



## **The financial and economic crisis: some implications for democracy building**

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New York, 15 September 2009

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1. This paper explores the main implications for democracy building of the global challenges of the financial and economic crisis. The paper addresses three key issues for democracy building in light of the crisis:

- What lessons can be drawn for democracy building from previous financial and economic crises?
- What are the implications of the financial crisis for democracy and in particular democracy building?
- What is the role of democracy building multilateral actors in coping with the implications of the crisis?

### **I. The financial and economic crisis: key dimensions**

2. The financial turmoil that erupted in the USA with the emergence of the subprime lending crisis in August 2007 led in 2008 to the implosion of the US financial system. For the purpose of this paper, the date of 15 September 2008 is quite symbolic as it marked both the first-ever

celebration of the UN International Democracy Day, and the collapse of the Lehman Brothers, which precipitated the beginning of the worst financial crisis since the Great Depression of the 1930s.

3. The global financial crisis and the economic downturn have become key issues for national and international action. While existing global crises linked to energy, food and particularly climate change, are unlikely to disappear from the international agenda, the financial crisis and its broader economic effects are the main focus of current debates at the United Nations, the International Financial Institutions (IFIs) and international summits at different levels (G7/G8, G20, regional summits, etc).

4. **The crisis is both global and systemic.** Projections in May 2009 anticipated a contraction of the world economy by 2.6% in 2009, compared with an average rate of growth of more than 3% in the years prior to the crisis.<sup>1</sup> Signs of recovery in 2010 are already apparent, but risks of prolonged impacts of the recession are high. The Gross Domestic Product (GDP) of industrial countries has fallen at annual rates of 7% to 8% during the last quarter of 2008 and the first quarter of 2009. "After a sharp and synchronized global downturn in late 2008 and early 2009, the world economy has shown signs of stabilization entering in the second half of 2009 (...) The high unemployment rates and the large output gaps worldwide will continue to linger as the key downside risks for the global recovery."<sup>2</sup> The global financial crisis is expected to have a major impact on low-income countries, especially in sub-Saharan Africa. The IMF estimates that the crisis is projected to increase the financing needs of low income countries by at least \$25 billion in 2009, and much larger needs are possible.<sup>3</sup>

5. The implementation of national stimulus packages by advanced economies, and above all the USA, seems to have led to a preliminary recovery by the international financial markets from the immediate effects of the crisis. However, the medium and long-term impact of the crisis is unfolding in the economic and social spheres, with spillover effects in the political domain.

6. **Both emerging markets<sup>4</sup> and developing countries,<sup>5</sup> that at first seemed immune from the turmoil coming from the United States, are affected, though the impact differs greatly based on the context of each country and region.<sup>6</sup>**

7. For example, countries that had adopted export-led growth strategies and liberalized their capital accounts are suffering from the reduction of the aggregate demand of the nations to which they exported. These economies are experiencing the side effects of waning exports, a decrease in commodity prices, and declining domestic demand. The sharply rising food prices that contributed to the temporary success of some such countries produced a sudden and large fall in real wages and living standards while unemployment was on the rise. Emerging markets and developing countries are coping with the same vicious circle that is affecting the developed nations: their weakening economies are interacting with weaknesses in their financial systems.<sup>7</sup>

8. In particular, **the social costs of the economic downturn fuelled by the financial crisis are among the long-lasting consequences that may impact political stability, both in democratic countries and authoritarian regimes.**

9. As the economic crisis deepens, the social costs are also becoming more evident. The exposure and impact varies across regions, countries and sectors but according to the UNDP “it is becoming more apparent that what started as a financial crisis is turning into a human development crisis.”<sup>8</sup>

10. The World Bank estimates that in 2009 an additional 46 million people will fall into extreme poverty, i.e. in addition to the 1.5 billion people who already live on just over one dollar a day. The principal transmission channels will be via employment and wage effects as well as declining remittance flows. Developing countries face the challenge of how, with fewer resources, “to pursue policies that can protect or expand critical expenditures, including on social safety nets, human development and critical infrastructure.”<sup>9</sup>

11. In addition, experience from past crises suggests the potential for a slowdown in progress in reaching the MDGs.<sup>10</sup> The IMF and the World Bank expressed the fear that the global crisis would deter emerging and developing economies from meeting the MDGs targets by 2015. Especially the achievement of the first goal (MDG-1) on halving extreme poverty by 2015 from its 1990 level is at risk. For developing countries as a whole, growth is now projected to fall to 1.6% in 2009, from an average of 8.1% in 2006 and 2007. Growth in sub-Saharan Africa is projected to slow to 1.7% in 2009 from 6.7% in 2006 to 2007.<sup>11</sup>

12. The International Labour Organization (ILO) estimates that a rise in unemployment in 2009 could reach more than 50 million, compared to 30 million in 2007, if economic conditions continue to deteriorate. They estimate also an increase of up to 200 million in the number of working poor, principally in developing countries.

