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WALL STREET AND ELECTIONS IN LATIN AMERICAN EMERGING DEMOCRACIES

by
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TABLE OF CONTENTS

ACKNOWLEDGMENTS....4

PREFACE....5

RÉSUMÉ....6

ABSTRACT....7

I. INTRODUCTION....8

II. CAPITAL MARKETS AND ELECTIONS IN EMERGING DEMOCRACIES: A REVIEW OF THE LITERATURE....11

III. DESCRIPTION OF THE DATA....15

IV. INVESTMENT BANKS' RECOMMENDATIONS AND ELECTIONS IN EMERGING DEMOCRACIES: STYLISED FACTS....18

V. HYPOTHESES OF THE MODEL AND ANALYSIS OF THE IMPACT OF ELECTIONS ON BANKS' RECOMMENDATIONS....26

VI. CONCLUSIONS....35

REFERENCES....37

ANNEX 1....42

ANNEX 2....43

ANNEX 3....45

ANNEX 4....46

ANNEX 5....48

OTHER TITLES IN THE SERIES/ AUTRES TITRES DANS LA SÉRIE....50

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PREFACE

Political cycles represent a core issue for capital markets in developing and emerging countries. This paper analyses the intricate links between financial markets and emerging democracies and highlights changes in the ways analysts and investors react to political cycles in emerging markets.

Financial markets have, in the past, been particularly sensitive to political events. All the major financial crises in Latin America of the past decade and a half took place during an election year. Even in 2006, an unusually calm period in light of the number of presidential elections, markets remained highly sensitivity to elections: the day following Felipe Calderón's narrow victory in July's 2006 Mexican presidential elections, the stock market gained almost 5 per cent in a day, bond prices soared and the peso saw its biggest one-day appreciation in six years.

In order to test the impact of the stability of democracies on financial markets, this paper uses a unique and untapped database of sovereign debt recommendations given by the most important investment banks in emerging economies, from 1997 to 2008.

The paper stresses two major results. Firstly, the political cycle is a determinant variable in explaining investment banks' recommendations. Moreover, the relationship is particularly strong before electoral contests, suggesting that investment banks' perceptions deteriorate considerably on the eve of presidential elections. Secondly, investment banks' outlooks depend on the signal sent by candidates concerning the credibility of future economic policies. In particular, if candidates are not committed to defending sustainable macroeconomic policies, investment banks' downgrade sovereign debt.

A clear policy conclusion is that prudent macro-economic management is particularly relevant the year before and above all the year of the election. Precautionary measures are particularly welcome in order to anticipate and avoid painful stress if markets react negatively. A good example of precautionary macro-economic management is the reduction, in election years, of foreign currency-denominated debt and the pursuit of longer debt maturities.

Financial markets play a monitoring role during election campaigns, downsizing candidates´ unsustainable promises. The other side of the coin is, however, the financial overshooting that tends to go hand in hand with election cycles.

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RÉSUMÉ

Cet article étudie les interactions entre le cycle politique et les marchés de capitaux dans les pays émergents, en examinant comment les stratèges de Wall Street réagissent au plus important des évènements politiques en Amérique Latine: les élections présidentielles. Dans ce but, nous avons construit une base de données qui rassemble les recommandations portant sur la dette souveraine et émises par les principales banques d'investissement actives sur les marchés émergents de 1997 à 2008. L'analyse de l'impact des élections présidentielles sur les recommandations des banques d'investissement montre que le cycle politique est une variable clé pour expliquer la rétrogradation des titres souverains pendant les trois mois qui précèdent les élections présidentielles. Il apparaît aussi que la crédibilité des politiques macro-économiques (budgétaires et monétaires) annoncées par les candidats lors des campagnes présidentielles joue un rôle décisif sur les recommandations des banques d'investissement.

Mots clés: Marchés émergents, Information, Études des banques d'investissement, Élections.

Classification JEL: D72, G11, G14, G15, G24

ABSTRACT

This paper focuses on the interactions between the political cycle and capital markets in emerging economies, examining the way in which Wall Street strategists react to major Latin American political events, specifically presidential elections. For this purpose we construct a database of all sovereign bond recommendations of the major investment banks active in emerging bond markets from 1997 to 2008. Assessing the impact of presidential elections on investment banks' recommendations, we conclude firstly, that the political cycle is a major determinant variable in explaining the downgrading of sovereign bonds in the three months prior to presidential elections. Secondly, the credibility of future macro (fiscal and monetary) policies announced by presidential candidates during campaigns stands out as an important determinant of investment banks' recommendations. In particular, if candidates are not committed to defend sustainable macroeconomic policies, investment banks' downgrade sovereign debt prior to elections.

Keywords: Emerging Markets, Information, Investment Banks Research, Elections.

JEL Classification: D72, G11, G14, G15, G24

I. INTRODUCTION

Political cycles are a core issue for capital markets in emerging countries. Financial markets react to political events, whether cabinet reshuffling or elections, and tend to be particularly sensitive to the uncertainty of election outcomes, often overshooting in terms of spreads, foreign exchange and interest rate volatility. Indeed, one definition of emerging markets might be those countries where political uncertainty translates into important financial volatility. In this understanding, graduating from the emerging markets asset class implies a decoupling of the political and financial cycles, as we argued in a previous study (Blázquez and Santiso, 2004).

In developed countries, political outcomes such as presidential elections are not perceived, from a financial market point of view, to be the critical junctures they are in developing countries. That does not mean that they do not have resonance on financial markets (as stressed by Snowberg *et al.*, 2007; Bernhard and Leblang, 2006*a*; and Leblang and Bernhard, 2006), but the magnitude and the scope of their impacts are not as strong as in emerging countries (Campello, 2007).

Consider the example of Latin America, a key region for emerging bond markets (in 2007 it accounted for nearly 57 per cent of the EMBI Global market capitalisation, the leading index provided by JP Morgan). All the major financial crises in the region over the past decade and a half coincided with election years: the Tequila crisis of 1994 was a presidential election year in Mexico (Santiso, 1999); the devaluation of the real at the beginning of 1999 took place a couple of months after the Brazilian elections of October 1998; and, again, in 2002, the financial crisis suffered by Brazil developed during a presidential election year (Martínez and Santiso, 2003; Santiso, 2006*a*; Jensen and Schmith, 2005), as did as the massive debt default in Argentina of the previous year. The 1980s debt crisis, ushered in by the Mexican default, also took place during an election year. The argument can be generalised to other emerging markets regions (Whitehead, 2006), where financial crises and political crises tend to go hand in hand (Chang, 2007).

Some studies have already underscored the influence of political events on financial markets. As pointed out by Bernhard and Leblang (2006*b*), political processes such as presidential and legislative elections, cabinet formations and referenda, have an impact on the behaviour of actors in capital markets. Incorporating political variables can also improve the predictive performance of models and crisis forecasting (Leblang and Satyanath, 2008). Portfolio allocations made by investors are also sensitive to political cycles and consequently exchange rates. During election periods, sovereign bond and stock market prices can also become extremely volatile. The role of political information is crucial in determining capital markets' micro-behaviour during political processes. This is particularly relevant in emerging countries, above all during presidential elections, as underlined in earlier work on the behaviour of bond spreads and risk premia during Brazilian election processes of the 1990s and early 2000s (Santiso, 2006*a*). More recently, other studies on other emerging regions such as Eastern Europe or Asia have similarly underlined the sensitivity of exchange rates to political variables (respectively Frieden, Leblang, and Valev, 2008; and Hays, Freeman and Nesseth, 2003).

Fear of uncertainty lies behind these results. First, there is the fear that incumbent parties adopt expansionary economic policies prior to elections to attract voters. Second, there are doubts about the credibility of major candidates' economic policy platforms. High volatility in capital markets during electoral cycles can also be interpreted as a lack of commitment on the part of emerging democracies' governments and political parties to credible and stable economic policies. At a more conceptual level, the over-reaction of financial markets to elections in democracies raises the issue of the political preferences of financial actors. As stressed by Przeworski (1991), one of the characteristic features of democracy is precisely that outcomes appear uncertain. In a democracy, the results of an election or the parliamentary outcome of a proposed reform is always an open and uncertain issue. Therefore, electoral competition, collective choices and preferences crystallised during reform processes, are all part of the usual life of a democracy and at the same time, boosters of uncertainty to which financial markets tend to be very sensitive.

This present paper focuses on Latin America, both because of the importance of its bond markets and because of the active, if sometimes halting, process of democratic consolidation in the region. Latin America has dominated emerging bond markets over the past two decades, in terms of issuances, liquidity and asset allocations. International capital markets have been keenly sensitive to political events in the region since the return of democracy, which triggered the boom in capital bond markets.

This study analyses the intricate links between financial markets and emerging democracies and uncovers the changing patterns in analysts' and investors' reactions to political cycles in emerging markets. In this light, the 2006 political season is a landmark: a uniquely eventful year brimming with elections, surprises and drama, yet one in which, even at the height of the political hubbub, capital markets showed remarkably little volatility. Whereas previous election cycles sent investors heading for the hills, in 2006, with 80 per cent of the continent's population heading to the polling booths, the markets maintained an Olympian calm. Clearly, it is difficult to compare electoral cycles from one year to another, given that international financial and economic conditions are not stable. For instance, the considerable increase of international liquidity across financial markets during 2006 could count as an important factor behind the relative stability of Latin American markets (in terms of sovereign bond spreads, exchange rates, equity market returns,…) over that period (see the argument along these lines by Izquierdo and Talvi, 2008).

In order to test the impact of the stability of democracies on financial markets, we use a unique and untapped database of sovereign debt recommendations given by the most important investment banks in emerging economies.

This paper addresses the following core questions. How big is the impact of electoral cycles on investment banks' perceptions of Latin American economies? To what extent are investment banks' recommendations sensitive to the credibility of presidential candidates' announced economic-policy platforms? Does stability of economic policies affect banks' outlooks? Finally, by comparing the 2006 electoral cycle with previous cycles, can we conclude that the impact of electoral cycles on Wall Street strategies has declined?

The remainder of this paper is organised as follows. After reviewing the literature on the interactions of financial markets and elections in emerging democracies (section II) we describe the unique database used in this paper (section III), based on major investment banks recommendations' on emerging markets between 1997 and 2008. In section IV, we discuss the interaction of politics and capital markets. We present stylised facts on the relationship between political processes and investment banks' recommendations. Section V illustrates the sensitivity of emerging markets analysts over the past decade to political events like elections in emerging-market democracies. More precisely, by using an ordered-probit model, we test the impact of politics on investment banks' recommendations. Lastly in section VI we conclude, summarising the key findings of the paper and the policy implications of this research.

II. CAPITAL MARKETS AND ELECTIONS IN EMERGING DEMOCRACIES: A REVIEW OF THE LITERATURE

Elections, the formation and dissolution of governments, removals of cabinet members, legislative decision-making are all essential to a functioning democracy, but are inherently unpredictable phenomena. Although banks are sensitive to democratic transitions, increasing their lending in the years following democratisation (Rodríguez *et al*., 2008), it also appears that financial markets behave quite nervously in the face of regular democratic events such as elections in emerging countries.

The monitoring of politics by financial markets tends to intensify during election periods. Financial operators intensively covered political events during the meltdown of Argentina in 2001 and the subsequent collapse can be seen as a clear example of crisis in political governance, representation and legitimacy. Similarly, Mexico's 1994 elections and the 'Tequila crisis' of 1995 and the South Korean presidential election in 1997 all captured analysts' attention (Chang, 2002). Election years are therefore viewed as critical junctures from a financial investor's point of view, increasing the density of reports incorporating political dimensions. In fact, when the behaviour of financial variables during election years in emerging markets is examined more closely, political events are also associated with high volatility. Bussière and Mulder (2000) found (for 22 emerging countries between the 1994 and 1997 period associated with the 'Tequila' and Asian crises), that elections and political volatility are significantly related to currency crises while coalition stability is not.

Political cycles, such as presidential elections, in emerging countries tend therefore to have strong impacts on capital markets' behaviour and on market variables such as exchange rates, sovereign bond spreads and stock returns as well as on the information transmitted in capital markets (*e.g.*, sovereign bond ratings or investment banks' recommendations).

