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Financial Markets and Politics: The Confidence Game in Latin American Emerging Economies

JUAN MARTÍNEZ AND JAVIER SANTISO

ABSTRACT. This article focuses on the interactions between politics and financial markets in emerging economies. More precisely, it examines how Wall Street reacts to major Latin American political events. The case study focuses on the 2002 Brazilian presidential elections. The first section of the article provides a critical review of the available literature. The second section presents an empirical study of Wall Street analysts' perceptions of the 2002 presidential elections in Brazil, based on reports produced by leading Wall Street investment firms. The final section uses polling and financial data from previous Brazilian elections to place the events of 2002 in comparative historical perspective.

Keywords: • Emerging economies • Financial markets • International political economy • Latin America

The overriding objective of policy must ... be to mollify market sentiment. But, because crises can be self-fulfilling, sound economic policy is not sufficient to gain market confidence; one must cater to the perceptions, the prejudices, and the whims of the market. Or, rather, one must cater to what one hopes will be the perceptions of the market.

Paul Krugman (2002)

Introduction

At the heart of financial transactions lies a question of confidence. Economists from Smith to Coase have emphasized the importance of confidence, whether to explain the wealth of nations or the birth and death of firms. More recently, Paul Krugman has highlighted the contemporary “games of confidence” that lie behind financial turbulence. Given financial needs and a lack of savings, Latin American emerging markets are highly dependent on international capital flows.

The trick for policy-makers is to keep debt premiums low by maintaining investor confidence in their countries' respective economies. "The peculiar thing," explains Krugman (2002: 113), "is that, because speculative attacks can be self-justifying, following an economic policy that makes sense in terms of the fundamentals is not enough to assure market confidence. In fact, the need to win that confidence can actually prevent a country from following otherwise sensible policies and force it to follow policies that would normally seem perverse."

Part of the confidence game lies in the interaction between politics and economics, or to be more precise, in the perceptions of analysts, fund managers, national and international investors, and rating agencies engaged in emerging-market political games (Santiso, 2003). In emerging markets, financial turbulence and politics are closely linked. Elections are frequently associated with significant increases in financial market spreads. Not only do bond spreads tend to increase during electoral periods, but agency sovereign risk ratings also tend to deteriorate (Reihart, 2002; Reisen, 2002). Both agencies and bondholders view elections as periods of uncertainty, and hence of increased risk. In the same way, sudden swings in capital flows and currency devaluation are also associated with electoral years. Moreover, output losses from financial crises tend to be larger in emerging markets than industrial countries. One explanation lies with politics and the so-called "weak government hypothesis": weak governments delay the implementation of necessary, but politically costly economic reform (Calvo, 2001, 2002).¹

The problem of instability in emerging markets may even have grown worse since earlier phases of globalization (Eichengreen and Bordo, 2002; Bordo et al., 2001: 51–82; Bordo and Panini Murshid, 2002). With capital flowing more easily into and out of emerging markets, following liberalization and the more open finance of the 1990s, emerging markets have experienced an increased frequency of crashes. When compared with developed countries, the frequency of crashes in developing economies tends to be much higher. According to a recent analysis, the frequency of crashes for a closed emerging country is 25 percent on average during a year, against less than 9 percent for a developed country (Martin and Rey, 2002). The frequency of crashes for an open emerging country is close to 62 percent, compared to less than 10 percent for a developed country. Not only are emerging markets more prone to crashes than developed countries, but also open emerging countries are more exposed to financial crashes than closed emerging markets.

The 1990s witnessed a consolidation of democracy in the developing world. With the spread of democracy, politicians became more aware of social pressures, and they tended to delay costly adjustments. Emerging markets are particularly susceptible to this problem of delayed reform because of more general institutional weakness. As recent research has established, countries with weak institutions tend to adopt poor macroeconomic policies, and this leads in turn to bad macroeconomic performance and higher financial volatility (Acemoglu et al., 2002). Indeed, these authors argue that: "distortional macroeconomic policies are not typically chosen because politicians believe that high inflation or overvalued exchange rates are good for economic performance. Instead, they reflect underlying institutional problems in these countries" (Acemoglu et al., 2002).

This article focuses on the interactions between politics and finance in emerging economies. More precisely, we will examine how Wall Street (that is, the financial markets) incorporates and reacts to major Latin American political

events. Our case study focuses on the 2002 Brazilian presidential elections. The first section of the article presents a critical review of the existing literature. The second section presents an empirical study of Wall Street analysts' perceptions of the 2002 Brazilian presidential election. This analysis is based on the reports of Wall Street investment firms, focusing on the top fixed-income teams as ranked by Institutional Investors, Bloomberg and Latin Finance in their league tables.² The third section introduces historical data from previous election cycles in Brazil to set recent events in a comparative historical perspective.

Financial Markets and Politics in Emerging Markets

Finance and politics are closely linked, as can be seen in the history of national currencies developed by political authorities within specific territorial boundaries or in the systematic effect of electoral policy and political regime on the size and composition of government spending (Persson, 2002: 883–905; González, 2002: 204–224). Interactions between politics and economics are also central to understanding financial crises in emerging markets. Probably the most relevant definition of an emerging market is an economy whose political outcomes and uncertainties (such as a presidential election or a cabinet reshuffle) tend to have high impacts on financial variables and therefore on stock markets. A leading emerging-market bond fund manager explained:

At PIMCO, we ask two basic questions whenever confronted with indications of actual or prospective political noise. First, can this noise undermine the economic and financial outlook for the country? Essentially, we were inquiring about potential impact on debtors' capacity and willingness to meet their payment obligations. The second question concerns the potential reaction of other market participants. When closely considered, it is not particularly surprising that, in most cases, the immediate market reactions to increased political noise has been very pronounced price volatility. After all markets generally dislike uncertainty, especially when it emanates from what is still viewed as Byzantine emerging markets politics. (El-Erian, 2002a: 3)

The paradox is that, in spite of such evidence, few empirical studies have focused on the links between political variables and financial markets. One explanation might be the difficulty that economists have had in formalizing political variables. Another might be the hesitation of sociologists to open the "black box" and explore the socioeconomics of financial markets. However, the so-called second-generation models of crises,³ in considering optimal government behavior and the political dimensions of economic trade-offs, have begun to introduce political variables into the analysis of financial crises. Eichengreen, Rose and Wyplosz were among the first to address the political dimension of financial crises, finding intimate links between political processes and exchange-rate turbulence (Eichengreen et al., 1995: 249–312). Later, Frieden, Ghezzi and Stein argued that weak governments might be more vulnerable to currency crises. In a detailed study of the behavior of real and nominal exchange rates in Latin America, they confirmed that changes in exchange-rate regimes coincided with elections (Frieden et al., 2001: 20–63). To be more precise, devaluations were generally postponed until after elections. In fact, in the months following elections (2, 3 and 4 months after), the average rate of nominal depreciation tends to be twice as high as in the months preceding elections. In the case of

presidential elections, the average rate of nominal depreciation tends to be even higher: 4.5 times higher than in the preceding months. Overall, the probability of major devaluations increases in the run-up to elections, with governments tending to put off the adjustment where possible until after the votes are cast.

Conversely, when governments embark on programs to stabilize the exchange rate, they tend to carry them out during pre-election periods, counting on a political dividend from currency stability. For example, between 1970 and 2000 there were 34 changes of currency regime aimed at achieving greater stability in 18 Latin American countries. In 26 of these cases, the change occurred ahead of major elections; in other words, 76 percent of the cases occurred in the run-up to an electoral process (Schamis and Way, 2001). Overall, strategies for stabilizing the exchange rate are most frequently implemented ahead of presidential elections, with a probability three times higher than at any other point in the political cycle. Another study (focused on 88 speculative attacks on emerging-market currencies between 1985 and 1999) also established that the propensity of politicians to defend a currency regime is greater in the months leading up to an election, but declines dramatically thereafter. The defense of the currency is 63 percent stronger in the 4 months preceding an election than in a normal period, but this drops to 19 percent in the 3 following months (Leblang, 2001).⁴

In recent years, there has been increasing interest among economists, political scientists and sociologists in this topic and a growing body of literature is now exploring the connections between financial markets and politics (Santiso, 1999b: 307–330; Bacmann and Bolliger, 2001; Barber et al., 2001; Boni and Womack, 2002). The emerging literature suggests that political variables are indeed significant explanatory factors in emerging markets' crises. For example, structural political variables are correlated with currency crises: left-wing governments are more vulnerable to such crises, while strong governments with legislative majorities and fragmented oppositions tend to be the least vulnerable (Block, 2001b; Drazen, 1999).

If we focus on Latin America, it is clear that political dynamics are a key variable for understanding financial crises. The three most recent and significant financial crises in the region (Mexico in 1994, Brazil in 1999 and Argentina in 2001) took place during a corresponding presidential or parliamentary electoral year (see, for an analysis of the first crisis, Santiso, 1999a). The same is true of other emerging markets: for nine other emerging economies, the financial crises of the 1990s happened during electoral periods or political transitions (Mei, 1999).⁵ Moreover, among the three types of risk to which financial markets are exposed (financial risk, political risk and policy risk) political risk appears to be the major driver behind capital flight from emerging markets.⁶

Elections in emerging countries have significant effects on market spreads and rating agency decisions. On average, elections in emerging markets tend to be associated with a decline of 1 rating level on a 17-point scale (0–16). Similarly, sovereign debt due to the sale of US Treasury bills tends to increase by 21 percentage points 2 months after a major election in an emerging economy when compared to the same period without an election. "Together," underlines Steven Block in his stimulating study, "these results suggest that at least two key actors in international credit transactions, agencies and bondholders, view elections in developing countries negatively and exact a substantial premium on developing sovereigns and sub-sovereign individuals seeking capital" (Block and Vaaler, 2001).⁷ Overall, these results suggest that elections entail a substantial financial cost for developing countries.

