Is there a democratic premium or preference for democratic regimes by financial markets? Starting from this core question, Santiso’s book investigates the complex interactions between the worlds of politics and finance, a topic that has important implications for economic growth. To address these intricate links, Santiso focuses on times of elections in emerging markets because they are a unique laboratory; those countries that have recently experienced both economic and democratic transitions show a particularly close relationship between politics and finance; and elections are periods where uncertainty increases. The analysis of the behavior of different financial actors is enriched by Santiso’s professional experience in both the banking industry and international organizations, especially as former OECD Development Centre chief economist. Besides, the book uses a unique and unexploited database covering more than 5,000 bank recommendations on emerging markets and fund manager portfolio flows and asset allocations.

Santiso opens with a brief introduction to the structure of his book and uses the first chapter to place in context what is meant by emerging market in this changing world. He explains that the term “emerging market” originated as a strictly financial concept to describe the developing countries that are included in indices used by portfolio managers as “investible universes”. Paradoxically, although in the last decade emerging assets has changed from being something exotic and marginal to acquire relevance, only few countries are coverage by global financial markets and most developing countries simply do not exist for them. Latin America, however, is extensively covered, and therefore represents a magnificent case for this study.

The next chapter shows that uncertainty about the outcome of elections is the key explanatory variable for markets’ reactions to elections. The ups and downs of financial variables can be explained by economic fundamental, but part of the history involves self-fulfilling prophecies and changing perceptions. Santiso assesses the dynamics of the confidence game in financial crisis through the evidence in Brazil, whose recent history offers a unique trajectory to understand these intricate links. In Brazil, a leftist candidate, Lula, tried four times to be elected. When he finally won in 2001 Brazil was close to fall into default, but a bit after the picture has changed radically. Brazil exemplifies the ways in which financial markets overact to the uncertainty and the importance of external factors, but also how some decoupling between political and financial cycles can be achieved. History, memories, context and institutions matter. Through the outstanding narration of Santiso other fundamental questions emerge. In open economies voters within the borders of a country are no longer the sole actors of elections. But, which are the political preferences of financial markets? How should political actors need to incorporate the behavior, actions and reactions of markets as variables in their strategic decisions? Certainly the need for political candidates to keep the loyalty of financial markets narrow the range of policies within they are allowed to move, which has both good and bad implications.

The analysis done up to this point suggests that that financial markets generally react positively to democracies but, otherwise, democratic elections have negative effects when they create political uncertainty. However, financial markets are not homogeneous and the subsequent chapters aim to deepen the analysis focusing on the specific behavior of involved actors. Thereby, chapter 3 enters the black box of financial markets by examining brokers, who are the sell-side analysts. For this purpose Santiso uses a database covering all recommendations on sovereign debt made by major global investment banks between 1997 and 2008 and data about Latin American elections. Whereas, Chapter 4, which discusses the behavior of fund managers (the buy side), expands the scope to consider both equities and bonds. After testing several hypothesis of the relationship between finance and politics the findings support the idea that what drive markets is uncertainty and that politicians have some scope to diminish the information asymmetry. In this regard, good news for
brokers is that they have similar behavior around elections to that of their clients, becoming more risk averse. In any case, it should be taken into account that not all investors react exactly in the same way to elections. For example, portfolio bond investors might be risk averse to a shift to the left whereas equity investors could benefit from this. The next chapter examines fiscal policies and political budget cycles. The evidence illustrates that governments tend to be expansionary during elections and that financial markets are especially sensitive to new left-leaning candidates. However, it is no less true that the fiscal management has also become more prudent over time.

Chapter 6 illustrates the interactions between democratic transitions and financial markets, focusing on bankers and their behavior in terms of bank lending. Hardly any prior research exists on the role of that is played by politics in explaining cross-border banking movements. Greater lending involvement in young democracies can be explained because democracies tend to be much more transparent than non-democracies, but also by new business opportunities. The question of political preferences of bankers is particularly interesting. Much attention has been devoted to the contribution of banking to economic development but none to political development.

Santiso concludes with an overview of the confidence game between finance and politics, emphasizing that they are intertemporal games in which investment recommendations and decisions about the future are supported by retrospective data. On the basis of this, the book suggests some policy options for minimizing potential disruptions before elections. For example, delegate policymaking to politically insulated institutions acted as a confidence anchor. At the same time, while it is important to encourage market participants to closely monitor political dynamics, policymakers and governments “also need to keep a close watch on the watchers”. This recommendation doesn’t have any cost and allows policymakers to use the information to respond and curb perceptions.

The book provides an insightful and excellent assessment of the interactions between politics and financial markets, a topic that has not been studied in sufficient detail so far. To understand the ecosystem Santiso based his analysis on a wide array of previously unexploited financial market indicators, original micro-level evidence, and well written and well documented case studies. Additionally, he presents his findings in a manner that is accessible to readers of diverse academic and methodological backgrounds. His analysis contributes to the understanding of the behavior, actions and reactions of the key players linking finance and politics, which is very important not just for emerging countries. So, in the context emerged after the 2008 global financial crisis, the sensitivity of financial markets to political decisions has resurfaced also in developed economies. Accordingly, “Banking on Democracy” is a must read for policymakers and practitioners alike as well as excellent reading for anyone interested in politics, elections, and Latin America.