Is there a democratic premium?

Elections and Financial Markets in Emerging Economies

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Over the past decades nearly all the major financial crises in developing countries have occurred in synchronization with electoral cycles. In the 2000’s, this situation began to change, with many emerging countries experiencing a “decoupling” of their financial and electoral cycles. The presidential elections in Brazil, of October 2010 confirmed also this new trend, as the previous ones at the beginning of the year that took place in Colombia, Costa Rica or Chile.

In 2006, most Latin American countries experienced major elections without suffering any crises. In 2010, Chile, Costa Rica and Colombia held elections and avoided the previously inevitable slump in the stock exchange and impact on the spreads, in spite of a highly risk averse international environment. We deconstruct the intricate links between finance and politics in emerging markets in a recent paper “Portfolio managers and political events in emerging countries: how investors dislike policy uncertainty”.

Politics matters for financial markets. The reverse is also true: Financial markets matter for politics. These complex links are particularly relevant in emerging markets. We focused on the links between the worlds of finance and politics. We specifically look at elections (as one of the major critical junctures in modern democracies) and the way portfolio managers react by investing or divesting during election times. One of the core questions we address - using unique and unexploited databases - is whether a democratic premium exists, in other words, whether financial markets (in this case portfolio managers of share and bond holdings) tend to react positively or negatively to elections in emerging markets and democracies.

The study of the relationship between finance and politics is obviously not new, nor should it be seen as exclusive to developing economies. The past is full of examples of extreme, critical, junctures linking finance and politics. Some economic historians (such as Niall Ferguson) argue, for example, that the origins of major political events such as the French Revolution can be traced back to a stock market bubble caused by a

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convicted Scots murderer. Political connections can undoubtedly boost your stock returns, for example, companies supporting the Nazi movement in the 1930s experienced much higher returns and far outperformed those without connections. Between 1927 and the early 2000’s, the excess return in the US stock market, was consistently higher under the Democratic presidencies than under Republican ones, according to Santa-Clara and Valkanov (2003).

The year 2010 thus far has also underlined how financial markets continue to be sensitive to political issues, in particular around election times. In early 2010, for example, market participants had some doubts as to whether Ukraine would continue to make coupon payments on their bonds, as the political instability around the January 2010 presidential election fueled the nervousness of financial markets. The latest Greek crisis of late 2009 and early 2010, also underlines how much elections drive market sensitivity. In early October 2009, the Greek Socialists won the general election, defeating the Conservatives who had been in power since March 2004. Some weeks later, the new government revised the 2009 deficit projection sharply upwards to 12.5 percent of GDP, from the 3.7 percent announced earlier in the year, in doing so they initiated a process of a major financial meltdown that continues to send waves across Europe.

The Greek turmoil prompted comparisons with Argentina who defaulted in the early 2000s, precisely during an election period. Some analysts such as Desmond Lachman, a former Wall Street banker, even argued in the Financial Times that Greece could follow the steps of Argentina and later Nouriel Roubini also warned about this possible outcome. This episode has once again underlined the intricate links between financial markets and politics.

**Democracies and emerging markets**

The relationship between democracy and finance is however particularly close in emerging markets where we have been witnessing a major trend towards democratization over the past decades, concurrent with increased activity in the domestic and global financial markets.

Mexico for example, suffered major financial collapses in 1976 and above all in 1982 and 1994, again, all occurring at the same time as presidential elections. Nevertheless, the Mexican paradox is that in the past financial shocks occurred during periods of autocratic regime, supposed to bring less policy uncertainty as the same party continues in power. And it is precisely when the country experienced a major political transition, in 2000, with a new party that came into power, that markets did not collapse once again and did not fall into a financial crisis. Similarly, in 2006 the turbulences of the past decades were once again avoided, bringing Mexico in a new era where financial markets and electoral cycles seem now decoupled.

Argentina’s default in 2001, the major failure of an emerging country, also took place in an election year. As did the Brazilian turmoil a year later, as the country weathered the
months of anxiety leading up to the presidential election, with Lula’s looming election victory spawning panic within the business community (Martínez and Santiso, 2003) which eventually proved unfounded. Thus, even the possibility of a change in government in Latin America has frequently cast doubt over the progress achieved, triggering considerable financial upheaval, capital flight and loss of confidence.