In fact, for countries with weak economic fundamentals, political instability further aggravates financial vulnerability. This is particularly relevant in emerging economies, where political-institutional instability tends to be higher. Philippe Aghion et al. (2001) found that the bulk of institutional political changes that occurred over a 20-year period in a large sample of 177 countries were concentrated in emerging countries. Of 294 significant changes, Africa and Latin America experienced the highest degree of political instability, with 138 and 59 institutional changes respectively (compared to 15 changes in all the industrialized countries). Africa alone accounted for nearly half of all political institutional changes recorded during the period, and Latin America for some 20 percent.

The impact of democratic politics on currency and bond markets is not confined to emerging markets. Uncertainty about electoral outcomes and government survival also has repercussions for financial markets in Organization for Economic Cooperation and Development (OECD) countries, where political events, elections, polls, and cabinet formation and dissolution make it more difficult for traders to forecast economic conditions (Leblang and Bernhard, 2000: 291–324; Lowry, 2001: 49–72). However, the impact of electoral processes is particularly relevant for emerging markets, for here the associated uncertainties are greater and currency or bond traders' confidence more fragile. For example, during election times, governments tend to increase public spending in order to win political support, potentially hurting investors' interests.⁸ Although this is not specific to emerging countries, fiscal deficits tend to be more critical here because of their financial needs and their difficulty in accumulating capital (Alesina et al., 1999: 233–255).

This tendency must be analyzed more carefully, however, since not all election years are associated with financial disruptions. Empirical research provides considerable evidence of fiscal-policy distortions during election periods in emerging countries. In a study that analyzes 17 Latin American countries over a time period from 1947 to 1982, a panel regression shows an increase of more than 6 percent in public expenditure in the pre-election year and a decrease of more than 7.5 percent in the post-election year (Ames, 1987). Politicians seeking re-election clearly have a strong incentive to manipulate fiscal policy to their advantage. The consequence of the electoral cycle is therefore to create the well-known tendency for fiscal performance (carefully monitored by analysts and investors) to worsen in election years, leading to macroeconomic instability. According to a study that examined a sample of 123 developing and industrialized countries, fiscal deficits tended to be on average 1 percent of GDP higher in election years (Shi and Svensson, 2001). Among emerging economies, the fiscal deficits in election years were even larger—on average 2 percentage points of GDP higher.

Another recent study, examining 69 countries, confirms the evidence of electorally motivated changes in the composition of public expenditure in emerging countries. In election years, public expenditure tends to shift toward short-term (and visible) consumption and away from public investment goods. Typically, current expenditure shares show an increase of as much as 2.3 percentage points during election years, while long-term expenditure such as capital investment tends to decline by as much as 1.55 percentage points. However, countries with noncompetitive systems exhibit no election-year effect on public spending (Block, 2001a). In the same way, political institutions that limit

the discretionary behavior of policy-makers will tend to reduce the volatility of government expenditures and revenues prior to and after elections (Henisz, 2002).

The response of financial markets to electoral and partisan change, examined in a study of 78 developing countries using monthly data from 1975 to 1998, confirms that speculative attacks are more likely just after an election as compared to all other periods (Leblang, 2002). The reaction of global financial markets to politics in new democracies within the same region may also differ, depending on the degree of democratization and the transparency (or perceived transparency) of the policy-making process, the length of time democratic institutions have been in existence, and the scale of the government's legislative majority and its political cohesion (Hays et al., 2001; MacIntyre, 2001: 81–122).

Thus politics is far from neutral in financial markets. Moreover, there is clear evidence that financial-market participants take account of political events. The returns of certain stocks can be affected directly by expectations of political outcomes (Lin and Roberts, 2001), and the corresponding stock price movements occur in the weeks immediately prior to elections (Pantazis et al., 2000). The monitoring of political events in emerging markets by financial analysts can be seen in the research products of investment boutiques that constantly ponder over uncertain political outcomes. Some firms, such as Lehman Brothers, have even created specific joint ventures to incorporate analysis of political and social factors more consistently into their fixed-income research.⁹ In addition, the French financial operator CDC Ixis developed a specific approach for considering the impact of political risk in emerging markets (CDC Ixis, 2002a).

There are also clear links between lack of transparency, political uncertainty and financial crises (Haggard, 2000; Drazen, 2000; Chang, 2002). Rational contagion in emerging markets can be driven in part by political considerations. Because of their opaque policy processes, less democratic countries can suffer more from contagion in international financial markets. At the same time, because political rumors float freely within globalized political regimes (regardless of the existence of emerging markets), all countries, democratic or authoritarian, suffer some of the costs.

It is also interesting to consider stock-market behavior when firms announce investment in a country with secure or, on the contrary, unsecured property rights. In an empirical study examining shareholder perceptions of the foreign direct investment (FDI) announcements of large US firms, the authors found that the average abnormal return for investments in countries where property-rights regimes were weak scored negatively (0.0554 percent). In other words, investments in environments with poorly defined property rights were greeted by a negative share-price response (English and Moore, 2002).

Analysts Analyzed: Wall Street and the 2002 Brazilian Presidential Election

Obviously, the monitoring of politics intensifies during crisis periods. This was underlined by the coverage of political issues during the Argentine meltdown at the end of 2001—an economic collapse described by some financial operators as clear evidence of a crisis of political governance, representation and legitimacy (see, for example, J.P. Morgan Chase, 2001). Election years are critical junctures from an investor's point of view, and at such moments the density of finance-industry reports incorporating political dimensions jumps sharply.

From this perspective, the 2002 presidential elections in Brazil represent a paradigmatic case. The Brazilian episode also underlines that financial turbulence is contingent—neither inevitable, nor preordained, but rather involving a country that has entered a risky zone, a speculative tunnel, where the government lacks the political and economic capacity to curb market perceptions in order to fend off financial pressures. As Eichengreen (2002a: 9) has stressed, at such a critical juncture:

if investor sentiment turns against the country, for whatever reason, the government of a country with heavy financial burden or a weak economy may be unable to sustain the harsh policies of austerity needed to deflect mounting pressures. If, on the other hand, market sentiment remains favorable, the same economic and financial fundamentals will be sustainable, and no crisis will result.

An appreciation of such market sentiment is therefore central to understanding the dynamics of financial turbulence. In other words, it is necessary to understand how Wall Street cognitive regimes shift regarding a country. The purpose of this section is to examine such changing perceptions regarding Brazil during the 2002 electoral contest.

It is important to stress at the outset that in 2002 economic fundamentals were also worrying investors. More precisely, and in contrast to other emerging-market crises, investors were concerned less with exchange rates than with debt dynamics. In 1999, Brazil adopted a floating exchange-rate regime, and the recent round of market turbulence has concerned fiscal sustainability rather than the maintenance of a fixed exchange rate. During the period covered by the present article there was a major shift in Brazil's macroeconomic framework, with the pre-1999 concerns of investors giving way to very different post-1999 preoccupations. It is also important to appreciate that "Wall Street" does not form a uniform "epistemic community": the views of investors and analysts are multiple. For example, the concerns of investors in equities and investors in debt (government bonds) are unlikely to be perfectly coincident. But in the post-1999 world, and particularly during the 2002 elections, it was the possibility of government default on its debt (and not exchange-rate instability) that loomed largest. To understand investor and analyst nervousness, it is also important to keep in mind that Brazil is by far the largest Latin America economy, contributing 40 percent of regional output. It is also a major equity and bond emerging market for international investors.

At the beginning of 2002, the country's sound economic track record was being praised by almost everybody from New York to London and from Washington to Sao Paulo. Brokers' reports stressed the substantial decoupling between the Argentinean and Brazilian economies, pointing to the weak trade links between the two partners and low Brazilian banking exposure to Argentina. Investment bank and broker reports lauded Brazilian economic and political achievements, with some analysts emphasizing Brazil's future potential: "Global decoupling seems to gain ground," wrote a bullish strategist at the time, "funds are flowing to emerging markets, but have not reached Brazil," and "Brazil could now be the last diversification play" (Morgan Stanley, 2002a). Others stressed the decoupling between Brazil and its troubled neighbor Argentina: "the correlation between daily returns on Argentina and Brazil in the EMBI+ [Emerging Markets Bond Index Plus], which stood at very high levels between 1995 and 2000, dropped to 0.8 in the summer of 2001 when deposits withdrawals accelerated in Argentina,

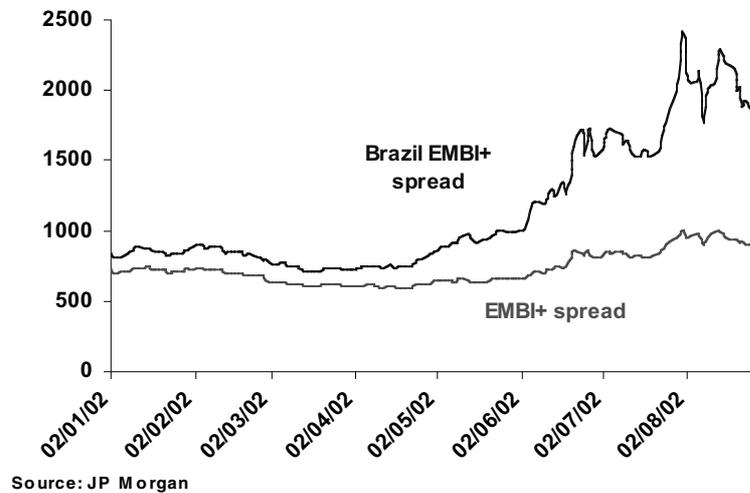
and slumped to 0.15 in November 2001 when Argentina's default was announced."¹⁰

