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BANKING ON DEMOCRACY: THE POLITICAL ECONOMY OF INTERNATIONAL PRIVATE BANK LENDING IN EMERGING MARKETS

by

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PREFACE

Private banks are key actors in economic development. They can also be key actors in political development. Private capital movements have risen over the past few decades and bank flows have contributed heavily.

In the context of its activities on Financing for Development, the OECD Development Centre monitors these trends and maps both official and private flows to developing countries and emerging economies. This paper is part of that effort; at the same time it goes much further to examine whether and, if so, why, banks like to lend to new emerging democracies. Much attention has been paid in academic literature and policy debates to banks' role in economic development; little attention has been given, however, to banks' political preferences and their role in political development. This paper begins to fill that gap.

Using panel data on 29 countries for the period 1984-2004, the authors find that bank lending correlates positively with levels of democratisation as measured by different indicators; relative stability of economic policy also seems to spur financial inflows. On the contrary, frequent cabinet turnovers do not seem to be important determining factors of banks' lending behaviour.

These findings have direct implications for policy making: the market seems to reward democratic transitions and policy stability. Democratisation and political development seem to spur increased private flows and contribute to economic development.

Prof. Louka T. Katseli
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RÉSUMÉ

Les flux de capitaux privés ont connu un essor sans précédents au cours des dernières années. Les flux bancaires ont pris part à cette dynamique. Néanmoins, excepté quelques rares travaux empiriques, peu de travaux ont été consacrés aux facteurs politiques expliquant cet essor, et encore moins de recherche a été dédiée à l'économie politique des flux bancaires privés. Le travail présenté aborde cette question en croisant une série d'indicateurs sur la démocratie, l'incertitude et la stabilité politique, avec les séries de flux bancaires développés par la Banque des Règlements Internationaux (BRI). Il propose une économie politique des flux privés bancaires internationaux en abordant deux questions : les banques préfèrent-elles la démocratie ? Tendent-elles à primer les transitions démocratiques, la stabilité des politiques publiques et la stabilité politique ? Un des résultats les plus intéressants du travail présenté est de corroborer que les facteurs politiques importent pour les banques internationales. Celles-ci tendent en particulier à augmenter leurs prêts internationaux dans les trois années qui suivent une transition démocratique. Cette tendance est particulièrement prégnante en Amérique latine où, pays vers lesquels les opérations de crédit bancaire internationale ont augmenté avec l'essor de la démocratie.

ABSTRACT

Private capital movements have risen in recent decades, and bank flows have been part of this story. Some empirical studies have analysed the political drivers of private international liquidity, but paradoxically very few have looked at the political economy of bank flows. Even less research exists on the role of politics in explaining cross-border banking movements towards emerging democracies. The present study links compiled indicators on democracy, policy uncertainty and political stability to international bank lending flows from data developed by the BIS. It provides an empirical investigation of the political economy of cross-border bank flows to emerging markets and tries to answer two questions. Do bankers tend to prefer emerging democracies? Do they reward democratic transitions as well as policy and political stability? One of the major findings is that politics do matter, and international banks tend to have political preferences; annual growth in bank flows usually booms in the three years following a democratic transition, especially in Latin America.

JEL Classification: F34, F21, G21, K00

Keywords: capital flows, banks, democracy and emerging markets.

I. INTRODUCTION

Wall Street and the City have begun to take a fresh look at emerging markets. During the 1990s, financial and economic variables dominated their analysis. Since 2000, political and ethical variables have become increasingly relevant. Examples of this interest abound. In 2004 the research firm Innovest Strategic Value Advisors and emerging market specialist Rexiter Capital Management launched the world's first "sustainability" investment strategy exclusively focused on emerging markets¹. The major investor of the fund created – the large Dutch pension fund ABP – looked for a range of products combining the benefits of the potential performance of emerging markets with its own interest in sustainability and governance issues such as climate change and human rights. By the end of 2004, a group of leading UK-based investors, which manages a combined €330 billion, had set aside a specific portion of its commission budget to reward broker research on extra-financial areas such as governance and labour relations. A few weeks later, the Norwegian government established ethical guidelines for its huge Oil Petroleum Fund².

These examples followed the increasing interest of pension funds such as Calpers – a major US pension fund with nearly \$170 billion of assets under management in 2005, which started to invest in emerging markets in 2000 – in considering non-financial criteria such as political stability, transparency and labour rights (along with four other more traditional financial criteria). An effect of this approach has been an improvement in ratings, with the scores of the 27 countries included in the Calpers financial screening improving on average. Among them, Morocco, Malaysia, Sri Lanka and Jordan, all of which were excluded from the list of countries suitable for investment in 2002, topped the list for country improvements in 2003³. When excluded from foreign investment, emerging-market countries tend to improve their governance practices and standards in order to attract investment⁴.

Like asset managers, bankers also increasingly take into account other variables to assess their investment decisions around the world. In 2003, a leading group of top global bankers launched the Equator Principles, an unprecedented initiative led by ten of the world's largest

1. See <http://www.rexiter.co.uk/>

2. See http://www.norges-bank.no/english/petroleum_fund/

3. See Hebb and Wojcik (2004). See also for socially responsible investments in emerging markets, Chan-Lau (2004), Calpers' website: <http://www.calpers.ca.gov/> and Wilshire Associates: <http://www.wilshire.com/>

4. In equity markets most of the variation in governance ratings across firms in developing economies is attributable to sovereign country characteristics rather than firm characteristics (Doidge *et al.*, 2004).

banks to address the social and environmental impact of the projects that they finance⁵. Since then, all the big names in project finance (41 by mid-2006) have signed up for this series of guidelines for assessing their project finance deals based on those used by the International Finance Corporation (IFC), the World Bank's private financing arm. Banks with such impeccably capitalist credentials as Citibank, BBVA, ABN Amro or HSBC are all lining up to prove that their operations can measure up on sustainability goals. In 2006, a new revised set of guidelines (Equator II) was approved, expanding requirements for labour conditions, community health, safety and security.

The financial sector has also increasingly scrutinised human rights issues, mainly a focus of industrial companies⁶ in the past⁷. Because banks face growing scrutiny from NGOs for their role in financial projects that might involve such issues, they can no longer afford to be perceived as complicit in ethical and environmental abuses of their customers. Institutional investors, particularly those involved in active management and socially responsible funds, ask more questions about political governance and human rights, and both issues are on the agendas of bankers. Litigation risks have also risen, as exemplified by claims for more than \$100 billion faced in the United States in 2003 by more than 30 of the world's leading international banks and corporations for their role in supporting apartheid in South Africa. The US lawyer Ed Flagan became famous for suing Swiss banks on behalf of Holocaust survivors.

The financial sector has witnessed a proliferation of initiatives, mostly voluntary. They include among others the 160 financial institutions that are part of the UNEP FI; the 2 300 business finance and non-commercial participants in the UNG Global Compact; the OECD Guidelines for Multinationals Enterprises; the 41 major banks and export credit agencies that have adopted the initial Equator Principles; the many FTSE and Fortune 500 pension funds and asset managers that have incorporated environmental, social, governance and human-rights issues into their investment mandates; and the principles of responsible investment launched in 2006 by the UNEPD FI Asset Management.

At the same time, foreign banks rush towards China. By mid-2005, the Royal Bank of Scotland, together with Merrill Lynch and a Hong-Kong based tycoon, secured a deal of \$3.1 billion for a 10 per cent stake in the Bank of China. The previous year, another UK bank, HSBC, paid \$1.7 billion for a 20 per cent stake in Bank of Communications. Later Bank of America struck a \$3 billion deal for 9 per cent of China Construction Bank while Goldman Sachs, Deutsche Bank, JP Morgan, ING, Credit Suisse, and many other investment and commercial

5. See <http://www.equator-principles.com/>. For a critical monitoring of this initiative by a group of leading NGOs see BankTrack, Principles, profits or just PR? Triple P investments under the Equator principles. An anniversary assessment, 2004 at <http://www.banktrack.org/>

6. For a detailed analysis on human rights and multinationals, see Colonomos and Santiso, 2005.

7. For a review, based on good practices and case studies, of how financial services are affected by and manage the challenges associated with human rights, see the study of European asset manager F&C Asset Management and KPMG, Banking on Human Rights: Confronting Human Rights in the Financial Sector, London, September 2004 and the F&C (Isis Asset Management) reports available online: <http://www.isisam.com/aboutus.asp?pageid=2.8.3.7#banking>

operations keep flying every month towards the new frontier of capitalism. The enthusiasm of international lenders for diving into the deep waters of China's high-growth and high-risk banks remains hard to fathom. It is based mainly on a conventional, rose-tinted view of China, still underdeveloped but with a huge population, and it pays little heed to the political regime.

Lured by a huge market economy and "efficient" corruption in the spirit of Shleifer and Vishny (1994), FDI runs as high as \$60 billion a year, with banks a part of the rush towards the Chinese gold mines. Most mergers and acquisitions (M&A) by foreigners have involved buying minority stakes in state firms, mainly China's banks. Goldman Sachs, UBS, Bank of America, HSBC, Citigroup and others have spent more than \$10 billion on holdings of less than 10 per cent in the country's three major banks. So far China has collected more than \$20 billion for stakes in banks, investment boutiques and fund-management companies.

Nevertheless, a new agenda clearly is emerging for private international banks. Political issues such as human rights do appear on their radar screens. But what about democracy? What about political regimes? Do private banks take them into account in decisions on whether to invest in a country? Put another way, do they have political preferences? The Chinese rush might suggest a mixed answer, but this paper will show that banks tend to love democracies more than initially suspected, particularly emerging ones (an argument that remains to be tested once China experiences a democratic transition).

Private capital movements have risen in recent decades, and bank flows have been part of this story. Academics and policy makers have seen such movements as both panacea and anathema. Some empirical studies have analysed their political drivers, but paradoxically very few have looked at the political economy of banking. Hardly any research exists on the role of politics in explaining cross-border banking movements. Bankers' democratic preferences are particularly under-researched. We need to know more about banks' political preferences and their potential impact on both economic and political development.

This paper focuses only on the specific set of private flows involved in cross-border lending by international banks. The questions raised are narrow. Do banks react positively (*i.e.* with increased lending) when an emerging democracy appears? Do they do so after democratic transitions? Is there any relation between democratic consolidation and bank lending? Separate studies (the work presented here is part of a larger project on the political economy of private capital flows) examine political preferences in other types of capital movements. Neut and Santiso (2006) look at foreign direct investors. Nieto and Santiso (2007) study the political economy of portfolio investment. Together, these papers thus cover the three major types of private capital flows: bank flows, FDI and portfolio flows.

The issue is not whether private banks prefer democracies worldwide but whether they contribute to political development by lending to emerging democracies. Their overall democratic preferences emerge quickly from a look at cross-border banking claims. By the end of 2005, the stock of cross-border claims of Bank for International Settlements (BIS) reporting banks was \$21 450 billion (BIS, 2006), with most of the claims directed to developed OECD economies, all democracies. Only \$2 396 billion, less than 11 per cent of the total, went to emerging market economies, with most of that to emerging democracies like South Korea, Brazil and Mexico.

China concentrates a stock of only \$114.6 billion in cross-border bank claims, less than 0.53 per cent of the world stock. Banks therefore clearly prefer lending (more than 99 per cent of their claims) to democracies⁸. This is not surprising or new information. It is more interesting to look at whether banks tend to prefer lending to new, emerging democracies. Do they react to democratic transitions and are they sensitive, once transition is achieved, to democratic consolidation? Much research has covered the contribution of banking to economic development but none has focused on how bank lending affects political development.

This study uses newly compiled sets of indicators on democracy, political stability and policy certainty, linking these datasets with international banking flow data developed by the BIS. This allows empirical investigation of the political economy of cross-border bank flows in emerging markets and thus a contribution to the rapidly growing literature on the determinants of international private capital flows and the overall analysis of the political preferences of bankers regarding democracy.

The paper proceeds as follows. It first reviews the literature on the issue and develops a theoretical argument on why banks should prefer emerging democracies. It then focuses on the political economy of bank flows to emerging markets in order to gauge whether bankers have a political regime preference. It also specifically discusses banking activity in Latin America, a region where democratic transitions have been very dense, and rival political hypotheses such as the influence of policy instability. The theme “banking on democracy” underlines the importance of banks in not only economic but also political development⁹.

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8. In terms of bank assets the picture does not change; bank assets vis-à-vis developed OECD countries account for 37 per cent of world GDP and those vis-à-vis emerging economies for less than 3 per cent.
 9. “Banking on Democracy” was first used as a title in an influential paper by John Freeman (1990). Freeman’s paper dealt with a very different set of issues, however. It discussed mainly the relationship between international financial flows in general and political sovereignty.