13. **The gender dimension of the crisis should be addressed**, with women constituting the majority of the poor. Estimated impacts of the crisis will include in both developed and developing economies: gendered employment effects; gender norms and employment (i.e. women will likely lose their jobs before men); gendered welfare effects (particularly in developed and middle income countries); income shocks and children, especially in female-headed households (in terms of education, health, etc.); and ethnic inequality (immigrants—rather than nationals—will lose their jobs first).<sup>12</sup> The gender dimension of the crisis should be part of any dialogue on reforms both at the national level (stimulus packages, social infrastructure spending, gender responsive budgeting, etc.) and at the international level (for example, the reform of the international financial institutions).

14. **While the economic and social implications of the financial crisis are being extensively analyzed, little research has been carried out on its impact on democracy—and the capacity of democracies to**

**cope with fallout.** This is worrying, as the international and domestic political implications of the crisis should not be underestimated.

15. This overview will centre the analysis of the implications of the crisis for democracy building on three questions:

- Are lessons from previous crises relevant to the current situation?
- What is the impact of the crisis on democracy building?
- What is the role for international actors at global/regional levels?

## **II. Lessons for democracy building from previous crises**

16. Some authors addressed the democracy dimension of the impact of the financial crises of the 1990s.<sup>13</sup> However, the extent to which such lessons are relevant to the current crisis is limited, as their scale, depth and context is different. Every crisis is unique, and lessons from past crisis responses cannot yield precise guidance for delivering effective crisis support today. They can, however, point to crucial factors that may make a difference to the effectiveness of today's response. Brower and Carothers summarized three research findings on the political effects of previous crises:<sup>14</sup>

- Not only the great majority of past economic crisis did not lead to regime change, but it often did not even bring about a change of government;
- Democracies have been more resilient against the destabilizing effects of economic crises than nondemocratic regimes, with the exception of one-party authoritarian regimes;
- When regime change did take place, several other factors increased the likelihood of economic crisis leading to it.<sup>15</sup>

17. From a **democracy perspective** and contrary to the widespread perception that democratic systems may be slower in responding to financial crises, a recent study shows that more voices in the political process do not obstruct the level of speed required by the financial markets.<sup>16</sup> In other words, the constraints on executives posed by democratic systems of institutional checks and balances would allow for formal and credible choices that do not slow down the policymaking process and lead to better economic outcomes.

18. Among the most important lessons from previous financial crises are:

- The importance of understanding institutional incentives in the design of policy responses; and
- The fact that short-term responses to a crisis—macroeconomic stabilization, trade policies, financial sector policies and social protection—cannot ignore longer-term implications for both economic development and vulnerability to future crises.

19. From a **democracy building perspective**, lessons from the Asian financial and economic crisis of 1997-1999 revolve around the notion of democratic governance, particularly on establishing and strengthening

mechanisms to ensure transparency, accountability and effective anti-corruption. Stephan Haggard analyzed the impact of the crisis on six administrations in four East Asian countries: South Korea, Thailand, Malaysia and Indonesia. His conclusions are that the economic crisis of 1997-1999 accelerated existing trends for democratic progress in the region, by contributing to “a change of regime in Indonesia, to a strengthening of political opposition elsewhere, and to growing pressures for changes in regulatory regimes and in the social contract.”<sup>17</sup>

20. As noted by Amartya Sen, two general lessons can be drawn from the Asian financial crisis.

- The first one is related to the links between the undemocratic nature of the governments and the “unquestioned acceptance of nonaccountability and nontransparency, often reinforced by strong family links between the government and the financial bosses”.
- The second lesson is related to the fact that, following the evolution of the financial crisis in a general economic recession, “the protective power of democracy—not unlike that which prevents famines in democratic countries—was badly missed. The newly dispossessed did not have the hearing they needed.”<sup>18</sup>

21. The **two elements—preventive and protective**—of Sen’s argument on the role of democracy in financial and economic crises are inter-related. On one hand, when democratic public spaces are weak, their weakness contributes to fuelling a financial crisis by means of absence of transparency and accountability. On the other hand, because of that very weakness, the most vulnerable population—especially “the unemployed and those newly made economically redundant”—do not have a voice when the impact of the economic crisis is unequally shared within the society.

### **III. Implications for democracy building**

22. We may consider that the current crisis is related, to some extent, to democracy deficits. The background to the crisis is a tendency of financial markets to bypass transparent, democratic procedures, coupled with the increasing influence of powerful lobbies capable of getting disproportionate privileges from the system, while the costs of recovery of the system failure will have to be borne by the public at large.<sup>19</sup> The financial and economic crisis may also undermine, together with the credibility of free-market capitalism, some values usually associated with Western models of liberal democracy, and with democracy in general, especially in emerging economies with fragile democratic institutions.

23. The latest Economist Intelligence Unit’s (EIU) Democracy Index shows that by comparing the results in 2008 and those of 2006, the dominant pattern is one of stagnation. While the actual impact will depend on the depth and length of the economic recession, according to the EIU,<sup>20</sup> nations with a weak democratic tradition may be vulnerable to setbacks over the

next few years. There are “several ways in which democracy could be adversely affected:

- Economic recession could boost extremist political forces in Western Europe, and is also likely to feed anti-immigrant sentiment (...).
- Many non-consolidated democracies are very fragile and if subject to intense socio-economic stress, backsliding on democracy is possible (...).
- The shallowness of democratic cultures (...) also underscores the fragility of many democracies and the potential for reversals.
- Serious recessions typically threaten democracy via increased social unrest (...).
- The financial and economic crisis may increase the attractiveness of the Chinese model of authoritarian capitalism for many emerging markets.
- Democracy promotion by the Western world was already discredited by the experience in the Middle East over recent years. The economic crisis is likely to further undermine the credibility of efforts by developed nations to promote their values abroad”.