This celebration of Brazilian success culminated in March 2002 during the Annual Meeting of the Inter-American Development Bank (IADB) held at Fortaleza, Brazil. Arminio Fraga, a major confidence-game player and expert, and appointed as central bank governor in 1999 after a brilliant career in Wall Street at Salomon Brothers and Soros Fund Management, was elected Man of the Year by *Latin Finance* magazine and dubbed "the man who saved Brazil." Typical of the mood with regard to Latin American emerging markets was the Merrill Lynch report and summary conclusions of the IADB meetings. Like its competitors, Merrill Lynch organized an investor conference in Fortaleza, attended by portfolio managers, officers of the IMF, and US Treasury representatives. The firm's emerging-markets debt strategist concluded that:

The mood in Fortaleza was generally upbeat. In contrast to one year ago in Santiago de Chile, there was no major crisis in the making, such as it was the case with Argentina back then. Indeed, one of the more remarkable market, economic, and political developments over the past year has been how little regional contagion has been triggered by the Argentine crisis. . . . The principal focus at the meetings was the Brazilian elections, and participants appeared to be reassured that despite a volatile period ahead, a candidate from the government coalition is still the most likely successor to President Cardoso. (Merrill Lynch, 2002b)

But by late April the currency had slumped, and the risk premium on Brazilian bonds soared, putting them on a par with Nigerian paper. Why such a sudden fall from grace? The key was that in October 2002 Brazil faced an important presidential election. By March, opinion polls started to appear and to be assessed by major Wall Street brokers. Investors abhor uncertainty, but the 2002 presidential election presented Brazilian voters with an important choice. Constitutional provisions prevented President Fernando Henrique Cardoso, who since 1995 had contributed so much to the modernization of the Brazilian government and economy, from competing for another term. There were three major contenders for the presidency: two leftist candidates, Luiz Inacio Lula da Silva and Ciro Gomes, and José Serra (Cardoso's man).¹¹ The first two candidates had in the past spoken of the possibility of debt restructuring. But in the wake of Argentina's default on its public debt just a few months earlier, market sensitivity regarding the debt issue was high. Moreover, some analysts recalled that previous presidential elections in Brazil had also produced costly devaluations that wrecked the economy. Between April and July 2002, when investors started to worry that one of the leftist candidates might actually win, anxiety was transmitted to financial variables. By July spreads levels jumped above 2000 bps (see Figure 1), and the currency had sunk to more than 3.50 reais per dollar (from a level of 2.30 reais at the beginning of the year).

By the beginning of May 2002 a few brokers started to publish cautious reports drawing attention to political factors. Later in the month nearly all the Wall Street boutiques began to crunch numbers to assess the sustainability of Brazilian debt dynamics. Brazilian public debt actually represents a rather unusual case among emerging markets, which amplifies its sensitivity to financial variables. In mid-2002, Brazil's debt was 80 percent indexed to either domestic interest rates or to currency-exchange levels. Models were used to determine what primary fiscal

FIGURE 1. *Brazilian and Emerging Bond Spreads*

surplus would be required to stabilize the debt–GDP ratio, using stress-case scenarios for the major variables affecting debt dynamics (real interest rates, the exchange rate, GDP growth and net contingent liabilities).¹²

The shift toward a more cautious tone regarding Brazil was mainly triggered by opinion polls revealing strong support for Lula, the candidate of the leftist-leaning Workers Party.¹³ As Walter Molano (2002a) of BCP Securities explained in a briefing report issued at the end of May entitled *Da Lula Monster*: “there seems to be a sense of panic as economic agents realise that Lula will win the elections. The behaviour by the multinationals seems to be the mirror of what is happening in the bond market. It is too bad that Brazil will not get the benefit of the doubt.” The impact of the more cautious stance on Brazil was exacerbated by the risk-averse approach to emerging markets that arose because of doubts concerning the US recovery. But in the case of Brazil, politics reinforced the risk aversion. Lula’s strength in the polls was perceived as a growing risk by investors and analysts, because it presented a serious threat of discontinuity in economic policy. As a result of the increased political uncertainty, many of the investment banks began to shift their portfolio recommendations for Brazil from “overweight” to “neutral.” At this point, Wall Street analysts did not play down the vulnerabilities and risks ahead, but neither did they perceive a Brazilian crisis as imminent or inevitable. The rollover of domestic debt was seen as large but manageable, and the capacity of the Brazilian government to meet its foreign obligations was regarded as stronger than indicated by foreign obligation spreads. The major concern was rather the increasing impact on debt dynamics of prolonged investor risk aversion regarding Brazil (CDC Ixis, 2002b). Thus at this point, a Brazilian crisis was not seen as the most likely scenario by Wall Street analysts, who were still envisioning a happy ending in October.

More extensive political assessments then started to be published by analysts. For example, the BBA economic research team in Brazil published a detailed analysis of the Workers Party economic program (Banco BBA Creditanstalt, 2002).¹⁴

J.P. Morgan Chase (2002a) issued a comprehensive guide to the Brazilian parties and candidates. Poll results were dissected by all Wall Street firms, with some pointing to television as a crucial determinant of voting intentions. On 8 May 2002, UBS Warburg (2002), for example, devoted a complete report to discussing the impact of free television coverage on the presidential race that would officially get under way on 20 August.¹⁵ Other firms created specialized analytical devices to capture the political dynamics. An interesting example was Goldman Sachs (2002a), which developed a “Lulameter”—a model that tried to quantify the probability of a Lula victory, as was priced in by the currency markets.

As markets became preoccupied with Brazil, some boutiques even faced internal turbulence. On 3 May, for example, Santander Central Hispano’s New York research department downgraded Brazilian bonds to a “neutral” from a “heavy” weighting, citing the country’s sluggish economy and the political risks ahead of the October presidential election. In Brazil, officials publicly disagreed with the downgrade and the bank, which has substantial business interests in the country, moved toward firing the 12-member sovereign debt research team. In the end, worried about damaging its credibility on Wall Street, the bank decided not to fire its analysts. But the unit was instructed to stop sharing its recommendations with the press. This episode points to the pressures to downgrade within the financial industry, related to the relation between brokers’ sales-side research and other businesses units of investment banks (Boni and Womack, 2002). Several other investment banks, including Merrill Lynch, ABN-Amro and Morgan Stanley, downgraded Brazil at about the same time as Santander (see Table 1).

By the beginning of July 2002, J.P. Morgan Chase strategists implemented a second reduction of the “overweight” recommendation for Brazil.¹⁶ A month later, the firm’s analysts started to ask how long Brazil could sustain spreads above 2000 bps without defaulting. Based on a historical analysis, the quantitative team found 11 other examples of such high spreads. The results, however, were inconclusive as several countries had sustained spreads at these levels for a period of time

TABLE 1. *Wall Street Strategists’ Recommendations on Brazil’s Bond Debt, 2002*

	Rating change	Date
ABNAmro	Neutral from overweight	1 May
Goldman Sachs	Neutral from overweight	1 May
Santander Investments	Neutral from overweight	3 May
Deutsche Bank	Neutral from overweight	9 May
JP Morgan Chase	1st reduction of overweight	4 June
	2nd reduction of overweight	1 July
	Overweight to marketweight	22 July
	Moved to underweight	9 December
BCP Securities	Sell	8 August
Morgan Stanley	Downgrade to underperform	12 August
Salomon Smith Barney	Changes in marcoeconomic forecast	20 August
UBS Warburg	Increased overweight	30 August
Bear Stearns	Cuts to underweight	19 September
Merrill Lynch	Moved to underweight	25 September
Goldman Sachs	Moved to underweight	27 September
Merrill Lynch	Moved back to marketweight	4 October

Source: Based on JBIC and Wall Street investment bank reports, 2002.

TABLE 2. *Countries that Traded Above 2000 bps*

EMBIG countries which traded above 2000 bps spreads and defaulted	Days above 2000 bps before default	Default date
Argentina	38	December 2001
Russia	40	October 1998
Ivory Coast	2	March 2000
Ecuador	163	September 1999
EMBIG countries which traded above 2000 bps spreads and avoided default	Days above 2000 bps	Period
Mexico	8	March 1995
Venezuela	94	Spring 1995, August 1998
Bulgaria	32	Summer 1994, Spring 1995
Algeria	10	April 1999
Nigeria	308	1994–95, 2000
Pakistan	5	September 2000
Ukraine	97	June 2002, Spring 2001
Brazil	35	June 2002–October 2002

Source: Own estimations for Brazil and JP Morgan Chase, *Emerging Markets Outlook*, 2 August 2002.

ultimately avoiding default. Of the 11 countries, 4 defaulted (Argentina, Ecuador, Russia and the Ivory Coast), 2 completed distressed debt exchanges (Pakistan and Ukraine) and 5 others (Algeria, Bulgaria, Mexico, Nigeria and Venezuela) traded higher than 2000 bps without defaulting. Our calculations show that by the end of October 2002 Brazil had traded above 2000 bps for 35 days (see Table 2).

By the beginning of August, even the more bullish analysts for Brazil started to urge caution. The data were suggesting a “sudden stop capital flow” with portfolio investors lowering their Brazilian weighting, sharp cuts in credit lines as financial institutions reduced their exposure, and accelerated capital flight. In July, there were outflows of US\$1.1 billion from nonresident CC-5 accounts, twice the total for the previous month. In mid-July, Barclays Capital strategists were still stressing the differences between Argentina and Brazil, seeing Brazil as a moderately positive play (Barclays Capital, 2002a). Just a few weeks later, after the Brazilian spreads overshot 2000 bps and the real slumped to 3.50 to the dollar, the same source argued that “the trigger for all crises is now underway,” while public domestic debt restructuring and private exterior debt default probabilities during the next 3–6 months were raised to 45 percent and 35 percent respectively (Barclays Capital, 2002b). But by this time the elections were no longer the sole factor behind Wall Street perceptions of Brazilian risks.

