

## Democracy vs the Financial Markets

### How will Latin America's busy electoral calendar affect the performance of global financial markets in 2006?

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Will 2006 be a year of financial crisis in Latin America? With elections expected in Brazil, Mexico, Peru, Venezuela, and Colombia in addition to those which have already taken place in Bolivia and Chile, and with electorates across the Continent in truculent mood, the outlook for financial markets could be sombre. In the past, elections have caused bond spreads to widen alarmingly and have sometimes tipped financial markets across the region into crisis, especially when leading candidates were of the 'left.' Are individual markets vulnerable? And is the risk of contagion high? These are crucial questions for financial and economic managers interested in Latin America this year – and for global financial market stability.

Despite recent research that shows a clear relationship between elections and financial market volatility, there are three reasons not to panic. First, the perception of a Latin American shift 'leftwards' falls flat under closer examination given the heterogeneity of its emerging leaders. Second, the risks of contagion have fallen as investors have become better informed and more sophisticated managers of political risk. Third, Latin American economies are generally strong.

#### Latin American Election Calendar, 2006

COUNTRY	DATE	TERM
Chile	15 Jan 2006	4 years
Costa Rica	5 Feb 2006	4 years
Peru	9 Apr 2006	5 years
Colombia	May 2006	4 years
Mexico	2 Jul 2006	6 years
Brazil	1 Oct 2006	4 years
Ecuador	Oct 2006	4 years
Nicaragua	5 Nov 2006	5 years
Venezuela	Nov/Dec 2006	6 years

There are two well established links between elections and volatility. The first has to do with the impact of elections

on fiscal discipline, the so-called 'political business cycle.' Politicians interested in increasing their electoral prospects are likely to increase fiscal expenditure and spending promises in the run up to an election. Financial markets are likely to discount sovereign debt in the pre-electoral period as a result of a deteriorating economic outlook. The same argument has been made to explain why forward rates on emerging market currencies trade at a premium prior to elections. To date, Latin American bond and currency markets have not reacted strongly to the electoral risk, though foreign direct investment to certain countries has fallen over the past year.

The second has to do with the uncertainty generated by the electoral process, which may cause expectations of crisis to converge. News about candidates and their intended policy platforms can increase the propensity of markets to herd – in part because the impact of such news is harder to accurately price. It is released to markets at unexpected times and in unexpected ways, increasing the average impact of each piece of news; it is difficult to quantify and therefore its ultimate importance to asset prices is hard to determine; and it is uncertain due to politician's incentive to make policy promises that they do not intend to or cannot keep in the run up to elections. This was most easily observable in the Brazilian elections of 2002, when the candidacy of Luis Inácio da Silva (Lula) as Brazilian president sent financial markets into a tailspin and spreads reached levels higher than those seen immediately prior to the Argentine default of 2001 (see below).

Exacerbating the above is the fact that there is a perception the impact of elections on financial market volatility is more severe when the candidate in question is perceived to be of the 'left' – as the Brazilian case clearly shows. Across the region there is a deep questioning both of traditional Latin American politics and parties, which has led commentators to conclude that the region is undergoing a leftward shift. The observation is often supported by citing Lula in Brazil, Tabaré Vázquez in Uruguay, and most recently, Evo Morales