The events of 2006, however, demonstrated that there is no inevitable electoral curse. Despite being a very busy year for elections, no country in the region experienced a financial crisis. In other recent research studies (Nieto Parra and Santiso, 2008; Nieto Parra and Santiso, 2009), we based our arguments on more than 5000 observations and 700 reports issued by 13 investment banks, a unique database that covers 10 years of Latin American sovereign bond recommendations. We showed in particular that while analysts’ recommendations between 1997 and 2008 tended to be consistently negative as elections approached, in 2006 they were no longer systematically negative. In particular, for Brazil, Chile and Colombia, Uruguay or Peru, analysts no longer anticipate the risks of a credibility gap in economic policies. Exchange rates and risk premiums have not been eroded on a large scale as they have been on previous occasions.

**New research**

In Frot and Santiso (2010) we are using new datasets. We study the influence of two political events on portfolio equity flows, focusing primarily on data on portfolio flows before, during and after elections. In this regard, the paper enriches the aforementioned literature in addition to other works devoted to financial market reactions during elections in emerging countries. Campello’s (2009) research, for example, examines whether the behavior of stock markets around election periods is influenced by the political leanings of the likely winner of the contest. In our paper, we focus directly on the analysis of portfolio flows and fund managers themselves, rather than on stock market, foreign exchange or interest rate variables.

First, we look into whether elections are taken into account by portfolio investors when making investment decisions. We expect elections to affect equity flows because they create uncertainty about future policies regarding investors. Nevertheless, this is only valid if the election implies a change of leadership. We also try to find out which factors reinforce this effect: elections with narrow margins of victory may reinforce uncertainty, as the elected party/leader may not have sufficient power to impose their views. On the other hand, a very clear win may signal unrestrained power with little compromise, or even rigged elections. The political science literature also underlines that victory by a left-wing party generates greater uncertainty and that foreign investors react sharply to such an event. We collected party orientation data to test this prediction. Second, we estimate the effect of a change in the level of democracy. In doing so we ask the following simple questions: is democracy good for portfolio flows? Is an improvement or
deterioration in democracy indicators good or bad for portfolio flows?

Our results indicate that elections do affect portfolio equity flows. Such a finding confirms previous research: financial markets, in general, and financial markets in emerging countries, in particular, are highly sensitive to electoral outcomes as well as to regular democratic events such as elections. The period following an election is generally characterized by a fall in equity flows. However this occurs only if the incumbent is not reelected (or was not a candidate). We interpret this result as evidence that uncertainty about future policy plays a big role in explaining the effect of elections. We also find that the fall in portfolio equity flows is restricted to presidential regimes. The next graph shows the effect of an election, taking place in month 0, on equity flows, using an 18-month window. The vertical axis is in millions of constant USD, and measures the deviation from the counterfactual that no election occurs. There is little happening before the election, but equity flows are below the counterfactual in the months immediately following the election.

![Effect of an election, occurring in month 0, on equity flows (in USD mil).](image)

Turning to ideology, we find no significant evidence for the hypothesis that a post-election change from left to right (or vice versa) supposes a decrease in portfolio equity flows. In contrast, the change in ideology affects bond flows, and the effect is more pronounced for a change from a right to a left wing government than the opposite. This set of results suggests that investors value continuity and stability in the political environment. A change of leader or of political ideology usually results in lower than
average portfolio flows. This result also confirms previous work and findings, but relies on a broader number of observations than in past studies. Finally, democracy in itself is not found to significantly influence portfolio equity flows, but (negative) changes in democracy do. A decrease in the democracy score implies lower portfolio flows. Yet, an improvement in such score has no effect. Again, investors do not particularly value a given political environment, but dislike changes in this environment.

**Conclusions**

The findings of our new research support our hypothesis that elections have an effect on portfolio flows only when they create political uncertainty. Such findings give policymakers some room of maneuver.

Political uncertainty can be quickly resolved and portfolio flows return to previous levels within an average of 8 months after an election. While this is a relatively short period, the economic costs may still be substantial, the worsening around election times being frequently severe, at least in the 1990s decade.

Politicians can take steps to reduce political uncertainty, by making their intentions clear. They can reduce the incongruous information foreign investors face by publicizing their political agenda to the financial actors in the country as well as to their citizens. Another option is for politicians to send a message of credibility and policy options by tying the hands of the electoral candidates ex ante through pre-electoral commitments binding them to implement "market friendly" reforms.

This strategy was successfully adopted by Lula in 2002 for example, which the current incumbents for the 2010 Brazilian election are already implementing. Looks here also, Latin America (at least some countries in the region) have been learning from the past and are upgrading themselves. It is no surprise that precisely the countries that achieved investment grade status over the past years, Chile or Mexico and more recently Brazil, are the ones where this decoupling between the financial and political cycles have been the most impressive.
References


