to support and/or benefit from the transition to procedural political democracy with universal suffrage. New rules of the successor post-transition political game may permanently reflect the distribution of political power during the transition.
6. Neoliberal economic reforms instituted in the hope of avoiding a future balance of payments crisis tend to generate inter-group distributional results similar to post-crisis orthodox structural adjustment programs.[37]
The final hypothesis is the most important.
7. The most significant factor in determining how capital inflows might affect democracy is the current political situation of a capital-importing country. Foreign capital inflows per se tend to be beneficial for economic development and political incumbents – although some types of capital inflows are easier for a country to digest than others, as this essay has argued. All other things being equal, therefore, foreign investment

received by an authoritarian government strengthens dictatorial rule, while foreign capital inflows into democracies reinforce procedural, representative government.

Thus, if one knew the existing political situation of a country, one perhaps could hazard educated guesses about how a shift in the form of capital inflows might incrementally alter the current national political game. This chapter has presented a deductively derived analytical framework. I should note that it was written in 1994–95, before the effects of Mexico's peso crisis had worked themselves through and in the context of East Asia being seen as relatively stable politically and as having, wisely, specialized in FDI rather than the portfolio equity and bond flows so prominent in the capital accounts of Latin America and, to a lesser extent, Eastern Europe (see Griffith-Jones and Stallings, 1995, and Stefano Manzocchi's chapter in this volume). In my conclusion to this volume, extensively revised in late 1997 and on the basis of the efforts of my fellow authors, I turn to some empirical cases to begin to assess these expectations.

Notes

1. I thank Shahid Alam, Thomas J. Biersteker, Thomas Callaghy, Susan Christopherson, John Echeverri-Gent, David Felix, Mary Ann Haley, Rebecca Hovey, Atul Kohli, Mukul Majumdar, Luigi Manzetti, Sylvia Maxfield, Geraldo Munck, Dale Murphy, Sanjay Reddy, Dietrich Rueschemeyer, Ben Ross Schneider, Moises Schwartz, Danny Unger, Birol Yesilada, Fei-Ling Wang, and the participants in the conference on 'Financial Globalization, Economic Growth, and Democracy in Emerging Market Countries' at Brown and Northeastern Universities (November 1995) for their helpful comments on various versions of this chapter and Chapter 14.
2. The Introduction's Table 1 uses data from the World Bank's annual *World Debt Tables*, but combines the data slightly differently than the World Bank. Use of the World Bank's categories, as in the chapter by Stefano Manzocchi in this volume, does not change the broad trends.
3. A large share of bank loans in the 1980s was not voluntary lending, but instead 'exceptional financing,' in which transnational money center banks agreed to loan countries like Mexico and Brazil 'new money' so they could make interest and principle payments due on past debt – thus saving both debtor country and creditor banks from the pain of a formally declared default.
4. Many Latin American and African debtors had negative net transfers. In 1986, for example, Mexico's net transfers abroad totaled 5.3 per cent of its GDP, while Brazil's summed to 3 per cent (World Bank, 1995).
5. The big question is whether heightened volatility is inevitable, because of advances in computer and telecommunications technologies. Helleiner (1994) argues that financial globalization has only come about because of political choices (including the deceptively passive choice not to regulate) made by the leading industrial capitalist economies. Financial globalization also has been propelled by structural changes occurring within the domestic economies of the OECD countries. Two institutional and regulatory trends that began in the

early 1980s, securitization (the bundling together and resale of in the capital markets of long-term lending commitments formerly held to maturity by banks and other financial institutions) and the large shift of household savings in OECD countries away from bank deposits and toward investments in mutual funds and other institutional investors, have occurred in tandem with the technology-driven inauguration of 24 hour global trading. Domestic and international financial market changes thus reinforced one another.

6. The 1997 East Asian financial crisis was in full swing as this book was in its final editing. US treasury secretary Robert Rubin was busy trying to convince a reluctant US Congress of the necessity of contributing to rescue packages for South Korea and Indonesia, which many members of that body saw as either foreign aid for far-away lands or bailouts of wealthy banks, both highly unpopular causes with constituents. The South Korean package, negotiated by the IMF in December, was for $57 billion, breaking the previous record of $50 billion set in the February 1995 package for Mexico. The general lesson appeared to be that the list of countries whose possible financial crashes the financial authorities in the major advanced industrial countries found threatening had expanded, as the 1997 'Asian flu' seemed even more contagious than the 1995 'tequila effect.'
7. The chapter by Manzocchi in this volume summarizes some of this literature.
8. This essay is not, of course, the first to theorize about the impacts of different institutional forms of foreign capital inflows on recipient countries. Barbara Stallings (1990) suggested that an important influence on the more positive growth experiences of Korea and Taiwan, as compared to Mexico and Brazil, in the 1980s might have been the institutional form of foreign capital inflows. The two East Asia countries relied more on capital from public sector sources and on loans. In contrast, the Latin American countries imported more private capital and direct investment by multinational corporations, both of which compromised host country autonomy. Furthermore, by the 1980s, the two East Asian societies had raised domestic savings rates sufficiently to reduce significantly their overall reliance on foreign inflows. A few years later, Stallings and Stephany Griffith-Jones noted that the institutional forms of capital flows again had shifted. In that paper, they considered both long-term loans and FDI more advantages forms of capital inflows, from the viewpoint of capital importers, than portfolio equity, while noting that, as of 1991–92, Asian developing countries were more fortunate on these grounds than Latin American and Caribbean ones (Griffith-Jones and Stallings. 1995, p. 158).