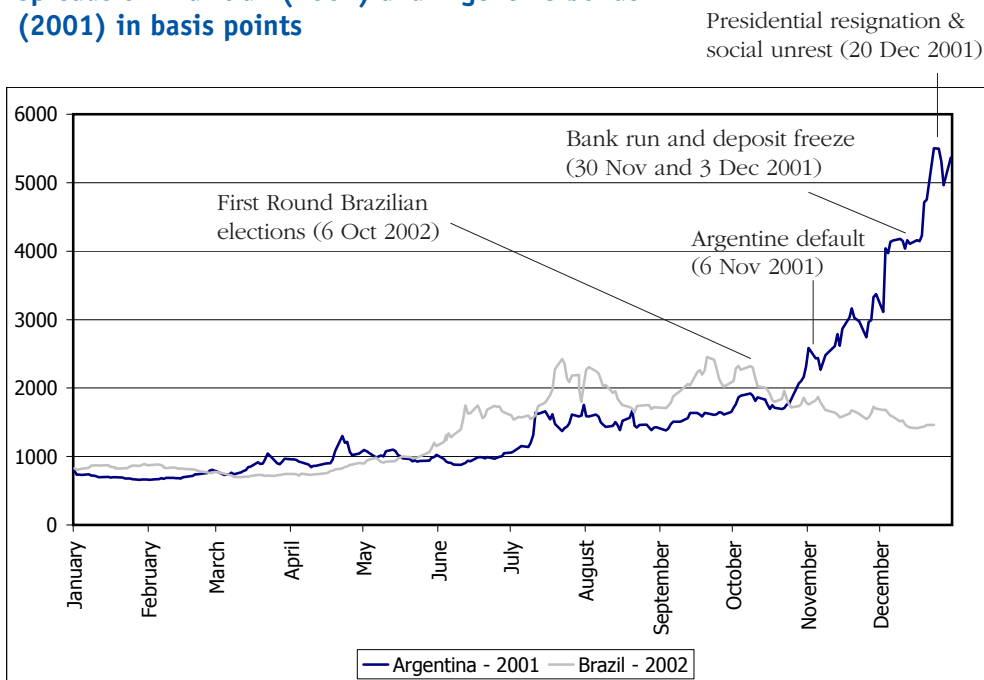
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### Spreads on Brazilian (2002) and Argentine bonds (2001) in basis points



Source: JPMorgan's Emerging Market Bond Index (EMBI)

in Bolivia and Michelle Bachelet in Chile. Hugo Chavez's 'Bolivarian Revolution' in Venezuela and Nestor Kirchner's particularly Argentine brand of economic nationalism are often included in such examples. The candidacy of the former Mayor of Mexico City and left-leaning PRD member for the Mexican presidency could likewise rattle markets given the country's close ties to the US and the recurrent trend for Mexican financial crises to occur during election years (the so-called 'sexenio curse').

Despite this risky contagion cocktail there are three strong mitigants against region wide crisis. First, the 'left' in question is a broad church. There is little reason to group together social-democratic leaders in Chile and Brazil with Chavez's economic nationalism, and see the trend as a homogenous one. The Latin American left has pursued fiscally responsible policies, even at the risk of undermining their support base, throughout the 1990s and more recently under Lula in Brazil.

Second, the most recent emerging market financial crisis in Argentina resulted in limited contagion, in no small part because of investors' more orderly readjustment of portfolios. The ability to differentiate among Latin American risks has increased as the emerging market class has expanded. Diversification of the investor base may have helped to reduce the propensity of investors to dump assets

in a fire-sale when things go wrong. Additionally, a perception of overreaction to Lula's election may temper contagion risks in this electoral season.

Third, and most importantly, most of the economies in question currently have strong macroeconomic fundamentals and commitment to neo-liberal economic policy has been enhanced by an array of international trade and investment agreements. Sovereign debt in countries in the largest markets is increasingly denominated in local currency, reducing liquidity risks. In Brazil, for example, this has meant that external debt has gone from 44.5% of GDP in 2001 to 27.5% in 2005. The boom in commodity prices

has increased trade surpluses and reserve rates, further insulating economies. And the movement towards free floating currencies across the region has reduced the risk of speculative currency crises.

Given these strengths, investors are encouraged not to panic and to take a long run and differentiated view of Latin American risk. The 'institutionalised uncertainty' that comes with democratic contestation should be seen as a positive alternative to Latin America's previous political systems. Doing so will not only help to avoid heavy financial losses and global instability, it will also reduce the likelihood of further shifts towards economic nationalism by depriving would-be populist leaders of an easy target to point blame for the regions' woes.

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