24. At the most general level, we can already witness changes in the perceptions of democracy per se and in the perceived linkages between democracy and actors such as the state, the private sector, civil society, political parties and legislatures, in their oversight function *vis-à-vis* approval and control of compliance with regulation, and broader national development strategies. Two key dimensions of the debate are:

- The role of political institutions in coping with the crisis; and
- The advantage of democracy in dealing with the crisis.

### *III.1. What is the role of political institutions in coping with similar crises?*

25. Certain authors have noted that emerging **short-term political risks** associated with the current crisis include **rising nationalism and political tensions** that can pose a challenge to governments in both emerging economies and developing countries. “Nationalism is clearly on the rise, and is leading to a resurgence of protectionism under different guises... Mounting political tensions within countries will also be the rule rather than the exception, stressing the capacity of democratic regimes to process conflict in an institutional way.”<sup>21</sup> Other authors stressed that, given the high vulnerability of some emerging markets to financial implosion, there is a risk of major geopolitical instability “because many of these vulnerable countries lie on political fault lines. Such crises help promote anti-Western reactions, including militant forms of Islamic fundamentalism.”<sup>22</sup>

26. There are different and sometimes contradictory views on the implications of financial crises for **long-term economic growth**. Some authors believe that crises have adverse consequences for growth because of increased volatility; others believe that financial crises provide opportunities for the design and implementation of important reforms. The contexts in

which economic crises occur, especially the institutional context, is important for assessing whether they are instrumental for long-term growth. Among other factors, this may depend on the type of political institutions in place, and the political compromises that different institutional setting produce. Incentives and constraints faced by local political actors shape policy responses at the time of crisis.

27. According to Cavallo and Cavallo,<sup>23</sup> **democratic political systems are more prone than others to deliver good policy responses** that help to correct past policy mistakes, learn from the crises, and improve long-term growth. They argue that stronger democratic institutions can greatly mitigate the negative effects of crises on long-term growth, while autocratic governments typically amplify the negative outcome of crises. Higher levels of government constraints also have a positive impact on growth through their interaction with crises. More regulated political participation provides a more structured public space for political discussion at times of crisis.

28. A policy implication of this position—relevant to the argument of this paper—is that while countries with solid democratic institutions and stronger checks-and-balances may welcome crises as opportunities to enhance growth, countries with weak political institutions would face severe political constraints in coping with crises. And yet, in the past external actors have pushed reform packages on such countries in exchange for the aid needed to cope with the crisis. The results have been mixed.

29. **Democratic institutions play a vital role in enhancing the accountability of governments to the citizens as far as policy responses are concerned.** As the World Bank puts it, “the speed and scope of government intervention are affected by political economy factors. While countries with competitive elections are no less likely to experience financial crises, in the event of a crisis they are likely to intervene more rapidly in insolvent institutions. The fiscal transfers they require to resolve a crisis typically are 10-20% of GDP less than those made by countries lacking competitive elections. They also suffer far smaller growth collapses. The reason that there is no difference in the likelihood of a crisis is that asymmetric information is so great in banking regulation that voters cannot hold politicians responsible for bad decisions prior to the crisis. However, once the consequences of failed regulation become large and visible, politicians exposed to elections are more likely to address them in a way that serves the public interest in their crisis response; for example, they are less likely to prop up existing owners and they are less likely to subsidize large creditors who should have known better.”<sup>24</sup>

30. From this perspective, both political parties and legislatures will play an important role. As to the role of **political parties**, the economic downturn represents a major challenge to the credibility of actors that already garnered—before the financial crisis—low levels of public confidence in polls across the various regions of the world. On the ideological side, the crisis has requested governments and coalitions with different orientations to adopt measures that strengthen the role of the state in the economy. On this issue

**traditional ideological divides are blurred** as a result of the adoption of stimulus packages and other economic measures to face the consequences of the economic downturn. Among some notable trends at the national level, countries like Iceland, heavily hit by the financial crisis, show the emergence of new political parties with an anti-establishment platform.<sup>25</sup> In countries like Hungary, whose economic downturn was only highlighted—not caused—by the financial crisis, existing parties are tempted by populist agendas that would delay economic and public sector reforms.<sup>26</sup> In countries like Venezuela and Bolivia, the financial crisis provides rhetorical ammunition to **populist leaders** who interpret it as a sign of the structural weaknesses of global capitalism. On the resource side, the regulatory measures that will be strengthened and enforced at the national and international level to prevent future crises will have consequences in terms of increased transparency in the **funding of political parties**.

31. **The importance of domestic politics** in dealing with the financial crisis is confirmed by the fact that stimulus packages, direct intervention in financial institutions, and regulatory reforms are among the main instruments used by governments in coping with the impact of the crisis. In particular stimulus packages typically go through legislatures, where the policy debate is driven by domestic issues. The scope for sound parliamentary action is wide.