There are two main reasons that could explain the high impact of presidential elections on emerging capital markets. First, during electoral cycles, fiscal and monetary policies tend to be expansionary (Block and Vaaler, 2004). As pointed by Shi and Svensson (2006) and Brender and Drazen (2005), this is particularly true in developing countries. More precisely, if voters have a greater capacity to monitor fiscal policy, the increase of fiscal deficits during elections will be higher. Indeed, the importance of informed voters on fiscal outcomes around elections is crucial (See Shi and Svensson, 2006; Brender and Drazen, 2005). From a theoretical point of view, the traditional research literature indicates that incumbent government parties face incentives to implement expansionary economic policies in order to increase their popularity and support from voters during electoral years (Nordhaus, 1975; Hibbs, 1977; Alesina, 1987; Alesina, Roubini and Cohen, 1997). In particular, Rogoff (1990) shows that even rational voters might vote for incumbents that run fiscal deficits, given imperfect information problems. This view has been challenged more recently by other authors (Brender and Drazen, 2008).

Increased public expenditures around elections does not necessarily imply a deterioration in the fiscal deficit. As pointed out by Drazen and Eslava (2005) for the case of municipal elections in Colombia, the increase of capital expenditures by the incumbent party does not affect the fiscal deficit. Incumbent parties tend to increase expenditures in spending categories that will affect voters. This is particularly evident for emerging economies (Drazen and Eslava, 2005; Gonzalez, 2002; Khemani, 2004)[1]. Empirical research finds that incumbent parties facing re-election, particularly incumbents from parties with left-wing orientations[2], have incentives to engage in unsustainable expansionary economic policies (Leblang, 2002).

Expansionary monetary policies have been widely observed during electoral cycles. Remmer (1993) finds that inflation is higher in Latin American countries during elections periods in the 1970s and 1980s. Block (2002) finds increased growth in money supply across Sub-Saharan African countries during election years since the 1960s. Blomberg, Frieden and Stein (2005) argue that as an election approaches, the probability of maintaining a fixed exchange rate increases. As noted by the authors, "if political and economic factors make the peg difficult to sustain, of course, we should see an increase in the probability of leaving the exchange rate after an election". The increase of monetary and/or fiscal policies during elections could potentially affect the credibility of economic regimes and hurt investors' interests. In capital markets, bond or currency traders' confidence is damaged. In emerging markets, this behaviour is critical because of the difficulty faced by the public sector to attract capital, needed to address a broad range of development objectives (Ames, 1987; Schuknecht, 1996; Alesina *et al*, 1999).

A second reason presidential elections affect emerging capital markets has to do with uncertainty concerning future economic policies. This is particularly relevant when (i) there is uncertainty about the incumbent party's re-election prospects, and (ii) the "outsider" party promotes unsustainable economic policies during campaigns. Indeed, as pointed by Pantzalis *et al*. (2000), "an expectation of an incumbent loss is associated with more uncertainty than when the incumbent is re-elected". Instability and uncertainty are central to understanding the links between financial markets and politics in emerging countries. More particularly, financial instability and financial market overreactions during electoral processes can be explained by uncertainty regarding institutional stability and continuity, rather by uncertainty linked to democracy itself. A case study in this regard is the Brazilian presidential election of 2002. In order to find an effective indicator that shows the influence of Brazilian presidential elections on financial markets, Martínez and Santiso (2003) use as a political uncertainty variable the popularity of the "outsider" candidate Lula in electoral polls.

[1] For an extensive review of the literature regarding voters and fiscal policy around elections, see Eslava, (2006).

[2] By left-wing parties, we mean those more concerned with unemployment and GDP growth and less concerned with inflation. The preferences of right-wing parties, in contrast, are the opposite (see Alesina *et al*., 1997 for a more detailed analysis of political ideologies and economic policies).

Empirical evidence analysing the impact of politics on capital markets is abundant. Although the impact of electoral cycles for investors and financial intermediaries is strongly felt, the reaction of global financial markets to politics in emerging democracies may differ significantly within a single region, being dependent on the degree of democratisation and the transparency of the policy-making process, the historical existence of democratic institutions, the scale of the government's legislative majority and its political cohesion (Hays *et al*, 2003; MacIntyre, 2001).

Eichengreen, Rose and Wyploz (1995) were among the first to address the political dimension of financial crises, finding close links between political processes and exchange-rate turbulence. Leblang and Satyanath (2006) find that institutional variables such as divided government and government turnover are important determinants for speculators' behaviour and increase the likelihood of currency crises. Martínez and Santiso (2003) find a high and positive correlation between political uncertainty and sovereign risk premia during the 2002 Brazilian crisis.

Political colours in emerging democracies tend also to matter to financial markets. Block (2003) found that right-wing governments in developing countries were less conducive to currency crises and that 'strong' governments (those with larger legislative majorities and those which face more fragmented legislative opposition) tend to be also less vulnerable to financial crises. Bond spreads for right-wing incumbents tend to increase with the likelihood of left-wing challengers' victory (Block *et al.*, 2003). Cho (2007) also found that bond investors tend to downgrade left-wing governments when other economic and policy outcomes are controlled for. Investors may be willing to invest in left-leaning governments over centre/right governments if leftist governments provide policy certainty (Cho, 2008).

Mukherjee and Leblang (2007) examine the relationship between political partisanship, interest rates and volatility of stock prices in two developed countries, the United States and United Kingdom. They find that traders in the stock market rationally expect higher (lower) post-election interest rates during the incumbency of the left-wing (right-wing) party – Democrats and Labour (Republican and Conservative) – and in election years when they expect the left-wing (right-wing) party to win elections. Campello (2007) shows that, both in developed and developing countries, portfolio managers react to the prospect of a left turn in the political system by selling their holdings. They also tend to react positively when a change from left to right occurs and also when a right-wing government succeeds another right-wing government, suggesting that investors tend to value the maintenance both of market friendly policies and of continuity. Lastly, more recent studies showed, contrary to the conventional wisdom, that left-leaning governments are more likely to be associated with higher stock market capitalisation than their counterparts from the right of the political spectrum (Gourevitch, Pinto, and Weymouth, 2008).

More generally, interaction between actors in capital markets and governments is crucial during political cycles. As pointed out by Santiso (2003), "exit" and "loyalty" options are at the heart of the confidence game between financial markets and politics. In contrast to "exit" cases, loyalty is directly linked to credibility. The propensity to remain loyal depends on the confidence attached to the actions of governments and political parties. One way that governments tend to play this confidence game has been to signal credibility and commitments towards market friendly policies with the appointments of ministers of finance or central bankers with suitable pedigrees (mostly trained in the US, frequently with previous international experiences in international organisations such as the IMF or investment banks, etc.) (see Chwieroth, 2007). Changes in these key people might also affect financial markets, as underlined by empirical research done on central bankers: the replacement of a central bank governor negatively affects financial markets on the announcement day (Moser and Dreher, 2007). Central bank governor changes in emerging markets may convey important signals about future monetary policy.

The reaction of market variables to political events is evident. By studying the exchange rate, Leblang (2002) confirms that speculative attacks are more likely just after an election as compared to all other periods. Frieden, Ghezzi and Stein (2001) find that during presidential elections the average rate of nominal depreciation in the second month after the election reaches seven per cent, around 4.5 percentage points higher than in other periods, a result theoretically explained by Bonomo and Terra (2005). In the stock market, Lin and Roberts (2001) find that returns of a certain number of equities were affected by expectations about the outcome of the March 2000 presidential election in Chinese Taipei. Pantzalis *et al*. (2000) demonstrate that a positive reaction of the stock market to elections depends on the country's degree of political, economic and press freedom as well as the incumbent's re-election chances. Concerning sovereign bond markets, Moser (2007) finds that sovereign bond spreads in Latin American countries during the period 1992-2005 are affected by political instability, as measured by the turnover of finance ministers.

In additional to market variables, information transmitted to investors is also affected by political outcomes, with ratings agencies tending to downgrade sovereign bond ratings during electoral periods (Reinhart 2002; Reisen 2002). There is no democratic premium: democracies do not tend to pay lower interest rates than autocracies and do not benefit from a democratic premium by rating agencies (Saiegh, 2005). Block and Vaaler (2004) underline that credit rating agencies downgrade developing country ratings more often in election years, and do so by approximately one rating level. They found that bond spreads are higher in the 60 days before an election compared to spreads in the 60 days after an election and that spreads trend significantly downward in the 60 days before an election, but then flatten out in the 60 days after an election. More recently, Vaaler and McNamara (2008), using a sample of 18 developing countries during the period 1987-2000, find that agency ratings decrease during election years in developing countries with left-wing incumbent candidates. This effect decreases as the number of rating agencies competing in emerging countries increases. The results presented so far contrast with those of Archer *et al* (2007). By using a sample of fifty developing countries from 1987 to 2003 and studying sovereign bond ratings issued by Moody's Investor Services, Standard and Poor's and Fitch Ratings, they find that political factors, such as election cycles, have little effect on ratings.

Another fundamental source of information in capital markets are the recommendations given by investment banks to investors in capital markets. To the best of our knowledge, there has been no systematic and regular analysis of the impact of political cycles on the outlooks provided by Wall Street strategists and analysts on sovereign bond markets. This paper seeks to bridge this gap.

III. DESCRIPTION OF THE DATA

In this section, we present the sources and explain the relevance of the data used for this paper. We use the information provided by investment banks to investors regarding their sentiments *vis-à-vis* public debt in emerging economies, and also data related to presidential elections in Latin American countries. Finally, we use financial and macroeconomic variables in order to control for the impact of presidential elections on recommendations.

The period analysed in this paper is from July 1997 to February 2008 and the frequency of observations is monthly. The nine countries included in this study – Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela – correspond to the largest Latin American economies, accounting for over 95 per cent of the total GDP of the region. They furthermore represent the major bond issuers within the emerging market asset class over the period.

We use the publications produced by the major investment banks operating in Latin American markets. All are foreign banks, US and European. In their weekly, monthly or quarterly reports they publish their recommendations for each individual emerging country, providing inputs for their clients, namely the "buy side" industry of portfolio asset managers, mutual funds, hedge funds, pension funds, etc. These recommendations represent a direct and strict link between financial intermediaries and investors and, as shown in previous research, they tend to have a significant impact on bond portfolio investors' asset-allocation decisions (Nieto Parra and Santiso, 2007).

The database is constituted by the recommendations of 13 investment banks, all of them major players in emerging bond markets as underwriters and dominant market makers: ABN AMRO (ABN), Barclays Capital (BARCLY), Bear Stearns (BS), Citigroup - former Salomon Smith Barney - (CITI), Credit Suisse - former Credit Suisse First Boston - (CSFB), Deutsche Bank (DB), Dresdner Kleinwort Wasserstein (DK), Goldman Sachs (GS), JPMorgan (JPM), Lehman Brothers (LB), Merrill Lynch (ML), Morgan Stanley (MS) and UBS (UBS). See Annex 1 for a description of these publications.

By collecting 699 reports issued by investment banks on emerging bond markets, we have over 5 000 recommendations to institutional investors from July 1997 to February 2008[3]. No reports before this period are available, either in the websites or databases of the brokers. The investment banks included in this database manage as underwriters more than 85 per cent of the Latin American sovereign IPOs over the period considered (see Table 1).

[3] For the period July 1997 to December 1999 the database contains only information from Citigroup.

Table 1. **Investment Banks' Recommendations Database**

Number of Observations July 1997-February 2008

	ABN	BARCLY	BS	CITI	CSFB	DB	DK	GS	JPM	LB	ML	MS	UBS	TOTAL
Argentina	15	3	56	107	82	50	57	25	83	19	40	57	14	608
Brazil	12	17	65	105	81	50	54	25	85	19	51	53	18	635
Chile	11	15	41	110	82	0	0	25	83	19	0	30	10	426
Colombia	12	15	65	107	82	51	57	25	85	19	44	54	12	628
Ecuador	1	16	58	106	67	51	53	25	81	18	46	41	15	578
Mexico	15	15	63	107	78	50	55	25	85	19	49	50	16	627
Peru	1	16	65	104	80	51	54	25	83	19	47	53	14	612
Uruguay	0	0	51	26	61	0	0	16	80	19	21	12	0	286
Venezuela	12	14	60	111	77	51	54	25	82	19	48	52	14	619
TOTAL	79	111	524	883	690	354	384	216	747	170	346	402	113	**5019**
Part. Underwriting (%)	2,6	2,3	0,6	9,3	6,0	10,6	2,4	9,7	21,8	0,1	7,5	7,8	6,9	**87,5**

Source: The authors based on investment banks' publications (for recommendations) and dealogic (for underwriting), 2008

The frequency of these publications is in most cases monthly. The recommendations that we use are those given regarding sovereign external debt. In order to compare the view of each bank towards Latin American countries at the same time, we have classified three types of recommendations: Overweight (the value of 1), Neutral (0) and Underweight (-1), corresponding respectively to the cases of buying, maintaining and selling with respect to an index (*e.g.* EMBI+ calculated by JPMorgan).

