

## The Difficult Transition to Democracy

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The Arab Spring has turned into something of a disappointment. In Tunisia, the recent assassination of Shokri Belaid, a secularist opposition leader, has increased tensions. S&P recently downgraded the country's sovereign risk due to rising political turmoil. In Egypt, protests have returned, this time against the Muslim Brotherhood-led government. Yemen remains in chaos. Syria is essentially in a civil war. Unrest continues in Bahrain but the minority Sunni leadership remains entrenched, mostly due to military support from Saudi Arabia. In Jordan, the king is under pressure to give more power to the legislature, which, to date, he continues to oppose.

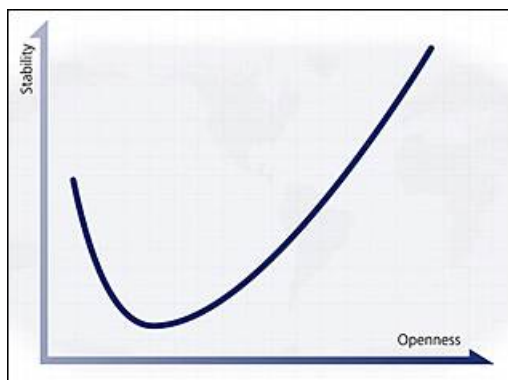
What went wrong? After the heady days when all seemed possible, why are these Arab nations unable to build democratic governments? Numerous theories abound, from the notion that these nations are not "culturally" advanced enough for democracy, certain religions are not conducive to democracy, to ideas that outside factors are preventing these democratic movements from developing.

U.S. foreign policy considers the spread of democracy as a major goal. The George W. Bush administration held the spread of democracy as a major bulwark against Islamic terrorism. However, as conditions in Egypt and Iraq show, elections are only part of the transition to democracy. Democracy also requires the protection of minority rights, rule of law, and a structure which accepts the rights of a loyal opposition.

In this report, we will discuss Ian Bremmer's theory of the "J-curve" and how it affects the transition to democracy. We will also examine how some major European nations made the transition to democracy with a particular focus on how messy and difficult these changes were. As always, we will conclude with the long-term impact on the financial markets.

#### The J-Curve

Ian Bremmer, in his 2006 book titled "The J-Curve," discusses how to use the idea of a "J" to describe the paradox of why new democracies seem fragile while established democracies are stable. Clearly, the goal seems to be democracy—nations want the long-term stability that democratic systems offer. However, getting there seems to be a problem. Bremmer encapsulated the issue with his curve.



Source: Ian Bremmer

Bremmer assumes a non-democratic nation begins its journey to democracy somewhere to the left of the minimum of the J. The further the country is to the left of the minimum, the more stable and less open it is. Openness is best described as a "measure to which a nation is in harmony with the crosscurrents of globalization—the processes by which people, ideas, information, goods, and services cross international borders at unprecedented speed... But openness also refers to the flow of information and ideas within a country's borders." Stability, on the other hand, "...has two crucial components: the state's capacity to withstand shocks and its ability to avoid producing them."

Non-democracies, such as monarchies, authoritarian and totalitarian regimes, and theocracies, ensure stability by being

closed societies. The head of state goes to great lengths to control the flow of information from the outside. The leadership also restricts how citizens can meet outside of government sanctioned bodies. In theocracies and totalitarian regimes, disagreeing with the state makes one an apostate or recalcitrant, respectively.

Although such societies are not free, they are stable. These governments can stay in power for long periods of time. However, as the J shape suggests, experiments with openness are risky because, for some period of time, increased openness will lead to increased instability. If the leadership sticks to the program and steadily opens the society to the world, stability increases until the new democracy becomes more stable than it was when it was non-democratic.

It should also be noted that the chart on the previous page is simply stylistic; it is not based on any quantitative data. However, it isn't hard to imagine curves that shift and change shape. Specific policies and outside events in a non-democracy could steepen or flatten the J portion and increase or decrease the risk of democratizing. For example, a booming global economy might make the transition to democracy easier by flattening the curve.

Sheri Berman discusses in a recent article some of the factors that act as impediments to transitioning to democracy. Perhaps the most significant is how autocrats govern. Autocratic leaders, because they lack the legitimacy that comes with being elected, are often forced to use "divide and conquer" tactics. These include giving one group favors for their support and pitting the favored groups against other groups. Such leaders try to project an image of universal support. Sham elections, a controlled (and fawning) media, and sagas of heroic acts are all part of the scheme. In reality, autocrats usually rule by managing factions within the state. As Winston Churchill observed, "Dictators ride to and fro on tigers they dare not dismount."