32. The different impact of the economic downturn on people living in extreme poverty and people who, emerged from poverty, face the risk of falling back into poverty as a result of the crisis, should be analyzed. In particular, the impact of the crisis on **the middle class** in emerging economies will be crucial for future democratization prospects and democracy consolidation trends in those countries.<sup>27</sup>

33. We will analyze these issues in the next section, in the broader context of how different political systems may manage the possible social unrest and crisis of consensus potentially associated with the economic crisis.

### *III.2. Does democracy provide an advantage in dealing with the crisis?*

34. The current crisis has raised concerns among some advocates of democracy promotion. The concerns stem from the emphasis, placed by many specialists on democratization, particularly from North- and West-based institutions, on free markets as an essential factor for democracy. This is also linked to the perception by some authors of a global identification of democracy with free markets and capitalism. From this perspective, the financial crisis would possibly discredit liberal politics and liberal models of democracy. Another element of concern is the worry of the political risks of a second Great Depression and its possible negative impact on the quality of democratic institutions and processes, based on the historical precedent of the political impact of the Great Depression of the 1930s.

35. Countering these positions, some democracy promoters make a case for the advantages of democratic regimes over authoritarian ones, in coping with the consequences of the crisis. According to Plattner, the economic crisis

could potentially bring “global gains for democracy, largely because of its impact on democracy’s competitors.”<sup>28</sup> From this perspective, states that embrace so-called ‘authoritarian capitalism’ (like China, Russia, and Iran) and that achieved economic success without providing political freedom, would suffer from the fallout of the crisis because they would face the challenge of ‘performance legitimacy’, at a time when they would be obliged by the crisis to decrease their delivery of economic goods. Since authoritarian states, unlike democracies, are unable to change their governments via elections without changing their regimes, in the short term they would be more vulnerable than their democratic counterparts.

36. Other democracy promoters stress the challenge posed to authoritarian regimes by social unrest fuelled by the most critical part of middle-class citizens hit by the crisis. According to Kurlantzick, for example, since ‘authoritarian capitalism’ retains power on the basis of an implicit bargain with the broad middle class whereby economic welfare compensates for lack of freedom, an economic downturn would turn unemployed workers or migrant workers into a major threat to the regime in countries like China.<sup>29</sup>

37. The counterargument is based on the role of China in the financial crisis, and its political implications. According to Ann Pettifor, “the result of deregulation (i.e. “globalisation”) in the 2000s was and is that capital can flow free and untrammelled around the world. The accompanying collapse of the Bretton Woods system (which contained mechanisms for curtailing the growth of imbalances between nations) meant also the growth of large balance-sheet contrasts (massive deficits in the United States and Britain, huge surpluses in China and Japan, for example). The countries in surplus—China most of all—exported their excess capital to the US.”<sup>30</sup> The foreign-exchange reserves of China are more than \$2 trillion, out of which about \$1.5 trillion has been invested in US assets, mostly US government debt or US government guaranteed debt.<sup>31</sup> According to some authors, China could even lead a new international “Beijing Consensus,”<sup>32</sup> as a key player in the reform of the international financial system.

38. In fact, some analysts<sup>33</sup> argue that despite the media attention on the possibility for social unrest in China, the country will remain stable for 2009. Unlike other economies, which face negative growth rates of their GDP as a consequence of the economic downturn, China coped with six consecutive quarters of slowing growth. China's growth rate for the third quarter of 2008 was 9%, the slowest rate that China had seen in five years. In the first quarter of 2009 China's growth rate fell to 6.1%, the lowest rate in over a decade, and far below to the double-digit growth rate that the country needs in order to create 10-12 million new jobs each year. The crisis already impacted net exports, one of the three pillars of Chinese growth in the last decades. If the economic slowdown will impact the second pillar, i.e. domestic consumption (both private and public), then prospects for fueling Chinese growth would mainly focus on the third pillar—domestic investment—more than it had in the past. An expected impact of the crisis in

China, mainly via the reduction in exports, is an estimated 30 million unemployed, many of them economic migrants without affordable housing. However, the Chinese Communist Party leadership can count on a political capital built over thirty years of impressive economic growth. Risks for the party *élite* are spread more in the medium- to long-term, and they relate to the social and environmental contradictions of the growth model implemented in these decades, like its growing environmental impact, the widening inequality gap between the rich and the poor, and the future challenges associated with an aging population.

39. According to George Soros,<sup>34</sup> China will emerge sooner from the financial crisis than Western economies, and their influence on the world will increase to an extent Western countries are not prepared for, because the Chinese model—undemocratic as it is—is better suited to deal with this particular crisis. Though heavily hit by the export collapse and the signs of social unrest, like more than 50,000 social demonstrations a year, Chinese rulers realize that, precisely because of the limitations on rights and democracy, they have to deliver economic prosperity. Given the power of the Chinese state in the economy and since there is no freely-elected parliament to go through to pass legislation on stimulus packages, the government can more easily than in other countries ensure that domestic investments fuel economic growth. An indicator of the difference of the Chinese model of state capitalism is the surge in bank lending in China, where most of the banks are government owned, even as credit in the rest of the world has tightened dramatically.

