DEMOCRACY UNDER STRESS

THE GLOBAL CRISIS AND BEYOND

EDITORS
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Hendrik Geyer
STIAS Director

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THE CRISIS THAT SHOOK THE WORLD

Ursula J. van Beek

Two things are infinite: the universe and human stupidity;
And I am not sure about the universe.

Albert Einstein

Introduction

This book is a cautionary tale about the September 2008 financial 'earthquake' and the global tsunami that followed. The worst of the panic might be over, but does this mean it is back to business as usual? Hardly. The earthquake exposed fault lines we can afford to ignore only at our own peril. In fact, the need to understand what happened, why it happened and what the possible long-term consequences could be, have turned into the most burning questions of our time, and certainly not only for economists.

The earthquake

At the epicentre of the global earthquake was the bankruptcy of Lehman Brothers in September 2008. This initial seismic event sent out shockwaves that triggered the global financial and economic crisis and plunged the world into the turmoil of the Great Recession. Since the originating event, unemployment rates in all the major liberal democracies, which were affected the most, are higher now than they were before 2008, and the level of their public debt has risen dramatically. Coupled with unwieldy budget deficits and poor growth prospects, the economies of these countries could well be weakened for years to come. The bleak reality is that the prospects for global economic growth predicted by most pundits in the midst of the short-lived burst in the market upswing in 2010 are very unlikely to be realised. The optimism that lulled governments, and the public, into believing the worst was over is now giving way to the realisation that the crisis is in fact not over, but has merely been delayed by stimulus packages and debt-shuffling from the private to the public sector on an unprecedented scale.

The world is now seen as more unstable in many key areas than it has been for many decades. At the time of writing, in the US a state budget crisis is looming; in the Middle East the Arab Spring is breaking up calcified autocratic orders, but the direction of political change is far from certain; and in Europe the profoundly serious situation in Greece and the shaky state of economic affairs in other peripheral, especially Southern European, countries raises the likelihood that the euro might not survive in its current form. There is even the possibility that the European Union project as a whole could be undermined and a more fragmented Europe will be less able to deal with the mounting global challenges.

The drama unfolding since 2008 ended the unquestioned supremacy of the model adopted by the rich developed democracies and firmly embedded after the Cold War; their seemingly ever-progressing economic development, which was the envy of the rest of the world, has now lost its shine. Economic progress has given way to a sustained decline in the trajectory of affluence, ending thereby the strong popular conviction that democracy and robust economic development necessarily go hand in hand. And there is also the risk that confidence in democracy itself might start to erode.

Against this trend, the economic strength of the more crisis-resistant emerging countries has been bolstered and has begun to crystallise into political power, as illustrated, among other things, by the upgrading in the course of the crisis of the G20 to a venue for heads of state. The global earthquake tilted the political axis of the globe away from the centre, with the result that established liberal democracies lost their monopoly on influence in global affairs. The question now is who will wield influence and in what way. The even more pertinent question is whether democratic principles can and will be applied, or whether different criteria will be used when deciding the fate of the world.

So far the crisis has not proved to be the earth-shattering event that was feared originally. The experience of the Great Depression in the wake of the 1929 stock market crash has not been repeated, nor has there been a similar degree of political upheaval: no young democracies have failed as yet, as was the case with many such fledgling democracies in the interwar period; nor has the economic downturn proved to be as deep as it had been in the 1930s.

Nevertheless, the crisis has taken a heavy economic toll on most countries and has profoundly changed the world in ways we have yet to understand. For one thing, a strong state is now believed to be better equipped than a weak one to sustain a fragile recovery, even as fiscal pressures force governments to unwind their stimulus packages. But are all states, or even most of them, up to the task? Not according to the 2010 state capability index compiled by the *Economist Intelligence Unit* (EIU) and based on 12 indicators that were thought to capture the main conditions likely to show whether or not a particular state has the ability to deliver. Of the 163 countries surveyed only 34 were classified as having highly capable states, and another 38 were classed as moderately capable; more than half of the countries were found to have either weak or very weak states.

At the same time polls show falling public support for capitalism, especially in the USA, the country that used to be the very epitome of free enterprise. And significantly, this is in sharp contrast to China, which has now emerged as one of the strongest supporters of capitalism. These sentiments suggest a shifting relationship between political systems and the free market in a context in which the success of China's state-capitalist model is becoming an advertisement for many developing countries.

Why and how?

The search for answers to the question as to why a calamity occurred starts with an attempt to identify and understand its causes, with a view to hopefully help avoid similar such occurrences in the future. But the causes of far-reaching events are inevitably multiple and hard to untangle. What triggered the downturn following the Wall Street crash on that fateful 'Black Thursday' on 24 October 1929, for example, still remains a matter of much controversy. Among many other specialist opinions, historians tend to emphasise structural factors such as massive bank failures and the crash itself, while economists point more often to monetary policies, especially the contraction of money reserves that resulted from policies adopted by the US Federal Reserve, or the decision by Britain to return to the Gold Standard at pre-World War I levels. While there will undoubtedly be prolonged and detailed future debates, it is already becoming quite clear that the most recent crisis, like the one before it, had many points of origin. The US Bipartisan Commission created in 2009 and the US Congressional Research Service between them identified no fewer than 26 different causes of the crisis, while according to the CEO of the ill-fated Bear Sterns 'everybody messed up': the government, the rating agencies, Wall Street, the commercial banks and the regulators.

