Daniel Daianu* (January 2025)

Finance and democracy: a more complicated relationship than meets the eye[1]

To answer **on whether and how global capital flows should support the building of young democracies** I would use two perspectives. Thus, one can take the financial system as given (as a basically “immutable” system, though this is not so if one thinks of the New Deal introduced in the US after the Great Depression, and reforms and re-regulatory measures after 2008) and delve into the questions put on the table. And there is another way to think about the issues involved by questioning the very working of finance, whether it helps to stabilize economies and whether it works for most citizens –to paraphrase Robert Reich[2]. I will also make a few comments on the impact of artificial intelligence on economy and politics, as some see it a savior for the whole world. The global context, with a series of extreme shocks and “radical uncertainty”, fragmentation (and the decline of multilateralism), a rule of law in international relations that is falling apart, EU’s growing travails, a so-called post-truth world, would be a useful approach for analysis as well, but it will not be touched upon here.

1. Finance nowadays and emerging economies

For a start, I will proceed on the first track of analysis (take nowadays finance as given) and try to provide answers to the four questions under discussion.

What guides investors’ decisions?

Investors are mainly guided by profits on their investments as this is what drives economic activity (despite explanatory tweaks and twists made by behavioral economists). But investors consider also the predictability of the local environment and the safety of their investments. Quite often, investors disregard environmental concerns, more so in poor countries, where institutions and civil

[1] Invited contribution to a project initiated by Lech Walensa, former President of Poland and Nobel Peace Prize winner

[2] Robert F. Reich: “Saving Capitalism –for the many, not the few”, New York, Alfred Knopf, 2016

society are weak. Not unfrequently investors prefer to deal with strong leaders to the extent their investments can, presumably, be secured; they, often, do not care about rulers when democracy is more of a façade. And there are cases when foreign investors support political regimes that practice an "open doors" policy, though with disregard of the lot of many local citizens -- regimes that are undemocratic. The story is more telling when local regimes/institutions have an "extractive nature", to use Daron Acemoglu and James Robinson's terminology[3] –and vast amounts of royalties go into the pockets of autocrats, or military rulers. Africa provides probably the most revealing and long lasting history in this respect.

There are many autocracies in Africa, the Arab world, etc. And there has been an erosion of democracy around the world for quite a while now. Authoritarian tendencies are on the rise in democracies as well; some of the latter evince traits of what Barbara F.Walter named "anocracies"[4].

The global financial crisis, the Pandemic, effects of climate change, the energy crisis, wars, etc. fuel the temptations to use authoritarian means of governance. The extreme right is gaining ground in rich, western countries, for various reasons --one being the flaws of unrestrained globalization. Therefore, I would argue that it does not fit the current world to use a simple binary logic in judging investment choice: democracies. vs autocracies. The world is very complicated and, apart from ideology and practical issues, fuzzy political inclinations, much confusion, geopolitical considerations play a major (I would rather say increasing) role in it.

Capital flows and nascent democracies

*S*hould global capital flows support the development of young, democratic countries, even if rates of return there are lower than in countries ignoring the democratic rule of law? This question intrigues me sort of, even if I am sympathetic with its value laden thrust. I will submit several derived questions in this respect. Who would set the gain discount that would distinguish investments in nascent democracies from those undertaken in non-democratic countries? Can such a variable (discount) be practiced and spread around the world? One could argue that ESG criteria (environment, social, governance) provide a promising

[3] Daron Acemoglu and James Robinsom: "Why Nations Fail", London, Profile Books, 2013
[4] Barbara F.Walter: "How Civil Wars Start. And How to Stop Them", Random House, 2022

multidimensional standard to such an end, but is it enough? To a certain extent IFIs try to support young democracies in their assistance operations (remember how and why EBRD was set up after 1990, or the Marshall Plan in 1947), but they cannot use a judgmental "variable geometry" across the board and regularly. There are many humanitarian cases around the world, most of them in countries with illiberal regimes, and to shun such cases for political/democratic reasons would be more than questionable.

In addition, IFIs are blamed, rightly or wrongly, by many in the emerging world that they uphold primarily the interests of the rich world. And BRICS, China in particular, are trying to create alternative instruments for financial assistance. To go too far with "politicizing" financial assistance would provide ammunition to those who see the rich West using its financial muscle for its own aims.