40. An indicator of the role of states in the global economy worldwide is the growing importance of Sovereign Wealth Funds (SWFs), i.e. state-owned investment funds that act globally. Some SWFs played a role in the financial crisis, either by making investments in several Wall Street financial firms (including Citigroup, Morgan Stanley and Merrill Lynch), or by denying bailouts to Lehman Brothers.<sup>35</sup> In late 2007 and early 2008, mainly because of the surge in the price of oil and other commodities, many SWFs increased their value. At the beginning of 2008, the total assets of SWFs, estimated at \$3 trillion, doubled the \$1.5 trillion managed by hedge funds worldwide. However, their value was far below the \$53 trillion managed by institutional investors like pension funds and endowments.<sup>36</sup> Out of the 10 biggest non-pension SWFs, only one is owned by an established democracy (Norway).<sup>37</sup>

41. The rise of SWFs could, in theory, be broadly positive in terms of both more efficient government investment, capital inflows for the countries in which investments are made, and sustainable long-term capital growth for resource-exporting countries. However, concerns about SWFs have been raised, including on their political dimensions in foreign relations, especially whether governments will use them simply as a financial tool or, in what is at the moment a purely hypothetical case, in pursuit of political objectives. As Ian Bremmer stressed, “Like all investment funds, SWFs look to maximize returns. But for state capitalists, these returns can be political as well as economic.”<sup>38</sup> This and other concerns (like the risk of mismanagement of international investments, potential incentives towards financial

protectionism in the host countries, potential SWFs contribution to market turmoil and uncertainty, etc.) pushed for greater international regulation of SWFs. In this context, the recent establishment of an International Forum of Sovereign Wealth Funds<sup>39</sup> should be considered as a step in the direction of establishing an internationally voluntary agreed set of best practices. In a democracy building perspective, the key issue is whether countries with SWFs “design and embrace best practice for these funds to enhance their accountability to citizens of the countries with the funds as well as to the citizens and markets in which they invest.”<sup>40</sup> In fact, the effectiveness of voluntary arrangements at reaching higher levels of transparency and consistency in SWFs will always depend on the will of the political leaders who control the funds.

### *III.3. What would the likely impact on democracy be at the regional level?*

42. The different impact of the financial and economic crisis at the regional level is linked to the conditions of national contexts, both across and within regions. The following paragraphs summarize preliminary findings on regional trends, based on initial assessments made by multilateral and regional organizations.

43. According to the projections of the ECLAC, IADB and the World Bank, the impact of the financial crisis on **Latin America** will include a negative growth (−0.3%) of the GDP; a reduction in the export (by about −15%) and prices of commodities (by about −35% for oil, copper and zinc, and −28% for agricultural produce); a reduction of remittances (by 5-8%) from migrants—especially from the USA—and possibly a return of migrants who lost their jobs in the host countries; rising unemployment rates (from 7.3% in 2008 to 8.3% in 2009); a fiscal crisis of the most vulnerable countries, which will be unable to implement counter-cyclical policies; reduction in the access to international credit, reduction in foreign direct investment, and contraction of the tourism sector.<sup>41</sup> The fluctuation of the prices of oil, minerals and commodities, while affecting some countries, actually favors others. If the economic crisis will not worsen or expand over time, and the IMF already suggests that countries like Chile and Brazil are on the verge of starting their recovery, threats to the sustainability of democracy in the region, or major political crises, will be unlikely.

44. Impacts in the region can be disaggregated at least at three levels:

- Democracy as a system: The crisis is not likely to threaten the sustainability of democratic institutions and processes;
- Governability: There are some concerns for a crisis of governability, which would result from social unrest due to the cascade effect of the financial, economic and social crisis, all closely inter-related; and
- Political trends: Impacts at the country/sub-regional level in terms of the results of the electoral cycle 2009-2010 may differ, especially as regards the possible strengthening of nationalist or populist trends. In this

perspective, the electoral cycle could represent a means for channeling social and political conflict.

45. The greatest concern is determined by rising unemployment and the negative impact on social development, and in particular on social services, poverty reduction, inequality and policies in support of the MDGs, which would mean a backlash on the achievements reached in the last five years.

46. In **Africa**, the financial crisis will reverse the recent achievements by African countries in raising growth rates. According to African Development Bank (AfDB), real GDP growth is expected to slow to 4.6 percent in 2009 from 6.2 percent in 2007. Data for the first quarter of 2009 show that the crisis has severely hit some African countries, like Botswana and Cameroon. However, some "more encouraging figures and leading indicators suggest that the bottom of the downturn has probably been reached", especially for countries like Kenya, Egypt and Malawi, which registered positive year-on-year growth rates<sup>42</sup>. Between the first and second quarter of 2009 unemployment data give a mixed picture, with unemployment stable in South Africa at 23.5% while it decreased in a country like Morocco from 9.6% to 8% due to job creation in the agricultural sector.