Given overall portfolio constraints, a buy recommendation must be offset by a sell recommendation, implying that investment banks are constrained to underweight an emerging country in the composition of the portfolio when they issue a favourable/overweight outlook on another country. However, it does not necessary imply that recommendations are symmetrically distributed (*i.e.*, the number of overweight recommendations are not necessary the same of underweight recommendations). Indeed, an overweight (underweight) recommendation could be compensated by more than one underweight (overweight) recommendation.

Election data draw upon two databases. The database compiled by IFES (*International Foundation for Election Systems*), accessible at http://www.electionguide.org/ is used for the period after 1998 and the database of the *Observatorio Electoral Latinoamericano* (http://www.observatorioelectoral.org/) is used for the period prior to 1998. To identify incumbent parties, political parties and results of the elections, we use the Political Database of the Americas (PDBA, http://pdba.georgetown.edu/) developed by Georgetown University.

Finally, the last type of data used in this paper relates to financial and macroeconomic indicators that could affect investment banks' recommendations. These variables are used as control variables and may be divided into three categories. The first comprises external or "push" variables, such as US industrial production growth, and two indicators of global risk, namely US High Yield and VIX index (*i.e.*, Chicago Exchange Volatility Index). The source of these variables is Thomson Datastream.

The second set of control variables are internal or "pull" macroeconomic variables. These variables represent macroeconomic conditions (domestic industrial production growth, inflation rate, local interest rates and exchange rates) and structural conditions affecting the solvency of the state (interest on public bonds over exports of goods and services, public bonds over exports of goods and services and finally reserves over imports). Data is tracked from Thomson Datastream, and the GDF (Global Development Finance) database developed by the World Bank.

Lastly, we employ "pull" financial variables. These variables are the investment value of sovereign debt (*i.e.*, EMBI Global index return)[4], sovereign bond spreads (*i.e.*, EMBI Global spread), the equity return in local stock markets, the relative size of the sovereign bond market (*i.e.*, EMBI Global weight for each Latin American country), the development of the bond market (*i.e.*, total debt trade volume over GDP), the liquidity of the sovereign bond market (*i.e.*, bid-ask spreads) and the sovereign bond ratings (*i.e.*, monthly change of Standard and Poor's rating). The source these variables is Thomson Datastream, EMTA (Emerging Markets Trade Association), Bloomberg and Standard and Poor's.

[4] More precisely, we use one month, 3-month and finally 12-month sovereign bond returns.

IV. INVESTMENT BANKS' RECOMMENDATIONS AND ELECTIONS IN EMERGING DEMOCRACIES: STYLISED FACTS

In this section we present the main stylised facts of the relationship between presidential elections and outlooks given by Wall Street analysts and strategists.

Politics and capital markets in Latin America

Presidential elections in emerging economies are an important event[5] for market analysts and in the subsequent strategy of actors in financial markets, such as institutional investors, sell-side businesses, and investment banks' debt origination.

The electoral cycle, and presidential elections in particular, seems to be an important variable in the analysis of investment decisions in the financial markets. Indeed, elections affect and are affected by capital markets. Depending on economic policies proposed by candidates and winners, financial agents react, either with strong and stable capital inflows or, at the other extreme, by contributing to financial instability and "sudden stop" problems (see Chang, 2006 for a theoretical point of view of the interactions between capital flows and elections in emerging economies).

In this section we study the impact of politics on investment banks' recommendations. Although we do not argue that the election of a president is the only variable analysed by research departments, we note that its influence is considerable. A publication by an important investment bank provides evidence of the relevance of the political cycle to recommendations concerning emerging portfolio allocation.

Credit Suisse - former CSFB - (11 May 2006 Fixed Income Research Sovereign Strategy Daily):*"We are moving to underweight in Mexico due to expectations of increased spread volatility ahead of the July presidential elections. We have moved from underweight towards a neutral stance on Peruvian assets because, in our view, political risk has declined as opinion polls show Alan Garcia as the likely winner in the second-round presidential vote that will be held on Sunday, June 4"*.

Market analysts, and in general private actors as a whole, are attentive to political issues and scrutinise in detail critical junctures like elections in emerging democracies. As pointed out by Persson and Tabellini (1994), central bankers and governments change over time, and private actors necessarily face uncertainty concerning policies to be followed by the new policy maker.

[5] In this study we take the presidential election date as a given date. See Bernhard and Leblang (2007) for the case in which incumbent politicians use their expectations of future economic performance to evaluate the possibility to call an early election.

In order to anticipate which kind of policies might be adopted, the private sector interprets signals sent by policy makers.

In particular, financial markets' radar is keenly tuned during periods of intense political activity. During election processes in particular, investment banks recommend portfolio allocations to investors depending on the credibility with which they perceive candidates' economic policy platforms, the evolution of the polls and the behaviour of incumbent parties. In cases in which investment banks do not expect any risk in presidential elections, they transmit that sentiment to institutional investors. A brief look at investment banks' publications prior to "no risk elections" confirms the favourable view concerning asset allocation for this kind of countries:

Citigroup remarked (August 23, 2006 Global Economic Outlook and Strategy) about the presidential elections in Brazil: *"whoever wins the election, the broad tenets of macroeconomic policies, including fiscal responsibility, inflation targeting, and a floating exchange rate, likely will remain in place".*
Similarly Credit Suisse - former CSFB - some days before the election date in Chile (Debt Trading Monthly, 02 December 2005), *"We would expect bondholders, particularly abroad, to remain largely unconcerned about the final outcome of the elections, given the strength of the country's institutional framework and the pro-fiscal discipline stance of the main candidates".*

However, investment banks' signals to investors are very clear in cases where a candidate is perceived to be 'risky'. In contrast to the example above, the same candidate, Lula da Silva, was once perceived as a significant threat to the continuity of market-friendly economic policy in Brazil. The aspiring president was nicknamed "Lula Preta" (*i.e.* "Dark Moon"):

According to Goldman Sachs (Emerging Markets Strategy November 07, 2002), *"We remain cautious about the prospects for this credit on the back of our perception that the incoming administration is poorly prepared to tackle the hard challenges of restoring confidence, stabilising the stock of net public debt, and simultaneously engineering a recovery of economic activity"... "Given the balance of risks, and the recovery of asset prices, we remain comfortable with our recommendations to Underweight external debt and short BRL interest rates".*

A similar pattern is observed during recent Peruvian elections. During the 2006 presidential elections, candidate Alan Garcia was perceived as the market-friendly candidate. This perception contrasts with past elections in which ex-president Garcia was perceived as a risky candidate, given the corruption scandals during his presidency in the 80's:

JPMorgan (3 May 2001 Emerging Markets Outlook) points in 2001 during the Toledo-Garcia campaign: *"Key is whether Garcia would avoid the temptation of boosting growth through un-orthodox means if the private sector is not fully engaged in, say, one to two years into his administration. Some local bankers fear that even a mere victory by Garcia in the runoff could spark a run on deposits and/or capital flight".* By contrast in 2006, CSFB (Global Emerging Markets Outlook, 24 March 2006) notes that the risk in Peruvian elections was due to Humalla or Lourdes Flores, becoming Garcia the market-friendly candidate *"The surge of populist presidential candidate Ollanta Humala in the polls has increased Peru's political risk".*

Opinions and expectations formed by actors in capital markets regarding future economic policies could turn out to be wrong, of course. This is the case in Brazil with Lula da Silva in 2002. As is pointed out by Archer *et al* (2007), there are often staggering differences between the populist campaign platforms offered by candidates and their actual policies once in office. However, signals sent by presidential candidates that lack credibility represent a risk for actors in capital markets. Indeed, the impact of these signals on both economic growth and stability of market variables is costly.

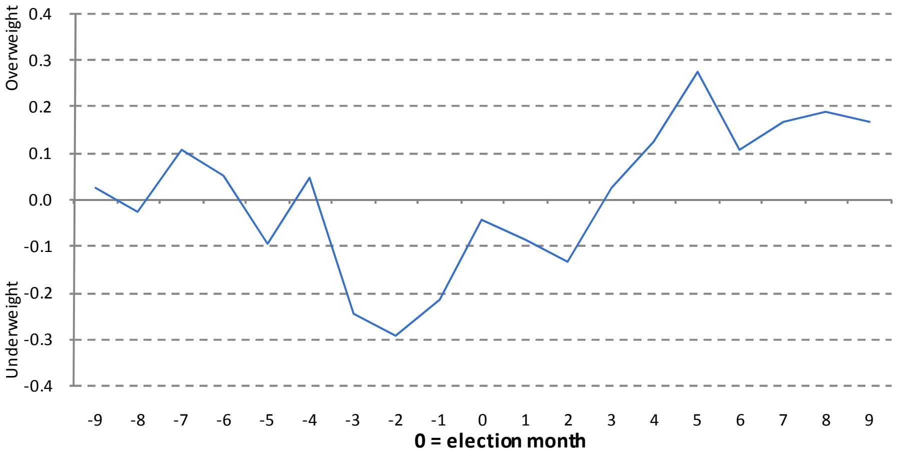
Finally, sometimes information transmitted by investment banks might be erroneous and costly to investors. For instance, some of the investment banks anticipated a victory of candidate Noboa in the 2006 elections in Ecuador, based on pre-election surveys:

Bear Stearns (October 16, 2006 EM SOVEREIGN / LATIN AMERICA) is a good example of the investment banks' strategies few days before the election date. *"A scenario of Alvaro Noboa being the next president of Ecuador (now quite likely) is a relatively positive outcome. On the plus side, he is a market-friendly candidate"* …. *"Despite the impressive rebound in prices seen today (Monday, October 16) as a result of the positive election surprise, we continue to see room for upside. Hence, we now think that this credit will outperform the market through the end of the year"*.

Indeed, for a large majority of countries, political processes are significant in the eyes of market participants. Concerning Wall Street's strategists and analysts, in annex 2, we present the recommendations given by investment banks to Latin American countries by taking into account the presidential elections dates. In a large number of presidential events[6], we observe a common pattern. There is a downturn in the recommendations (*i.e.* they tend to turn more negative) given by investment banks prior to elections followed by an upturn after the elections (*i.e.* they tend to become more positive). This pattern is observed above all in electoral cycles in which fear about the credibility of future economic policies is present. More generally, in order to determine the behaviour of capital markets' strategists and analysts during electoral periods, we calculate the average of the recommendations given by investment banks during nine months prior to and following presidential elections (0 being the election date). We apply a similar methodology to that of Stein *et al* (2004) and Stein *et al* (2005) for the case of the nominal and real exchange rates respectively.

[6] See Brazil in October 2002, Colombia in May 2002, Ecuador in July 1998, Ecuador in November 2002, Ecuador in November 2006, Mexico in July 2000, Mexico in July 2006, Peru in May 2000, Peru in June 2006.

Figure 1. **Investment banks' recommendations around presidential elections**



Source: The authors based on investments banks' publications.

Notes: Banks' recommendations can be classified into three groups: "overweight" (1), "neutral" (0) and "underweight" (-1). The index is calculated as the arithmetic average of all published recommendations. The Latin American countries covered are Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela. The dataset covers the period from July 1997 to February 2008, including 23 non-overlapping presidential elections. For elections with a second (run-off) round, the second round is taken as the election date.

Figure 1 illustrates the relationship between presidential elections and recommendations issued by investment banks. An increase in the recommendations means that investment banks have a more favourable view of Latin American sovereign bond assets. When the recommendations are close to 0, it means that investment bank analysts recommend remaining neutral in sovereign bond assets. Investment banks start to downgrade sovereign bonds three months prior to presidential elections. The considerable downgrade of recommendations three months before elections is followed by negative recommendations until the election date. Finally, as uncertainty concerning political outcome disappears, investment banks' outlooks on emerging countries improve considerably, recommending neutral positions in sovereign bonds and later turning positive.