II. THE POLITICAL ECONOMY OF BANK FLOWS IN EMERGING MARKETS: A REVIEW

Private capital flows towards emerging economies have surged in recent decades, far surpassing public official flows. The paradox is that until recently little empirical research has analysed the drivers of this global private liquidity (Stein and Daude, 2001 and 2004; Levy-Yeyati *et al.*, 2003; Mody *et al.*, 2003; Santiso, 2003; Obstfeld, Shambaugh and Taylor, 2004). This is particularly true for private international bank activity (Sapienza, 2004). Although some surveys examine the factors behind international banks' decisions to establish operations overseas, especially in developing countries (Galindo *et al.*, 2003; Buch, 2003; Wezel, 2004) and the economic determinants of cross-border claims (Buch and Lipponer, 2004), studies have not focused on political variables and institutions that might explain cross-border bank movements.

Much more research has covered the economic impact of private bank flows. Recent empirical studies, for example, have emphasised that banking liquidity has a positive effect on economic growth (for a review see Levine, 2004). Other studies have highlighted that capital inflows are not risk-free assets and have shown a strong relation between the volume of capital movements – bank flows included – and some recent financial crises characterised by sudden crashes and highly dollarised economies (Van Rijckeghem and Weder, 2003; Calvo *et al.*, 2004; Eichengreen and Hausmann, 2005).

The institutional and political environment nevertheless can strongly influence international capital transactions. Scholars have growing interest in how strongly law and politics are key drivers of international private capital flows (Rajan and Zingales, 2003) and financial crises (Santiso, 2006; Martínez and Santiso, 2003; Stein and Streb, 2004; Whitehead, 2004). Both portfolio and foreign direct investment in emerging countries are sensitive to political variables (Nieto and Santiso, 2007; Neut and Santiso, 2006). Empirical studies have highlighted that corruption exerts a distortionary influence on growth and FDI (Mauro, 1995; Wei, 2000a; Wei, 2000b). The quality of legal systems has a strong impact on financial development (Djankov *et al.*, 2003) and particularly on M&A (Rossi and Volpin, 2005) and project finance deals (Esty and Megginson, 2003).

The Lucas paradox – *i.e.* that in theory capital should flow from rich to poor countries, but in practice it does not (Lucas, 1990) – has been explained as resulting from institutional quality (or lack of it). Empirical evidence for 1971-1998, based on cross-country regressions using a sample of 50 countries, shows that the most important variables in explaining the paradox are secure property rights and non-corrupt governments (Alfaro *et al.*, 2003). Another study (Alfaro *et al.*, 2005) confirms these findings, showing that the historical determinants of institutional

quality had a direct effect on private capital flows during 1970-2000. Good institutions and/or bad monetary policies are also important in explaining the high volatility of capital flows during that period. A country that improves its institutional framework and increases its growth will receive more private capital flows. Countries that have better institutional quality and lower policy volatility will receive more stable capital flows. Countries with lower inflation volatility tend to experience less uncertainty in terms of capital inflows. For FDI, empirical evidence suggests that political variables are important and that multinational firms prefer to invest in democracies¹⁰. In sharp contrast with official development assistance by Western governments, which registered negative net flows to newly democratic regimes in the three years after transition, private direct investors significantly increased FDI in the three years following shifts to democratic rule in 23 countries since the mid-1970s (Pei and Lyon, 2003)¹¹.

Politics also matter for the more direct impact on banking dynamics. Governments are not disinterested parties in financial systems. They set the rules of the game and the security of financial contracts, for example. World history is full of examples of the strong links between political institutions and the development of financial systems, as highlighted by neo-institutionalist economists and historians. The decision to privatise banks is highly political (Clarke *et al.*, 2004), and in emerging economies, public or private bank ownership matters for performance; politics interfere with banking performance (Micco, Panizza and Yañez, 2005).

Another recent empirical analysis uses quarterly data on gross bilateral private banking transactions between 19 source and 51 recipient countries from the mid-1980s until 2002 and employs various panel methodologies. It highlights politics and institutions as key determinants of international private banking activities (Papaioannou, 2004). This research, including not only inter-bank loans but also significant amounts of portfolio and FDI flows related to bank activity, shows that a fall of 5 per cent in the political risk of the recipient country is accompanied by a 2 per cent rise in the volume of bilateral bank lending. The results are quite impressive because they show as significant all forms of risk identified in previous studies, namely economic, financial and political risk (Erb, Harvey and Viskanta, 1996). The most important of the three in explaining foreign bank capital movements is political risk, which confirms the findings of previous researchers (Gelos and Wei, 2002). Other key results showed that well functioning

10. In the first study evaluating the political regime preferences of multinationals firms, Rodrik regressed an indicator for democracy on the value of investment by majority-owned US affiliates abroad and found that countries with weaker democratic rights tend to attract less US capital (Rodrik, 1997). Two subsequent studies expanded the data, one focusing on 62 emerging economies during the 1990s (Harms and Ursprung, 2002) and the other focusing on 69 developing and emerging market economies covering 1972 to 1999 (Busse, 2003). Both indicate that, on average, FDI per capita is higher in democratic countries (but this positive relationship did not hold for some periods such as the 1970s).

11. Multinationals seem also to prefer to invest in countries run by left-wing governments. A study conducted on a cross section of 48 developing and developed countries shows that the left-right orientation of the chief executive in the host country has a statistically significant effect on the amount of FDI flowing to that country. Countries ruled by left-wing parties tend to receive more FDI (Martin Pinto, 2003), as left-wing governments are perceived as more willing to control conflicts and social demands.

institutions are key drivers of international bank flows. Banks tend to invest more in countries with non-corrupt bureaucracies, high-quality legal systems and non-government controlled banking systems. Corporate governance practices and political reforms such as privatisation can significantly increase the liquidity of domestic financial intermediaries and thus foster local investment.

Other studies have emphasised that legal systems can explain the specific formats of international bank contracts. Government ownership of banks around the world is associated with weak growth rates, weak protection of property rights, lower productivity, weak bank performance and low levels of financial development (Barth *et al.*, 2001; La Porta *et al.*, 2002). State-controlled financial systems tend to promote political rather than profit-maximising objectives. The Papaionannou (2004) estimates suggest that an increase of 1 per cent in a government's holdings in the banking system decreases the level of cross-border bank lending by 1.6 per cent. As suggested by García-Herrero and Martínez-Peria (2004), the claims of US, Spanish and Italian banks in 90 countries tend to be sensitive to transaction costs (informational costs) but also to government intervention in the financial sector as well as country risk, which includes not only economic and financial variables but also political factors. These results fall in line with other studies that have emphasised economic and political determinants of foreign banking activity (Martínez Peria *et al.*, 2005).

These studies highlight that foreign banks seem particularly concerned with political risk when considering investing and lending abroad. They tend to invest in countries with high-quality institutions and to allocate credit to countries not characterised by corruption and with efficient legal systems. The results imply that improving the efficiency of bureaucracies in recipient countries, tackling the issues of corruption and enhancing legal systems, particularly financial ones, are crucial in attracting foreign banks. The question of political regime preference remains untouched by most of these studies, however. Do international private banks have a democratic preference when considering their activity in emerging markets? More specifically do they increase or decrease their bank lending after democratic transitions? And why?

Banks are not homogenous and their activities worldwide are quite diverse¹². This study considers only private banks, not multilateral development banks. The BIS international banking database tracks only private bank lending. Analyses of multilateral bank lending as well as Official Development Assistance merit specific studies, although international development finance has already caught the attention of many scholars. There is a particular abundance of literature on the politics of development lending and of international debt (for an extensive review see, for example, Carlos Santiso, 2004). An interesting historical study could compare bank lending behaviour before and after the debt crisis of the 1980s¹³, checking in particular

12. The study leaves aside the political role of international bankers themselves, as individuals. Narratives of their political involvements in both developed and developing countries are part of a very large literature ranging from historical biographies and sagas on international bankers like the Warburg, Rothschild and JP Morgan founders and dynasties to broader academic studies. See, for example, the great Morgan biography of Strouse (1999), Carosso (1987), Ferguson (1998) and Sampson (1982).

13. Wellons (1987) analysed the huge growth of "sovereign debt" during the 1970s in conjunction with the recycling of petro-dollars to developing countries and found that significant over-lending to sovereign

behaviour during the 1970s when democratic breakdowns multiplied. Due to the lack of BIS data for the period this is not feasible.

The study also focuses on a specific banking activity — lending flows — for which there is a large and complete dataset available from the BIS. Banks are in fact very large entities and their activities range from bank lending to portfolio investments, through their fund-management subsidiaries, for example. Some are also involved in remittance business or insurance activities. For these other types of bank activities, in particular portfolio and FDI flows, other databases are used and other specific studies carried out (Nieto and Santiso, 2007; Neut and Santiso, 2006) as parts of the larger project of which this study is an element. For some banking activities abroad a lack of disaggregate data prevents the kind of analysis presented here. For example, there are hardly any data disaggregated by country (including emerging economies) on international derivative contracts comparable to the BIS data on bank lending and borrowing.

The BIS data include banking claims and liabilities, *i.e.* information on lenders and borrowers. The focus here lies on lending rather than borrowing (liabilities being the counterpart of claims and reflecting in the end the same kind of information). One question is set aside because of a lack of data. The BIS data set does not include disaggregate data on borrowers. Further research using other data sets (probably country case studies) could examine whether bankers in non-democracies tend to differentiate between borrowers. Do they discriminate between sovereign, authoritarian governments (and sub-national authorities), and private borrowers? This would test whether banks differentiate between undemocratic governments and their suffering subjects when making credit decisions.

The BIS monitors the foreign claims held by mostly OECD-country banks on the rest of the world. It provides the most comprehensive data on international banking activity. It defines the claims as those extended by international banks to residents outside the countries in which the banks are headquartered. Foreign claims may cover financial assets such as loans, debt securities and equities, including equity participation in subsidiaries. The BIS data allow study of stocks or flows of claims or liabilities, and they differentiate them by countries but not by public and private borrowers in specific countries. The analysis here centres on flows, *i.e.* new claims, rather than stocks in order to test whether international private banks react positively or negatively to democratic transitions, and whether they increase or decrease their lending with the later consolidation of democracy. This enables evaluation of the political development contribution of banks. They are known to be key actors in economic development in emerging countries (as well as developed countries) but do they also contribute to their political development? Between 1980 and 2005, more than 80 countries took significant steps towards democracy, particularly in Latin America and Eastern Europe. For that reason, Latin American and Eastern European countries receive special attention.

developing-country borrowers was driven by large international OECD-based commercial banks' well-founded belief that their own home-country governments were unlikely to allow the "sovereign" borrowing-country governments to default on payment.

In Latin America, the number of countries functioning as democracies — defined as regimes where governments come to and remain in power as the result of contested elections — peaked at over 80 per cent in 1989 and has remained at that level ever since. Eastern European countries also experienced a massive shift in political regimes, all of them becoming emerging democracies over the past two decades. Meanwhile, private capital flows towards emerging markets skyrocketed. Private international banks pour large amounts of money into emerging markets through their lending operations, but FDI has pride of place. Privatisation opened windows of opportunity and international banks invested heavily in emerging markets. In Latin America foreigners, especially Spanish banks, invested large amounts. In Central Europe, foreigners have also bought or built 80 per cent of the top local banks since the fall of communism, Austrian and Belgian banks being particularly involved. Both in Latin America and in Eastern Europe, private international bank lending has also been very active.

III. BANKS' PREFERENCE FOR EMERGING DEMOCRACIES: HYPOTHESIS AND ARGUMENTS

Why would banks prefer emerging democracies? Why would emerging democracies be good business for them? In making decisions, bankers analyse key policies, especially fiscal, monetary and trade policies. More generally, other variables such as privatisation and growth have been identified as basic drivers of banking activity and entry into countries. In considering all the variables, this paper centres attention on young democracies.

Look first at the key policies. Empirical research shows a complex relationship between democracy and fiscal policy. Democratically elected politicians are supposed to be prone to seek to minimise taxation and maximise spending, leading to an increase in budget deficits. Some studies find no significant relationship between countries' level of democracy and their average spending on social security and education (Mulligan *et al.*, 2004). Many other, more recent ones (Tavares and Wacziarg, 2001; Block, 2002; Block *et al.*, 2003; Keefer, 2005) indicate, as suggested by Converse and Kaptsein (2006) that young democracies tend to exhibit initial increases in public spending, with current expenditure picking up in election years and followed later by a long-term decline. Brender and Drazen (2004) find also that political budget cycles are strongly present only in newly democratised countries. In a sample of 68 democracies from 1960 to 2001, the traces of political budget cycles appear in the first four elections following democratisation. Thus emerging democracies' financial needs tend to increase in the very first years of their existence, leading them to boost their borrowing activity and to become potentially good clients of international banks.