Restrictions and capital flows

Should there be restrictions / bans on investing in countries with authoritarian regimes? *Prima facie*, it would seem so. But, again, this question prompts me to pose other questions. Who would make the political regime classification of countries? Especially when authoritarian tendencies are on the rise in democratic countries as well. Should OECD do it? But this organization is more of a think tank, though being a member of it is good for attracting investments. IFIs? This is done in a subtle way already, but, as mentioned, IFIs are seen by not a few emerging economies as being dominated by the rich West. Rating agencies do it by using both economic and political arguments in judging whether countries are suitable for investment grade investments. But they are more concerned with stability issues, than democracy per se.

The world gets multi polar, fragmentation is underway, trade protectionism is spreading. Who would impose restrictions, apart from those that are linked with security/geopolitical concerns (ex: the development of semi-conductors, responding to Russia's invasion of Ukraine). Imposing restrictions asks for effective policy coordination. But when the "outer world" (BRICS and other countries) is expanding, restrictions may not be effective.

The world needs global commons and this demands collaboration between the two economic and technological superpowers: the US and China. One way or another, these two countries, together with other big emerging economies (India. Brazil, etc.), have to find a common ground for the sake of human species' survival.

Means to encourage investment in democracies

What instruments, initiatives should be introduced to encourage / promote investment in democratic countries?

- First, one has to consider the growing debt in the world that dents development prospects. The rise in real interest rates is complicating the plight of the poor countries.
- IFIs have to undertake swifter concessionary lending; there are too many bureaucratic procedures and the volume of assistance is much inferior to needs[5].
- There should be restructuring of heavy debts for the poorest countries (by the way, Poland was forgiven a large chunk of its external debt in 1990)
- How to combat the effects of climate change and energy transition are herculean tasks for many emerging economies; it is laudable to talk about democracy, but when countries are ravaged by famine, inter-ethnic conflicts and wars, much more is at stake. Not least, geopolitics can play a highly nefarious role in this context.
- Regional development banks need to play a more active role and involve more voices, other stakeholders in their decisions.
- A resuscitated/reformed Bretton Woods framework would be welcome as it would have to consider world finance in a multi polar world and where unregulated finance (ex: shadow banking and crypto assets) produce recurrent systemic risks.
- Set up special financial facilities for helping countries to deal with climate change and energy transition; in the EU, this goal is pursued via national recovery and resilience plans.
- Not least, fight corruption and money-laundering resolutely and prosecute perpetrators relentlessly.

[5] As Anne O. Krueger says that traditional sovereign creditors must persuade emerging major lenders of the need for a faster, more effective restructuring mechanism…so that to avoid poorest countries being trapped in a never ending cycle of debt distress ("The Urgency of Global debt Reform, Project Syndicate, 3 January, 2025)

- How to support more vulnerable EU member states (the eastern flank) in bolstering their defense capacities is an open question. Can the EU budget play a significant role in this regard? Can collective defense bonds be issued?

2. **Overhaul finance to save democracy**

I share the view that for democracy to be saved one needs to ponder over flaws of capitalism[6], a thesis advocated ever more in the wake of the global financial crisis. Herein I paraphrase it and say that one needs to rethink finance in order to save democracy.

The global financial crisis that erupted in 2008 further proved that financial markets have inherent instability, that drivers of financial flows lead to cycles of boom and bust. Hyman Minsky's work[7], which is related to John Maynard Keynes' thinking, was rediscovered. Excessive speculation, a plethora of financial derivatives (toxic products), very lax regulations, have invited a terrible crisis. Here one finds the rationale for the re-imposition of financial market regulations after 2009 (following the wave of deregulation that began in the City of London in the 1980s and were continued in the US), the introduction of macro-prudential measures aimed at limiting excessive lending, financial flows, and requiring banks to hold higher capital and liquidity reserves.

The global financial crisis raised income inequality in advanced economies and made the middle class thinner. What is worse, the massive bailout of the financial sector caused enormous resentment in society at large. A lingering and persistent feeling has taken root that the "system" is rigged for the benefit of the very few. Martin Wolf, a leading Financial Times columnist, talks about a "crisis of democratic capitalism"[8].

The financial crisis, together with the Pandemic and the energy transition, the impact of Russia's invasion of Ukraine have brought about a cost of living crisis;

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[6] Daniel Daianu, "Overhaul capitalism to save democracy", Romanian Journal of European Affairs, 1, 2012, Bucharest. See also my book "Which way goes capitalism", New York/Budapest, CEU Press, 2009 and "When high finance cripples economy and corrodes democracy", Eurozone, 27 July 2011

[7] Particularly "Stabilizing an Unstable Economy", New Haven, Yale University Press, 1986

[8] Martin Wolf: 'The Crisis of Democratic Capitalism", London, Penguin Books, 2024

the latter shows up in political life and the rise of populism and demagogues, of radical groups. Societies are more fractured, divided.