By the beginning of August a respected Wall Street analyst, Walter Molano, took a more radical position, simply advising his clients that “It is time to get out,” and adding:

The outcome in Brazil does not depend on who wins the elections. . . . Over the past year, Brazil’s debt to GDP ratio exploded almost 20% as it went to 58% from 49%. In 2003, more than 90% of the amortizing domestic debt will be indexed to interest rates or the dollar. Therefore, the incoming administration

will need to restore investor confidence quickly in order to stabilize the exchange rate and interest rates. However, investors always need time to become comfortable with the new administration, even if it is Serra. It will be much worse if it is Ciro Gomes or Lula. Therefore, the odds are stacked against Brazil. (Molano, 2002b)

On 7 August 2002, the confidence game was still going on; this time with a new play from Brazil and the International Monetary Fund (IMF). The country announced an agreement with the IMF for a US\$30 billion loan to restore investor confidence in the country's battered financial markets. In fact, markets were already pricing in the announcement, rallying strongly in anticipation of the deal. Some leading economists had called for just such an accord (Edwards, 2002). The exchange rate fell from its high (3.46 reais to the dollar at the end of July) to 3.01 reais the day before the announcement, and the country's risk premium, as measured by bond yields over US treasuries, plunged below 2000 bps, tightening by more than 500 basis points in just a few days. The magnitude of the swing suggests the financial impact of the confidence game on volatile sentiments. Most analysts and fund managers welcomed the agreement. "This generous agreement . . . combined with O'Neill's trip to the region and final passage of trade promotion authority this week, creates a potentially significant positive shock for Latin America" (Bear Stearns, 2002b). Business could go on, the IMF play keeping Brazil alive as a "buy" opportunity. Confidence was further boosted when all the main presidential candidates pledged to honor the agreement. In one day, the Brazilian real rose by more than 5 percent against the US dollar, breaking the US\$3.00 barrier for the first time since the end of July. Around the world companies with large exposures in Brazil and Latin America experienced dramatic increases in their stock prices, and the Spanish equity market closed 5 percent higher.

However, the confidence game was also seen as a timing game; if the size of the loan (US\$30 billion in total) was impressive (and larger than expected by the market), some 80 percent of the funds were to be released in 2003, *after* the new administration assumed office in January. The IMF vote of confidence was clearly a cautious one. As a *Financial Times* columnist observed on the day following the announcement, the IMF "seems to have bet on binding future governments into the deal by back loading the disbursement of money heavily into next year—thus rewarding any future administration which agreed to stick to the fiscal targets." In the end, the IMF agreement kept the game going: "The IMF agreement could be the way to give some assurance to the market that sensible policies should be in place in 2003 (maybe beyond), regardless of who would be in charge by that time" (BBA Economic Research, 2002b: 2).

Walter Molano of BCP Securities was more sanguine, suggesting that while the IMF package represented a win-win solution for the US Treasury and State Department regarding their Latin America policy, and for the Cardoso administration (allowing the Brazilian president and his economic team "to finish their term in office without suffering the embarrassment of a default or an economic collapse"), in the end, the IMF's new money was modest, and left the essential problems unresolved. "It is time," concluded Molano, "to leave the party. Take the opportunity that there is a bid for Brazilian paper and look for the door" (BCP Securities, 2002a). Eichengreen suggested that geopolitics not economics had driven the IMF decision, and argued that the "real danger" was no longer Brazil's elections, "but the global economic climate in 2003." Thus, "the crisis will

reemerge, and unless the IMF and the US government are prepared to provide yet another mega-package, which is unlikely, Brazil will be forced to default and restructure its debt" (Eichengreen, 2002b: 5).

During the month of August, several leading economists criticized the IMF bailout, deploring the absence of a clear strategy (Hausmann, 2002). Others openly declared that "options such as an orderly restructuring of Brazil's nearly USD 250 billion debt must be considered with due speed, otherwise a default soon is likely" (Desai, 2002). "The IMF," wrote a senior fellow at the Institute of International Economics, "must put debt restructuring at the heart of its conditions for financial assistance" (Goldstein, 2002). In fact, financial market euphoria at the IMF rescue package was short lived. After the initial rally, and within few days, bond interest rates once again settled at levels incompatible with long-term solvency. The risk premium on Brazil's government bonds rose, while the real fell back once again to below 3.00 reals to the dollar. On 12 August, Morgan Stanley published a bearish report on Brazil, downgrading the country to "underperform," stressing that even with the rescue package it would be hard for Brazil to enter a virtuous circle. This move was synchronized with a shift of portfolio recommendations in nearly all South American credits to "underperform" (Morgan Stanley, 2002c). By the end of August another leading Wall Street investment bank, Salomon Smith Barney, altered its macroeconomic forecast for Brazil in 2003, anticipating reduced GDP growth, increased inflation and currency depreciation, with its base scenario predicated on an opposition victory in the October elections (Salomon Smith Barney, 2002a).

The Brazilian authorities continued their efforts to bolster confidence. At the end of August, Arminio Fraga met a group of market analysts in New York in an attempt to calm jitters (Salomon Smith Barney, 2002c). During the first weeks of September, while the polls increased concern of a Lula first-round victory, Finance Minister Malan and Central Bank Governor Fraga hit the road once again to reassure investors in Madrid, London, Amsterdam, Basel and Frankfurt. Then Brazil announced an upward adjustment in its primary surplus target for 2002, Serra rose in the polls, and trade and current-account data remained positive. Yet the investment banks remained skeptical,¹⁷ and leading international banks continued to try to reduce their Brazilian exposure, despite the public commitment that had been made in New York in August. Citigroup, in particular, while maintaining a pledge to local officials to keep trade lines open, continued to reduce lending exposure as reported by Bloomberg (Citigroup reported us\$9.3 billion in outstanding cross-border claims for Brazil on 30 June compared to us\$11.4 billion on 31 March). By September the collapse of confidence became generalized in the cognitive regime of Wall Street operators. Goldman Sachs, who in mid-September 2002 still believed that analysts had prematurely declared Brazil to be on an unsustainable debt path, had by the end of the month moved to an "underweight" stance. They anticipated that to deal with the confidence shock, "whoever wins will have to appoint a strong economic team, deepen fiscal adjustment, and implement structural reforms to reduce the public debt ratio gap and restore growth" (Goldman Sachs, 2002d).

Polls were confirming financial market fears of a widening gap between Lula and Serra, the former moving above 40 percent of declared voting preferences, while support for the latter remained unchanged. Arminio Fraga and Ilán Goldfajn (the deputy governor of the central bank for economic policy) tried to calm investor concerns about Brazil's debt levels with an article in a leading

confidence-game arena, the *Financial Times* (Fraga and Goldfajn, 2002). But Brazil's appeal to financial operators fell on deaf ears. Within a few days Brazilian spreads again crossed the 2000 bps frontier, while the currency depreciated to a record low. By the end of September, with the real tumbling and risk premiums rising, another leading Wall Street boutique, Merrill Lynch's emerging markets debt research team, joined Goldman Sachs in shifting to "underweight" recommendations (Merrill Lynch, 2002d).¹⁸

With the annual IMF-World Bank meetings approaching, new proposals on managing debt crises proliferated, such as those formulated by Guillermo Ortiz (governor of the central bank of Mexico) and Josef Ackerman (chairman of Deutsche Bank) (Ortiz, 2002; Ackerman, 2002). But after the meetings, the loss of confidence was even more pronounced. Walter Molano (BCP Securities, 2002b) was particularly bearish, describing the IMF-World Bank "Monster's Ball" annual meetings in these terms: "a gallows humor [sic] permeated the Fall Meetings, as investors, government officials and future ex-Ministers gathered for what seemed to be the last hurrah of the emerging markets." Meanwhile, "the fair weather friends on the sell-side [that is, Wall Street analysts] abandoned Brazil at its darkest moment" (BCP Securities, 2002b). At Bear Stearns, another leading Wall Street firm, the return from Washington was also gloomy. The sovereign debt restructuring mechanism (SDRM) absorbed most of their attention, and there was speculation that Brazil's next president might be tempted to follow this route: "But what about Lula? Lula might be a policy maker who would use this policy instrument (SDRM). Under this scenario, investors might be even more nervous than they already are" (Bear Stearns, 2002c).

By the beginning of October 2002, the political coverage of the Brazilian elections among Wall Street boutiques had intensified. Pimco, manager of the biggest emerging-market bond fund (US\$7 billion of developing-nation bonds in various funds), assured investors that Brazil would never default on its debt. "Brazil has the willingness and ability to make its debt payments," said El-Erian (Pimco's fund manager) to Bloomberg. "Those who are betting on a Brazil default are likely to lose. We're bullish on Brazil because it is a good buy at these levels." On 4 October 2002, Pimco managers declared that they were adding more Brazilian bonds to the roughly US\$1 billion of the country's dollar bonds they held as of 30 June, in what looked to be a desperate move to find some kind of buyers. Pimco's confidence that Latin America's biggest country would not default on US\$300 billion in public debt stood in stark contrast to the views of other Brazilian bond investors, as shown by an investor poll conducted by J.P. Morgan at the end of September. In fact, as Bloomberg observed, Pimco bought Brazilian bonds in the first 3 months of the year, just before the nation's currency and bonds started to slide as polls showed Lula widening his lead.

On 27 October, after 13 years and four attempts, Luís Inácio Lula da Silva became Brazil's 36th president. Market sentiment had already started to improve after 15 October, when bond spreads began compressing 500 bps. By mid-November 2002, the Brazilian real had rallied almost 10 percent from mid-October, and the Brazilian EMBI had tightened 30 percent from the end of September. A "market friendly" economic team (in the sense of a team committed to fiscal and monetary stability) was by then perceived as helping bridge the gap between Lula and the markets. Lula and the financial markets were living under a (brief) "Lula de Mel" (Merrill Lynch, 2002f). But as reports published at the time suggested, the romance might prove short lived, since most Wall Street boutiques

have maintained their cautious stance, pointing to fiscal weakness, soaring domestic debt, high interest rates, poor growth and rising inflation (J.P. Morgan Chase, 2002c; Lehman Brothers, 2002; Barclays Capital, 2002c). On 9 December 2002, J.P. Morgan also moved its recommendation on Brazil to “underweight” (J.P. Morgan Chase, 2002d). The confidence game would go on.