Given monetary policy's importance to the economic well-being of banks, one must also question how young democracies perform in this regard. Several studies reveal that democratic institutions enhance the quality of monetary policy making. As Converse and Kapstein (2006) underline, young democracies perform quite impressively on inflation; from an average of 125 per cent the year of the democratic transition, consumer price inflation drops to around 50 per cent on average in four years. This pattern is not uniform among regions, however. In Latin America, where hyperinflation has been very damaging, levels of inflation, while reduced, have remained very high four years after democratic transition; on average they reach 390 per cent in the year of transition and 123 per cent four years later, still high and damaging for banks. Yet the more general trend characterises the major recipients of bank lending, also the major countries of the region. In countries like Mexico, Brazil or Argentina, inflation has slowed dramatically in the years following democratic transitions and above all after democratic consolidations.

Good trade policy also leads to more banking activity, particularly increased lending through trade finance and export credits. Several studies corroborate that democracy increases

trade openness. Milner and Kubota (2005) show, for example, that higher levels of democracy are associated with more liberal trade regimes, particularly in newer developing-world democracies. These findings are consistent with other studies showing greater degrees of democracy significantly associated with higher trade-to-GDP ratios. Converse and Kaptsein (2006) found in their 114 cases of democratisation between 1960 and 2003 that such trade ratios increased by nearly 10 percentage points in the three years following democratic transitions, jumping from an average of 59 per cent of GDP in the year of transition to 69 per cent of GDP three years later¹⁴.

Privatisation in young democracies also tends to favour more banking activity. Privatisation operations are highly attractive for banks, implying high fees for those involved as advisers and lucrative lending operations to finance takeovers by private operators. Several empirical studies document that democracy is substantially and significantly associated with the extent of privatisation (for a review and analysis see Biglaiser and Danis, 2002). Democracies privatise more than non-democracies and young democracies especially use heavy privatisation programmes in order to finance increasing social demands. Privatisation has been particularly intensive in Latin American and Eastern European emerging democracies. Latin America accounted for 55 per cent of total privatisation revenues in the developing world in the 1990s, the proceeds reaching nearly \$180 billion (Chong and López de Silanes, 2004).

All the key policies, but mainly fiscal and trade policies, tend to support greater bank lending to emerging democracies. The results are more mixed for monetary policies. Privatisation booms, particularly intense in emerging democracies, also provide good reasons for banks to support increasing lending activity. Young democracies also grow faster in the first years following transition, as Rodrik and Wacziarg (2005) show. They found in an extensive sample of 154 countries that the first five years following democratic transition saw significantly higher economic growth and lower variance in growth rates.

These conclusions on growth might not be as clear as at first sight, however. The link between democracy and economic performance remains tenuous. Both the theoretical and the empirical literature are split over the effects of democracy on growth. Some scholars have questioned “development” theories, arguing that democracy has a questionable and statistically insignificant effect on economic growth (Przeworski *et al.*, 2000)¹⁵. On the effects of democratic transition on economic development, some argue that the causality runs from economic development to a higher probability of transition to democracy (Boix and Stokes, 2003; Boix, 2003). Others conclude that transitions to democracy do not necessarily become more likely when a country is more developed as measured by per capita income (Przeworski, 2004c). Feng

14. Other studies by López-Córdoba and Meissner find a positive relation between trade openness and democracy from 1895 onwards. The impact of openness by region shows some variation, and the authors note that commodity and petroleum exporters do not seem to become more democratic by exporting more commodities and oil (López-Córdoba and Meissner, 2005). While the impact of democracy on trade openness seems strong, there is much more discussion on the impact of trade on democracy: Rigobón and Rodrik (2004) find results totally different from those of López-Córdoba and Meissner, while Papaioannou and Siourounis (2005), find a much weaker impact of trade openness on democracy.

15. For a critical analysis of the new institutionalism literature, see Przeworski, (2004a).

(2003) reaches the same conclusion, using large samples of countries over long periods to show that the effect of democracy on growth is statistically insignificant. He also finds, however, that political democracy has a significant impact on private investment. Reductions in political instability and policy uncertainty have a positive impact on the economy.

Still others have established strong links between democracy and growth and between the quality of institutions and long-term growth (Acemoglu *et al.*, 2004; Persson and Tabellini, 2003; Persson, 2004), or found positive effects of democracy and the rule of law on economic performance, with the latter having a much stronger impact (Rigobón and Rodrik, 2004). The relation between democracy and the rule of law is not systematic, however, as highlighted by examples in Latin America where transitions to democracy have proceeded without consolidation of the rule of law. In the absence of meaningful judicial systems, democratisation often has not culminated in the consolidation of the rule of law (Malone, 2003), a key driver of private capital flows to emerging markets.

Growth performance improves after the transition to democracy. Moreover, growth under democracy appears more stable than under authoritarian regimes. Based on a sample of 40 countries and comparing their economic performances before and after they became democratic over the past 40 years, Jian-Guang Shen (2002) shows that the ten-year average growth rate is a half percentage point higher after transition to democracy. The five-year average growth rate after the adoption of democracy is even higher; a full percentage point. More than 60 per cent of the sample countries experienced growth acceleration after democratic transition. Rodrik and Wacziarg (2005) also reveal that major democratic transitions had positive effects on economic growth in the short run and tended to associate with a decline in growth volatility. Their findings are based on a large sample of countries, cover a long period (1950-2000) and confirm that particularly low-income countries experienced a short-term boost in growth after democratic transition.

Papaioannou and Siuourounis (2004) arrive at a similar conclusion by analysing the evolution of GDP growth before and after permanent democratisations in 1960-2000. According to their estimates, democratisation leads on average to an approximate increase of 0.7 per cent to 1.0 per cent in real per capita growth. It is associated not only with higher growth but also less volatile growth rates, confirming previous findings (Rodrik, 1997, 1999). Democratisation has the strongest impact on growth volatility in highly unstable countries such as those in Latin America.

Persson and Tabellini (2005a) conducted decisive research underlining that democratisations induce growth acceleration and therefore are good for banking business. Drawing on previous and complementary research (Persson, 2004; Persson and Tabellini, 2004; Persson and Tabellini, 2005b) and considering different forms of democracy, they show that becoming a democracy accelerates growth by 0.75 percentage points. With an estimated convergence rate of 6 per cent per year, they also show that the long-run effect on income per capita is 12.5 percentage points. The findings are based on a very large sample of about 150 countries, include 120 regime changes over 1960-2000 and are consistent with previous studies (Papaioannou and Siuourounis, 2004). Another result reveals that new presidential democracies

grow on average 1.5 percentage point more than new parliamentary democracies. This is particularly interesting for Latin American countries, where presidential regimes dominate.

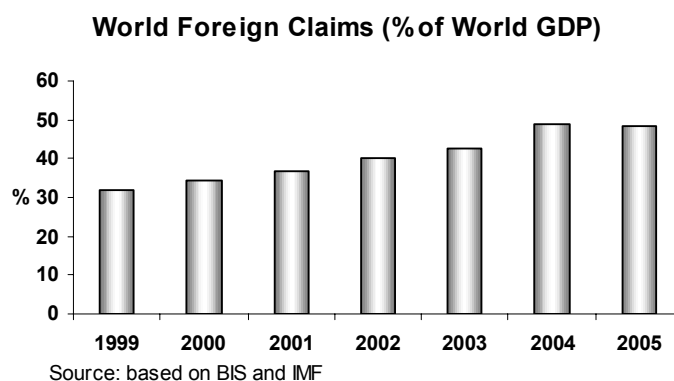
Other factors, more related to institutional quality and public goods outputs, may also have relevance for explaining increased bank lending in newly democratised countries. Democracies have more incentives to provide benefits for the public than do autocracies. They tend to be much more transparent than non-democracies, releasing more information on tax revenue collection (Bueno de Mesquita *et al.*, 2003). Based on a large empirical study tracking the missing data in the World Bank's World Development Indicators, Rosendorff and Vreeland (2004) found that the missing data are in fact correlated with regime type, thus showing that democracies are much more transparent than non-democracies. This is key; the institutions that matter for economic development are in the end those that induce governments to limit taxes on income, make rulers accountable and provide information on government policies, thereby allowing informed citizens to sanction misbehaviour (Przeworski, 2004*b*; Benhabib and Przeworski, 2004). Not surprisingly, foreign direct investors (international banks included) tend to prefer more transparent countries (Mody *et al.*, 2003), where transaction costs related to corruption are lower, for example.

Strong economic arguments, already tested empirically, thus help to explain a potential political preference for emerging democracies by banks. The empirical test of this preference remains an open question, however.

IV. BANK FLOWS TO EMERGING MARKETS: STYLISED FACTS

Before testing the hypothesis that bankers prefer emerging democracies, the importance of private bank flows needs emphasis. Private foreign lending can constitute a substantial fraction of claims in recipient countries. Over the past decade, foreign bank claims took off with greater financial integration and the opening of emerging countries to private capital flows. In consequence, private international loans equalled 48.3 per cent of global GDP in 2005¹⁶, more than the total of international trade flows combined with all foreign direct investment and global tourist receipts (Figure 1).

Figure 1. Global Foreign Claims



The test of the hypothesis depends for data on the BIS "Consolidated Foreign Claims of Reporting Banks on Individual Countries" statistical series from the fourth quarter of 1983 to the first quarter of 2006¹⁷. Because this study tries to show the relationships between private banking flows and levels of democratisation as well as between bank flows and changes in these levels, the focus lies on countries that have gone farther down the road towards democracy, *i.e.* mainly emerging countries. Private bank flows towards emerging countries are very low in nominal

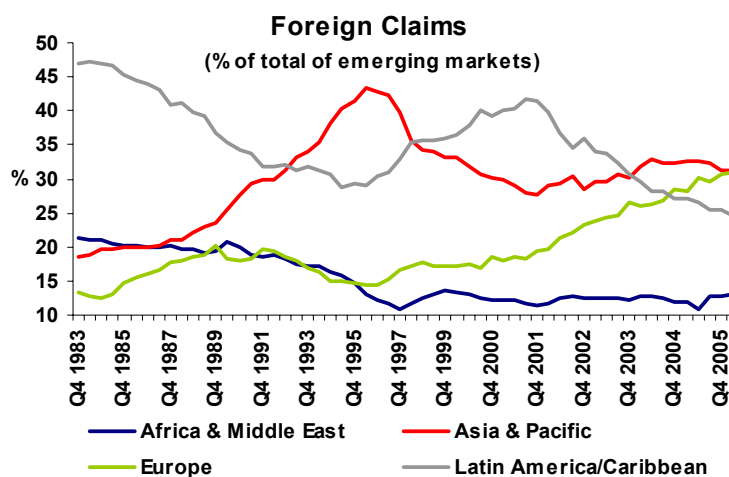
16. The BIS defines the foreign claims held by banks mostly from OECD countries vis-à-vis the rest of the world as those authorised by international banks on residents outside the country in which they are headquartered. Foreign claims may range from assets such as loans and debt securities to equities, including equity stakes in local subsidiaries.

17. For more information, see www.bis.org

terms compared with those to developed countries, which receive more than 90 per cent of the total. Yet they have great importance for developing economies in that they are equivalent to a relatively high percentage of their GDP.

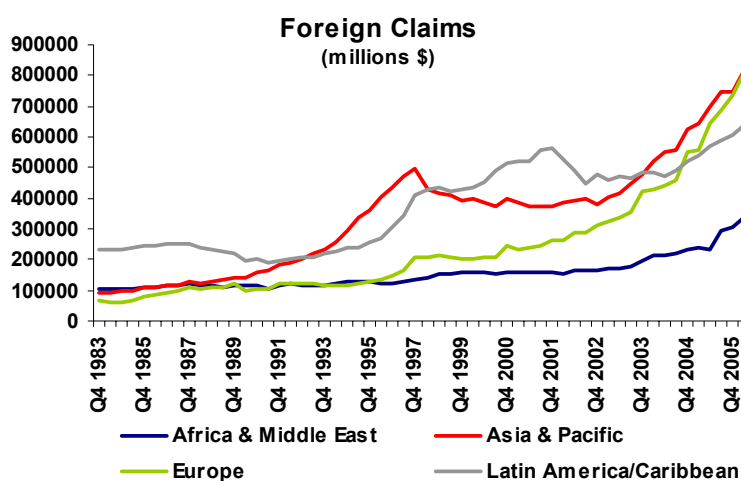
By region, Latin America and the Caribbean were the main recipients of bank flows in the mid-1980s, although they subsequently eased off (Figures 2 and 3). At the end of 1984, this region received 47 per cent of the flows to emerging countries, whereas Africa received about 21 per cent, Asia 20 per cent and Europe 12 per cent (See also Table 1 of Appendix 1). Latin America remained the biggest recipient until the fourth quarter of 2003. Since the beginning of 2004, Asia has received the largest share (31.4 per cent of the total in Q1 2006). In 2006, Emerging Europe became the second biggest destination with 31.1 per cent of the total, followed by Latin America with 24.5 per cent; Africa brought up the rear with only 13 per cent.

Figure 2. Foreign Claims on Emerging Countries



Source: Authors based on BIS data, 2006.