In order to check the robustness of this stylised fact, we use a simple panel data analysis:

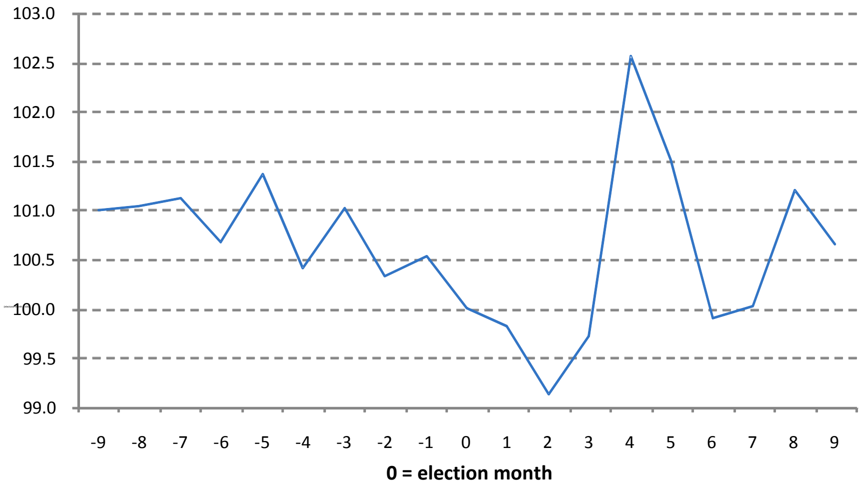
$$\mathrm{Re}\,c_{it} = \alpha_0 + \sum_{t=-9}^{9} \alpha_t month_{it} + \varepsilon_{it} \qquad (1)$$

where $\mathrm{Re}\,c_{it}$ is the median of the recommendations given by investment banks to country i during the month *t*; $month_{it}$ is a dummy variable taken the value of 1 for the country *i* and during the month *t*. *t* is in the interval [-9,+9] representing 19-month window centred on presidential elections.

Results are presented in annex 3 (Panel A) for Ordinary Least Squares (OLS) and country Fixed Effects (FE) regressions. From this simple econometric analysis we find that dummy variables indicating three, two and one month prior to elections are negatively and statistically significant at 1 per cent. Moreover, between three and one month prior to elections the negative coefficient is high in comparison with the whole interval studied. These results are consistent in both OLS and FE regressions. Stylised facts confirms that investment banks' perceptions deteriorate considerably just before presidential electoral results. Indeed, the coefficient on the one month dummy variable prior to election is high (-0.38 for FE and -0.36 for OLS regressions).

These results contrast with the real exchange rate pattern around elections in which the negative impact of presidential elections is observed *after* the election (see figure 2 for the period 1997-2008). There is an appreciation of the real exchange rate prior to elections (2.2 per cent over seven months) followed by a strong depreciation (3.5 per cent in the two months following the election). From month five, the real exchange returns to approximately the level observed before the initial appreciation.

Figure 2. **Real exchange rates around presidential elections 1997-2008**



Source: The authors based on Thomson Datastream.

Notes: The real exchange rate is calculated with respect to the US economy. Data is rebased so that the month of the presidential election (time 0) = 100. An increase in the index represents a depreciation against the dollar. The Latin American countries covered are Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela. Averaging is geometric in order to reduce the effects of outliers. The dataset covers the period from July 1997 to February 2008, including 23 non-overlapping presidential elections. For elections with a second (run-off) round, the second round is taken as the election date.

This pattern is confirmed by research studying the impact of presidential elections on capital-market variables. A variety of papers find that depreciations of the nominal and real exchange rates occur in the months succeeding the presidential elections (Bonomo and Terra, 2005; Frieden *et al*, 2001; Stein *et al*, 2005). As noted by these authors, different causes could explain depreciations of the exchange rate after presidential elections. All of them are stem from an over-valued pre-election currency. First, exchange-rate adjustments tend to be postponed as long as possible. Outgoing presidents avoid devaluing in the months prior to elections in order to limit the damage to their electoral chances or those of their party's candidate (Stein *et al.*, 2005).

Indeed, Blomberg *et al.* (2005) argue that the probability of abandoning fixed exchange rates is small prior to elections, and large following them. Second, increases in government spending (much of it on non-tradable goods) prior to elections leads to currency appreciations, only to depreciate later (Bonomo and Terra, 2005).

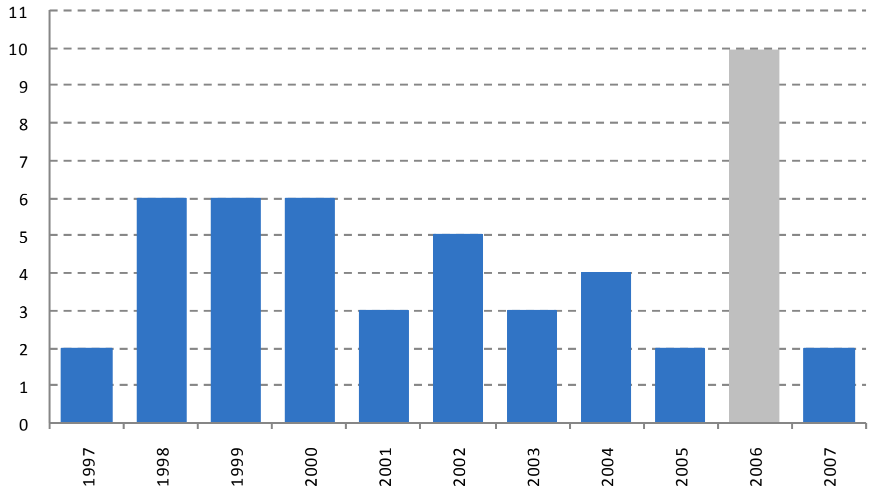
In other cases, pre-emptive depreciations of the exchange rate occur just prior to elections, perhaps because policy makers fear capital markets' judgments on the sustainability of economic policies (for example Mexico in 2006, and Brazil in 2002). The link with the public debt markets arises because market participants tend to be forward-looking when assessing the sustainability of the foreign-exchange anchor prior to elections. Precisely because they anticipate declines in the exchange rate following an election, investment banks downgrade Latin American public debt prior to elections.

Presidential electoral cycles prior and since 2006

There were elections in 2006 in all the large countries of Latin America other than Argentina. Over 80 per cent of the region's population went to the polls to elect their head of state, a quite exceptional total[7]. Figure 3 illustrates the high number of presidential elections with respect to previous years. In spite of this high density of electoral events, and contrary to previous election years with high densities, this time Latin American financial markets did not experienced major disruptions.

[7] More precisely ten presidential elections in less than one year: Chile (January for the second round), Costa Rica (February), Haiti (February), Peru (April for the first round and June for the second round), Colombia (May), Mexico (July), Brazil (October), Ecuador (October for the first round and November for the second round), Nicaragua (November) and Venezuela (December).

Figure 3. Latin America: Number of presidential elections



Source: The authors based on http://www.electionguide.org and http://www.observatorioelectoral.org/

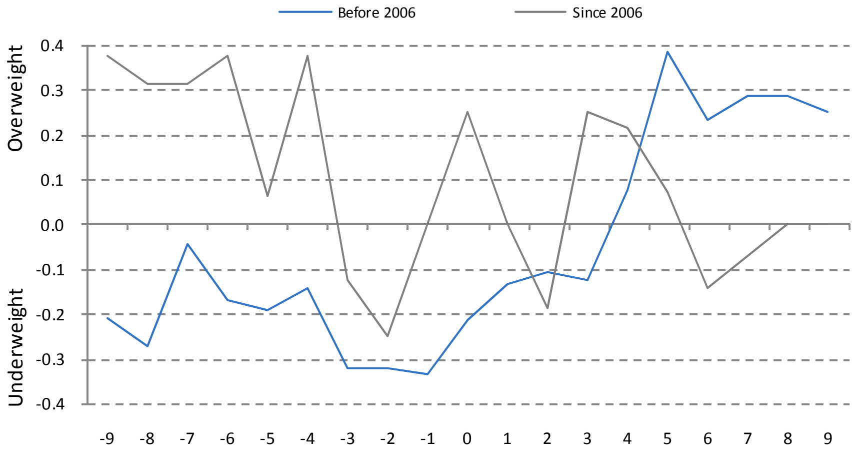
Notes: The Latin American countries covered are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. For elections with a second (run-off) round, the date of the final round is used.

It is not straightforward to compare the effects of electoral cycles in different years, given the variations in the international financial and economic context. The relative stability of 2006, for example, may have been attributable to the generally favourable liquidity in financial markets and favourable external conditions at that time (Izquierdo and Tavli, 2008, Hartelius *et al*, 2008).

For this reason, investment-bank recommendations may be more useful than other indicators of capital markets' confidence, since – as explained in next section – such recommendations filter out exogenous factors. During 2006 overall recommendations for the region stayed out of negative territory with an average value of 0.13. This is better than previous electoral cycles in the region. In 1998, 1999, 2000 and 2002 average recommendations were -0.13, 0.09, 0.07 and 0.02 respectively.

Figure 4 takes this further and looks at the evolution of market analysts' perceptions of Latin American policies over time. Bank recommendations are divided in two sub-samples covering elections before and after the start of 2006. In both subsamples recommendations fell prior to elections, but for the latter group remained above those of previous electoral cycles.

Figure 4. **Investment banks' recommendations around presidential elections**



Source: The authors based on investments banks' publications.

Notes: Banks' recommendations can be classified into three groups: "overweight" (1), "neutral" (0) and "underweight "(-1). The Latin American countries covered are Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela. Dataset covers the period from July 1997 to February 2008, including 15 presidential elections before 2006 and 8 presidential elections since 2006. For elections with a second (run-off) round, the second round is taken as the election date.

In order to check the robustness of this result, using simple econometric techniques, we run the regression presented in equation (1) of this section for these two sub-samples. Results are presented in annex 3 (Panel B). With respect to the first sub-sample (before 2006), the coefficients on the three, two and one month prior to elections dummy variables are high and statistically significant at 1 per cent. At the presidential election date this coefficient is significant at 5 per cent. In particular, one month prior to the election process, this coefficient is close to -0.5 in the FE and OLS regressions. As in the case of the regression for the full sample, this coefficient increases as the election approaches. By contrast, in the second sub-sample (since 2006), time dummy variables are not statistically significant, neither in OLS nor in country FE regressions[8]. Moreover, the value of the coefficient one month prior to the election is far smaller than in the case prior to 2006 (-0.17 in FE and -0.14 in OLS regressions).

Regression results suggest that the impact of elections on recommendations decreased in 2006 with respect to earlier electoral cycles. These results must be interpreted with caution given that the length of the two sub-samples differs. Indeed, the smaller number of observations for the latter period (only two years long) may itself explain why the effect of the 2006 electoral cycle is not significant.

[8] The exception is two months prior to presidential election. Both the OLS and FE coefficients are significant, but only at the 10 per cent level in both regressions.

V. HYPOTHESES OF THE MODEL AND ANALYSIS OF THE IMPACT OF ELECTIONS ON BANKS' RECOMMENDATIONS

In this section we first establish the hypotheses that we test empirically regarding the impact of elections on investment banks' recommendations given to sovereign debt. Second, we present the most important results of a model that estimates the determinants of the recommendations given by investment banks in Latin American countries.

Hypotheses of the model and econometric analysis of the impact of elections on investment banks' recommendations

This section sets out the hypotheses to be tested regarding the impact of political issues on investment banks' recommendations on sovereign debt. The main results of the model estimating the determinants of banks' recommendations in Latin America are then presented.

Hypotheses

Section IV outlined the impact of political cycles on investment banks' strategists and analysts. Preliminary results suggest that political events have a significant impact on sovereign debt recommendations issued by investment banks in Latin American countries. Specifically, prior to elections, investment banks downgrade sovereign debt issued by countries. Consistent with this finding we expect that:

Hypothesis 1 (H1): Presidential elections in Latin American countries have a negative impact on recommendations issued by investment banks. This effect is particularly significant prior to election date.

In order to test this hypothesis we define a window dummy variable that takes the value of 1 starting three months before and ending three months after elections. Additionally, we define another set of dummy variables in order to take into account of presidential campaigns on banks' recommendations. For that purpose, we define a window dummy variable equal to 1 three months prior to elections (0 otherwise).

In analysing investment banks' reports several factors affecting analysts and strategists' behaviour around elections may be identified. The risk of non credible future economic policies may be one of the most important factors determining recommendations during electoral cycles. Uncertainty regarding the scope of policy switches is a key driver of financial markets' negative expectations regarding electoral outcomes. In political systems with fewer "veto players" this uncertainty regarding the future political preferences and in particular the stability of policies tends to increase -- which is usually the case of emerging democracies plagued with fewer and lower quality veto players.