   Jeffery Winters (1994 esp. pp. 446–50) proposed a 'framework for analyzing capital control and end use.' He noted that recipient country governments have low discretion over the investment uses of either portfolio flows or foreign direct investment, medium abilities to control interstate loans (that is, official credits), somewhat greater options for investing private commercial loans as they please, and the greatest degree of discretion over 'state capital,' or revenues raised domestically, through taxes, borrowing and so forth.

   Sylvia Maxfield (1995, esp. pp. 12–15) was interested in the degree of influence different types of foreign investors have over the economic policies of recipient governments, positing the greatest leverage for portfolio equity investors, an intermediate amount for long-term bondholders, and the least leverage for foreign direct investors and commercial bank lenders. The determining factors for her were the costs to foreign investors of monitoring recipient country performance and, most importantly, the ease of capital repatriation.

Each of these analysts was concerned with the links between capital inflows and recipient country government autonomy and/or economic growth. None explicitly attempted to pursue the further possible link between the institutional forms of capital inflows and democracy.

9. For an alternative way to think through the meaning of 'democracy' in developing countries, particularly in Latin America, see Karl (1990).
10. Obviously the definition of democracy adopted by Communist countries, or 'peoples' democracies' does not include procedural political democracy as a component. Some theorists commited to economic equality as the foundation of democracy also see procedural political democracy as, at best, a smokescreen for oppression, and, at worst, an instrument of inequality and thus of the lack of democracy (see, for example, MacPhearson, 1966).
11. I exclude military assistance from this discussion for two reasons. Most military aid is in the form of contributions in kind, rather than financial flows. In addition, the rationale for military aid is entirely political and strategic, whereas economic aid may have some investment justifications as well as its overtly political ones.

    For the sake of analytical simplicity, I also exclude that small, albeit growing, portion of concessional foreign lending that flows directly to private sector recipients in the developing country, such as the loans made to local entrepreneurs by the World Bank affiliate the International Finance Corporation (IFC).
12. In some countries MNC investors have been encouraged to enter joint ventures with state-owned enterprises (SOEs). In principle, one could work through the analysis separately, first for MNC investors who formed wholly-owned subsidiaries or joint ventures with a local private partner, and second for MNC–SOE joint undertakings.
13. Due to limitations of the data, the statistics reported in the introduction assume that all 'government-guaranteed loans' are loans directly to the government, which of course overstates the size of my third category, although it is true that governments in capital-importing countries tend to exercise greater oversight over those foreign loans to local private firms that they guarantee. Categories three and four both bundle medium and long-term trade credit ('other guaranteed medium and long-term debt') with commercial bank loans.
14. In fact, some of the largest institutional investors in global markets actually are the pension funds of public sector employees, especially state and local government workers in the US. To the extent that pension fund managers attend only to maximizing profits and minimizing risks, their behavior mimics that of the managers of private sector pension or mutual funds.
15. It is difficult to know whether short-term debt flows are being borrowed by the emerging market country government or the local private sector, except on a case by case basis. Thus, the decision to include all such flows with my category six, portfolio inflows to the local private sector, has the result of overstating the size of this category relative to category five, portfolio flows to the government.
16. While many economists, perhaps a majority, would agree that portfolio capital flows are more volatile than, say, direct investment, opinions do differ. See note 4 to in William C. Gruben's chapter in this volume.

    Sylvia Maxfield (1997) suggests that portfolio investors may differ among themselves in volatility, with those seeking high yields (typically hedge and mutual fund managers) more likely to bolt at the slightest hint of crisis than investors whose principle goals are value and diversification (such as pension fund managers).