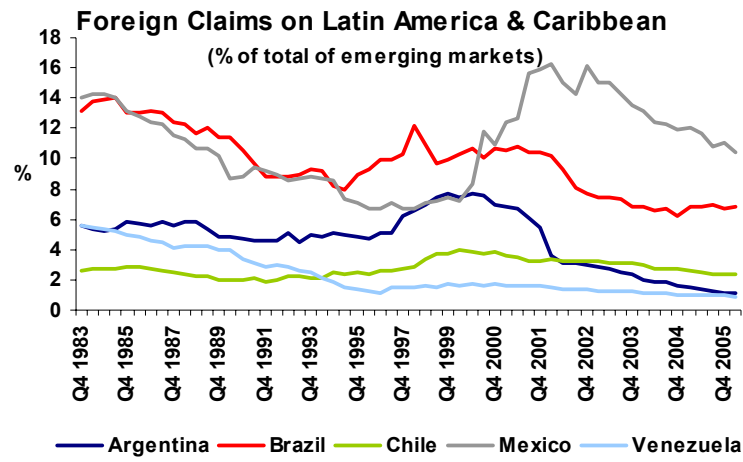
Figure 3. Foreign Claims on Emerging Countries



Source: Authors based on BIS data, 2006.

Mexico and Brazil account mainly for Latin America's predominance over the past 20 years (Figure 4). In fact, these two countries received the largest country shares of total loans to emerging markets over the past two decades, with flows exceeding those directed at Asian emerging economies, although Asia and Emerging Europe obtained more financing than Latin America as a whole. This arises from the greater concentration of banking flows to Latin America in a few countries, compared with the wider distribution among countries in Asia. Mexico and Brazil received similar amounts of financing until the second half of the 1990s, when Brazil grew in importance as Mexico decreased. From 2000 onwards, however, Mexico regained the top spot, reaching 10.5 per cent of the total in 2005 (similar to the shares of Africa and the Middle East in the same year). Brazil's importance as a fiscal paradise for banking investment fell considerably from the beginning of 2002, with its share of total emerging-country bank flows falling from 10.5 per cent at the end of 2001 to a mere 6.9 per cent in 2006. Other Latin American countries such as Argentina and Venezuela have experienced a considerable drop in foreign bank financing. The main winners from Latin America's loss of share since 2001 (including Mexico) have been emerging Asian economies and the Eastern European countries. Over the past three years they have included Taiwan, China, South Korea, India, the Czech Republic, Hungary and Poland (See Table 1 and Graphs 1 and 2 of Appendix 1).

Figure 4. Foreign Claims on Latin America & Caribbean



Source: Authors based on BIS data, 2006.

V. BANKS AND EMERGING DEMOCRACIES

Proximity and cultural factors seem to be variables behind these trends in bank flows. GDP, population, surface area in square kilometres, interest rates and even levels of corruption represent other key drivers of such flows (Papaioannou, 2004). This paper focuses not on these variables but on determining if political factors make some difference in the granting of international bank financing. To do so it uses variables such as the democratic transition year, the level of democratisation, the stability of economic policy, the political stability of ministries and the differences between presidencies in different emerging countries.

As many researchers highlight, the analysis of democratisation and private bank flows raises a number of methodological issues. Data availability is one, along with the measures used to gather the data. Most of the datasets present availability weaknesses, but more importantly the hypotheses, concepts and definitions behind them are open to question. One important issue regards causality. Private bank money may flow towards emerging democracies just because windows of opportunity like privatisations have suddenly opened. Banks may rush towards emerging democracies not because they are democracies but because they privatise their banks.

Democracies — at least in Latin America — had a strong propensity to privatise during the last decades of the 20th century. They tended to prefer fully to privatise assets while autocracies tried to maintain control over their economies. In the end, as highlighted by Giavazzi and Tabellini (2004), political and economic liberalisation have been closely connected. They feed on each other, so that it is difficult to discern the direction of causality. Analysis of the timing of different events does indicate, however, that the causality is more likely to run from political to economic reforms. Democratisation appears to lead to economic liberalisation, with the extent of liberalisation gradually increasing in the years following the transition to democracy. This would suggest that the political shifts induce economic liberalisation to a far greater extent than the other way around, particularly in Latin America, where in most cases political liberalisation took place before bank privatisation¹⁸.

18. In the classification of Giavazzi and Tabellini, all Latin American countries except Chile, Mexico and Peru liberalised their economies first and afterwards experienced political liberalisation. One can nevertheless discuss the assigned timing of both political and economic liberalisation. In Mexico, for example, permanent democratisation dated from 1994, whereas many scholars considered that 1988 or 2000 were the years when full democratisation took place.

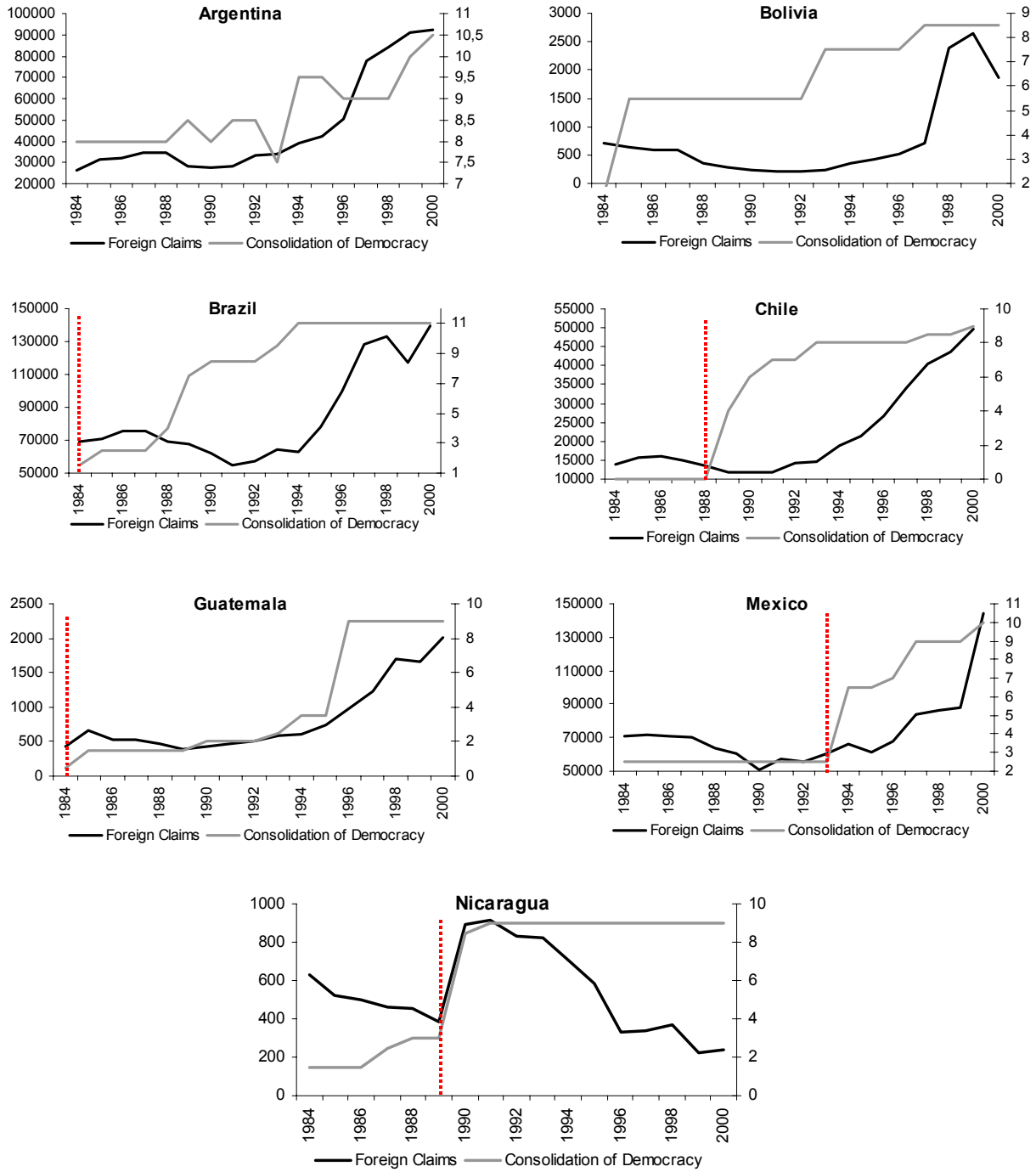
The first approach to the question “Do bankers prefer democracy in emerging markets?”, analyses the correlation between the BIS data series and political databases, using the standard classification of democracy of Przeworski *et al.* (2000)¹⁹. Two series indicate the level of democratisation. The first, called “Consolidation of Democracy”, was formulated by Schmitter and Schneider (2004). It measures the extent to which democracy consolidates itself. It provides yearly figures for a series of countries. The greater the value, the stronger democracy is rooted. The second indicator, more commonly used in economic literature, is the “Democracy Score” formulated by “Polity IV”. It measures countries’ existing levels of democracy. It also has an annual series. Its value ranges from zero to ten, where proximity to ten means a higher level of democratisation and *vice versa*.

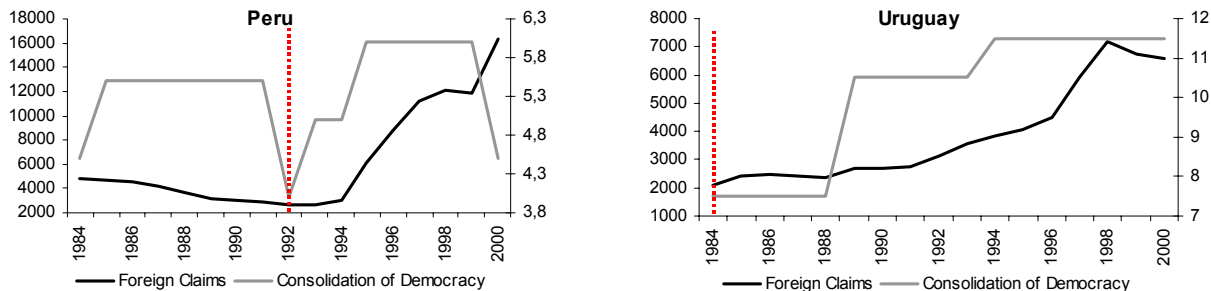
The years in which democratic transition took place in different countries also are useful to gauge whether banking flows increased after transition. These figures come from research developed by Giavazzi and Tabellini (2004), Carrillo *et al.*, (2004) and Przeworski *et al.* (2000). In line with Persson and Tabellini (2003), Persson (2004) and a large body of literature on the topic, a country is defined as a democracy if it has strictly positive values for the indicator POLITY2 in the POLITY IV database. In line with Giavazzi and Tabellini (2004), democratisation is an event in which a country becomes a democracy when this was not the case the previous year. The Giavazzi and Tabellini timing is verified and cross-checked with Carrillo *et al.* (2004) for Latin America and with Przeworski *et al.* (2000).

A graphical analysis of foreign claims by country in combination with the democracy indicators, shows a common pattern for countries and indicators (Figure 5 and Appendix 2). An increase in the democracy indicators has a positive impact on the entry of private foreign claims, although in some countries there is a lag of two or three years. This pattern is particularly important in Latin America, a region that experienced the most impressive democratic transitions over the past decade along with Eastern Europe (where the relation also looks strong as shown in the country cases in Appendix 2). In some of the graphs a vertical line shows the year in which transition took place.

19. Regimes are classified as democracies if in a given year they satisfy simultaneously four criteria: *i*) the chief executive is elected; *ii*) the legislature is elected; *iii*) more than one party competes in the elections; *iv*) incumbent parties have in the past lost an election and yielded office or will do so in the future. All regimes that fail to satisfy at least one of these criteria are classified as non-democratic (Przeworski *et al.*, 2000, pp. 18-29). Hence the political regime classification is simplified and becomes a dichotomous variable that takes a value of 0 if a country is a democracy and 1 if it is not according to the four cumulative criteria.

Figure 5. Foreign Claims (\$ millions) and Consolidation of Democracy Indicator in Latin America, 1984-2000





Note: See also in Appendix 2 the “Consolidation of Democracy” graphs for non-Latin American countries and the “Democracy Score” graphs for Latin American and non-Latin American countries.

Source: Authors based on BIS, 2006 for private bank flows; Schmitter and Schneider (2004), Giavazzi and Tabellini (2004), Carillo *et al.* (2004) and Przeworski *et al.* (2000) for political indicators.

Next, consider countries for which data are available and which have undergone democratic transition (mostly in Latin America and Eastern Europe). How did democratic transition affect private bank inflows? Taking the year of transition as $t=0$ for all countries, one can observe the growth rates of banking flows before and after transition. The results are striking. Before democratic transition, the annual growth of flows in the three previous years has a mean equal to 1.04 per cent. After transition, banking flows in the following three years accelerate, growing at an average of 4.37 per cent. For Latin American countries alone in the three years prior to transition, annual average growth was negative at -1.53 per cent, then jumped to 4.28 per cent for the three years after transition. Clearly, at least in Latin America, bankers tend to love new emerging democracies and increase their lending to them. A transition towards democracy tends to favour foreign bank inflows. The other side of this coin is that emerging borrowers have had easier access to foreign private bank lending, once they became democracies.