During the *Great Moderation* period, with low inflation and low unemployment, central banks underestimated the exceptional nature of certain conditions (including the impact of globalization) and tolerated the creation of speculative bubbles. Alan Greenspan, the former Fed chairman, called it "irrational exuberance". The same Greenspan, in congressional hearings on the causes of the financial crisis, noted that a wrong paradigm dominated the Fed's monetary policy.

Unfortunately, the non-bank financial system (*shadow banking*) is still insufficiently regulated. And how much capital and liquidity reserves are adequate remains a controversial topic – though common sense suggests that more reserves should make the system more resilient[9]. And worse, there is currently a reverse trend, with big financial institutions in the US and the EU asking for re-deregulation of finance. Some even say that Basel 3 is dead. This happens at a time when profits of major financial institutions have reached top levels in 2024, while public debts and budget deficits are at very high levels around the world.

To sum up, too much finance has enhanced speculative behavior and economic inequalities; it has increased the fragility of economic systems and has favored financial crises, which have forced governments and central banks to step in. All this has led to socialization of losses, massive frustration and resentment among ordinary citizens. And crises in advanced economies have very severe consequences for emerging economies, be they more or less democratic.

3. Artificial intelligence (AI) cannot provide a miraculous recipe

AI can be a boon as a new technological revolution. But it can also be a curse to the extent it fosters more concentration of power in markets and politics; for it undermines competition and makes survival of the fittest equivalent with power concentration to the utmost. And absolute power is inimical to checks and balances, to democracy.

[9] Anat Admati and Martin Hellvig favor higher capital and reserve requirements in order to make the banking system resilient (“The Bankers’ new clothes: what’s wrong with banking and what to do about it”, Princeton, Princeton University Press, 2013). See also Admati, “Nonsense and bad rules persist in banking”, Project Syndicate, 8 April, 2024

AI, as many argue, can lead to much higher income and power inequality.

AI can amplify "herd behavior" even if new technologies, algorithms, process much more information (*big data*), and the models used by banks and investment funds to manage risks are more sophisticated.[10] AI cannot eliminate contagion in markets, and it often asks for public intervention (by the central bank) as a *lender of last resort*. This was seen in the United Kingdom in 2022 after misguided decisions made by the Truss government, which affected the stability of the pensions system; it was also seen in the United States with the fall of Silicon Valley Bank and other turbulences in the banking system, which compelled the Fed to intervene through new lines of financial assistance.

AI, that underpins cyberfare, can bring components of the financial sector to a standstill and cause havoc in financial markets.

AI can lead to the destruction of many jobs, that would strain economic systems to the utmost. Without a considerable, compensatory, creation of new jobs, there will be very serious economic and social implications including financial tremors.

To conclude, AI cannot be the great remedy for our economic and social problems, in both rich and poor countries; it cannot be a guarantor for democracy. AI needs to be regulated so that it does not turn into another existential threat.

Final remarks

Fighting for democracy is more than a worthy endeavor, for this is not God given. Democracy is under siege nowadays due to wrong policies which have left many citizens behind, unrestrained globalization that, as Yasha Mounk put it, has enhanced a sort of undemocratic liberalism[11], the misuse of finance and massive power concentration in markets, a low capacity of governments to deliver effective public policies in the midst of a sequence of major adverse shocks (the financial crisis, the Pandemic, climate change, the energy crisis, the effects of wars).

[10]The LTCM hedge fund benefited from highly sophisticated models (two Nobel laureates worked there), that were thrown off track by extreme events, by non-linearities. Other similar failures occurred in financial markets over time.

[11] Yasha Mounk, “The People vs. Democracy”, Cambridge (Mass.), Harvard University Press, 2018

The world is too complicated for using a simply binary logic in thinking about how to shape the relationship between finance (investment) and the nature of a political regime.

Supporting decent political regimes, that cater to the needs of most citizens, should be an aim of IFIs, democratic governments and enlightened corporate chieftains. Having said that, one should not underestimate the power of the profit motive, as we live in capitalist societies. It is true that one can think about how to improve the working of capitalism and of finance, to make them function in the service of most citizens.

AI can be both a boon and a curse; it cannot be the savior of the world as some may think.

Ethics and morality, the fostering of global commons, are badly needed in today's world. But many current trends run counter to them; in spite of huge technological advance, the world is nastier, more chaotic, disorderly, and violent. But hope should never be lost.