Brazilian Elections and Financial Markets: A Case Study in Historical Perspective

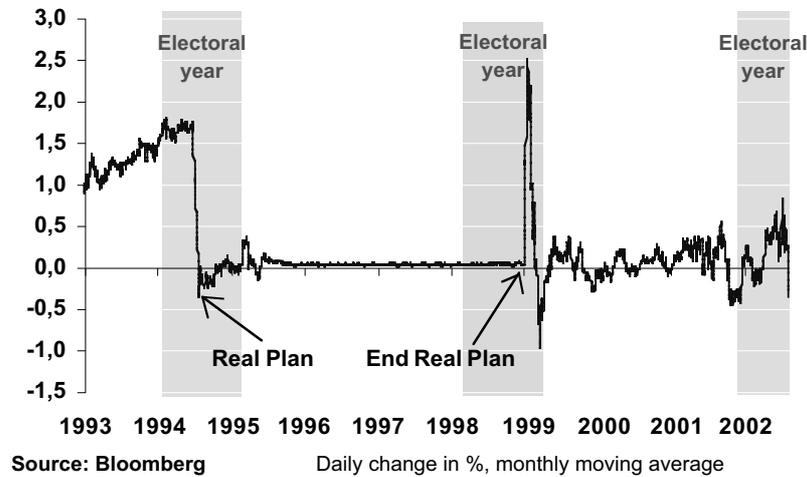
The analysis of Wall Street views on Brazil during the months preceding the presidential election illustrates that financial market opinion is dynamic, and even volatile. The differences of opinion, while important and reflecting diversity within the industry, narrowed as the elections approached. Uncertainty grew with Lula’s rise in the polls after April 2002, and the emergence of the “Third Man” (Ciro Gomes) in the polls during July. Brazil provides a perfect example in Latin America of the influence of politics on the markets (Frieden and Stein, 2001). Yet political uncertainty has always had a considerable influence on financial variables in Brazil.

This section of our argument focuses on the years of the past three Brazilian presidential elections: 1994, 1998 and 2002. We have chosen these years for two reasons. First (and this is true of any country), elections by definition always open a period of political uncertainty, as the winner remains to be determined. This uncertainty is particularly salient in emerging markets. The second point is specific to Brazil. Over the past three electoral cycles there have been parallel developments in the voting-intention polls, which have suggested that an anti-establishment candidate (Lula) might break the political monopoly of the ruling coalition (represented by Cardoso in 1994 and 1998 and by Serra in 2002).

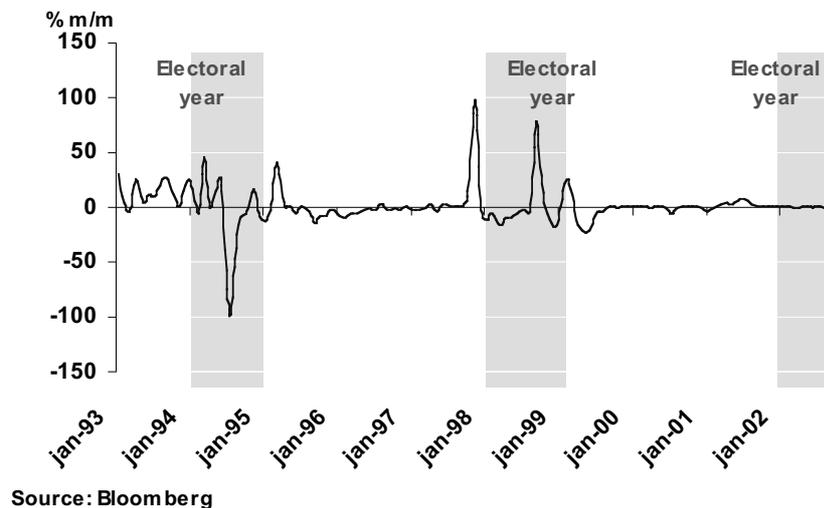
We use the percentage of the intended votes for Lula in the electoral polls as an indicator of political uncertainty. Comparing the three cycles reveals that these electoral years are remarkably similar in terms of political uncertainty and timing. In 1994, 1998 and 2002, Lula started his rise in the polls in April, reached a maximum in June, then slipped back until the elections in October. The only difference between the years is that in 1994 and 2002 Lula held the lead for quite some time, while in 1998 he was not able to achieve this (in the June polls he was virtually tied with Cardoso). Nevertheless, the fact that in 1998 Lula retained significant support gave him a real possibility of winning, and thus political uncertainty was not so different to the other two electoral years.

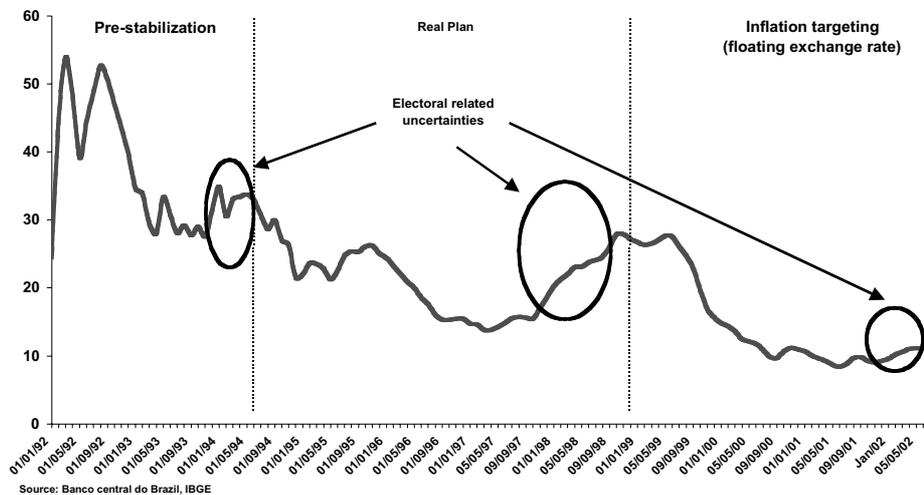
To confirm whether political uncertainty has an impact on financial variables in Brazil, we analyzed the behavior of the domestic short-term interest rate, for which we used the SELIC rate (the real-dollar exchange rate), and the long-term interest rates of the external public debt (represented by the Brazilian bond spread). First, we will look at the domestic short-term interest rate and the real-dollar exchange rate. In Figures 2 and 3, one can discern the high volatility of the cited variables in the electoral years.

Of course, these two variables are interrelated and are influenced by foreign shocks, as could be the case for the Asian crisis in 1997 or the Russian crisis in 1998. Likewise, the domestic interest rate and the exchange rate are seriously affected by economic policy decisions, such as the implementation of the Real Plan in July 1994 (an anchor for the exchange rate implemented to control inflation) and the devaluation of the real in January 1999. As noted at the

FIGURE 2. *Real-Dollar Volatility*

beginning of this article, such decisions are affected by the timing of the political cycle, and this makes assessment of the independent impact of electoral uncertainty on these two financial variables difficult. So the profile of the exchange rate during the past three electoral years presents two abrupt movements associated with the beginning and the end of the Real Plan in July 1994 and in January 1999, respectively. Logically, during the application of the Real Plan (which included the electoral year of 1998) the exchange rate was allowed to fluctuate only within a narrow band. What can be recognized is that in the first half of the other two electoral years (1994 and 2002) there was a gradual depreciation of the Brazilian real parallel to an increase in electoral uncertainty associated with the rise of Lula in the opinion polls.

FIGURE 3. *SELIC Volatility*

FIGURE 4. *Real Interest Rates, 1992–2002*

With respect to domestic short-term interest rates, reflected here by the overnight rate of the Central Bank of Brazil (SELIC), one can also observe peaks in the electoral years of 1994 and 1998. Of course, part of the interest-rate volatility was due to external shocks (such as the Russian crisis in August 1998), and it is difficult to ascertain the precise extent to which national electoral uncertainty aggravated financial volatility. The increased stability of the SELIC rate in 2002 is related to the current Brazilian exchange-rate regime. When the exchange-rate system was fixed or semi-fixed (as it was in Brazil up until the beginning of 1999), the adjustment to any internal or external shock came on the side of interest rates and real variables in the economy. In the current situation, the exchange rate is responsible for absorbing internal and external shocks, reducing the impact on interest rates and on the level of economic activity. This means that a strong increase in foreign-exchange volatility is consistent with the stability of the SELIC that was observed in 2002. Furthermore, irrespective of the foreign-exchange regime, in the first half of each electoral year there was an increase in real interest rates (see Figure 4), which resulted from the higher profitability demanded by investors to offset the increased risk premium associated with the possibility of an opposition victory in the presidential elections.

In summary, during the electoral years 1994, 1998 and 2002 the exchange rate was more volatile and real interest rates increased. Nonetheless, this is a consequence not only of the uncertainty associated with the evolution of the electoral polls, but also of the fact that the exchange rate and interest rate are interdependent and are conditioned by broader economic policy decisions (such as the Real Plan), which are in turn also influenced by the electoral calendar and the volatility associated with political uncertainty. In addition, of course, the financial volatility of the past three electoral years was in part provoked by external factors such as the crises that occurred in other emerging markets.

In an attempt to get a clearer picture of the effects of political uncertainty on financial markets, we now turn to long-term external interest rates. Here we used

the spread of Brazilian debt over US bonds in the EMBI (in 1994 and 1998) and EMBI+ (in 2002) indexes of emerging bonds of J.P. Morgan.