Another way to look at the democratic preferences of bankers is to consider the quality of the political regimes that emerged from democratic transition. Once democracy is in place, do foreign bankers take quality into account, *i.e.* do they react to democratic breakdowns at the micro level? Democratic breakdown is usually associated with the collapse of democracy (Linz, 1978). Since the 1980s, in fact, no Latin American country has experienced such a collapse, but there has been abundant discussion regarding the quality of these democracies. “Delegative democracies” have been criticised, for example, for being inadequately constrained by a weak network of state institutions whose role is to check executive abuses of power. In line with Barndt (2003), however, one can argue that democratic breakdowns can occur not only at the macro level but also at the micro level. Across the continent, “executive assaults” abound. These are events in which an elected president tries to restrict the access of certain individuals to state power by temporarily suspending their ability to avail themselves of the constitutive attributes of democracy meant to be enshrined in the regime. Executive assaults are in the end attempts by presidents to dismantle democracy at the micro-level, such as the attempt (an example from Barndt) by Banzer in Bolivia in 1999 to quash peasant protests by detaining the leaders and restricting the right to gather in public.

Based on a collection of executive-assault data since the onset of the third wave of democratisation in the region from the beginning of the 1980s for ten country-periods, Barndt reported 204 observations and more than 120 cases of assault. All countries except Chile experienced at least one case of assault and several experienced more than ten. Table 1 quickly confirms that foreign banks seem indifferent to the proliferation of executive assaults: they tend to increase their lending presence regardless of increases in micro-democratic breakdowns.

Table 1. Executive Assaults and Foreign Bank Presence in Latin America

Country	Executive Assaults		Foreign Bank Presence (% of total banks assets)		
	Period Analyzed	% of country-year with at least one assault	1990	2005	Increase
Argentina	1983-2002 (20 years)	30%	10	61	51
Bolivia	1982-2002 (21 years)	19%			
Brazil	1985-2002 (18 years)	38%	6	49	43
Chile	1990-2002 (13 years)	0%	19	62	43
Colombia	1979-2002 (25 years)	88%	8	34	26
Ecuador	1979-2002 (25 years)	58%			
Paraguay	1989-2002 (14 years)	28%			
Mexico	1979-2002 (25 years)	n.a.	0	90	90
Peru	1980-2002 (25 years)	87%	4	61	57
Uruguay	1985-2002 (18 years)	11%			
Venezuela	1979-2002 (25 years)	42%	1	59	58

Sources: Authors, 2006, based on Barndt (2003) for the data on democratic assaults; Clarke *et al.*, 2004; and own estimates for the data on the share of foreign banks in total assets.

VI. BANKS AND POLICY INSTABILITY IN EMERGING DEMOCRACIES

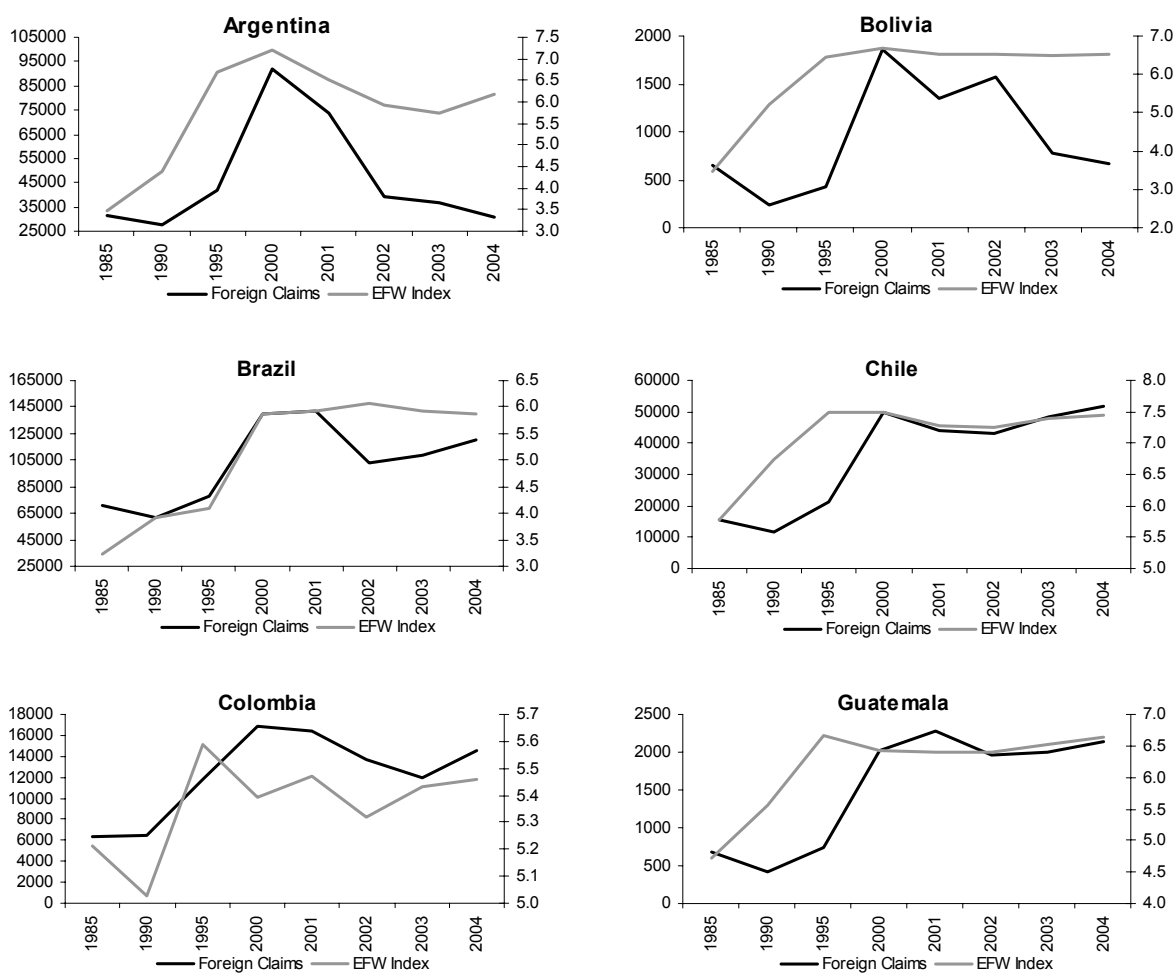
Given that bankers prefer emerging democracies, this section shifts the focus away from political regimes to policy stability in order to gauge whether bankers prefer it too. The common and generalised perception is that they tend to be risk-averse and avoid politically unstable countries for generally good reasons, because instability has a negative economic impact, particularly on growth, debt levels, fiscal deficits and inflation rates. In their core decision making on political risk, banks are put off by political instability in general because it increases policy instability, which in turn impacts negatively on growth and discourages private investment. Yet they do not seem sensitive to all kinds of instability. They show some neutrality toward democratic political instability, in spite of which they have continued to invest in Latin American emerging democracies in recent decades.

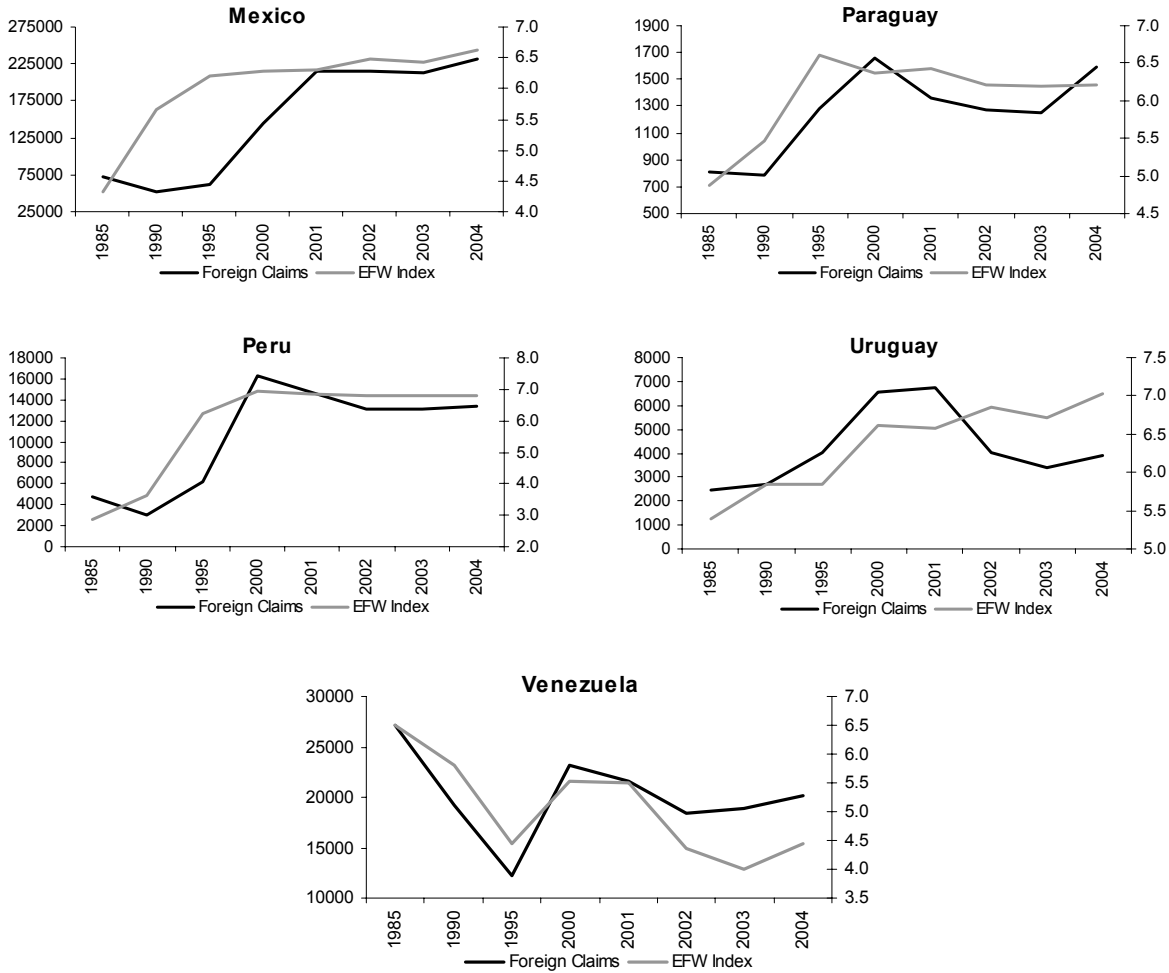
Latin America is known as one of the world's most politically unstable areas. Between 1945 and 2000, it saw around 160 occurrences of regime transition — shifts from non-democracies towards democracies and *vice-versa*²⁰. The region contains fewer than 10 per cent of the countries in the world, but it had more than 35 per cent of the regime transitions in the period. It averaged three regime transitions per country. South Asian countries in comparison had 1.4 transitions per country during the same years (Cheibub, 2003). Peru, for example (not the most unstable in the region by any means) had frequent political changes not only among the players in the game, but also in the playing field and the game itself. Since its independence in 1821, the country has had 13 constitutions and 108 governments, only 19 of which were elected and only nine of which completed their terms. Over the past two decades, democracy reappeared with three constitutional presidents installed between 1980 and 1992; a regime classified as semi-authoritarian between 1992 and 2001; and a fully democratic regime with two constitutional presidents since 2001 (Moron and Sanborn, 2006).

20. As highlighted by Epstein *et al.* (2005), the classification of political regimes is one of the most hotly debated issues in the study of democratisation. The problem arises because the predominant situation over the past few decades has in fact involved movements into and out of an intermediate category that clearly dominates the dynamics of regime transition. In their data covering all countries from 1955 to 2000, only 16 transitions from full democracy to autocracy and 22 reverse transitions from autocracy to full democracy occurred, while 149 transitions into or out of partial democracy took place. From 1955 to 2005, partial democracy always represented less than 30 per cent of all regimes. Neither are dictatorships all the same, and many, as Przeworski *et al.* (2000) argue, exhibit the full gamut of seemingly democratic institutions (Przeworski and Gandhi, 2004). For conceptual discussions regarding the problems of defining and measuring democracy, see also Cheibub and Gandhi (2004) and Bollen and Paxton (1998; 2000).

Latin American democracies have tended to stabilise over the decades, as Figure 6 shows. Policy instability is captured by an Economic Policy Stability Index. The index draws on the Fraser Institute's *Economic Freedom of the World Index* (EFW Index, Source: Freedom House Index), used among others by Mariano Tommasi (2005) (see also Tommasi and Spiller, 2007; Tommasi and Stein, forthcoming). A graphical analysis (Figure 6) of foreign claims by country against the Economic Policy Stability Index shows a strong relationship between both series. The greater an economy's stability, the higher the inflows of foreign claims (see Appendix 3 for comparable graphs for non-Latin American countries).