Hypothesis 2 (H2): Presidential candidates' signals concerning the credibility of future economic policies have an impact on outlooks issued by investment banks on sovereign debt. Anticipations are particularly important in this respect. Where major candidates' future economic policies are considered non credible, recommendations are likely to be negative.

In countries with solid systems of checks and balances, such as developed OECD democracies, the negative anticipations of financial markets regarding electoral outcomes tend to be lower. In such settings, institutions are perceived as solid anchors that limit the scope of policy swings; the greater the number of veto players, the narrower the policy swings (Henisz and Mansfield, 2006). Investments increase with the policy stability that veto players provide (Fatas and Mihov, 2006).

Governments sometimes attempt to overcome this credibility failure by making policy changes more difficult (Keefer and Stasavage, 2002, 2003), importing stability from abroad; as well, governments can gain policy credibility by adhering to strict rules, either monetary or fiscal. Re-elections tend to diminish the intensity of this uncertainty, as the sitting president remains in power. When immediate re-elections are not possible, as is frequently the case in Latin America, another way to deal with expectations regarding policy stability is to signal, before elections, the menu of policies that will be pursued in case of victory. The credibility issue, however, does not disappear, as promises by candidates can be viewed -- with reason -- as lacking credibility. Once elected, the credibility issue might remain. Here again, presidents can look for strategies to signal more credible commitments.

Methodologically, this study must measure candidates' commitment to credible economic policies. In absence of an indicator measuring the enthusiasm of presidential candidates for such policies during their hypothetical mandate, we resort a proxy that analyses the signals that candidates send to the international financial community (*e.g.*, foreign investors, analysts and bankers) during presidential campaigns: a standard publication, here the economic and political weekly *The Economist*.

The policy pronouncements of candidates were assessed to deem them credible or not. In particular, a pronouncement is deemed non-credible if reports express fears:

1. that expansionary fiscal policy will weaken debt sustainability;
2. that debt payments might be suspended or renegotiated;
3. that monetary policy will be inflationary;
4. that an independent central bank or inflation targeting regime, where one exists, will be abandoned;
5. that populist policies will be emulated.

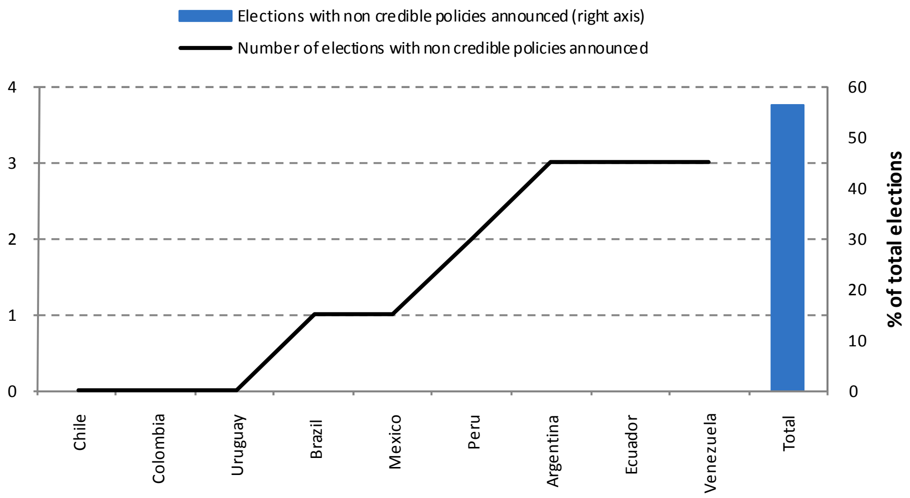
We use a dummy variable equal to 1 if programmes and speeches described by *The Economist* show that there is fear that candidates are not committed to a credible economic regime (see annex 4 for a detailed description of the construction of this dummy variable), and 0 otherwise.

Figure 5 presents the number of presidential elections in which candidates sent negative signals concerning the credibility of future economic policies during the period 1997-2008. For the sample as a whole (the blue bar at right) the economic policies of at least one of the major candidates were seen as non-credible in more than half the elections. However, results differ markedly among countries. No threat of non-credible policies was perceived in Colombia (run alternately by political forces sharing the same market-oriented policies) or in Chile (run by the same governmental coalition during the entire period and with political forces sharing the same credible agenda). Indeed, non-credible economic policy rarely arises in press coverage of elections in Chile[9]. While differing on details, all leading Chilean presidential candidates in the period covered supported the country's counter-cyclical fiscal rules and inflation-targeting framework.

For Mexico and Brazil, non-credibility was an issue only sporadically. Among the three presidential elections that took place in Brazil only one (October 2002) gave rise to credibility concerns. This was of course the initial election of Luiz Inácio Lula da Silva, discussed in detail above. In Mexico the unsuccessful presidential bid of populist Andrés Manuel López Obrador in 2006 was seen as a possible threat to the continuity of credible economic policies.

At the other end of the scale, Venezuela, Ecuador and Argentina all experienced significant swings in their policy orientations and were characterised by elections in which the variation between the economic policy platforms offered to the electorate was extreme.

Figure 5. **Non credible policies announced by candidates (1997-2008)**



Source: The authors based on The Economist.

Note: Countries analysed are Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela during the period July 1997- February 2008, covering 23 presidential elections.

[9] For instance, at the end of 1999 and the beginning of 2000, media attention was focused on Pinochet's arrest in London. From September 1999 until March 2000, nine articles on the Pinochet case appeared in *The Economist* compared with three related to the presidential elections.

In order to determine whether candidates with non economic platforms have a high likelihood of being elected, we define a dummy variable equal to 1 if a presidential race is between "economically credible candidates". In order to define competition during elections we use the methodology elaborated by Stein *et al* (2005): we call an election competitive if the difference between votes of first and second presidential candidates is less than 15 percentage points. This variable equals 1 in presidential elections in which there is a "non economically credible candidate" running, or if he obtained a large majority (higher than 15 percentage points) of votes[10].

There is however a risk of oversimplification in attributing the impact of elections on investment banks' recommendations only to credibility. Other factors such as economic policy instability and uncertainty about the outcome of elections can affect investment banks' behaviour during electoral cycles:

Hypothesis 3 (H3): Uncertainty during presidential elections is an explanatory variable for investment banks' outlooks on sovereign debt. In particular, the high likelihood of continuity of economic policies may have a positive impact on recommendations issued by investment banks (H3A). More general, the lack of uncertainty concerning the final outcome of presidential elections improves investment banks' outlooks on sovereign debt (H3B).

In section III we note that, according to research literature, incumbent-left wing parties may negatively impact market variables. The idea of this hypothesis is different. We suppose that, in the eyes of investment banks' recommendations, continuity is preferable, even if incumbents are pursuing non credible policies. Indeed, this hypothesis argues that recommendations are used by investors to determine short-term allocations and consequently are relatively unconcerned by long-term or structural factors[11].

With presidential elections coming up, all temporal horizons become focused on the very short term. Uncertainty is a crucial variable tracked by investment banks. Uncertainty for financial markets means volatility of sovereign bond returns and consequently, foreign actors in capital markets could prefer certainty on the future economic policies. By observing investment banks' publications, we note that in order to test uncertainty, monitoring of the polls is important for these banks[12].

[10] The sources of the information of electoral results are IFES (http://www.electionguide.org/), PDBA (http://pdba.georgetown.edu/) and Observatorio Electoral Latinoamericano (http://www.observatorioelectoral.org/).

[11] Santiso (2003), based on a questionnaire administered to investors, determines that fund managers change portfolio allocations every three months and are under pressure to obtain profits in the short-term.

[12] All the assumptions given by the investment banks concerning the result of the elections in Latin American countries take as principal input results of local polls. As a result, in order to obtain the accuracy of the polls and give a recommendation for each Latin American country, investment banks study in detail past performances of pollsters. See for example "Don't give up on Latin pollsters" by CSFB (Emerging Market Economics, 04 December 2006).

In order to test this hypothesis we take into account two variables. First, we provide a general definition of certainty. We use competition among candidates during elections as a proxy variable for certainty regarding the election outcome. We define non-competition and consequently certainty in elections as a case of a difference between votes of first and second presidential candidates higher than 15 percentage points. In this case (hypothesis 3B), the dummy variable takes the value of 1 and 0 otherwise.

Second, we restrict the definition of (un)certainty to (in)stability of economic policies. Stability is secured in the case of incumbent parties winning uncompetitive elections (hypothesis 3A). In other words, when the difference between votes of the incumbent and the challenger is higher than 15 percentage points, we suppose that investment banks' are less nervous about electoral cycles. To test this hypothesis, we use the interaction dummy variable "no-competition*incumbent winner".

Finally, inspired by stylised facts presented in section IV, we argue that the impact of political cycle on investment banks' recommendations has decreased since the electoral cycle of 2006:

Hypothesis 4 (H4): The impact of presidential elections on investment banks has decreased considerably since the 2006 electoral cycle.

Econometric analysis

Recommendations are qualitative variables, discrete-valued indicators of sovereign debt investment value in emerging economies. Most of investment banks class these recommendations on three categories: overweight (buying position with respect to an index), neutral (maintaining position with respect to an index) and underweight (selling position with respect to an index).

We therefore make use of the ordered-probit model in order to test the impact of political elections on investment banks' recommendations. Let $\mathrm{Re}\,c_{it}$ be the median of investment banks' recommendations given to country *i* at period *t*. Given that each bank recommendation could be positive (+1), neutral (0) and negative (-1), the median of these recommendations given to country *i* at period *t* can take the value of +1, +0.5, 0, -0.5 and -1. Consider an unobservable variable Z_{it} that maps values of the explanatory variables (right hand side of equation 2) into $\mathrm{Re}\,c_{it}$. The first part of the ordered-probit model relates explanatory variables to Z_{it} by means of a linear equation:

$$Z_{it} = \sum_{j=1}^{15} \alpha_j \, pull_{it} + \sum_{k=1}^{3} \gamma_k \, push_t + \beta_0 election_{it} + \beta_1 belection_{it} + \beta_2 afelection_{it} + \beta_3 nomf_{it} +$$

$$+ \beta_4 nocomp_{it} + \beta_5 inc_{it} * nocomp_{it} + \beta_6 election06_{it} + \beta_7 electionb06_{it} + \varepsilon_{it} \qquad (2)$$

The second part of the ordered-probit model links Z_{it} to $\mathrm{Re}\,c_{it}$ according to:

$$\mathrm{Re}\,c_{it} = \begin{cases} -1 & \text{if } Z_{it} \in (\infty, \mu_1) \\ -0.5 & \text{if } Z_{it} \in [\mu_1, \mu_2) \\ 0 & \text{if } Z_{it} \in [\mu_2, \mu_3) \\ +0.5 & \text{if } Z_{it} \in [\mu_3, \mu_4) \\ +1 & \text{if } Z_{it} \in [\mu_4, \infty) \end{cases} \qquad (3)$$

where the parameters μ_j define the partitions of the range of Z_{it} associated with each value of a rating.

The explanatory variables are classified as pull variables, push variables and political variables. The 15 $pull_{it}$ variables correspond to internal variables that could affect investment banks' recommendations. These variables are:

1. The exchange rate, measured as the annual variation (in percentage).
2. The spread of the sovereign bond spreads, measured as the level of the EMBI Global spread as well as the 3-months differences of the EMBI Global spread.
3. The local interest rate, measured as the level of interest rate as well as the monthly difference.
4. The equity return, measured as the annual return of local stock markets returns.
5. The CPI, measured as the annual inflation rate.
6. The Industrial production, measured as the annual rate of the industrial production.
7. The interest paid of public bonds over exports of good and services.
8. The level of public bonds over exports of good and services.
9. The international reserves over imports of good and services.
10. Weight of the local sovereign bond market, measured as the EMBI Global weight for each country *i*
11. Sovereign Bond returns measured as the monthly, 3-months and 12-months returns from EMBI Global return index.
12. Sovereign ratings, measured as the monthly difference of the sovereign bond ratings of Standard and Poors's. We use a linear transformation of ratings. Higher ratings correspond to higher values (*e.g.*, a bond rated D scores 1 and a bond rated AAA scores 23).
13. Depth of bond market measured as the quarterly trade volume of bond markets (private and public) over GDP.
14. Volatility of sovereign bond returns measured as the standard deviation of EMBI Global returns during last 6 months and 12 months.
15. Liquidity of the market measured as bid-ask spreads.