Unlike the domestic short-term interest rates, the spread of Brazilian bonds is not influenced by the exchange-rate system because the bonds are denominated in a foreign currency and so provide the best approach to “country risk.” Nevertheless, the Brazilian debt spread over US bonds can be increased by external shocks, such as a rise in the risk aversion of international investors or a financial crisis in another emerging country that reduces the general attractiveness of emerging-country debt. To isolate the impact of such external shocks we used the spread between Brazilian bonds and all emerging bonds integrated in the EMBI+ index. An increase of the spread between Brazilian debt and the whole group of emerging countries cannot be attributed to higher risk aversion by foreign investors, nor to the “herd effect” associated with a crisis in another country, given that in these two cases the deterioration would be similar for all these emerging bonds. So the cause of any hypothetical increase in the spread between Brazilian and the basket of emerging-country bonds would have to be domestic. In this case, the political variables are the prime suspect, given that they influence not only the “ability to pay” the debt (as an increased premium is demanded at moments of uncertainty), but also the “willingness to pay” (associated with the electoral victory of an opposition candidate).

Thus, to find a more effective indicator that shows the influence of Brazilian presidential elections on financial markets, we studied the correlation between political uncertainty, represented by the popularity of Lula shown in electoral polls, and sovereign risk, represented by the evolution of the spread of Brazilian external bonds over the whole emerging-country group within the EMBI (in 1994 and 1998) and EMBI+ (in 2002) indexes.¹⁹

Comparing the graphs corresponding to each of the past three electoral years, a certain “seasonality” can be observed with regard to the movement of the spread between Brazil and the ensemble of emerging bonds (see Figures 5–7). Until March in each year, the relative spread narrows slightly. This coincides with either the absence of polling data (in 1994) or with a slight decline in Lula’s support (in 1998 and 2002). From March onward, a relative deterioration of the Brazilian debt position occurs in each of the three years. This can be related in 1994 to the appearance of the first polls, which revealed substantial support for Lula at 35 percent, or in 1998 and 2002 to the fact that he had acquired majority support. The relative deterioration of the Brazilian debt position peaked in May and June of 1994 and 1998, when Lula reached his maximum popularity in the polls. From then on, he lost support: steadily in 1994, and with ups and downs in September and October 1998. Correspondingly, the Brazilian debt spread improved. Although emerging-debt volatility was increased by the Russian crisis in August 1998, this did not alter the fact that in the months prior to the presidential elections in October, the relative spread in Brazil was still being influenced by the opinion polls.

In 2002, the opinion polls registered an evolution parallel to those in 1994 and 1998, with a progressive decline of Lula’s popularity from May to June. Nevertheless, from that point on, there is a decoupling between our electoral uncertainty index and the relative spread in Brazil. There are two reasons that explain this occurrence, and in each case, the political factor plays a revealing role. The first element is the emergence of a new challenger in 2002 (Ciro Gomes) who had a more heterodox program than Lula. This is a situation that did

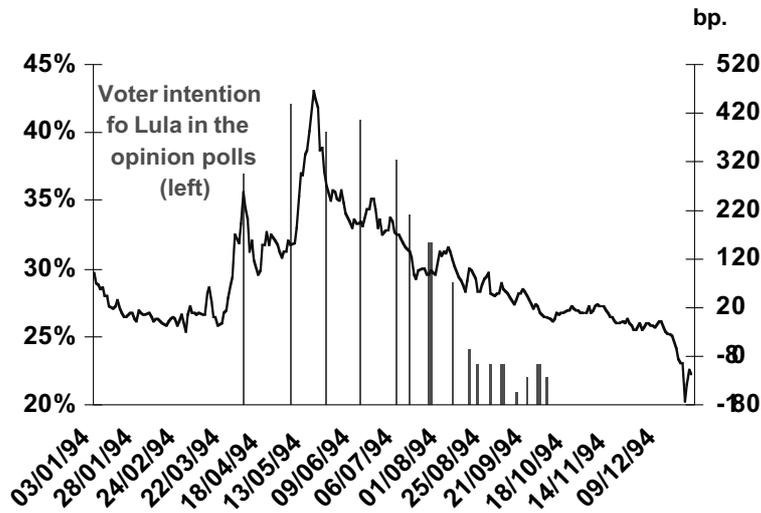


FIGURE 5. *Spread Brazil-Emerging Countries and Electoral Polls, 1994*

not obtain in the previous electoral cycles of 1994 and 1998, and helps explain the continuing deterioration of Brazilian sovereign risk (see Figure 8).

However, the further deterioration of the Brazilian debt position in the May–July period is associated with other factors, such as the inherent dynamism of the Brazilian debt. Although most of the Brazilian debt is domestic (and therefore denominated in Brazilian reais), its peculiar composition makes it especially sensitive to financial variables, and so to the volatility of electoral years. About 50 percent of the public domestic debt is interest-rate indexed, while 30 percent is exchange-rate indexed. This composition is a legacy of Brazilian history, rather than a result of policy decisions by recent administrations. If Brazil could borrow

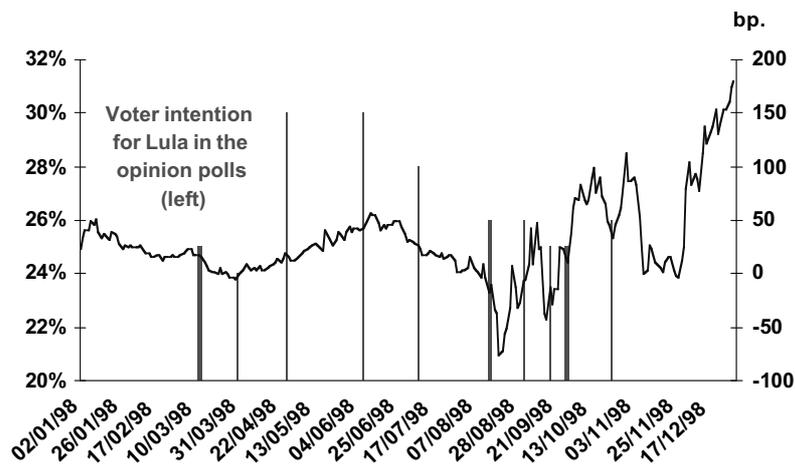


FIGURE 6. *Spread Brazil-Emerging Countries and Electoral Polls, 1998*

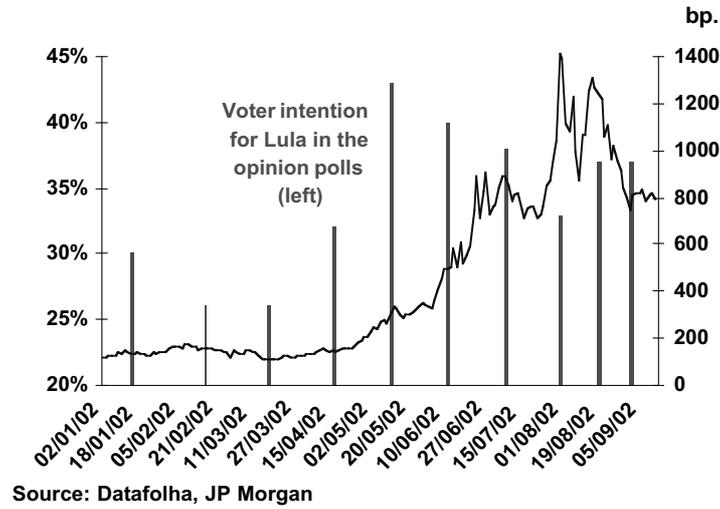


FIGURE 7. Spread Brazil-Emerging Countries and Electoral Polls, 2002

at fixed rates with long-term maturity dates, it would do so. As the graph shows (Figure 9), the Brazilian government was only able to borrow at fixed rates when the Brazilian exchange-rate system was fixed or semi-fixed. With a floating real, Brazil has attempted to increase the proportion of fixed-rate debt, but the markets have not cooperated, limiting the weight of fixed-rate debt to total debt to 10–15 percent. Moreover, the small proportion of domestic debt that Brazil has been able to acquire at fixed rates over the past few years has been with short-term maturation dates.

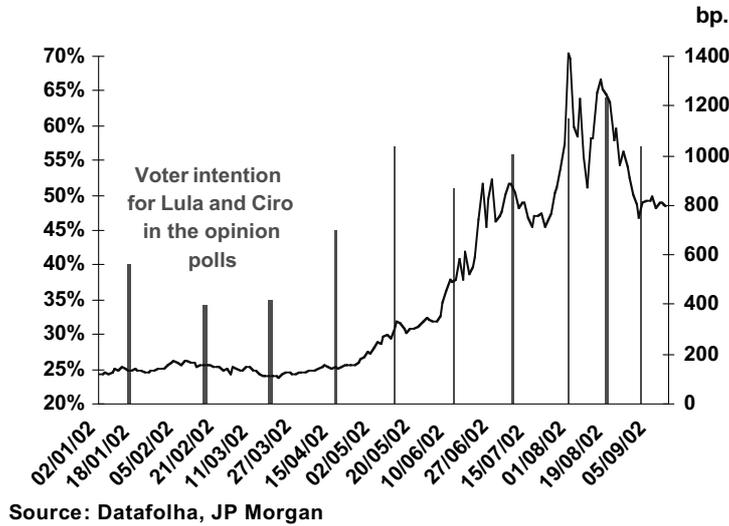
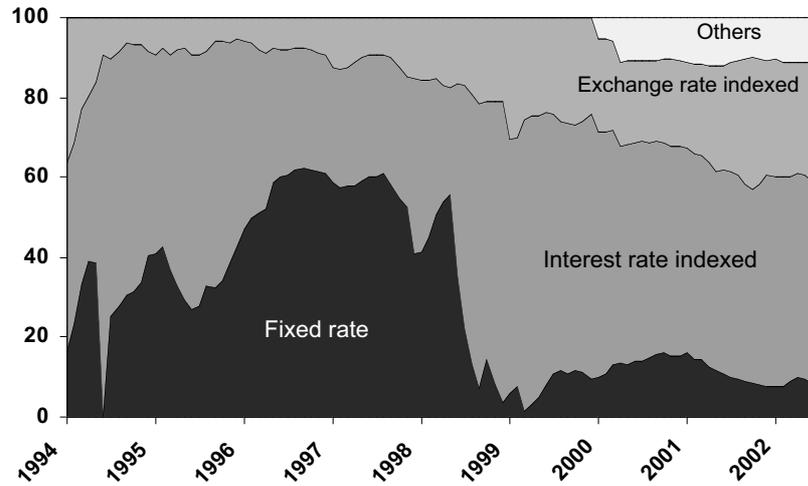


FIGURE 8. Spread Brazil-Emerging Countries and Electoral Polls (Lula and Ciro), 2002



Source: Banco Central do Brazil

FIGURE 9. *Domestic Public Debt Composition*

So, the negative impact that electoral uncertainty in Brazil has on financial variables also affects the country's risk in an indirect way, through an increase in the domestic debt–GDP ratio, given the increased sensitivity of the domestic national debt in Brazil to the variations of the interest and exchange rates.