Figure 6. Foreign Claims (\$ millions) and Economic Policy Stability Index in Latin America





Source: Authors based on BIS and The Fraser Institute, 2006.

In the analysis of democratic changes and banking flows, the possible effect on foreign claims was observed mainly after abrupt changes in the indicator (as in the case of transition). Bank flows are more sensitive to political stability; less abrupt changes in the index also have effects on flows. Table 2 shows correlations of the indicators of democracy and the economic policy stability index with foreign claims. Generally the correlations are high with the stability index and lower with the democracy indicators. They cover each of the 30 countries included in the database for the periods of data availability. Algeria stands out as an exception; not only is the overall result not confirmed, but greater economic policy stability is associated with smaller inflows.

Table 2. Correlations of Foreign Claims with Economic Policy Stability Index (EFW), Consolidation of Democracy Index (CoD) and Democracy Score (DS)

	Correlations		
	Foreign Claims vs EFW	Foreign Claims vs CoD	Foreign Claims vs DS
	1985-2004	1984-2000	1984-2004
Russia	0.92	0.90	0.75
India	0.90	---	---
Polonia	0.87	0.48	0.50
Peru	0.86	0.24	0.25
Brazil	0.85	0.46	0.22
Paraguay	0.80	---	---
Turkey	0.80	0.86	0.10
Greece	0.79	0.51	0.27
Romania	0.78	0.40	0.49
Hungary	0.76	0.54	0.34
Portugal	0.76	0.57	---
Slovenia	0.76	0.67	0.50
Czech Rep	0.74	0.71	0.52
China	0.73	---	---
Venezuela	0.71	---	0.30
Ukraine	0.71	0.83	0.57
Morocco	0.71	0.88	---
Slovakia	0.70	0.64	0.66
Colombia	0.69	---	-0.73
Tunisia	0.69	-0.30	0.59
Chile	0.68	0.57	0.53
Mexico	0.66	0.70	0.83
Argentina	0.66	0.77	0.07
Guatemala	0.65	0.90	0.86
Spain	0.64	0.08	---
Uruguay	0.48	0.72	0.35
Bolivia	0.45	0.49	0.06
Bulgaria	-0.01	-0.28	-0.08
Nicaragua	-0.77	0.13	-0.24
Algeria	-0.95	-0.47	-0.54

Note: EFW stands for *Economic Freedom of the World* (Fraser Institute data); CoD *Consolidation of Democracy* data (Schmitter and Schneider data); and DS *Democracy Score* (Polity IV data).

Source: BIS, The Fraser Institute, Schmitter and Schneider (2004), and Polity IV

VII. BANK FLOWS AND POLITICAL STABILITY IN EMERGING DEMOCRACIES

This section analyses the entry of banking flows into Latin American countries and their possible relationship with the stability of ministerial and gubernatorial offices. As already demonstrated, banks have tended to boost their activity in the region, increasing their lending after the return of democracy despite the long track record of political instability in Latin America. Political regime instability has almost disappeared since the third wave of democratisation in the sense of no major democratic breakdowns in the region. This contrasts with the previously large number of *coups d'état* and other successful efforts to remove sitting governments through illegal and sometimes violent action – more than 70 in Latin America over the last half century alone and nearly one per year from the 1800s to the 1970s. Yet this does not mean that political instability has disappeared. Regular events such as elections, cabinet reshuffles or political crises still remain. What impact does such democratic instability, political change within a democratic regime, have on bank flows?

Democratic political instability can be measured in terms of cabinet turnover; *i.e.* changes in the composition of a cabinet within a government's lifetime (Huber and Martínez-Gallardo, 2003). A dataset developed by Martínez-Gallardo (2004) records within the limits of source availability all the changes in the composition of cabinets in seven Latin American countries between 1988 and 2000. Cabinet changes include both terminations (ministers who resign from their posts and take up work elsewhere) and reshuffles, where ministers move from one portfolio to another. All such changes take place, therefore, within the rules of the democratic game.

Democratic instability thus defined has been quite intensive in Latin America with notable differences between countries and presidential mandates within them. By the end of President Figueres' four-year mandate (1994-1998) in Costa Rica, 15 of his 25 original ministers still held the same positions, while just two of the ministers originally appointed by Colombian President Ernesto Samper remained in the government (and both moved to different portfolios). The average time spent in office by ministers in Figueres' cabinet was 35 months; the average for their Colombian counterparts over the same period was less than half that (15 months).

Cabinet stability for the countries included in the dataset (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Venezuela, Ecuador, Bolivia, Peru, Paraguay, and Uruguay) also varies with respect to reshuffles and terminations. Reshuffles have been substantially less common than terminations, less than 10 per cent of all the movements recorded. Abrupt changes (terminations) have been more common. The relative frequency of reshuffles also varies across countries, ranging from only 4 per cent of movements in Colombia and Ecuador to 8-11 per cent

in most countries (Chile, Bolivia, Venezuela, Brazil, Peru, Paraguay and Costa Rica), 12 per cent in Mexico, 14 per cent in Uruguay and even 21 per cent in Argentina²¹.

Changes in ministerial tenures should have some impact on bank flows to the extent that they could affect the quality of democratic policy making and the performance of governments. Ministerial cabinets are consistently more stable under situations of higher growth rates and in more constant environments for law and order. Cabinet changes are, in one way or another, political responses to shocks. Ministers may be changed due to shifts in presidential strategy, opposition pressure, or exogenous shocks like financial crises. Obvious examples are the departure of finance ministers in the wake of financial disruption or economic crisis. A political shock might cause a party to pull out of a ruling coalition, forcing ministers who are members of that party to abandon the executive. Vacancies produced by such events can be filled with politicians or technocrats from within the cabinet in order to smooth the change. After the 1994 devaluation in Mexico, for example, President Zedillo replaced his minister of finance with another cabinet member in an effort (unsuccessful) to overcome the crisis (Santiso, 1999).

Bankers seem indifferent as to whether centre, left or right-wing governments are in power and whether they have an absolute majority or operate in coalition with other parties. They show the same indifference to political instability as measured by cabinet turnover (Table 3). The correlations of foreign claims with ministerial stability and the average duration of ministers in office are insignificant at 0.10 and 0.06 respectively. Bank flows just do not appear as sensitive to ministerial turnover measured by time in office.

An econometric exercise checks and confirms the results (Table 4). Several empirical studies analyse the determinants of bank flows (Papaioannou, 2004). The purpose here is simpler: to verify the previous findings for political variables using another tool. The analysis uses panel data on 29 countries for 1984-2004 (annual frequency). The explanatory variables for bank flows are economic (GDP, population, human capital proxies and interest rates) and political (the “consolidation of democracy”, “democracy score” and “economic policy stability” indicators, plus ministerial stability and the composition of governments).

Foreign claims, apart from depending on GDP and population, also correlate positively with levels of democratisation in recipient countries. The results are confirmed with both the “consolidation of democracy” indicator (CoD in Table 4) and the “democracy score” indicator (DS). The economic policy stability indicator (EFW) also influences financial inflows, but the results are less trustworthy because the EFW data are available only every five years for 1985-2000, which means a smaller pool of information. A country receives more financing when its gross domestic product increases, its population is higher, more financing came the previous year and the country enjoys both greater democratisation and more economic policy stability. Ministerial stability and the composition of governments or banks do not appear as determinant factors, nor do interest rates or human capital.

21. The number of reshuffles vs. terminations also varies across portfolios. Finance, for example, accounts for only 4 per cent of reshuffles (*i.e.* 96 per cent terminations) while Interior has 14 per cent (86 per cent terminations). One might expect that a large number of Finance terminations would have a bigger impact on the banking sector.

Table 3. Foreign Claims and Ministers Stability in Latin America

		Presidency Including months	Foreign Claims % of total Latam	Ministers Stability (% total)	Ministers Average duration in months
Argentina	Menem	<i>Jul-89/Apr-95</i>	14.73	53.45	46
	Menem 2	<i>May-95/Nov-99</i>	18.35	34.48	28
	De la Rúa	<i>Dec-99/Dec-01</i>	17.34	31.03	22
Bolivia	Zamora	<i>1989/1993</i>	0.12	32.50	27
	de Lozada	<i>1993/1997</i>	0.16	32.50	33
	Banzer	<i>1997/2001</i>	0.42	42.50	39
Brazil	Collor	<i>Jan-90/92</i>	29.52	21.88	29
	Franco	<i>92/Dec-94</i>	28.83	42.71	44
	Cardoso	<i>Jan-95/Dec-98</i>	31.39	31.25	30
	Cardoso 2	<i>Jan-99/Dec-02</i>	25.87	20.83	20
Chile	Alwyn	<i>Dec-89/Dec-93</i>	6.36	37.29	22
	Frei	<i>Jan-94/Dec-99</i>	8.63	55.93	41
	Lagos	<i>Jan-00/...</i>	9.03	23.73	16
Colombia	Gaviria	<i>Jun-90/May-94</i>	3.47	35.78	42
	Samper	<i>Jun-94/May-98</i>	4.60	45.87	59
	Pastrana	<i>Jun-98/May-00</i>	4.17	29.36	32
Ecuador	Borja	<i>Aug-88/Jul-92</i>	1.87	18.10	23
	Duran	<i>Aug-92/Jul-96</i>	1.25	28.45	38
	Bucaram	<i>Aug-96/Jan-97</i>	1.07	12.07	14
	Alarcon	<i>Feb-97/Jul-98</i>	0.98	16.38	19
	Mahuad	<i>Aug-98/Jan-00</i>	0.75	18.97	25
	Noboa	<i>Feb-00/Dec-02</i>	0.34	15.52	18
	Salinas	<i>Jan-88/Dec-1993</i>	27.27	41.98	40
Mexico	Zedillo	<i>Jan-94/Dec-00</i>	23.60	41.98	37
	Fox	<i>Jan-01/Act</i>	38.21	22.22	19
	Rodrigues	<i>1954/1993</i>	0.33	26.98	20
	Wasmosy	<i>1993/Mar-98</i>	0.40	36.51	26
	Cubas Grau	<i>Apr-98/Mar-99</i>	0.34	17.46	11
	González Macchi	<i>Apr-99/Aug-03</i>	0.30	23.81	16
	Fujimori	<i>Apr-90/Mar-95</i>	1.41	44.90	57
Peru	Fujimori 2	<i>Apr-95/Mar-00</i>	2.88	51.02	61
	Paniagua	<i>Apr-00/Jul-01</i>	2.97	13.27	14
	Lacalle	<i>Apr-90/Mar-95</i>	1.52	53.70	36
Uruguay	Sanguinetti 2	<i>Apr-95/Mar-00</i>	1.58	38.89	23
	Battle	<i>Apr-00/Act</i>	1.09	25.93	15
	Perez	<i>Jan-89/May-93</i>	9.66	36.92	60
Venezuela	Velazquez	<i>Jun-93/Jul-94</i>	8.53	13.08	19
	Caldera	<i>Aug-94/Dec-98</i>	4.66	33.85	47
	Chavez	<i>Jan-99/Jan-00</i>	4.55	18.46	38
	Chavez 2	<i>Aug-00/Act</i>	3.94	10.77	22

Source: based on BIS and Martínez-Gallardo (2004)

Table 4. Foreign Claims Determinants

Foreign Claims (FC)			
	Log FC		Log FC
Log_GDP	0.792 (0.078)*	Log_FC (-1)	0.393 (0.022)*
Log_Population	0.712 (0.325)*	Log_GDP	0.307 (0.067)*
DS	0.034 (0.012)*	Log_Population	0.855 (0.265)*
Constant	-9.44 (5.23)	DS	0.03 (0.01)*
		Constant	-11.46 (4.26)*
R - sq	0.776	R - sq	0.844
Obs.	483	Obs.	463
Groups	26	Groups	26

Foreign Claims (FC)			
	Log FC		Log FC
Log_GDP	0.372 (0.089)*	Log_GDP	1.206 (0.14)*
Log_Population	1.123 (0.495)	Log_Population	0.268 (0.42)
CoD	0.035 (0.013)*	EFW	0.103 (0.045)*
Constant	-13.22 (7.99)	Constant	-5.179 (6.92)
R - sq	0.642	R - sq	0.561
Obs.	336	Obs.	206
Groups	24	Groups	27

Estimation by Fixed-effects

* Significance at the 5% level

Log_FC(-1) is a lag of one period of foreign claims

Note: EFW stands for *Economic Freedom of the World* (Fraser Institute data); CoD *Consolidation of Democracy* data (Schmitter and Schneider data); and DS *Democracy Score* (Polity IV data). We show the standard deviation in brackets.

Sources: IMF, IFS, World Bank, The Fraser Institute, Polity IV, and Schmitter and Schneider.

