



International IDEA

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and Its Impact on Development**

**The Democracy Building Dimension of the Financial and
Economic Crisis**

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Mr. President, Excellencies, Ladies and Gentlemen,

The date of 15 September 2008 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.

While different trends are emerging, it is difficult to be conclusive on the real impact of the crisis on democracy building at this early stage. Notwithstanding, the crisis provides an opportunity for reform but this will also depend on the quality of the political institutions and how deep democratic practice and culture has permeated a given country or region.

The crisis is both global and systemic. The implementation of national stimulus packages by advanced economies, and above all the USA, seems to have led to some preliminary signs of 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.

Both emerging markets and developing countries that at first seemed immune from the financial turmoil erupted in the United States, **are affected**, though the impact differs greatly based on the context of each country and region.

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.

The UN SG report highlighted the potential for a slowdown in progress towards the MDGs, an increase in the cost of achieving them by 2015, and the likelihood of a disproportionate burden on women, as experienced in previous crises. It also stressed that a prolonged recession and insufficient attention to social needs could cause problems of social unrest and weakening governance.

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.

The International Labour Organization (ILO) estimates that the rise in unemployment in 2009 could reach more than 50 million, compared to 30 million in 2007, if economic conditions continue to deteriorate. They also estimate an increase up to 200 million, the majority of them in developing countries, in the number of working poor. **The gender dimension of the crisis** should be addressed, with women constituting the majority of the poor.

What lessons can be drawn for democracy building from previous financial and economic crises? From a democracy perspective, contrary to the widespread perception that democratic systems may be slower in responding to financial crises, more voices in the political process do not impede the need for speed required by the financial markets. The constraints on executives posed by democratic systems of institutional checks and balances allows for formal and credible choices that do not slow down the policymaking process and lead to better economic outcomes.

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.

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

- The first one is about the links between the undemocratic nature of the governments and the “unquestioned acceptance of nonaccountability and nontransparency”.
- The second lesson is the fact that, following the evolution of the financial crisis in a general economic recession, “the protective power of democracy... was badly missed.” The risk is therefore that the newly dispossessed do not have the hearing they need.

The two elements—preventive and protective—of democracy in financial and economic crises are inter-related. 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.

What are the implications of the financial crisis for democracy and in particular democracy building? 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, nations with a weak democratic tradition may be vulnerable to setbacks over the next few years, and also established democracies may face challenges like the boosting of extremist political forces and anti-immigrant sentiments.

Emerging **short-term political risks** associated with the current crisis are nationalism and political tensions that will 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.

There are different views on the implications of financial crises for **long-term economic growth**. While the crisis may have adverse consequences for growth because of increased volatility, it could also provide opportunities for the design and implementation of important reforms. However, since economic crises do not occur in an institutional vacuum, whether they are instrumental for long-term growth may depend, inter alia, on the type of political institutions prevailing at the time of a crisis and the political compromises that such an institutional setting delivers. Policy responses will be shaped by the incentives and constraints faced by the key political actors during the time of crisis.

Democratic institutions play a vital role in enhancing the accountability of governments to the citizens as far as policy responses are concerned. As noted by the World Bank, “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.”

In 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.

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.

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.

In **Latin America**, according to the projections of the ECLAC, IADB and the World Bank, the financial crisis will impact in terms of a reduction in the export and prices of commodities; a reduction of remittances from migrants—especially from the USA—and possibly a return of migrants who lost their jobs in the host countries; rising unemployment; 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 reduction in the tourism sector. 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.

Though no impact on democracy as a system is likely in the region, some concerns arise for a crisis of governability, which would result from the cascade effect of the financial, economic and social crisis, all closely inter-related. 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.

In **Africa**, 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 supports. For some countries, the consequences could be more disruptive, as violence and opposition intensify. Political turbulence is likely to accompany the economic downturn.

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.

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

existing programs to support governance reforms, and by devoting greater political and diplomatic resources to the management of governance challenges in the region.

What is the role of democracy building multilateral actors in coping with the implications of the crisis? 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.

Current multilateral 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, all revolving around the **protective and preventive functions of democratic institutions and practices**:

- 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.

The reform of the international financial architecture has been on the international agenda for a while. 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."

In terms of **oversight**, the agenda for national and regional **parliaments** includes a wide range of issues: "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." Much closer parliamentary interaction with the international financial

institutions should be ensured so as to exercise greater parliamentary oversight.

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. 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.

The current crisis does provide some opportunities alongside the serious challenges that we have analyzed above. Such opportunities should not reinforce the systemic conditions that led to the crisis; they should rather be opportunities for change. 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 democracy building practitioners and institutions to turning such opportunities into reality.

In conclusion, the impact of the financial and economic crisis for democracy building is not well understood and sufficiently analyzed. This work is particularly relevant to policy-makers in view of the importance placed on the political dimensions of the crisis, in terms of both immediate responses and systemic reforms by the international community.

International IDEA thinks that international efforts at monitoring the global impact of the crisis should take into account also its democracy building dimensions, and policy implications, to provide analysis for use by partners and policy makers. Such assessments should focus in particular on:

- the role of strengthened democratic institutions and processes in coping with the financial and economic crisis;
- the political implications of the reform of the Bretton Woods institutions by emphasising the role of political actors like legislatures, political parties, and civil society organizations.

International IDEA is committed to contributing, in partnership with the UN, to a better understanding of the political dimensions of the crisis to enhance policy responses, both at the national and regional levels, and within a reformed international financial architecture.

I thank you for your attention.