The increase in Brazilian spreads during 2002 can be related not only to the fear of a change in the “willingness” to pay back domestic debt associated with the growing possibility of a victory by one of the opposition candidates (Lula or Ciro Gomes), but also to the deterioration of the “ability to pay,” associated with the influence of financial variables on the increment in the domestic debt–GDP ratio. One can appreciate that behind both explanations lie political factors rather than any underlying change in the fundamentals of the Brazilian economy.

Given this explanation for the apparent disassociation between the popularity of Lula and Brazil's emerging-debt spread in 2002, we will now proceed to quantify the influence of political uncertainty on the Brazilian spread. To do this, we calculated the correlations for the electoral periods of 1994, 1998 and 2002 (defined in each case as the time period between the appearance of the first and last electoral poll) between the Lula popular vote in each of the polls and the mean of the relative Brazilian spread over the group of emerging countries. The result is illustrated in Table 3. In each of the election years, one can observe a high and positive correlation between electoral uncertainty and the risk premium investors demanded for Brazilian debt. The electoral year has been subdivided into two periods in order to exclude the months of June, July and August, when a disassociation between Lula's popularity and the Brazilian spread occurred (which is explained by political factors mentioned previously). If we were to adjust our measure of political uncertainty by adding together the intended votes for Lula and Ciro Gomes, the correlation with the relative spread of Brazil is very high both in the period between January and May (0.97) and also for the whole period (0.88).

Aware of the risks associated with election years, the Brazilian authorities built up a very accommodating amortization profile for domestic public debt around

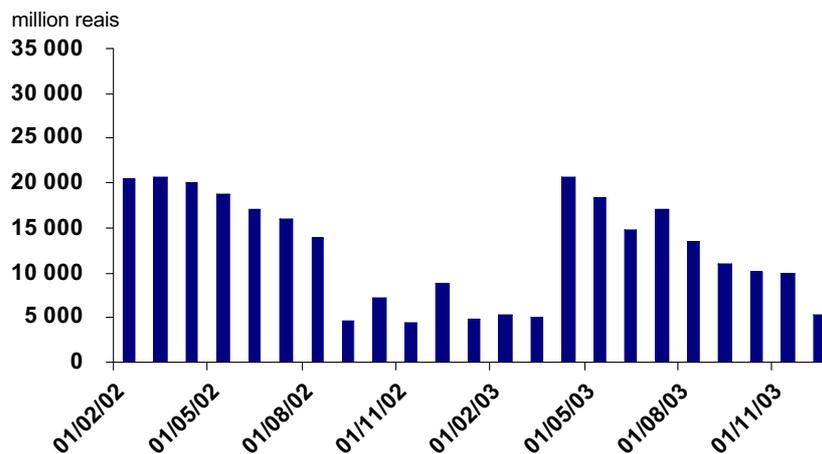
TABLE 3. *Cross-Correlation Between the Brazil-Emerging Debt Spread and Popularity Vote for Lula*

1994	
<i>April–October</i>	0.92
1998	
<i>March–September</i>	0.68
2002 (Lula)	
<i>January–August</i>	0.54
<i>January–May</i>	0.98
2002 (Lula and Ciro)	
<i>January–August</i>	0.88
<i>January–May</i>	0.97

Significance level: 0.50 (1994); 0.63 (1998); 0.60 (2002)

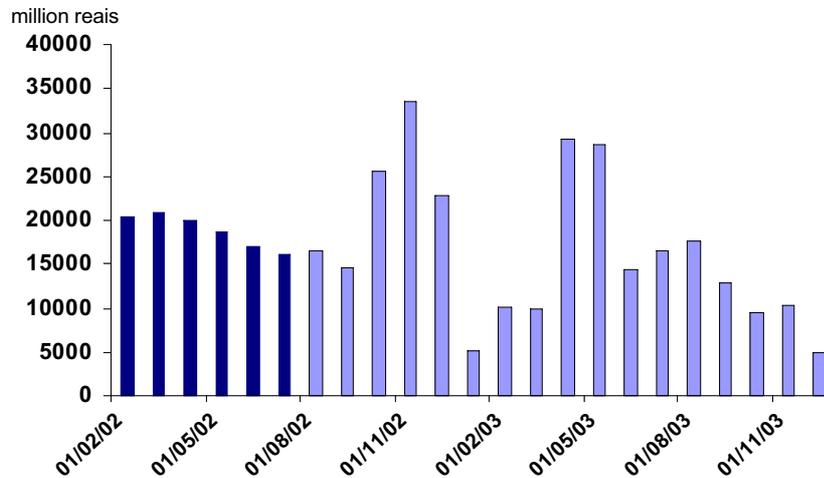
the holding of the elections in October and in subsequent months (see Figure 10). This “valley of transition” aspired to limit the impact of the elections on Brazilian debt.

But the progressive increase in political uncertainty associated with Lula’s stable spot in first place in the opinion polls and the large increase in the popularity of Ciro Gomes completely distorted the amortization profile designed by the Brazilian authorities at the beginning of the year. The beautiful “valley of transition” created by Brazilian leaders was transformed under market pressure into a more abrupt “geography” with significant peaks (see Figure 11). The market did not accept bonds with maturity dates longer than the term of the Cardoso government, because it assumed that there was a high possibility that the new government would have a lower “willingness to pay.” While Brazilian presidential elections are held in October, the government changeover does not take place until December; thus, in the months before the election, the government was basically forced to emit domestic debt with amortization dates prior to the end of 2002.



Source: Banco Central do Brasil

FIGURE 10. *Amortization Profile of Domestic Public Debt, January 2002*



Source: Banco Central do Brasil

FIGURE 11. *Amortization Profile of Domestic Public Debt, June 2002*

Conclusion

As the number of crises in emerging markets grows, so do the books and articles published on the subject (Eichengreen, 2003; Edwards and Frankel, 2002; Feldstein, 2002; Dooley and Frankel, 2002). However, few studies have been devoted to the interaction between financial markets and politics. This research has used empirical evidence to examine these links. The specific case study of Brazil, analyzed through the perceptions of Wall Street analysts and a historical and quantitative economic perspective, has shown that these ties are strong for emerging markets (Chang, 2002). In fact, the essential character of emerging markets lies precisely in this intricate link between political uncertainty and financial volatility—what could be called the economic fog of democratic uncertainty. In developed countries, political outcomes such as presidential elections are not perceived, from a financial market point of view, as such critical junctures as in developing countries. As this article has argued, electoral outcomes matter in emerging markets to a much greater degree than they do in industrialized countries. Further research would be needed in order to understand precisely why elections in emerging economies assume this level of importance. One possible answer may be provided by recent economics literature that emphasizes that the existence of strong institutions dominates other factors in explaining why countries are economically successful. Indeed, some analysts would argue that democratic forms of government are more likely to deliver stable institutions over time than autocratic governments (Olson, 2000; Santiso, 2002).

The question of instability and uncertainty is central to understanding the intricate links between financial markets and politics in emerging economies. More particularly, financial instability and financial market overreactions during electoral processes can be explained by uncertainty regarding institutional stability and continuity, rather than by uncertainty linked to democracy itself. In other words, instability in emerging markets derives not from the democratic process

itself, but from the background of institutional weakness in emerging democracies. Where institutions are weak, and consequently the government's ability to honor its promises over time is called into question, the identity of the winning candidate becomes much more important to investors than in countries with strong and stable institutions. To put the point another way, in countries with strong institutions, the government's ability to honor its commitments is not primarily dependent on the identity of officeholders. Whether Bush or Gore had won in 2000, the US government would have met its obligations to holders of treasury bills. In Brazil, however, the outcome of the election did (or was perceived to) make a difference. Some preliminary findings related to institutional weakness suggest such a link. Recent research has underlined that lack of transparency and institutional weakness affect international portfolio investments. Not only do international funds invest less in less transparent countries, but also herd behavior among funds (mimetic volatility) tends to be more prevalent in less transparent countries (Gelos and Wei, 2002).

At a more fundamental level, examination of market reactions to the 2002 presidential elections in Brazil encourages broader reflection on the relationship between democracy and the financial markets. As Georges Soros, a leading "voice" in global finance and Chairman of Soros Fund Management, pointed out: "admittedly, Brazil is going to elect a president who the financial markets do not like; but if international financial markets take precedence over the democratic process, there is something wrong with the system" (Soros, 2002: 13). In an interesting Wall Street report another analyst made a similar point: "we believe that investors can't rightfully ask presidential contenders to state everything they intend to do when and if elected. Trying to figure out what to believe and what not to believe from any presidential candidate is extremely difficult and sometimes unfair to them. Our opinion is that investors should wait for the political dust to settle on what the next elected president intends to do" (Morgan Stanley, 2002d: 3). Kenneth Maxwell from the Council on Foreign Relations put it even more bluntly: "Wall Street analysts and IMF bureaucrats should leave Brazilian politics to its 115m voters and stop confusing fact and fantasy" (Maxwell, 2002).