At a superficial level the common denominator of the two periods preceding the onset of both the 1929 and the 2008 financial meltdowns was a sense of 'the good times', especially in the United States, where both the crises originated. Rapid industrial/economic growth along with high consumer demand and elevated aspirations characterised both the 'Roaring Twenties' and the two 'feel good' decades of growing prosperity associated with the progress of globalisation after the end of the Cold War. There was ample evidence of enormous wealth, excess, expanding credit and recklessness in speculation on the soaring stock markets in both instances when the world came tumbling down.

But the devil, of course, is in the detail, as the respective chapters by Stan du Plessis and Dirk Berg-Schlosser aptly illustrate. While excess and greed played a role, so did the incentives that created the credit-fuelled bubble, in the US property markets in particular, and the concurrent gearing in the US financial sector that led highly geared banks first into a position of weakness and then into failure on so massive a scale that policy intervention became indispensable. The reason why the problem was not contained locally but spread to the rest of the world was that the modern banking system relies on globally interlinked financial markets and that the world economy has become tightly integrated not only into the financial system across the world but also into the flow of goods and services across boundaries.

Some instructive comparisons have been made in this volume between the current crisis and the one that triggered the Great Depression. For example, in contrast to the present situation, of the 15 European countries in the inter-war period that could be described, albeit in some cases at a stretch, as parliamentary democracies only eight survived; the other seven fell victim to circumstance and turned to more authoritarian forms of rule, especially to fascism that set them on the slippery slope towards World War II. Reminiscent of the more current woes, international trade fell sharply during the Great Depression along with all major economic indicators, while unemployment rose steeply. The severe budget cuts and other austerity measures, which most of the hapless governments of the day had implemented, did not prevent the crisis situation from deteriorating even further. Instead the measures were met with strong social and political responses as large numbers of people took to the streets in often peaceful, but sometimes also violent, protest – a situation not dissimilar to the developments witnessed lately in Greece.

The most significant positive difference between then and now has been the avoidance of the 'beggar thy neighbour' policy implemented by nearly all central banks in the 1930s. This policy, which put short-term domestic interests above longer-term considerations of international cooperation and stability, can be contrasted with the current efforts to coordinate, at the regional and global levels, policies meant to counter the adverse effects of the crisis, even if the efficacy of these efforts is sometimes doubtful. There is also a major difference between the young democracies of the inter-war period and the well established liberal democracies of today. In the 1930s other political alternatives were at hand in the form of 'anti-system parties' spread across the political spectrum from left to right. They posed a real threat to the democracies that were as yet not fully consolidated, because they carried the considerable potential for non-democratic or anti-democratic alternatives to emerge, and emerge they did. In contrast, no coherent extremist social and political forces or reactions have so far materialised in the developed democracies of today, while the general structural and political-cultural conditions continue to favour the persistence of democracy. But the situation is less clear in the case of the younger 'Third Wave' democracies. As Berg-Schlosser notes, their continuing democratic future could be more dependent on policy and actor effects, and this makes them more comparable to the unconsolidated democracies of the 1930s.

For this very reason the democracies of the Third Wave are of particular interest in this book as its aim is not only to come to grips with how the crisis happened and how it was handled in the short term, but also to hypothesise about its possible long-term consequences, especially with regards to the future of democracy. One of the speculative questions posed in this volume is therefore whether the global crisis and its aftermath might bring on the reversal or further expansion of the Third Wave of democracy.

Political systems and the economy

The Great Recession accentuated the emerging global division into democratic and authoritarian capitalisms. China's economic success, in particular, started to undermine the once almost unshakable belief in political science that democracy and economic progress went together, whereas an autocratic regime was more likely to show poor economic performance. It is now also far less clear whether democracy increases the probability of economic success, or rather – and this is more likely – produces an improvement in the living standards of broad segments of a society, but only when good economic performance is already in place. And this leads to the question of whether the model of authoritarian capitalism might become a more attractive alternative to liberal democracy of the Western type, which is combined with a market economy, but is also 'encumbered' by the whole package of civic values such as human rights, the role of an individual in society, etc.

The first answers to the various questions emerge from the chapters by Ursula Hofmann-Lange and Philip Mohr. They both pursue the topic of the complex relationship between political systems and the economy, but look at this through the different lenses of their respective disciplines of political science and economics. What becomes evident from the political science perspective is that the democratic system requires a careful balancing of the concepts of liberty and equality. The in-built tension springs from the model's essential need for a market economy, which per se implies inequalities of wealth, and the concurrent necessity to ensure the equality of its citizens not only in terms of political rights, but also in terms of the responsibility of democratic governments to reduce socioeconomic disparities. This contradiction is democracy's inherent weakness. The strength of a democratic dispensation is greater political flexibility, whereby inefficient governments can be voted out of power without the threat of a decline in regime legitimacy and the possible consequent risks of political instability. In that sense democracies are generally better equipped than authoritarian political systems to weather economic crises.

But are democracies also better at guaranteeing economic success? The recent revolutions in Tunisia, Egypt and Libya showed once again how authoritarian leaders tend to exploit their political power to amass private fortunes in collusion with large private enterprises. Since neither side of the pact has an interest in ending the mutually profitable relationship, the ousting of the old leadership alone will not suffice. And if the old networks are left in place, while there is no legal framework of market regulation needed for a properly functioning market economy and the tradition of the rule of law is weak, then there can be no development of a competitive and successful market economy, despite democratisation. On the other hand, some authoritarian governments, notably China, promote the liberalisation of