

Book Review: Banking on Democracy: Financial Markets and Elections in Emerging Countries

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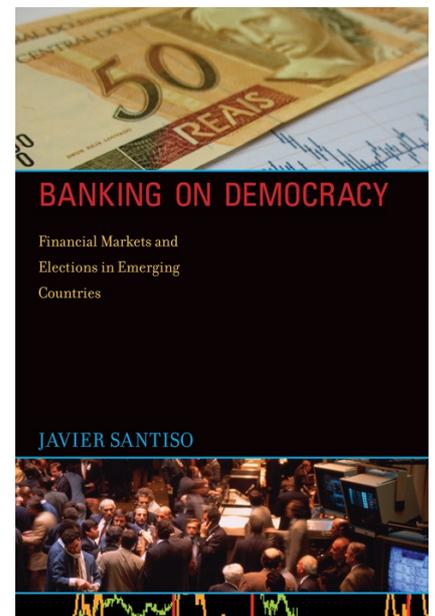
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In *Banking on Democracy*, **Javier Santiso** investigates the links between politics and finance in countries that have recently experienced both economic and democratic transitions. He focuses on elections, investigating whether there is a “democratic premium” — whether financial markets and investors tend to react positively to elections in emerging markets. This is an excellent assessment of the relationship between markets and elections in emerging economies, writes **Ilana Rothkopf**. While Santiso’s empirical studies are complex, he presents his findings in a manner that is accessible to readers of diverse academic and methodological backgrounds.



Banking on Democracy: Financial Markets and Elections in Emerging Countries. Javier Santiso. MIT Press. July 2013.

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Do markets prefer democracy? How do political budget cycles impact elections and vice versa? In *Banking on Democracy: Financial Markets and Elections in Emerging Countries*, **Javier Santiso**, Professor of Economics at ESADE Business School, assesses the interactions between financial markets and democratic elections in emerging Latin American economies. Santiso asserts and later illustrates that political transitions and economic upgrades converged in Latin America with particular frequency and intensity in the last decade. As a former OECD Development Centre chief economist with experience in academia, international organisations, and the private sector, Santiso draws on his professional experience and access to unique datasets to craft an insightful, well-informed study of this phenomenon.

Santiso opens with a brief introduction to the structure of his book and an overview of recent studies that cover the relationship between politics and finance. He then utilises his first chapter to place emerging markets in the context of a changing global economy and to clearly define his terms. “Emerging markets,” Santiso explains, originated as a strictly financial term to describe the developing countries that are included in indices used by portfolio managers “investible universes” (p.10). The author’s survey of country coverage by the world’s top investment banks finds that 35 economies are regularly covered by brokers, and that only 10 of these countries are emerging economies. In other words, over 120 developing countries, “simply do not exist for global financial market investors,” (p.27). Latin America, however, is extensively covered, and thus presents an excellent opportunity for this study. This chapter

also provides a historical analysis of emerging markets and identifies the key differentiations between developed, emerging, and developing markets from a financial perspective – the ability or inability to raise debts in their own currencies.

One of the most interesting aspects of this book is the presentation of Brazil as the primary country case study in Chapter 2. Santiso later draws on the implications of this case study throughout his succeeding chapters. This chapter claims that Brazil exemplifies the ways in which financial markets overreact to the uncertainty of the policies a leftist political candidate might pursue. Uncertainty, Santiso explains, is the key explanatory variable for markets' reactions to electoral outcomes.

Luiz Lula's 2002 presidential campaign and victory illustrate this dynamic. Santiso also places his Brazil study in the appropriate historical, political, and financial contexts. For example, he notes that Lula's campaign-trail comments about debt restructuring must be considered in light of financial markets' extreme sensitivity to debt following Argentina's 2001 public debt default. After Lula's electoral victory however, an IMF agreement to maintain certain fiscal and economic policies, as well as the Lula government's decision to place the "right people" in the ministry of finance and central bank, all acted as confidence anchors. The empirical component of this case study further supports the hypothesis that political uncertainty affects financial markets. Santiso assesses how domestic short-term interest rates (using the "Special System for Settlement and Custody [SELIC]), exchange rates, and the long-term interest rates for external public debt (over)react to elections. This analysis supports the author's claim that market instability originates not in the democratic process itself but from the perception of institutional weakness and uncertainty.



Turtle on a Brazilian Real bank note. Credit: [ydan](#) CC BY-NC-ND 2.0

Although the subsequent chapters reference the Brazil case study where appropriate, they emphasise the fact that the case of Brazil is not, in fact, especially unique among Latin American emerging markets and democracies. Whereas the third and fourth chapters cover the effect of democratic elections on the buy-side and sell-side of financial markets respectively, the fifth chapter examines fiscal policies and political budget cycles. The existing literature illustrates that although economic policies and platforms tend to be expansionary during elections, financial markets are especially sensitive to new candidates. Here Santiso draws on his findings in the Brazil case study: that financial markets will be initially averse to left-leaning newcomers, such as Lula, whose potential fiscal policies are

perceived as riskier than the incumbent's. The empirical component in this chapter draws on the United States Economic Commission for Latin American and Caribbean public finance database on general government accounts. This study examined policies of 28 OECD and 19 Latin American countries for the period of 1990 to 2006. The author's findings here are consistent with the literature, and imply that major elections in Latin America impact fiscal policy to a much larger extent than they do in wealthier countries. However, these policies in emerging Latin American economies have also become more prudent over time, as illustrated by the empirical evidence

Santiso concludes with an overview of the confidence game in emerging economies, some policy recommendations, and comments on the Arab Spring as a reminder that "not everything that glitters is gold" (p.237). He notes that although the states that experienced the greatest political upheaval have relatively little importance in financial markets, emerging markets still present unique political risks. One such recommendation includes encouraging market participants to closely monitor political dynamics in emerging economies, while policymakers concurrently scrutinise market analysts in turn. As empirical research suggests a strong correlation between bond recommendations and bank's business activities in a given country, Santiso also recommends that governments and central banks monitor these recommendations.

Overall this is an excellent and intriguing assessment of the relationship between financial markets and elections in emerging economies. While Santiso's empirical studies are nuanced and in some cases rather complex, he presents his findings in a manner that is accessible to readers of diverse academic and methodological backgrounds. Additionally, his quantitative analyses are accompanied by useful visuals and detailed explanations. This study covers broad literatures in a comprehensive yet concise manner, identifies shortcomings in this existing literature, and further suggests useful avenues for future study.

Ilana Rothkopf completed an MSc in International Relations at the LSE in 2012, and holds an undergraduate degree in Political Science and Middle East studies from McGill University. Her research interests include foreign policy analysis, religion and international relations, political identity and the Middle East. [Read more reviews by Ilana.](#)