47. As noted by Shimelse Ali<sup>43</sup>, "the impact of the financial crisis has been transmitted to African economies not through the credit crunches and liquidity freezes that are currently strangling advanced and emerging economies, but rather through the global recession that followed." The reduction in growth will impact on people living in poverty and those who are more vulnerable to economic volatility as they are clustered just above the poverty line.

48. For average Africans, who have not broadly prospered despite several years of good macroeconomic performance, the negative effects of the financial and economic crisis on livelihoods are likely to be abrupt and unsettling, with many countries expected to experience increased protest and political pressure on governments to furnish stronger social support. For some countries, the consequences could be more disruptive, as violence and opposition intensify. Political turbulence is likely to accompany the economic downturn.

49. The current economic crisis carries significant implications for democracy and governance assistance by major donors. African countries will confront further problems of managing distressed economies, and many will face new risks to the stability of fragile democracies. Economic governance and democratic resilience pose major challenges throughout the region. For donors, a central predicament will be to respond effectively to Africa's economic and political disruption even as OECD governments face increased domestic resource constraints and ambivalent political commitment.

50. Economic difficulties for donor countries are likely to encourage reductions in overseas assistance, yet the global crisis makes it all the more important to sustain support for African political reform and democratic development. Countries in economic distress require sound economic

management, effective policy responses to popular discontent, and stable institutions to foster growth and social provisions. Donors can best respond by preserving and strengthening existing programs to support governance reforms, and by devoting greater political and diplomatic resources to the management of governance challenges in the region.<sup>44</sup>

#### **IV. Role of multilateral actors at global and regional levels**

51. The financial and economic crisis has already impacted ordinary citizens in all regions of the world. They will ultimately pay the bill for the multi-billion bank bailouts, for example through higher taxes, less spending on public goods other than financial stability, and therefore fewer public services for people at a time of greatest need during a recession, the threat of unemployment, and delayed achievement of the MDGs.

52. In the last months a series of international conferences, summits and expert meetings highlighted the role of national and multilateral actors in the crisis. These involved the UN, IFIs, regional organizations, global policy fora like the G20—and in particular the summit held on 2 April 2009 in London<sup>45</sup>—and international organizations like the Inter-Parliamentary Union (IPU) and the Club de Madrid.<sup>46</sup> The meetings addressed both how to respond to the immediate consequences of the crisis and to address the systemic flaws that made its unfolding possible.

53. On 4-5 April 2009 the UN System Chief Executives Board for Coordination (CEB) adopted a plan of action on nine joint initiatives in the fields of: finance; trade; employment, production and aggregate demand; environment; food security; social services, empowerment and social stability; international cooperation for development; monitoring and analysis.<sup>47</sup> The plan contains some innovative ideas (like a Global Jobs Pact, a Green Economy Initiative, and a Social Protection Floor). Their success will depend on the availability of additional resources and a combination of commitment at the national level by all the domestic political actors, and at the international level by regional and global actors. A key recommendation of the plan concerns the confirmation or increase of donor commitments with regards to Official Development Assistance (ODA).

54. All UN specialized agencies, funds, programmes and entities are assessing the impact of the financial and economic crisis on their operations. For example, the UNDP has established an internal monitoring mechanism whose main findings can be accessed online.<sup>48</sup> The G20 called on the UN to establish an effective mechanism to monitor the impact of the crisis on the poorest and most vulnerable.<sup>49</sup> The UN System CEB action plan proposed a monitoring and analysis initiative, led by the IMF and the UN Department of Economic and Social Affairs (DESA), to strengthen macroeconomic and financial surveillance and implement an effective economic early warning system; and to establish a UN system-wide vulnerability monitoring and alert mechanism to track developments and report on the political, economic, social and environmental dimensions of the crisis.<sup>50</sup>

55. Current policy debates focus on responses to the crisis and the need for a new international financial architecture. Out of the many political and technical issues addressed in this debate, we will focus on three aspects that are crucial for democracy building:

- How to **ensure that both national and international responses take into account the role of political institutions and democratic processes** in coping with such crises;
- How to **reform the international financial architecture by focusing on accountability and transparency mechanisms**, in a way that would help prevent the occurrence of future crises; and
- How to make **oversight** of the implementation of regulatory frameworks more effective at the national level, by involving other actors than the executive.

56. Interestingly, the above aspects revolve around the two dimensions of Amartya Sen's argument on lessons drawn for democracy from the Asian financial crisis of 1997-1998: the **protective and preventive functions of democratic institutions and practices**.

57. Miguel D'Escoto Brockmann, President of the 63<sup>rd</sup> Session of the UN General Assembly, convened a Commission of Experts on Reforms of the International Monetary and Financial System chaired by Joseph Stiglitz. The Commission recommended ten immediate measures and ten systemic reforms.<sup>51</sup> Among the **immediate measures**, some are directly or indirectly related to the quality of democratic processes at the domestic level, like the inclusion in national stimulus packages of spending measures to be undertaken in developing countries to offset the impact of the decline in world trade and financial market disintermediation, in addition to meeting the traditional Official Development Assistance commitments. The Commission called also for greater policy space for developing countries, in particular to address the contradictory attitude of the IFIs in previous financial crises, when they encouraged—or induced—developing countries to pursue pro-cyclical policies (at the same time developed countries pursued counter-cyclical policies). In fact, conditionalities attached to official lending and support had often required developing countries to adopt the kinds of monetary and regulatory policies which contributed to the current crisis. The Commission invited governments to assess the redistributive consequences of bailouts to consider their impact on recovery, and called for appropriate parliamentary oversight of appropriations.