When states move toward democracy, these groups usually harbor strong animosities toward each other. When the controlling effect of the autocrat diminishes, these concerns come to the fore. Civil conflicts become common. For those on the outside, the violence and chaos that seem to accompany the road to democracy appear as faults of national character. However, the mistake that is often made by outsiders is to believe a new government begins from a "blank slate." Instead, the new government begins with all the distorted legacies of the earlier government. Until those can be addressed, it is very difficult to keep order, much less make democracy work.

Another factor that slows the creation of a functioning democracy is the culture of corruption that usually develops in autocratic states. Markets ideally require rule of law (markets need the state to enforce contracts and offer a judiciary to adjudicate commercial disputes); democracy, by design, is also based on the rule of law. The principle that each citizen is equal before the law is a guiding principle of democracy.

Autocracy, on the other hand, is usually based on the rule of the man. The leader effectively is the law. The dictator and his minions enforce the law and often do so for their own enrichment. Usually, the instruments of regulation and law enforcement in the autocracy are free to implement policy as they see fit, which means that those in the state bureaucracy use their position for personal enrichment as well. Businessmen eventually realize that the state clearly acts as an impediment to business; however, it can also act as a partner. Through bribery, businesses can curtail competition, creating state-protected monopolies.

At the same time, the dictator must provide a bare minimum of support for the population to control dissent. Basic goods are often provided at deeply subsidized prices to quell unrest. For example, Iran for many years fixed the price of gasoline at \$0.40 per gallon; this lasted until 2010, when the increasing cost of subsidies became unsustainable. Currently, Venezuela only charges \$0.18 per gallon. Iran is a theocracy and Venezuela is a weak democracy. Another trick often used is setting price ceilings on necessities below the cost of production. Private sector firms will tend to stop producing these goods, since there is scant incentive to sell goods at a loss. The result is that prices for consumers are attractive but there are no goods for sale at that price. The dictator will blame "profiteers" for the lack of necessities on store shelves when, in reality, the price ceiling is the culprit.

The behavior of the government becomes a cause of inefficiency in the economy. The distortions brought by the inability to enforce contracts tend to limit the size of businesses. Capital markets are nearly non-existent. Most capital is raised through family and friends, and the ability to sell a business is nearly impossible. Bureaucratic snarls impede the registration of legitimate businesses so, in many non-democracies, the "black" or unofficial market becomes the primary provider of goods and services.

Interestingly enough, the countries that are most able to maintain a non-democratic state are often raw material providers. The state usually controls the extraction and sales of these goods and commodity revenues become the primary source of government funding. The state has an independent source of funds, and does not have to tax or confiscate resources from its citizens. Thus, its citizens have little input in how the country operates.

Another typical distortion used by autocracies is the manipulation of the exchange rate. If the country is an exporter, the exchange rate is usually pegged below fair value to lower the cost of exports. If the country is an importer, the rate is pegged higher than fair value to depress the cost of imports. In the latter case, foreign exchange crises occur frequently, as imports drain foreign reserves. To address this issue, a nation may tier its exchange rate, setting different exchange rates for different goods. This opens up additional avenues for corruption as well-placed members of the autocracy will try to import goods at the preferred rate and sell the goods at the market rate, earning the spread.

When these distorted economies attempt to democratize, problems develop rapidly. Usually, the subsidies and ceilings are removed, which causes rapid inflation. Since the creation of an independent judiciary takes time, the culture of corruption remains, further weakening the economy. The economy was a mess under the autocratic regime, but there was some semblance of order. Under democracy, at least at first, the mess remains without the order.

### Some Historical Examples

President George W. Bush's policy to democratize the Middle East and undermine the influence of radical jihadism has had, at best, a mixed record. Afghanistan is struggling with ethnic, tribal, and sectarian differences that plagued earlier governments. Iraq has held elections but the Shiites in power are showing autocratic tendencies. Overcoming sectarian divisions has proven to be very difficult. Elections in the Palestinian area led to the terrorist group Hamas gaining control of the Gaza Strip. These outcomes have analysts questioning the wisdom of Bush's policy.

However, it should be noted that many European nations faced difficult struggles in converting to democracy as well. The French Revolution was a bloody event that British conservatives, most famously Edmund Burke, held up as an example of the need for limited democracy. However, Berman makes the case that, with reference to France, the kings ruled in concert with a small and narrow aristocracy; the king gave favors to the nobles and the latter extracted resources from the peasants.

By the late 18<sup>th</sup> century, several expensive wars had seriously weakened the kingdom's fiscal situation. The state, not wanting to tax the nobles, resorted to borrowing. Finally, in 1789, the king was forced to call a national assembly to deal with the debt. The divisions caused by the king's favoritism to the aristocracy broke into the open, leading to a bloody revolution.

However, in the decades after the French Revolution, the government steadily evolved from a hereditary kingdom to a constitutional monarchy to a limited democracy to a modern democracy. Note that it took several generations (and one major dictator, Napoleon) before this occurred.