The three $push_{it}$ variables correspond to external variables that could affect investment banks' recommendations. These variables are:

1. The US industrial production measured as the annual industrial production growth.
2. Global risks measured as 3-months difference of the US high yield of the US corporate bonds and VIX index which is calculated from the implied volatilities of a wide range of S&P 500 index options.

The variables $election_{it}$, $belection_{it}$ and $afelection_{it}$ correspond to the dummy variables used to test the impact of investment banks' recommendations on months around elections ($election_{it}$), prior to elections ($belection_{it}$) and during and after elections ($afelection_{it}$). According to results presented in previous section, we use a 7-month window (-3 through +3) for the variable $election_{it}$, 3-month window (-3 through -1) for the variable $belection_{it}$ and 4-month window (0 through +3) for the variable $afelection_{it}$. These three variables are used to test H1. H1 is confirmed if β_0 and β_1 are significant with $\beta_0 < 0$ and $\beta_1 < \beta_2$ (with $\beta_1 < 0$).

The variable $nomf_{it}$ represents the case in which non-credible economic policies are announced by the leading candidates during campaigns. It is used to test H2. H2 is confirmed if β_3 is significant and negative ($\beta_3 < 0$).

The variables inc_{it} and $nocomp_{it}$ represent respectively incumbent parties winning an election and the low level of competition during elections. The interaction term $inc_{it} * nocomp_{it}$ captures the stability of political regimes. These variables are used to test H3. H3 is confirmed if β_4 and β_5 are significant with $\beta_4 < 0$ (hypothesis 3B) and $\beta_5 < 0$ (hypothesis 3A).

Finally, variables $election06_{it}$ and $electionb\ 06_{it}$ are used to determine respectively the impact of presidential elections since 2006 and before that year. Both variables are used to test H4. H4 is confirmed if β_7 is significant and, in absolute values, $\beta_6 < \beta_7$ (with $\beta_7 < 0$).

Results are presented in annex 5. First we expose the regression presenting only control variables (first regression in annex 5). Second we analyse the hypotheses introduced above.

Most of the control variables explaining recommendations are directly linked to the sovereign bond market. Indeed, the level of sovereign bond spreads, solvency indicators such as the ratio of public bonds over exports and the ratio of international reserves over imports, 12-month and 3-month sovereign bond returns, changes in sovereign bond ratings and development of the bond market (trading volume over GDP) are statistically significant variables explaining banks' recommendations. More precisely, as expected, increases in past bond returns have a positive impact on recommendations. Improvement in solvency indicators and favourable changes of sovereign bond ratings positively affect recommendations given by investment banks. Moreover, investment banks' outlooks react positively to higher trading volumes over GDP. We expect an inverse relationship between of the level of sovereign bond spreads and recommendations; however, we could attribute the positive relationship between recommendations and bond spreads to investment opportunities. Indeed, when the sovereign bond spread is low, the likelihood of high returns on investment is small and recommendations can consequently be "pessimistic". Finally, the only control variable statistically significant (though only at 10 per cent) which it is not directly related to the sovereign bond market is growth of industrial production. As expected, it has a positive impact on recommendations.

With respect to *push* variables (*i.e.,* US industrial production, US high yield and VIX index), we note that they are not statistically significant. The results summarised here for control variables are valid for all regressions presented in annex 5[13].

Concerning hypothesis 1 (H1), we note that presidential elections have a negative impact on banks' behaviour (β_0 < 0) and it is significant at 1 per cent. When we concentrate in the 3-months prior to elections (β_1) and after elections (β_2), we find that the first coefficient is smaller than the second ($\beta_1 < \beta_2 < 0$) and it is statistically significant at 1 per cent. Additionally both coefficients are negative. H1 is confirmed.

Hypothesis 2 (H2) and hypothesis 3 (H3) are tested. More precisely, we test H2 during two periods. First, we test this hypothesis around elections (window dummy between month -3 and month +3) and second prior to elections. First, we note that H2 is confirmed around elections (regressions IV, V, VI and VII). Indeed, investment banks downgrade countries in which there is a fear that a non-credible candidate wins presidential elections. Moreover, coefficients are statistically significant at 1 per cent. Non-credible economic policies dummy variable is also negative before elections (regressions VIII, IX, X and XI). In absolute values, coefficients are higher with respect to previous case and are significant at 1 per cent (the exception being regression IX in which it is statically significant at 5 per cent). Indeed, by including the dummy variable non-credible policies of candidates ($nomf_{it}$) during the 3-months prior to elections, we find that there is an additional fixed cost for these risky countries prior to elections (coefficient β_3 higher in absolute values than β_1 and β_2).

Hypothesis H3A relates to incumbent parties winning non-competitive elections (incumbent leader in annex 5). The impact of an incumbent party leader in an election is not statistically significant (regressions VI, VII, X and XI). Hypothesis 3A is rejected meaning that incumbent parties re-elected in non-competitive elections do not affect investment banks' recommendations. Moreover, the interaction variable (incumbent leader*non-credible policies) is not statistically significant (regression VII).

Hypothesis H3B is also rejected. There is no well-measured impact of the absence of uncertainty on investment banks' recommendations (regressions IV, V, VIII and IX). Uncompetitive elections are not related to positive recommendations. Additionally, the interaction variable (no-competition*non-credible policies) is not statistically significant.

Finally variables $election06_{it}$ and $electionb06_{it}$ are used to test H4 (regression XII). The impact of electoral processes since 2006 on recommendations is not significant. By contrast,

[13] The exception is the 3-month EMBI Global return. For the regressions VIII, IX, X and XI this variable is not statistically significant.

before 2006, the impact is statistically significant and investment banks downgraded Latin American countries considerably during electoral episodes. On average, around elections prior to 2006, investment banks downgraded Latin American countries well superior with respect to 2006-2007. As expected, we obtain that $\beta_6 < \beta_7$, in absolute values. As noted in previous section, though, caution is called for in the interpretation of these results, given that the length of the two sub-samples differs. Indeed, the smaller number of observations for the latter period (only two years long) may itself explain why the effect of the 2006 electoral cycle is not significant.

VI. CONCLUSIONS

This paper has analysed the impact of Latin American presidential elections on investment banks' recommendations, studying market analysts' reactions to recent electoral cycles in Latin American countries.

In order to determine the implications of the political cycle on market behaviour, a database was constructed, covering all recommendations by major global investment banks present in emerging bond markets from 1997 to 2008. The 13 brokers covered in the database are the dominant players in emerging bond markets as underwriters and market makers.

The most important findings are as follows. First, the political cycle is a determining variable in explaining changes in investment banks' recommendations. Moreover, the relationship is particularly strong prior to presidential elections: investment banks' perceptions deteriorate considerably just before presidential elections occur. Secondly, investment banks' outlooks depend on the signals that candidates send concerning the credibility of their economic policy platforms. In particular, if investment banks perceive that candidates are not committed to defend sustainable macroeconomic policies, they downgrade sovereign debt. By contrast, the absence of uncertainty surrounding the re-election of incumbent candidates does not seem to have an impact on banks' recommendations. Finally, by comparing the 2006 electoral year with earlier presidential elections, results suggest that the impact of political cycles has declined in Latin American democracies. However, political risk remains an important determinant today, with populist candidates still abounding in Latin American democracies.

This paper suggests avenues for further research. It would be interesting to test the sensitivity of portfolio flows, both debt and equity, to elections in emerging democracies. The results should be in line with those presented here, in light of earlier research on the linkages between bond analysts' recommendations and emerging markets portfolio flows (Nieto Parra and Santiso, 2007), but this hypothesis remains to be tested.

It would also be interesting to explore the reverse relation. In this paper, we tested the impact of political events like elections on financial emerging markets through bond recommendations from major investment banks. Politics impacts financial markets and, as shown, this is particularly true for emerging markets. That said, do financial markets anticipations and reactions also affect political outcomes? Earlier research in this area (Santiso, 2006a; Mosley, 2003; Martínez and Santiso, 2003) suggests that the answer may be yes. Indeed, it may also be that financial markets, because of their aversion to uncertainty and unorthodox economic policies, tend to restrict the political options available to decision makers in emerging democracies.

Actors in financial markets can constrain economic policy choices but they can also act as a blessing in disguise, limiting the scope of unbounded political rationality. They limit the menu of options (Biglaiser and DeRouen, 2007) but in so doing might also promote greater pragmatism and gradualism in the policy making, avoiding the "political economy of the impossible" characteristic of the macroeconomic populism favoured by so many governments in Latin America during the 1980s (Santiso, 2006*b*).

Prior to election day, for example, financial markets can help inhibit the proliferation of promises that cannot be kept (Chang, 2006; Maxfield, 2000; Haggard, Lee and Maxfield, 1993; Maxfield, 1990). After election day, they can furthermore channel more pragmatic and gradualist approaches, avoiding the search for shortcuts and unsustainable policies.

In conclusion, the understanding of financial market behaviour requires a political economy approach. There are complex interactions between politics and finance, between individuals and institutions, and among macroeconomic and financial variables. As such, the name of the game in emerging markets is confidence -- trust and mistrust. For that reason, commitment to credible economic policies by political parties and candidates is crucial to actors in financial markets. In return, not only are financial markets sensitive to electoral processes and politicians but perhaps also to actors in financial markets themselves, an issue that invites further research and analysis.

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ANNEX 1

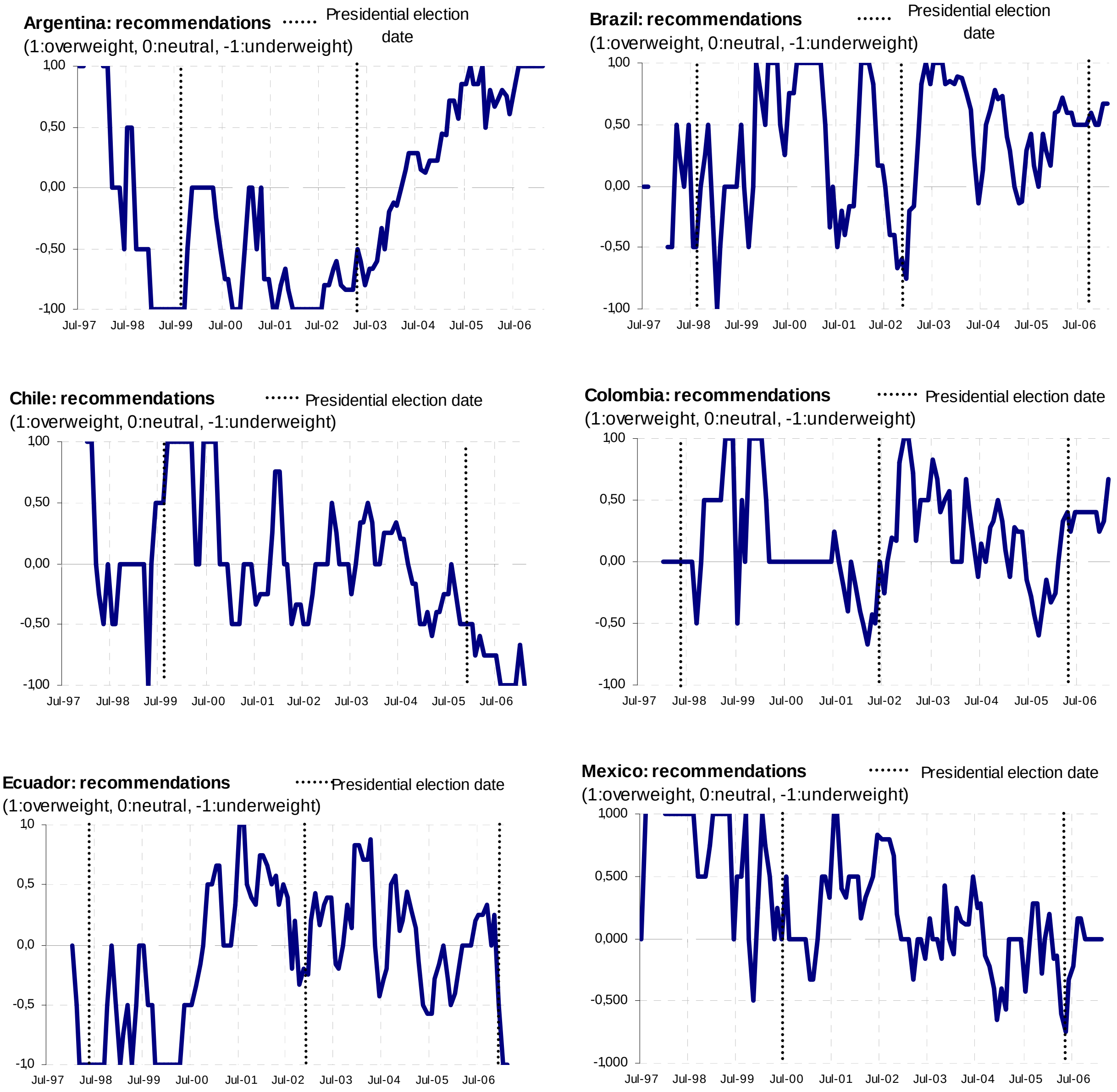
Description of the Investment Banks' Publications