58. As for **systemic reforms**, the Commission confirmed the need to reform the governance of the Bretton Woods Institutions and other non-representative institutions, like the Financial Stability Forum, that have played a role in the global financial system, including by giving greater voice to developing countries, ensuring greater transparency to the IFIs' decision-making processes, and adopting an open democratic process for the election of the leaders of the IMF and the World Bank. The Commission proposed also the establishment of a new Global Reserve System to contribute to global

stability, economic strength, and global equity. The Commission suggested also that a globally representative forum to address areas of concern in the functioning of the global economic system be established, for example by creating a Global Economic Council within the United Nations, to assess developments and provide leadership in economic, social and ecological issues.

59. Any **reform of global governance mechanisms** will have to address the challenge posed by the relative weight and capacity of traditional donors and external actors to influence democratic reforms and change in a situation in which a player like China is increasingly becoming a global banker and is on the way of acquiring an increased role in the governance of the IFIs.

60. The UN hosted a World Conference on “The World Financial and Economic Crisis and Its Impact on Development” in New York on 24-26 June 2009. The main recommendations adopted in the outcome document were the creation of an open-ended working group of the UN GA on the theme of the Conference and the suggestion that the UN Economic and Social Council (ECOSOC) establish an ad-hoc panel of experts to advice on the crisis and its impact on development. The Conference stressed the need for inclusiveness in the debate on the reform of the IFIs, as opposed to an international action led by “smaller ‘clubs’ of the international system that operate independently of the UN—the G8, G8+5 and G20, for example—[that] have less legitimacy but are able to agree on things and deliver accordingly.”<sup>52</sup>

61. The reform of the international financial architecture has been on the international agenda for a while. In the last years the need for a new global governance emerged in order to manage two converging trends: the ascent of emerging economies, and in particular the so-called BRIC (Brazil, Russia, India, and China), and the relative decline of both the US and Europe in the economic arena. The financial and economic crisis catalyzes the plea for an urgent reform of the international financial institutions and responds now also to the need of creating new global mechanisms for effective oversight and control of the global financial system. In Paul Krugman’s words, we have to “relearn the lessons our grandfathers were taught by the Great Depression”, along with a basic principle: “anything that has to be rescued during a financial crisis, because it plays an essential role in the financial mechanism, should be regulated when there *isn’t* a crisis so that it doesn’t take excessive risks.”<sup>53</sup>

62. In terms of **oversight**, as noted at the recent IPU Parliamentary Conference on the Global Economic Crisis, the agenda for national and regional **parliaments** includes a wide range of issues, including: “helping governments design better counter-cyclical policies, particularly in the fiscal area; designing better social protection systems and incentives to keep existing jobs and create new ones, to manage the social effects of the crisis; guaranteeing the transparency of financial bailouts; helping avoid the resurgence of protectionism; improving financial regulation; strengthening international cooperation and helping in the design of a better structure of global and regional economic governance.”<sup>54</sup> Much closer parliamentary

interaction with the international financial institutions should be ensured so as to exercise greater parliamentary oversight.

63. An important dimension of the debate on oversight will be the conditions for **the creation of political space on financial regulation**. Such space would require more stringent regulatory frameworks, and the introduction of mechanisms that would constrain the political power of the financial industry. Examples include the increase of the accountability of central banks to democratically elected officials, and of public officials in economic policy positions, and the adoption of measures to limit the size of the financial industry.<sup>55</sup> This is a very critical issue, as it could conflict with widely accepted practices, like the deregulation of the financial sector in the last decades, or fundamental principles, like the central banks' independence of political control. The preservation of the independence of central banks from the possible manipulation by a political party, or a coalition of parties, is certainly an important principle. However, it is equally important to avoid that the action of central banks is influenced by vested interests in the financial sector.

64. In conclusion, many analysts commented on the fact that the current crisis does provide some opportunities alongside the serious challenges that we have analyzed above. It should be noted that such opportunities should not reinforce the systemic conditions that led to the crisis; they should rather be opportunities for change. As noted by Saskia Sassen, "the financial "crisis" could serve as one of the bridges into a new type of social order. It could help all involved—citizens and activists, NGOs and researchers, local communities and networks, democratic governments—to refocus on the work that needs to be done to house all people, clean our water, green our buildings and cities, develop sustainable agriculture (including urban agriculture), and provide healthcare for all."<sup>56</sup> Since democratic processes are about making change possible within a framework of shared democratic values and through democratic processes, there is an enormous scope for the action of democracy building practitioners and institutions aimed at turning such opportunities into reality.

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<sup>1</sup> UN DESA, *Monthly Briefing on the World Economic Situation and Prospects*, No. 8, Global Economic Monitoring Unit, Development Policy and Analysis Division, Department of Economic and Social Affairs, 7 May 2009.