VIII. CONCLUSIONS:

Banks are willing to increase their lending to newly emerging democracies. They also prefer emerging democracies where policies are stable, but they seem indifferent to democratic political instability. The preference for emerging democracies is particularly striking in regions like Latin America and Eastern Europe, where democratic transitions multiplied in the past two decades; cross-border bank lending tends to rise in the years following authoritarian breakdowns.

Solid economic reasons explain why international banks prefer emerging democracies. Good fiscal and monetary policies and institutional quality in emerging democracies favour banking business. This preference needs testing for other flows such as FDI, portfolio investment and the lending behaviour of public institutions like the multilateral development banks. According to some studies, financial markets do not particularly reward democracies, with no apparent, significant difference in the interest rates paid by democracies and non-democracies in emerging markets²².

Bankers' preferences may lie in ethical as well as economic considerations, as the introduction to this paper suggests. Banks might prefer lending to emerging democracies not only because it is good business in economic terms, but also because it is good business ethically, a pledge of support for democracy, freedom and responsible public order, "all things living" along their journey *In Search of a Better World* as envisaged by the Anglo-Austrian philosopher Karl Popper in his collection of essays and lectures on the need for a new professional ethic.

22. Sebastian Saiegh (2004*a,b*) provides very stimulating research on this issue, examining the effect of political institutions on country risk and interest rates. He shows that emerging democracies are more likely to reschedule their debts than are authoritarian regimes and appear to pay higher interest rates. These findings are based on data for developing countries covering 1971-1998.

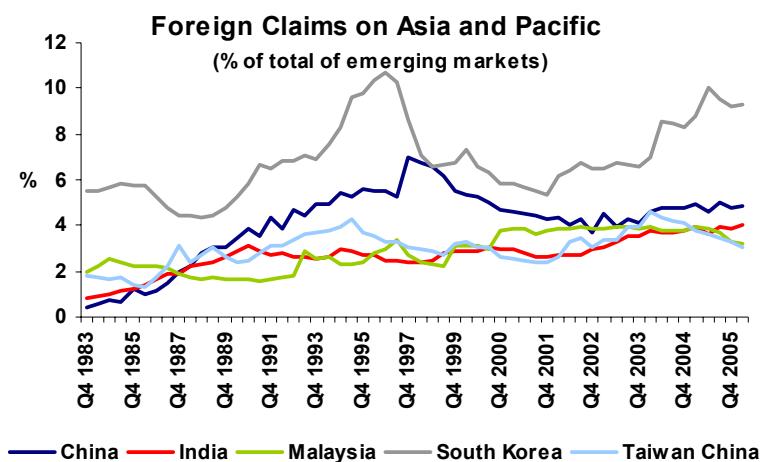
APPENDIX 1. FOREIGN CLAIMS ON EMERGING COUNTRIES STATISTICS

Table 1. Evolution of Foreign Claims on Emerging Countries
(% of total received by emerging countries)

	1984	1986	1988	1990	1992	1994	1996	1998	2000	2002	2004	2006
Developing Countries	100	100	100	100	100	100	100	100	100	100	100	100
i) Africa & Middle East	21.0	20.0	19.7	20.0	18.2	16.3	12.2	12.4	12.2	12.5	12.1	13.0
Algeria	1.6	2.2	2.4	2.6	2.3	1.9	1.1	0.6	0.4	0.3	0.3	0.2
Egypt	1.2	1.1	1.0	1.0	0.6	0.5	0.4	0.5	0.8	0.9	0.6	0.8
Iran	0.2	0.2	0.2	0.6	1.4	1.3	1.1	0.7	0.8	0.8	1.2	1.0
Iraq	0.7	1.3	1.4	1.6	0.8	0.7	0.5	0.4	0.1	0.1	0.1	0.1
Israel	1.1	0.9	0.7	0.6	0.5	0.5	0.5	0.6	0.6	0.8	0.6	0.6
Kuwait	1.2	1.0	0.8	1.0	1.3	1.1	0.5	0.5	0.4	0.5	0.4	0.4
Liberia	1.4	1.2	1.3	1.5	1.6	1.5	1.2	1.2	1.2	1.1	1.0	0.7
Morocco	0.8	0.9	0.8	0.8	0.8	0.7	0.5	0.6	0.8	0.9	0.7	0.6
Saudi Arabia	1.2	0.9	1.0	0.8	1.5	1.4	0.8	1.3	1.3	1.1	0.9	0.8
South Africa	3.8	2.8	2.5	2.5	2.1	1.8	1.9	1.9	1.7	1.6	1.6	3.5
United Arab Emirates	1.4	1.0	1.0	0.7	0.6	0.9	0.8	1.0	1.1	1.2	1.7	1.9
ii) Asia & Pacific	19.6	19.9	22.0	27.7	31.1	38.2	42.9	34.3	30.1	28.5	32.4	31.4
China	0.7	1.2	2.8	3.8	4.7	5.4	5.5	6.6	4.7	3.7	4.7	4.8
India	1.0	1.6	2.3	3.1	2.6	3.0	2.5	2.5	3.0	2.9	3.8	4.0
Indonesia	2.7	2.9	3.1	4.5	4.6	4.9	5.9	4.1	3.4	2.5	2.0	1.9
Malaysia	2.5	2.2	1.7	1.6	1.8	2.3	3.0	2.3	3.8	3.8	3.8	3.2
Philippines	2.6	2.5	2.1	1.7	1.2	1.1	1.6	1.6	1.7	1.6	1.3	1.1
South Korea	5.7	5.3	4.3	5.8	6.8	8.3	10.7	6.5	5.8	6.5	8.3	9.3
Taiwan China	1.7	1.7	2.7	2.5	3.4	4.0	3.3	2.9	2.6	3.1	4.1	3.0
Thailand	1.5	1.3	1.6	2.8	4.0	6.4	7.7	4.8	3.3	2.6	2.1	1.9
iii) Europe	12.4	16.1	18.5	18.1	18.6	14.9	14.5	17.6	18.5	23.1	28.6	31.1
Croatia	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.6	1.4	1.6	1.9
Czech Republic	0.0	0.0	0.0	0.0	0.0	0.7	1.3	1.5	2.0	3.2	3.9	3.8
Hungary	1.4	1.8	2.0	2.0	1.4	1.2	1.3	1.8	1.9	2.7	3.6	3.2
Poland	1.7	1.9	1.7	1.9	1.9	1.0	1.1	1.9	3.9	5.7	5.9	5.0
Russia	0.0	0.0	0.0	0.0	0.0	6.2	5.7	5.0	3.1	2.9	3.5	4.2
Slovakia	0.0	0.0	0.0	0.0	0.0	0.1	0.3	0.5	0.4	1.0	1.3	1.8
Soviet Union	3.2	5.0	6.1	7.1	8.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Turkey	0.9	1.5	1.8	2.6	2.4	2.1	2.3	3.1	3.5	2.5	2.8	3.4
iv) Latin America/Caribbean	47.0	43.9	39.7	34.2	32.1	30.6	30.4	35.7	39.2	35.9	27.0	24.5
Argentina	5.2	5.6	5.9	4.8	5.1	5.1	5.0	6.9	7.0	3.0	1.6	1.1
Brazil	13.9	13.2	11.7	10.6	8.9	8.2	9.9	10.9	10.6	7.7	6.2	6.9
Chile	2.8	2.8	2.3	2.0	2.2	2.5	2.7	3.3	3.8	3.2	2.7	2.4
Colombia	1.3	1.2	1.1	1.1	1.1	1.4	1.8	1.9	1.3	1.0	0.8	0.7
Ecuador	1.0	1.0	0.8	0.6	0.5	0.4	0.3	0.3	0.1	0.1	0.1	0.1
El Salvador	0.1	0.0	0.0	0.1	0.0	0.0	0.1	0.1	0.2	0.2	0.1	0.1
Mexico	14.2	12.4	10.7	8.8	8.6	8.6	6.7	7.1	11.0	16.1	12.0	10.5
Peru	1.0	0.8	0.6	0.5	0.4	0.4	0.9	1.0	1.2	1.0	0.7	0.4
Uruguay	0.4	0.4	0.4	0.5	0.5	0.5	0.4	0.6	0.5	0.3	0.2	0.2
Venezuela	5.4	4.6	4.2	3.3	2.8	1.8	1.1	1.6	1.8	1.4	1.0	0.9

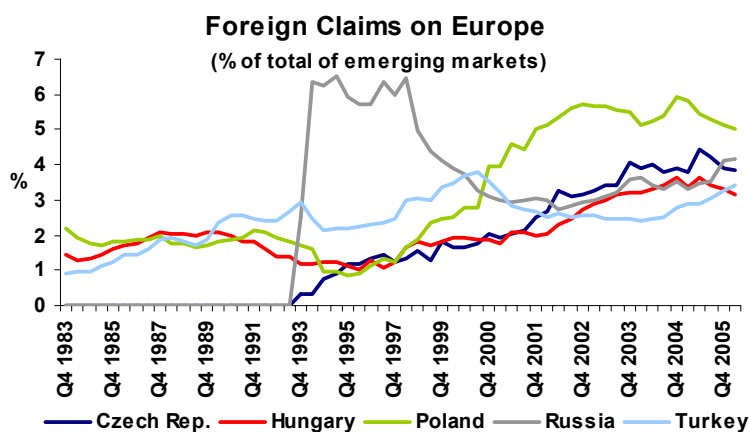
Source: Authors based on BIS data.

Figure 1. Foreign Claims on Asia and Pacific



Source: Authors based on BIS data, 2006.

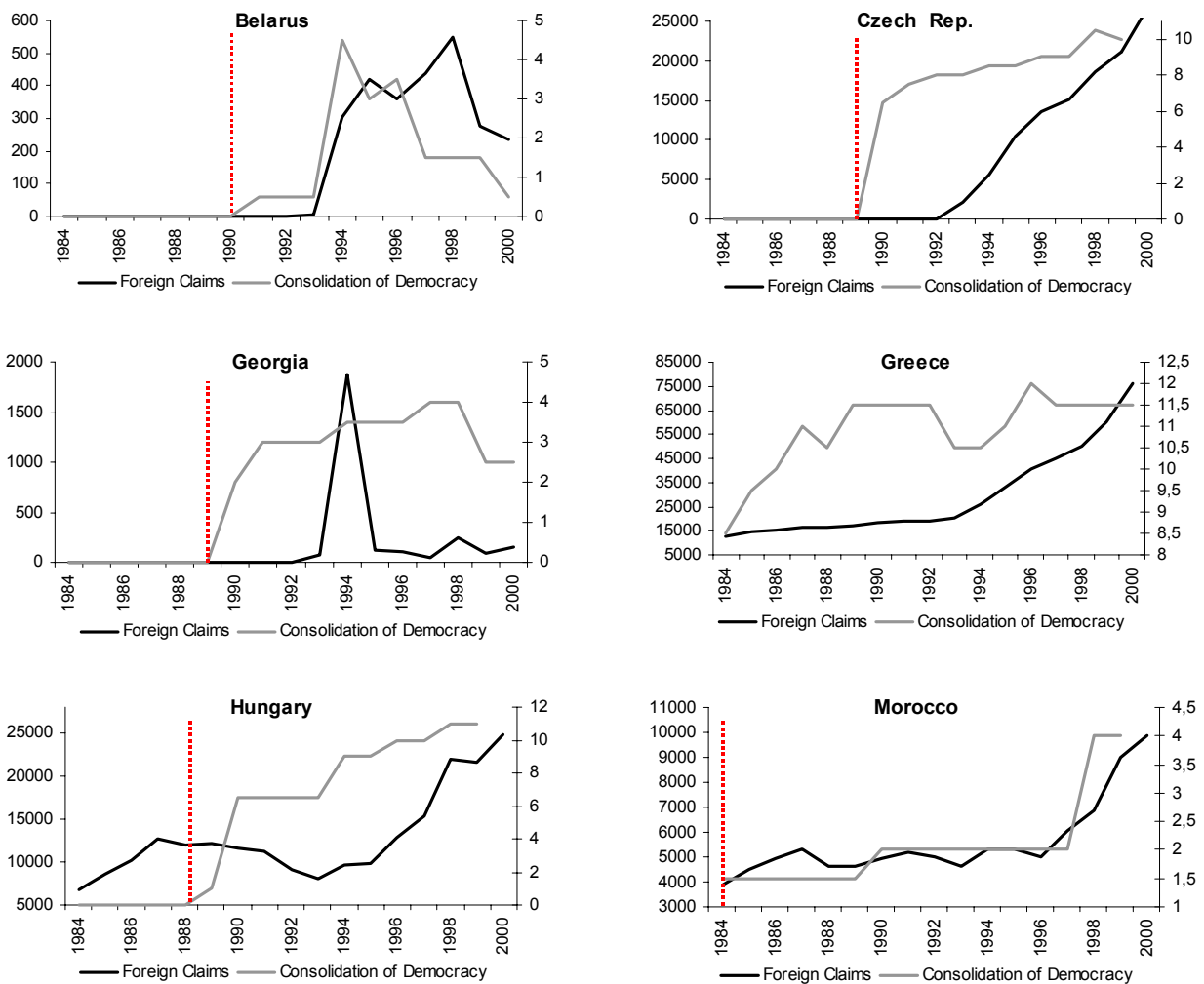
Figure 2. Foreign Claims on Emerging Europe