17. There is an important caveat. Good, comparable data on all of these categories is difficult if not impossible to unearth: the World Bank's annual *World Debt Tables*, which only started reporting non-debt capital flows such as FDI and portfolio equity in the 1990s, probably is the best source. Particularly difficult to measure with existing data is the distinction between public versus private recipients of commercial bank loans or portfolio flows: that is, easily available data sets do not clearly differentiate between my categories three and four, or five and six.
18. I thank Stefano Manzocchi for this point.
19. In what John Gerard Ruggie (1982) termed the 'compromise of embedded liberalism,' advanced industrial countries during the postwar decades extended to one another the privilege of deviating in their domestic economic regulatory regimes from the market liberalism they all espoused for the international economy. Thomas Callaghy (1989, 1993) points out that this privilege – which might be summarized as the right to selective domestic protectionism along with mostly free access to other rich countries' domestic markets – has never been extended to most developing countries. The exceptions have been those countries, such as South Korea or Taiwan, or Francophone Africa, that had strategic value for the most powerful advanced industrial countries (see also Stallings, 1995).
20. On neoliberal (also known as 'orthodox' or 'neoconservative') economic policies in Latin America, see Pastor (1992) and Foxley (1983).
21. Chase-Dunn and Bornschier (1985) detail some of the ways in which the presence of multinational direct investors skews the host country regulatory environment in a more conservative, neoliberal direction.
22. There also is pressure from global investors for capital-importing countries to construct regulatory frameworks consistent with norms in the advanced industrial democracies. See the chapters by Porter and Echeverri-Gent in this volume.
23. See, for example, the concerns expressed in Cerny, (1993) and Strange (1986).
24. O'Donnell (1973) hypothesized that the breakdown of previously existing democracy in Brazil in 1964, Argentina in 1966, Chile in 1973, and Argentina again in 1976 (after a three-year democratic interlude) came about because these societies already had passed through the 'easy' stage of import-substituting industrialization (ISI), during which period the usually combatitive forces of industrial capital and labor both could become wealthy together. The harder stage of ISI, in contrast, would require diversion of all the surplus created by industrial production into profits and new investment, leaving nothing available for added increments to workers' wages. Consequently, went the argument, authoritarianism was the only economically viable political system, because under electoral democracy, workers would demand concessions that inevitably would produce economic stagnation. Whether or not one accepts O'Donnell's explanation of the phenomenon, Latin America's experience during these decades definitely calls into question the assumption of mutually reinforcing and linear political and economic progress. See also Collier, ed. (1979).
25. Obviously, they are far from the first to raise this concern. However, their recent articulation of these somewhat familiar arguments stands out for its modulated tone, careful historical scholarship, and cross-regional empirical and theoretical investigation.
26. Their argument, while different in many particulars from that of O'Donnell referred to earlier, is not inconsistent with either his empirical observations or his theoretical explanation.

27. I thank Ben Ross Schneider for first bringing the 'optimistic hypothesis' to my attention.
28. The term was coined by O'Donnell (1973).
29. Some businesses, of course, have profits that mainly depend upon monopoly or oligopoly rents deriving from excessive government regulation with particular characteristics that favor their interests. Oligopolists dislike market liberalization at least as much as those who favor government intervention to redistribute income, protect the weak, or solve collective action problems. That is, my assumption of uniform policy preferences across the business community is a simplication of reality. On balance, it is usually true that the business community as a whole will prefer more of the neoliberal policy agenda than many other domestic political actors in developing countries. However, the greater the degree to which the activies of local big business community are fairly characterized by the term 'crony capitalism,' the fainter its likely support for truly free markets. (Of course, local oligopolists probably will dislike the policy agendas of leftist reformers even more.)
30. Individual big business-persons may well prefer mass democracy for altruistic and normative reasons; they also may associate democracy with modernity. There are plenty of empirical examples of such behavior, as in the business tycoons who secretly financed Mohandas Gandhi or Nelson Mandela.
31. The structural position, and consequent political preferences, of ambitious entrepreneurs in post-Communist regimes is more complex. They tend to be strong supporters of political democracy, which they, like many of their fellow citizens throughout the national class structure, rather unanalytically associate not only with political freedoms but also with the capitalist economic prosperity of the Western industrial democracies and Japan. The political attitude of business in many countries in Eastern Europe and the former Soviet Union is further complicated by the connections many new businesspersons have with the old Communist apparatchik class (who often have been the only group with sufficient capital to buy privatized state firms) and/or with criminal organizations (who ran the thriving underground 'capitalist' economy during the Soviet era).
32. Any group whose main political resource is sheer numbers (of potential voters) or good organizational skills (useful for building a strong, grass-roots political party base) benefits from a shift away from authoritarian political rules (which benefit an elite of some kind, whether membership in that elite is defined by heredity, loyal membership in the ruling political party, or control of the means of production) to the political rules of mass electoral democracy. Once again, my argument regarding the importance of 'labor' as a political actor is somewhat different – and rather more simplistic – than that of Rueschemeyer *et al.* (1992). It is not, I think, inconsistent with their analysis.
33. For a game-theoretic treatment of why this should be so, see Sturzenegger (1995). For evidence in the Latin American case, see Oxhorn and Ducatenzeiler (1998).
34. Social science researchers generally assume that human social systems, whether families or national political systems, assume patterns of behavior that, once regularized, tend to persist until upset by some crisis. See Stinchcombe, 1968.
35. An important caveat is that lower-income groups may be disproportionately benefited by an early end to inflation. See the chapter by Randall Stone in this volume and also Armijo (1998).
36. For a more skeptical view of the growth prospects of neoliberal economic reforms, see Przeworski *et al.* (1995).

37. However, preemptive market-oriented reforms (at some point followed by economic growth) might be preferable to waiting for an economic and political crisis before adjusting, thus potentially increasing both their eventual economic and political costs.

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