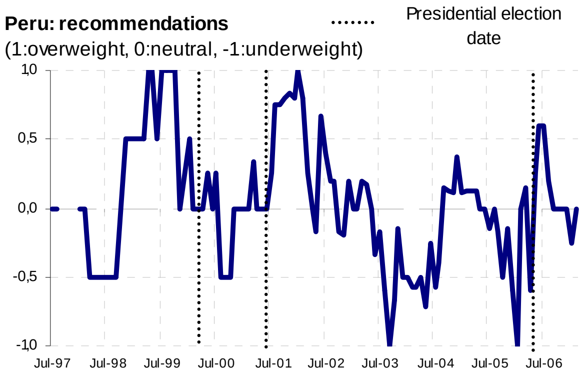
Institution	Name of the Publication	Frequency	Start Date
ABN AMRO	Emerging Markets Fortnightly	Bi-weekly	Jan-04
Barclays Capital	LatAm Drivers Fortnightly	Bi-weekly	Feb-04
Bear Stearns	Global Emerging Markets Monthly	Monthly	Oct-02
Citigroup (Citi-Salomon Brothers)	Economics/Strategy	Monthly	Jul-97
Credit Suisse (CSFB)	Debt Trading Monthly	Monthly	May-01
Deutsche Bank	Emerging Markets Monthly	Monthly	Sep-01 to Dec-05
Dresdner Kleinwort Wasserstein	EM Strategist	Monthly	Jan-04
Goldman Sachs	Global Interest Rate Strategy	Bi-weekly	Aug-01 to Aug-03
JP Morgan	Emerging Markets Outlook and Strategy	Monthly	Jan-01
Lehman Brothers	Emerging Markets Compass	Monthly	Sep-04
Merrill Lynch	Emerging Markets Debt Monthly	Monthly	Feb-03
Morgan Stanley	EMD Perspectives Quarterly	Quarterly	1Q-00
UBS	Emerging Markets Debt Strategy Perspectives	Monthly	Feb-02 to Apr-04

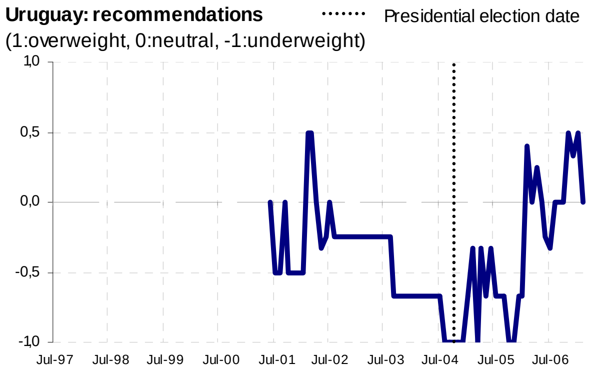
Source: The authors based on investment banks' publications, 2008

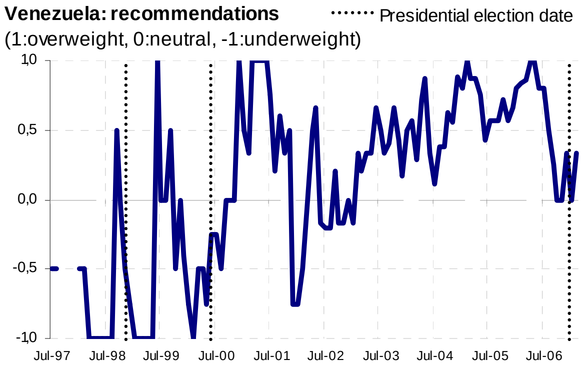
ANNEX 2

Investment banks' recommendations during Presidential Elections









Source: The authors based on investments banks' publications, http://www.electionguide.org and http://www.observatorioelectoral.org/.

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ANNEX 3

Investment banks' recommendations around elections (Panel A: lhs. and Panel B: rhs.)

PERIOD	1998 - 2007	
	OLS	FE
9	-1.33699e-01	-1.56099e-01
	[0.93]	[1.12]
8	-0.18827	-0.20584
	[1.27]	[1.44]
7	-4.62682e-02	-6.21734e-02
	[0.31]	[0.43]
6	-0.09084	-0.09955
	[0.63]	[0.71]
5	-0.23232	-0.24880*
	[1.65]	[1.82]
4	-0.09860	-0.12031
	[0.71]	[0.90]
3	-0.38078***	-0.40249***
	[2.76]	[3.01]
2	-0.43552***	-0.45410***
	[3.08]	[3.32]
1	-0.35746***	-0.38053***
	[2.59]	[2.84]
0	-0.18552	-0.19711
	[1.31]	[1.44]
-1	-0.22702	-0.25009*
	[1.64]	[1.87]
-2	-0.27643*	-0.28802**
	[1.96]	[2.10]
-3	-0.13370	-0.15610
	[0.93]	[1.12]
-4	-0.03586	-0.05554
	[0.25]	[0.40]
-5	0.12404	0.08604
	[0.86]	[0.61]
-6	-0.03366	-0.06538
	[0.24]	[0.48]
-7	0.02958	-0.00178
	[0.21]	[0.01]
-8	0.04623	0.01511
	[0.33]	[0.11]
-9	0.03633	0.00521
	[0.26]	[0.04]
Constant	0.14007***	0.14873***
	[5.49]	[5.99]
Observations	1051	1051
R-squared	0.03	0.04
Number of Countries		9

Absolute value of t statistics in brackets
* significant at 10%; ** significant at 5%; *** significant at 1%

SAMPLE	PERIOD	1998 - 2007	
		OLS	FE
BEFORE 2006	9	-3.48966e-01*	-3.69298e-01**
		[1.92]	[2.10]
	8	-0.42425**	-0.43740**
		[2.24]	[2.39]
	7	-1.99694e-01	-2.09948e-01
		[1.06]	[1.15]
	6	-0.30002*	-0.29821*
		[1.65]	[1.69]
	5	-0.32791*	-0.33986**
		[1.87]	[2.00]
	4	-0.28175*	-0.30172*
		[1.66]	[1.84]
	3	-0.44693***	-0.46690***
		[2.64]	[2.85]
	2	-0.46006***	-0.47397***
		[2.63]	[2.80]
	1	-0.47196***	-0.49326***
		[2.79]	[3.01]
	0	-0.35292**	-0.35589**
		[2.02]	[2.10]
	-1	-0.27196	-0.29326*
		[1.61]	[1.79]
	-2	-0.24577	-0.24875
		[1.40]	[1.47]
	-3	-0.26563	-0.28597
		[1.46]	[1.62]
	-4	-0.07261	-0.07465
		[0.41]	[0.44]
	-5	0.23278	0.20287
		[1.33]	[1.19]
	-6	0.09804	0.07662
		[0.58]	[0.47]
	-7	0.14990	0.12940
		[0.88]	[0.79]
	-8	0.14682	0.12685
		[0.87]	[0.77]
	-9	0.12450	0.10453
		[0.74]	[0.64]
SINCE 2006	9	0.23637	0.20981
		[1.03]	[0.94]
	8	0.17387	0.14731
		[0.75]	[0.66]
	7	0.17387	0.14731
		[0.75]	[0.66]
	6	0.23637	0.20981
		[1.03]	[0.94]
	5	-0.07613	-0.10269
		[0.33]	[0.46]
	4	0.23637	0.20981
		[1.03]	[0.94]
	3	-0.26363	-0.29019
		[1.14]	[1.30]
	2	-0.38863*	-0.41519*
		[1.69]	[1.86]
	1	-0.13863	-0.16519
		[0.60]	[0.74]
	0	0.11137	0.08481
		[0.48]	[0.38]
	-1	-0.13863	-0.16519
		[0.60]	[0.74]
	-2	-0.32613	-0.35269
		[1.41]	[1.58]
	-3	0.11137	0.08481
		[0.48]	[0.38]
	-4	0.07566	0.01959
		[0.31]	[0.08]
	-5	-0.06720	-0.12326
		[0.27]	[0.52]
	-6	-0.28149	-0.33755
		[1.14]	[1.42]
	-7	-0.21006	-0.26612
		[0.85]	[1.12]
	-8	-0.13863	-0.19469
		[0.56]	[0.82]
	-9	-0.13863	-0.22228
		[0.52]	[0.86]
	Constant	0.13863***	0.14755***
		[5.46]	[5.98]
	Observations	1051	1051
	R-squared	0.06	0.07
	Number of Countries		9

Absolute value of t statistics in brackets
* significant at 10%; ** significant at 5%; *** significant at 1%

ANNEX 4

In order to define non credible economic policies of candidates during elections, we observe the commitment of candidates to follow credible economic policies during presidential campaigns. More precisely, we determine whether the signal that candidates are sending is credible.

To that end, we analyse the interaction between political parties and candidates with international market participants. One piece of this game is the information transmitted to international financial actors concerning future economic policies.

We study this information through the press. In particular, by using The Economist[14] as source of information we determine which candidates are announcing non-credible economic policies. For that purpose, we take into account all articles related to our sample countries three months before the presidential election (with the election month included).

We define that candidates are announcing non-credible economic policies if, in any article related to the country, we find that there is a fear that a candidate realises one of the following policies in the event to be president:

1. Expansionary fiscal policy (reduction of taxes or increase of public expenditures) could be damage the sustainability of the debt.
2. Announcement of non-future payment or renegotiation of the debt.
3. There is an inflation concern (instability of prices) due to an expansionary monetary policy (low interest rates or devaluation of the currency).
4. In cases in which independent central bank and/or inflation targeting framework exist, announcements about the abandon of these policies.
5. Economic programs similar to those of previous or present "populist" presidents following expansionary economic policies.
6. Support and agreement with populist presidents of the region.

Consequently, countries take the value of 1 in the dummy variable when one of the above mentioned events are cited in the periodical during and three months before the election date.

[14] More precisely, we use The Economist.com archive as source of information. It contains web-only content as well as all articles from *The Economist* newspaper published since June 1997.

The *The Economist* articles employed in this research to define this dummy variable for the case of the presidential elections in Brazil in 1998, 2002 and 2006 are:

Brazil:

"The battle royal for Brazil´s real" Sep 10th 1998
"Last stand?" Sep 17th 1998
"Why the left isn't winning" Sep 17th 1998
"Will Brazil be next?" Sep 17th 1998
"Can Cardoso use financial chaos to reform Brazil?" Sep 24th 1998
"After Cardoso´s big day" Oct 8th 1998

"Panic comes calling" Aug 1st 2002 | SAO PAULO
"Stopping the rot in Brazil" Aug 1st 2002
"South America's dominoes" Aug 6th 2002
"Que sera, Serra" Aug 15th 2002 | SAO PAULO
"A matter of fait" Aug 15th 2002 | SAO PAULO
"On the attack" Aug 29th 2002 | SAO PAULO
"Lula scents victory at last" Sep 19th 2002 | SAO PAULO
"Race against time" Sep 26th 2002 | SAO PAULO
"The meaning of Lula" Oct 3rd 2002
"Running out of time" Oct 3rd 2002
"Now for round two" Oct 7th 2002
"Talking victory" Oct 24th 2002 | SAO PAULO
"What will Lula do?" Oct 28th 2002

"Contentment and complacency" Aug 31st 2006 | SÃO PAULO
"Who leads Latin America?" Sep 28th 2006
"Love Lula if you're poor, worry if you're not" Sep 28th 2006 | CONTAGEM
"A run-off in Brazil" Oct 2nd 2006 | SÃO PAULO
"When victory spells defeat" Oct 5th 2006 | SÃO PAULO
"Wanted: a champion for privatization" Oct 26th 2006
"Lula the political prizefighter" Oct 26th 2006 | SÃO PAULO
"Lula's comfortable win" Oct 30th 2006 | SÃO PAULO

The articles used for the other elections in Latin American countries are available under request.