<sup>2</sup> UN DESA, *Monthly Briefing: World Economic Situation and Prospects and Monitoring of Global Vulnerability*, No. 11, Global Economic Monitoring Unit, Development Policy and Analysis Division, Department of Economic and Social Affairs, 12 August 2009.

<sup>3</sup> IMF, 2009, *The Implications of the Global Financial Crisis for Low-Income Countries*, International Monetary Fund, Washington DC, March 2009.

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- <sup>4</sup> As noted by the World Bank, “evidence of the toll that the financial crisis is having on middle-income countries is mounting. Growth prospects for emerging market and developing countries have been revised downward by a similar magnitude as for advanced economies”. The report notes in particular that Latin America’s prospects “are closely tied to those of the United States, with the impact being felt through a variety of channels including declining remittance flows”. See World Bank, *Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis*, Background Paper prepared by World Bank Staff for the G20 Finance Ministers and Central Bank Governors Meeting, Horsham, United Kingdom on 13-14 March 2009.
- <sup>5</sup> Stephany Griffith-Jones and José Antonio Ocampo, *The Financial Crisis and Its Impact on Developing Countries*, Poverty Reduction Discussion Paper PG/2009/001, UNDP, New York, January 2009.
- <sup>6</sup> “The most direct channel linking the developed world to the financial crisis emanating from the developed world in 2008 is through exposure to assets that are at the heart of the crisis, notably (though not only) the sub-prime mortgages. However, the more important channels for most developing countries will probably be indirect, notably through trade (via declining demand for developing-country exports or declining export process, including commodities), investment (as external finance contracts) and remittances (also stemming from the recession in the developed world)”. See World Bank, *Lessons from World Bank Research on Financial Crises*, Policy Research Working Paper 4779, Development Research Group, The World Bank, November 2008, Washington DC, page 4.
- <sup>7</sup> Christopher Rude, *The Global Financial Crisis: What Needs to Be Done?*, Friedrich-Ebert-Stiftung, Initiative for Policy Dialogue (IPD), New York, November 2008.
- <sup>8</sup> See: [http://www.undp.org/economic\\_crisis/overview.shtml](http://www.undp.org/economic_crisis/overview.shtml).
- <sup>9</sup> World Bank, *Swimming Against the Tide...*, 2009, page 1.
- <sup>10</sup> World Bank, *Swimming Against the Tide...*, 2009, page 10.
- <sup>11</sup> World Bank and IMF, *Global Monitoring Report 2009: A Development Emergency*, The World Bank, Washington DC.
- <sup>12</sup> Stephanie Seguino, “The Global Economic Crisis, Its Gender Implications, and Policy Responses”, Paper prepared for “Gender Perspectives on the Financial Crisis” Panel at the Fifty-Third Session of the Commission on the Status of Women, United Nations, New York, 5 March 2009.
- <sup>13</sup> Such crises include the 1994-1995 crisis in Latin America that hit in particular Mexico and Argentina, the 1997-1999 Asian crisis in Thailand, Malaysia, Indonesia and South Korea, the crisis of the 1990s in Japan, and the Argentina crisis in 2002.
- <sup>14</sup> Julia Brower and Thomas Carothers, “Will the International Economic Crisis Undermine Struggling Democracies?”, Web Commentary, Carnegie Endowment for International Peace, April 28, 2009, at [http://www.carnegieendowment.org/files/economic\\_crisis\\_political\\_change\\_2.pdf](http://www.carnegieendowment.org/files/economic_crisis_political_change_2.pdf).
- <sup>15</sup> These factors included “weak internal cohesion among the ruling elites prior to the crisis, weak civilian control over the military, domestic conflicts—such as ideological polarization, labor unrest, and challenges from insurgency movements—and in the case of authoritarian regimes, the existence of a moderate and credible opposition movement.” (Brower and Carothers, “Will the International...”, page 2).

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- 30 Ann Pettifor, "America's Financial Meltdown: Lessons and Prospects", *Open Democracy News Analysis*, 17 September 2008, [www.opendemocracy.net](http://www.opendemocracy.net).
- 31 According to Krzysztof Rybinski, "nowadays Chinese leaders can crash the dollar and send the US economy into a tailspin recession with just one comment—namely that China will stop buying dollars." See Krzysztof Rybinski "A new world order", *Open Democracy News Analysis*, 31 March 2009, [www.opendemocracy.net](http://www.opendemocracy.net). Though this is a purely hypothetical scenario in the short- and medium-term, it should not be forgotten that China promoted a debate ahead of the April 2009 G20 summit in London on the creation of a new reserve currency, to eventually replace the US dollar as the global benchmark.

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- 46 In its Barcelona Declaration of 26 March 2009, the Club de Madrid called for a strong and timely public sector response, by placing the social costs of the crisis at the centre of macroeconomic policy packages, and correcting the regulatory deficit. It called also for supporting emerging and developing countries' economies by recapitalizing the IMF and the major multilateral banks, and reviewing the conditionalities previously imposed on developing countries for accessing IMF resources.
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- 48 See [http://www.undp.org/economic\\_crisis/overview.shtml](http://www.undp.org/economic_crisis/overview.shtml).
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