The problem lies precisely in the fact that financial markets are forward looking, and anticipation and what Albert Hirschman once called "the political economy of impatience" are central. Thus financial and political temporalities can conflict. With presidential elections coming up, all temporal horizons become focused on the very short term. Financial anxiety resonates with political elections, which are by definition dominated by uncertainty. In the Brazilian case, the uncertainty related to the growing probability of a Lula victory—that is to say, on the increased likelihood of an anti-establishment vote. At a more fundamental level, this raises the question of financial market tolerance for electoral uncertainty in emerging democracies. In the end, if we accept Przeworski's definition of democracy (that is, a regime whose essence is the institutionalization of uncertainty locked in electoral outcomes), we are led to the question of the political preferences of financial markets (Przeworski, 1991).

Further empirical research is needed to explore the intricate links between financial markets and politics. It would, for example, be interesting to establish whether there is a "democratic premium" in financial markets. In other words, are financial markets "politically correct"? Do markets give a positive premium to democracy or, on the contrary, are democratic elections in emerging countries systematically correlated with financial volatility, rising risk premiums and

exchange-rate ups and downs? The analysis of Brazilian presidential elections presented here invites comparative empirical research on a wider sample of countries (for example, the 21 emerging countries composing the J.P. Morgan EMBI+ index). Regarding creditworthiness, recent research suggests that there is no “democratic advantage,” because although democracies are supposed to pay lower interest rates than authoritarian regimes (given that they are more capable of making credible commitments to repay debts), the evidence shows that this expectation is unfounded. Historical research, using a large sample of data on sovereign loans for 132 countries during the period 1970–1990, suggests not only that dictatorships were less likely to reschedule their debts, but also that the major source of better borrowing conditions for emerging democracies was due to the behavior of multilateral agencies that tend to bail out democracies rather than enhance the capacity of these emerging democracies to make credible commitments (Saiegh, 2001). A closer view of emerging-market fund managers’ political preferences and the democratic premium would be interesting in order to corroborate or, on the contrary, disprove the idea that democracy and markets always go hand in hand. In addition, a comparative historical perspective might shed useful light on the intricate links between emerging democracies (expansion of the franchise) and financial markets during the 19th century.

Further research would also be needed to put names and faces to this confidence game. After all, we are not just talking about abstract figures, but also about men and women acting and interacting in this so-called confidence game of financial markets. The Brazilian case underlines how trust (and mistrust) is embodied by individuals. Pedro Malan, the Brazilian Finance Minister, and Arminio Fraga, Brazil’s central bank governor, were both key players—favorite sons of the financial markets and the IMF. Wall Street, the US Treasury and Washington-based multilaterals liked dealing with them, an asset denied to Lula or Gomes. Both Malan and Fraga are comfortable in the high-tech world of financial markets and international policy-making. They speak the same language of orthodox economics, both are US educated, and both moved in the same circles as IMF officials and Wall Street players. Arminio Fraga was a former fund manager for Soros, while Pedro Malan has been an executive director of the World Bank. As the stimulating research done by Barro and Lee (2002) suggests, it would be interesting to explore the intricate links between finance and politics by examining the origins of ministry of finance and central bank officials in emerging economies. Most likely this would confirm the intuition that over the past decade the “right” background (a US education with experience and contacts in the financial circles of New York and Washington) has become a necessary (but not sufficient) precondition to playing the confidence game successfully.

The presidential candidate from the ruling Brazilian coalition had such a pedigree; according to the perceptions of the financial markets, Lula and Gomes did not. Lula had no Ph.D. or IMF pedigree. Instead, he rose from shoeshine boy to mechanic, and then to leader of the Sao Paulo autoworkers’ union, fighting against the military regime and organizing strikes during the 1970s. Lula’s victory represents the (exceptional) victory of democracy and social mobility in a country known for its social inequality. It is also a large victory in the world’s fourth biggest democracy. Lula won by an ample margin: 53 million to 33 million votes. (Indeed, his triumph is the largest since Reagan’s 1984 total of 54.5 million votes, the largest-ever vote for a US presidential candidate.) However, in a globalized (financial) world, winning the political vote in your home country is not enough.

For the rest of his mandate, Lula's challenge will be to restore and maintain financial confidence. A few days before the second-round elections, one fund manager quoted in the *Financial Times* stated that "to save Brazil" (that is, to win Wall Street confidence) Lula would have to implement sound economic policies, make careful appointments to top economic positions, and collaborate closely with international financial institutions (El-Erian, 2002b).

The consequence of Wall Street's aversion is that leaders who do not share this approved pedigree must find a way to win over the financial markets. Presidential races are not only national races, involving citizens, the media, candidates and so on. Presidential candidates also have to win the confidence game, that is, the vote of approval of financial markets. On 5 August 2002, for the first time in 113 years, a candidate for the Brazilian presidency, Lula, visited the Sao Paulo Stock Exchange, to break some taboos after choosing its former chairman as his vice-presidential running mate. On 19 August, he was back again to seek the approval of financial operators who were becoming more and more nervous. Lula and Gomes met Cardoso in a symbolic move to agree on basic economics and to boost confidence. Once elected, Lula intensified the "market-friendly" signals directed toward Wall Street in a continuing effort to win its confidence, naming a former international banker as governor of the central bank and a respected, pragmatic technician as finance minister.

The political economy of financial markets explains much of the dynamic of international finance. The ups and downs of financial variables can be explained by economic fundamentals. But part of the story behind emerging-market financial crises is of self-fulfilling prophecies, risk seeking and risk aversion, and changing perceptions. As we have tried to emphasize, there are complex interactions between politics and finance, between individual and institutional interactions, and macroeconomic and financial variables. In the end, the name of the game in emerging markets is confidence, trust and mistrust.

Notes

1. On the dynamics of capital flows and crises, see also Eichengreen (2003). However, there is a fundamental dilemma as the same institutions that can provide a credible commitment to stable policies may impede adjustment to external shocks (Rodrik, 2002). For a detailed analysis of institutional and political checks and balances and policy volatility, see Henisz (2002). On the links between political commitments, checks and balances, and their effects on private investment across countries, see Stasavage (2002: 41–63).
2. According to Bloomberg's survey on emerging-market bond underwriting, in 2002 the ranking was as follows: (1) Salomon Smith Barney (US\$10.0 billion of bonds placed for emerging-market borrowers during the year); (2) J.P. Morgan (US\$8.6 billion); (3) Morgan Stanley (US\$5.7 billion); (4) CSFB (US\$5.0 billion); (5) UBS Warburg (US\$3.1 billion); and (6) Deutsche Bank (US\$3.0 billion).
3. After Krugman's (1979: 311–325) seminal work and the first generation models, a second generation of financial crisis models have been developed following Maurice Obstfeld's (1994: 189–213) key work.
4. A careful study of Latin American exchange-rate regimes from 1960 to 1994 shows that the probability of the maintenance of a fixed exchange-rate regime increases by about 8 percent as an election approaches, while the aftershock of an election conversely increases the probability of getting out of the peg by 4 percent. Economic factors such as the size of the tradable sectors exposed to international competition also help to explain the propensity to maintain or leave a fixed exchange-rate regime (Bloomberg et al., 2001).

5. Economic history provides plenty of examples of political events framing economic uncertainty and stock-market volatility. Consider Argentina's peso exchange rate during the 19th century (Irigoin and Salazar, 2000; Irigoin, 2000).
6. See the empirical evidence based on a portfolio-choice model that relates capital flight to rate of return differentials, risk aversion and the three types of risk mentioned for a panel of 47 developing countries over 16 years (Vu Le and Zak, 2001).
7. For similar results, establishing that share prices in a sample of 33 developed and developing countries react negatively to uncertainty in the outcome of elections, see Pantzalis et al. (2000: 1575–1604).
8. There is a large literature drawing on several traditions that deals with public finance, government expenditure and the size of government, both for developed and developing countries. Among the many works looking at the systematic effects of electoral rules and political regimes on the size and composition of government spending, consider Persson (2001), Drazen (2000) and Persson and Tabellini (2000).
9. In October 2001, Lehman Brothers fixed-income research department and Eurasia Group's political science experts launched a joint venture in order to cover political risks in emerging markets, using analytical tools such as the Lehman Eurasia Group Stability Index (LECSI) which incorporates political factors (65 percent of a country's weight) and economic factors (35 percent). See <http://www.lehmaneurasiagroup.com/>.
10. For a balanced assessment of Brazilian economic weaknesses and risks, see Cr dit Agricole Indouez (2002).
11. For further information, see their respective websites: <http://www.lula.org.br/> and <http://www.cirogomes.com.br/>.
12. See, for example, Deutsche Bank (2002) and Goldman Sachs (2002b). Some brokers did such analyses before, but the series of simulations realized were mainly to stress the Brazilian capacity to manage turbulence, as underlined, for example, in a report stressing that "there is ... very ample room for the real to weaken in 2002 before dynamics could become unstable" (Merrill Lynch, 2002a).
13. See the Workers Party's website for more information: <http://www.pt.org.br/>.
14. For a more detailed analysis of political data and polls, see also BBA Economic Research (2002a). In addition, see the reports from Bear Stearns (2002a) and, for an extensive analysis of the Brazilian presidential candidates' economic platforms, Merrill Lynch (2002c). On the specific candidacy of Ciro Gomes, see Salomon Smith Barney (2002b).
15. See also Citigroup and Salomon Smith Barney (2002) and Morgan Stanley (2002b).
16. For an extensive analysis of the situation at this time, see J.P. Morgan Chase (2002b).
17. See, for example, Morgan Stanley (2002e). Others, however, were more bullish on the near-term outlook for Brazil, stressing improvements (a growing trade surplus and lower current-account deficits), but noting that "an upside for Brazilian financial assets largely depends on the new president appointing a strong economic team and implementing economic policies to reduce the debt to GDP ratio" (Goldman Sachs, 2002c).
18. A few days later, just before the Brazilian elections on 6 October 2002, Merrill Lynch issued a new report upgrading Brazilian bonds (Merrill Lynch, 2002e).
19. Note that Brazil is included in the whole EMBI and EMBI+ indexes.

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