ANNEX 5

Investment banks' recommendations and elections

	Control	Hypothesis1	Hypothesis1	Hypoth. 2&3	Hypoth. 2&3	Hypoth. 2&3
	I	II	III	IV	V	VI
US Ind. Production	1.34597e-01	1.10754e+00	1.11327e+00	7.49468e-01	7.03334e-01	6.69308e-01
	[0.08]	[0.63]	[0.63]	[0.43]	[0.40]	[0.38]
EMBI Global Spread	0.00019**	0.00021**	0.00020**	0.00024***	0.00024***	0.00024***
	[2.21]	[2.40]	[2.37]	[2.75]	[2.79]	[2.81]
Local interest rate	-6.37297e-02	-7.04611e-02	-6.44638e-02	-2.40163e-03	8.14879e-03	1.12569e-02
	[0.13]	[0.15]	[0.13]	[0.00]	[0.02]	[0.02]
Exchange rate depreciation	0.39693	0.29782	0.29253	0.23731	0.22667	0.24295
	[1.61]	[1.20]	[1.18]	[0.95]	[0.90]	[0.97]
Diff. EMBI Global Spread	-0.00012	-0.00013	-0.00012	-0.00015	-0.00014	-0.00015
	[0.72]	[0.78]	[0.73]	[0.87]	[0.85]	[0.89]
Equity Return	-0.30215	-0.26810	-0.26683	-0.23266	-0.23137	-0.26119
	[1.63]	[1.44]	[1.43]	[1.24]	[1.23]	[1.39]
Inflation rate	-0.90148	-0.49544	-0.45391	-0.54735	-0.49871	-0.54232
	[1.13]	[0.61]	[0.56]	[0.68]	[0.61]	[0.67]
Industrial Production growth	0.94500*	0.96620*	0.97363*	1.04039*	1.06511**	1.03093*
	[1.80]	[1.83]	[1.84]	[1.94]	[1.98]	[1.93]
Diff. local interest rate	-0.24332	-0.27491	-0.26903	-0.30806	-0.31345	-0.32091
	[0.12]	[0.14]	[0.14]	[0.17]	[0.18]	[0.17]
Diff. US High Yield	0.00101	0.00102	0.00100	0.00099	0.00098	0.00098
	[1.56]	[1.57]	[1.53]	[1.52]	[1.50]	[1.51]
Diff. VIX Index	0.01373	0.01519	0.01510	0.01611	0.01627	0.01660
	[1.24]	[1.36]	[1.35]	[1.44]	[1.46]	[1.49]
Interest pbonds / X	-0.40985	0.16079	0.10982	0.50974	0.59511	0.42357
	[0.16]	[0.06]	[0.04]	[0.20]	[0.23]	[0.17]
pbonds / X	-1.26024***	-1.28496***	-1.28270***	-1.35734***	-1.37651***	-1.35446***
	[5.51]	[5.60]	[5.59]	[5.83]	[5.85]	[5.85]
Res/Imp	6.93052***	6.94445***	6.95061***	8.56901***	8.63851***	8.44001***
	[2.84]	[2.83]	[2.83]	[3.45]	[3.47]	[3.40]
EMBIGWeight	0.79302	1.09867	1.08707	1.43609	1.46564	1.44943
	[0.77]	[1.07]	[1.06]	[1.38]	[1.41]	[1.40]
EMBI Global Return Index (1 month)	-0.34089	-0.53678	-0.53201	-0.41260	-0.39752	-0.36475
	[0.30]	[0.47]	[0.46]	[0.36]	[0.35]	[0.32]
EMBI Global Return Index (3 months)	1.54282*	1.67271*	1.53233*	1.90064**	1.92352**	1.96857**
	[1.77]	[1.91]	[1.73]	[2.16]	[2.18]	[2.23]
EMBI Global Return Index (12 months)	2.74702***	2.54094***	2.53597***	2.41072***	2.39303***	2.45539***
	[5.82]	[5.37]	[5.36]	[5.04]	[4.99]	[5.14]
Diff. sovereign bond ratings	0.15317**	0.15269**	0.15559**	0.13893*	0.13889*	0.13908*
	[2.02]	[2.00]	[2.04]	[1.83]	[1.83]	[1.83]
Trade volume / GDP	1.80963***	1.53238***	1.54843***	1.62736***	1.62869***	1.64354***
	[4.27]	[3.56]	[3.59]	[3.81]	[3.81]	[3.84]
St. deviation EMBI return (6 months)	10.34349	21.10073	18.87436	23.44892	26.18886	21.09258
	[0.50]	[1.01]	[0.90]	[1.09]	[1.19]	[1.00]
St. deviation EMBI return (12 months)	21.78765	9.23619	11.11812	12.20279	11.40435	13.50275
	[0.94]	[0.40]	[0.47]	[0.52]	[0.49]	[0.58]
bid-ask spread	0.43840	0.45250	0.45454	0.49331	0.48075	0.53253
	[1.27]	[1.31]	[1.31]	[1.42]	[1.38]	[1.53]
Around elections [-3,+3]		-0.52043***				
		[3.89]				
Before elections [-3,-1]			-0.67426***			
			[3.48]			
During and After elections [0,+3]			-0.40699**			
			[2.41]			
non-credible policies before elections (bf)						
Incumbent leader (inc)						0.27737
						[1.01]
interaction variable (inc*non-credible bf)						
no-competition (nocp)				-0.06450	0.01575	
				[0.30]	[0.06]	
interaction variable (nocp*non-credible bf)						
non-credible policies (around elections)				-0.76619***	-0.71366***	-0.80126***
				[4.22]	[3.50]	[4.57]
interaction variable (inc*non-credible ar)						
interaction variable (nocp*non-credible ar)					-0.25599	
					[0.57]	
elections 2006						
elections before 2006						
Observations	657	657	657	657	657	657
Pseudo R2	0.1318	0.1406	0.1413	0.1437	0.1439	0.1442

Absolute value of z statistics in brackets

* significant at 10%; ** significant at 5%; *** significant at 1%

	Hypoth. 2&3	Hypoth. 2&3	Hypoth. 2&3	Hypoth. 2&3	Hypoth. 2&3	Hypoth. 4
	VII	VIII	IX	X	XI	XII
US Ind. Production	6.61260e-01	4.54019e-01	3.89611e-01	4.05406e-01	4.16865e-01	1.07407e+00
	[0.38]	[0.26]	[0.22]	[0.23]	[0.24]	[0.61]
EMBI Global Spread	0.00024***	0.00021**	0.00023***	0.00022**	0.00022**	0.00022**
	[2.80]	[2.49]	[2.62]	[2.49]	[2.50]	[2.54]
Local interest rate	1.13524e-02	-8.66796e-03	1.68525e-02	6.82763e-03	7.94297e-03	-6.84468e-02
	[0.02]	[0.02]	[0.04]	[0.01]	[0.02]	[0.14]
Exchange rate depreciation	0.24202	0.30274	0.26472	0.32099	0.32175	0.27766
	[0.97]	[1.22]	[1.06]	[1.29]	[1.30]	[1.12]
Diff. EMBI Global Spread	-0.00015	-0.00012	-0.00011	-0.00012	-0.00012	-0.00014
	[0.88]	[0.70]	[0.68]	[0.70]	[0.71]	[0.80]
Equity Return	-0.26075	-0.26042	-0.25289	-0.29955	-0.30007	-0.31379*
	[1.38]	[1.39]	[1.35]	[1.60]	[1.60]	[1.65]
Inflation rate	-0.53353	-0.65168	-0.51383	-0.66313	-0.67527	-0.38448
	[0.66]	[0.81]	[0.63]	[0.82]	[0.83]	[0.47]
Industrial Production growth	1.03160*	1.04073*	1.09947**	1.02289*	1.02107*	0.96233*
	[1.93]	[1.95]	[2.04]	[1.92]	[1.92]	[1.82]
Diff. local interest rate	-0.32075	-0.26359	-0.28416	-0.27259	-0.27311	-0.28430
	[0.17]	[0.15]	[0.17]	[0.14]	[0.15]	[0.15]
Diff. US High Yield	0.00098	0.00098	0.00094	0.00097	0.00096	0.00108*
	[1.51]	[1.49]	[1.44]	[1.49]	[1.48]	[1.65]
Diff. VIX Index	0.01658	0.01443	0.01511	0.01454	0.01464	0.01496
	[1.48]	[1.30]	[1.36]	[1.30]	[1.31]	[1.34]
Interest pbonds / X	0.41224	0.37560	0.60593	-0.00221	0.02529	0.44862
	[0.16]	[0.15]	[0.24]	[0.00]	[0.01]	[0.18]
pbonds / X	-1.35403***	-1.33907***	-1.38882***	-1.31625***	-1.31760***	-1.29285***
	[5.85]	[5.77]	[5.91]	[5.71]	[5.71]	[5.63]
Res/Imp	8.46986***	7.93187***	8.21154***	7.73451***	7.67167***	6.85460***
	[3.38]	[3.21]	[3.31]	[3.13]	[3.10]	[2.79]
EMBIGWeight	1.45637	1.05138	1.18895	1.06720	1.05382	1.23572
	[1.40]	[1.02]	[1.15]	[1.04]	[1.02]	[1.20]
EMBI Global Return Index (1 month)	-0.36122	-0.29714	-0.27937	-0.22988	-0.22879	-0.62812
	[0.31]	[0.26]	[0.24]	[0.20]	[0.20]	[0.55]
EMBI Global Return Index (3 months)	1.97168**	1.23056	1.40189	1.25687	1.23007	1.70379*
	[2.23]	[1.40]	[1.59]	[1.43]	[1.40]	[1.94]
EMBI Global Return Index (12 months)	2.45380***	2.53993***	2.47298***	2.62412***	2.62616***	2.63589***
	[5.13]	[5.33]	[5.17]	[5.53]	[5.53]	[5.48]
Diff. sovereign bond ratings	0.13909*	0.14720*	0.14587*	0.14812*	0.14810*	0.15805**
	[1.83]	[1.94]	[1.92]	[1.95]	[1.95]	[2.07]
Trade volume / GDP	1.64226***	1.73849***	1.72235***	1.76898***	1.77196***	1.45723***
	[3.84]	[4.08]	[4.04]	[4.15]	[4.16]	[3.36]
St. deviation EMBI return (6 months)	20.94725	16.02971	23.92985	9.96111	10.16388	23.27488
	[1.00]	[0.75]	[1.08]	[0.48]	[0.49]	[1.11]
St. deviation EMBI return (12 months)	13.49000	19.03964	15.98176	22.47494	22.60530	9.83758
	[0.58]	[0.81]	[0.68]	[0.97]	[0.97]	[0.42]
bid-ask spread	0.53138	0.42225	0.40340	0.46994	0.47413	0.47583
	[1.53]	[1.22]	[1.16]	[1.35]	[1.36]	[1.37]
Around elections [-3,+3]						
Before elections [-3,-1]						
During and After elections [0,+3]						
non-credible policies before elections (bf)		-0.84857***	-0.70417**	-0.92538***	-0.95989***	
		[3.08]	[2.43]	[3.39]	[3.23]	
Incumbent leader (inc)	0.29368			0.23661	0.20168	
	[0.91]			[0.86]	[0.68]	
interaction variable (inc*non-credible bf)					0.23084	
					[0.30]	
no-competition (nocp)		-0.19368	0.02363			
		[0.92]	[0.09]			
interaction variable (nocp*non-credible bf)			-0.62304			
			[1.46]			
non-credible policies (around elections)	-0.79642***					
	[4.37]					
interaction variable (inc*non-credible ar)	-0.06106					
	[0.10]					
interaction variable (nocp*non-credible ar)						
elections 2006						-0.31347
						[1.49]
elections before 2006						-0.65573***
						[3.83]
Observations	657	657	657	657	657	657
Pseudo R2	0.1442	0.1390	0.1402	0.1389	0.1390	0.1416

Absolute value of z statistics in brackets

* significant at 10%; ** significant at 5%; *** significant at 1%

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