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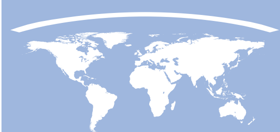

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Are the Financial Markets Politically Correct?

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- Investment bank recommendations regarding public debt issued by emerging countries tend to turn particularly unfavourable during the run-up to an election.
- This aversion is actually linked more to the uncertainty generated by such events than to their nature. In particular, candidates' programmes, especially with regard to monetary and budget aspects, are crucial to the stability of banks' recommendations during electoral periods.

Are the financial markets politically correct? In other words, do they have preferences when it comes to political regimes or partisans? This issue has often been explored with regard to foreign direct investment (FDI) or public development aid, but rarely in relation to portfolio flows in emerging countries.

The universe where stock and bond portfolio managers invest in the sphere of emerging markets is relatively narrow. It is generally limited to the MSCI (Morgan Stanley Capital International) index for equities, and to the EMBI (Emerging Markets Bond Index) for fixed-income assets. The number of countries included in these indexes ranges between 30 and 40. All of them, with just two or three exceptions, are democracies. As a result, one might conclude that the financial markets are hugely biased towards democratic regimes. At first glance, then, they can be viewed as being "politically correct".

However, this first glance does not seem to stand up to closer examination. Indeed, most of the major financial crises that have shaken emerging countries have coincided with elections. This is true, for instance, in Latin America, where all the major crises occurred during presidential elections, such as the Mexico shock of 1994 or the Brazil crisis in 1999 (a few months after the election in October 1998) and again in 2002. In other words, the financial markets tend to become particularly unfavourable when an election is just around the corner.

This aversion is actually linked more to the uncertainty generated by such events than to their nature. Its intensity varies depending on the likelihood of certain candidates being elected (in general, candidates situated to the left of the political spectrum generate more aversion). This phenomenon is dynamic rather than static – it varies over time. These are some of the conclusions of an as-yet unpublished empirical study recently conducted on emerging markets[1] .

Using a single database covering over 10 years (1997-2008) and containing more than 5 000 observations, we explored how financial analysts react during electoral periods in emerging democracies. In all, close to 700 financial reports from 13 investment banks were dissected. The analysis focused on the emerging bond markets and on Latin American markets, but it can be replicated for all emerging countries as a whole, and extended to investment in equities as well.

We studied all the recommendations by these analysts, both positive and negative, as elections neared. In general, banks tend to place the country in question under surveillance during the three months prior to an election, or to reduce their generally positive bias towards it. The banks' recommendations are particularly sensitive to the credibility given to the candidates' programmes, particularly in relation to monetary and fiscal policy.

This sensitivity to the electoral cycle is nevertheless not uniform. For certain emerging countries like Chile, for example, elections have virtually no impact. These types

1. See Sebastián Nieto Parra and Javier Santiso, "Wall Street and Elections in Latin American Emerging Democracies", *Working Paper* No. 272, OECD Development Centre, October 2008. This work was presented at LACEA 2007, the Spanish Central Bank (Banco de España) and the Bank for International Settlements (BIS). It was also used as a background document for the OECD *Latin American Economic Outlook 2009* (forthcoming) www.oecd.org/dev/LEO

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of countries are however an exception, although we see that in 2006, the intensity of the political cycle did not prompt aversion phenomena comparable to those recorded in preceding cycles.

Bank analysts thus prove to be particularly sensitive to the signals being sent by presidential candidates. They judge and size up their promises in detail, and adjust their recommendations based on their conclusions. When candidates who seem to be in a position to win an election make promises they deem to be hardly credible or that can affect the country's macroeconomic balance, analysts invite their clients – namely portfolio managers and other investors – to reduce their investments.

All elected officials seeking re-election or aspiring to run again for office have a converging interest in not taking the reins of power in the midst of an economic crisis. In certain cases, for example Brazil in 2002[2], the outgoing officials can adjust their promises and sometimes even let their hands get tied (for instance, with the IMF), thus sending a strong signal to the markets about the credibility of their programmes.

2. For more details, see Juan Martínez and Javier Santiso, "Financial Markets and Politics: The Confidence Game in Latin American Emerging Democracies", *International Political Science Review,* 2003, vol. 24 (39) pp. 363-395.

The example of Brazil is equally interesting with regard to preventive strategies: in 2002, an electoral year, the incumbents deliberately reduced debt volumes reaching maturity in anticipation of possible turbulences. In the end, the strategy turned out not only to be wise, because the markets definitely overreacted, frightened to see a leftist candidate (in this case Lula) reaching the seat of power; but doubtless it also helped avoid the worst. Afterwards, the adjustments and readjustments in president Lula's programmes showed that the negative forecasts were unfounded, and the markets then embarked on a veritable Lula de mel (or "Lula honeymoon") with the new Brazilian government.

Such international preventive or leveraging strategies are one possible response to the aversion of financial markets faced with uncertainties in any election. They are even more welcome when, as highlighted above, the markets are far from being indifferent to political events. On the contrary, an election in an emerging country is viewed as a decisive event by Wall Street. This sensitivity to the political cycle by the markets is indeed a characteristic of the emerging countries.

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