Italy's path to democracy was rocky as well. The process of unification began in the 1860s and continued into the 20<sup>th</sup> century. Piedmont controlled the north and Sicily the south. The Piedmont group eventually controlled the government and tried to impose its systems on the rest of the country. Infighting between Catholic and Socialist parties paralyzed the government, creating a path for Benito Mussolini to take control. The dictator was credited with "making the trains run on time." Although Mussolini was welcomed for bringing stability to Italy and democracy was blamed for the chaos, the real culprit was the divided nature of the country. Authoritarian regimes merely hide these divisions; as noted above, they are often used to remain in power. However, after WWII, Italy became a fully functioning democracy (though a somewhat ragged one, having over 60 governments since WWII ended). Clearly, Italy's path to democracy was difficult.

The last case, Germany, is also an interesting case in point. Germany was unified by the Prussians after the Franco-Prussian war of 1870. The government was headed by a hereditary monarch with a chancellor who acted as executive. From the formation of Germany in 1871 until his removal by King Wilhelm II, Germany was run by Otto von Bismarck, the "Iron Chancellor." Bismarck ran the legislature but reported only to the king. He managed the country by creating a coalition of the landowning aristocracy (the Junkers) and the owners of the industrial sector of the economy. He subsequently demonized Catholics and Socialists; the former were put under heavy suppression during the *Kulturkampf*, which was a pogrom against Catholicism. Clergy were arrested and the Jesuits were expelled. By demonizing various groups, Bismarck was able to more easily control the opposition. However, this came at great human cost.

World War I ended the German monarchy. A democracy replaced it after the war; however, it proved to be weak and divided. The military class and the aristocracy held that, given German superiority in terms of industry and military matters, the only way it could have lost the war was due to civilian "backstabbers." Field Marshall Paul von Hindenburg, who won the presidential elections against Adolph Hitler in 1932, is said to have ascribed to this theory. Hindenburg, though he despised Hitler, needed him and his National Socialist Party to form a government. Thus, he named Hitler chancellor; Hitler took full power after Hindenburg died in 1934. Hitler's radical positions on race and religion can be tied to the "backstabbers" theory; for Hitler, the Jews played that role.

After Germany's defeat in WWII, the divided nation developed two different governments. East Germany was a communist totalitarian state while West Germany evolved into a fully functioning democracy. Germany's path to democracy was clearly rocky.

## **Ramifications**

American presidents, almost by default, support democracy. However, this paper suggests that the path to democratization can be very difficult and can often take longer than several presidential terms. At this juncture, President Bush's push for democratizing the Middle East appears foolhardy. It will only bring instability in a region that is critical to global energy supplies. However, as the history of France, Italy, and Germany has shown, it may be too soon to say whether Bush was completely wrong in his approach. He never sold it as a long-term process; politically, to tell the American people that we are embarking on a democracy project that may take decades and involve wars is not a winning strategy. If the country is clearly devoted to democracy, though, such long-term views are probably necessary.

From a market perspective, real support for democracy will generally entail significant unrest and disruption. Broadly speaking, this situation would be bearish for equities and bullish for debt. However, we suspect most administrations will pay lip service to democracy while supporting non-democracies to lessen the likelihood of global distress.

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Bremmer, Ian, *The J-Curve*, Simon and Schuster, 2006, page 7.

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Berman, Sheri, *Foreign Affairs*, January/February 2013 edition, Vol. 92, Number 1, pages 64-74

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Democratization, or democratisation, is the transition to a more democratic political regime, including substantive political changes moving in a democratic direction. It may be the transition from an authoritarian regime to a full democracy, a transition from an authoritarian political system to a semi-democracy or transition from a semi-authoritarian political system to a democratic political system. Transitions to and from democracy tend to occur globally and in waves, meaning that they have been clustered in both space and time rather than distributed randomly. The American political scientist Samuel Huntington identified three main waves of democratization. Proponents of structural explanations pointed to the difficulty faced by democracy-promotion efforts in places like Bosnia, Iraq, and Afghanistan, as well as the failure of many third-wave democracies to consolidate, as evidence that democratization requires more than elite consent. There is no consensus on which conditions are most important or exactly how they function to promote democratization. With the fledgling democracy expanding the space for political assertion, Egypt's liberals have a chance to enhance their profile in the public domain. Voting in droves in the first parliamentary elections held after the fall of dictator Hosni Mubarak, the Egyptian electorate seems to have overwhelmingly balloted for the well established Islamist parties. The rise of the Islamists, in the form of the Muslim Brotherhood's Freedom and Justice Party (FJP) which has, in the course of Egypt's three-stage elections, secured the maximum number of seats, followed by the ultra-conservative Al Nour coalition, has shocked the secular-liberal political formations.