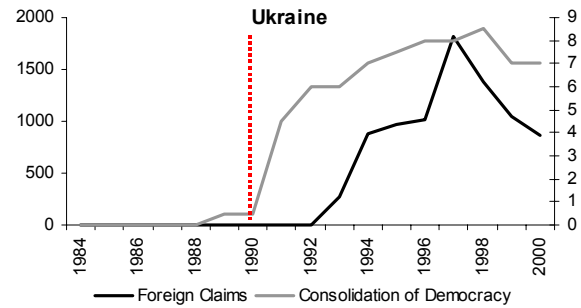
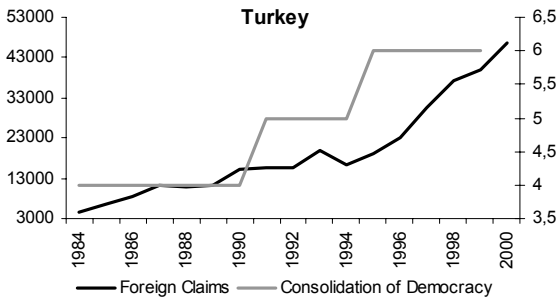
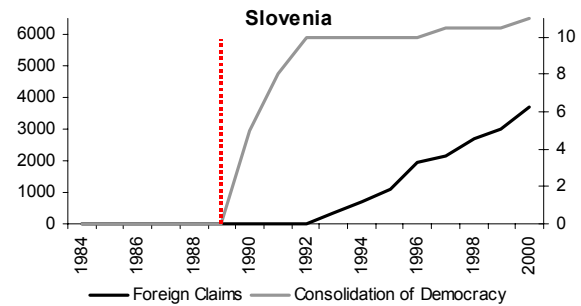
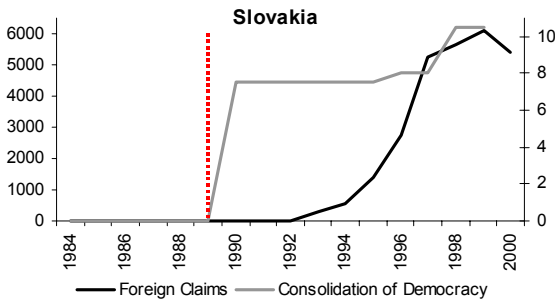
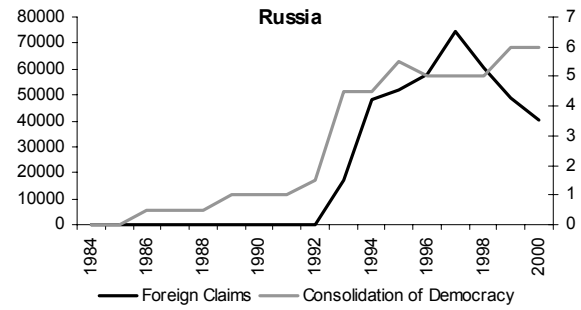
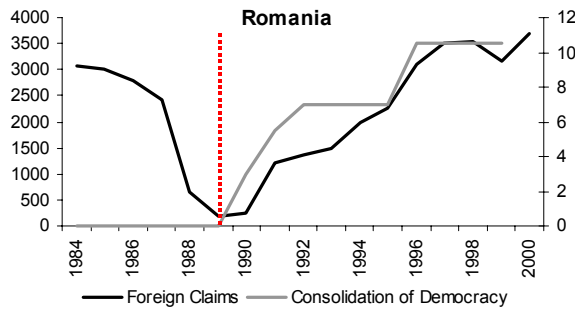
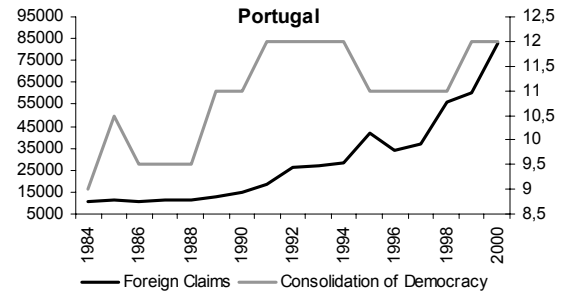
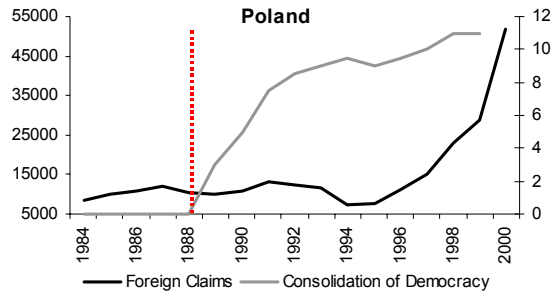


Source: Authors based on BIS data, 2006.

APPENDIX 2. FOREIGN CLAIMS AND DEMOCRACY

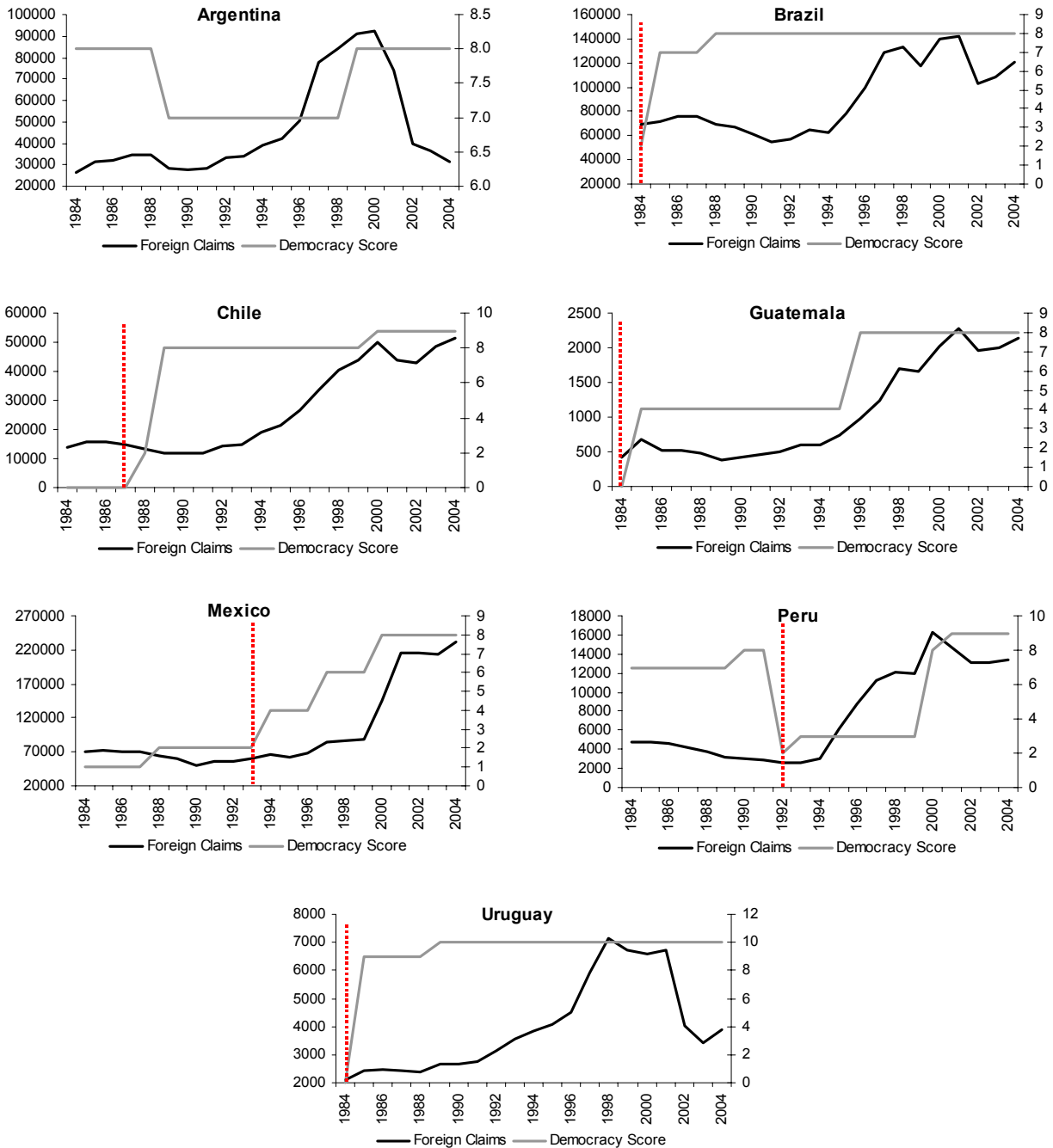
Figure 1. Foreign Claims (\$ million) and Consolidation of Democracy Indicator for Other Countries





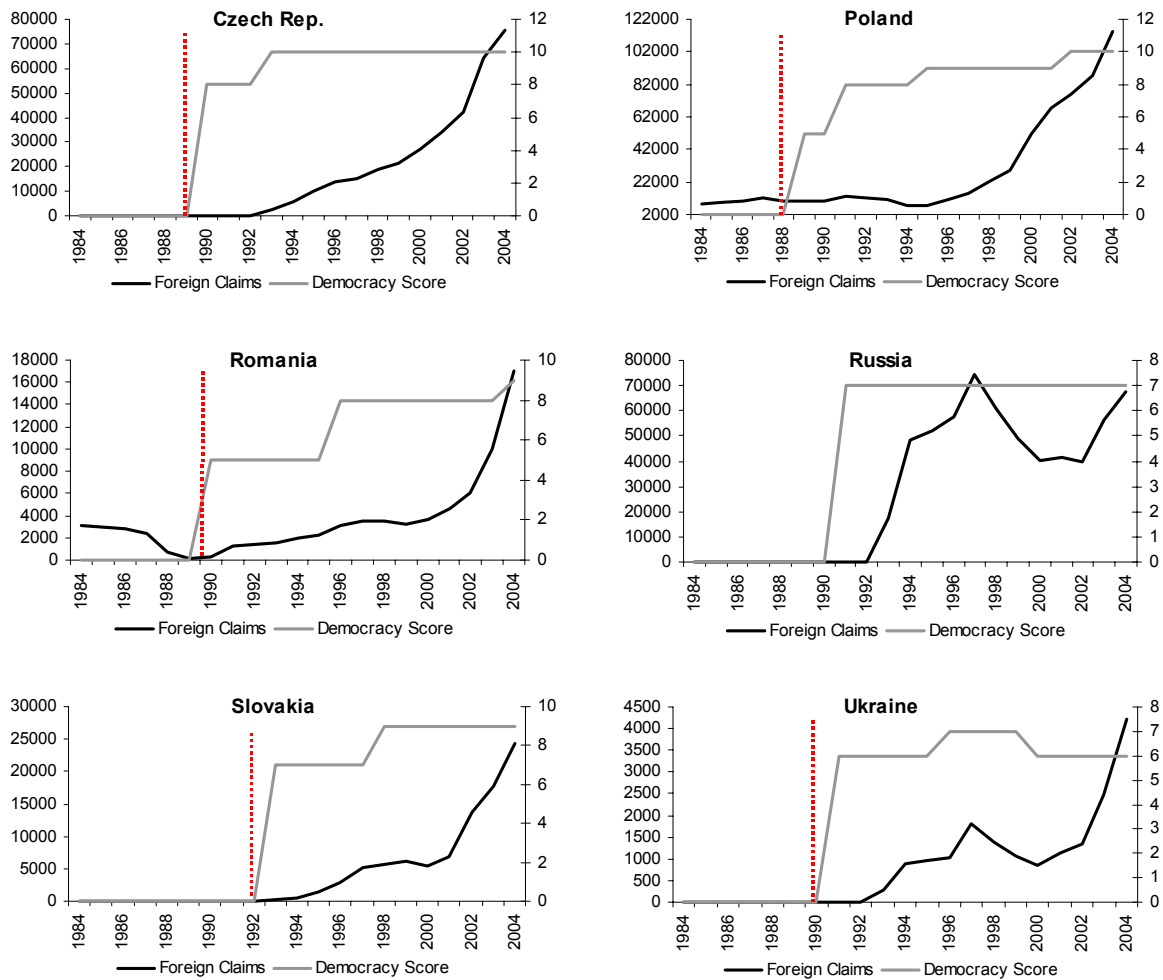
Source: Authors based on BIS data, 2006; Schmitter and Schneider (2004), Giavazzi and Tabellini (2004), IADB (2004) and Przeworski *et al.* (2000).

Figure 2. Foreign Claims (\$ millions) and Democracy Score Indicator (Latin America)



Source: Authors based on BIS data, 2006; Schmitter and Schneider (2004), Giavazzi and Tabellini (2004), IADB (2004) and Przeworski *et al.* (2000).

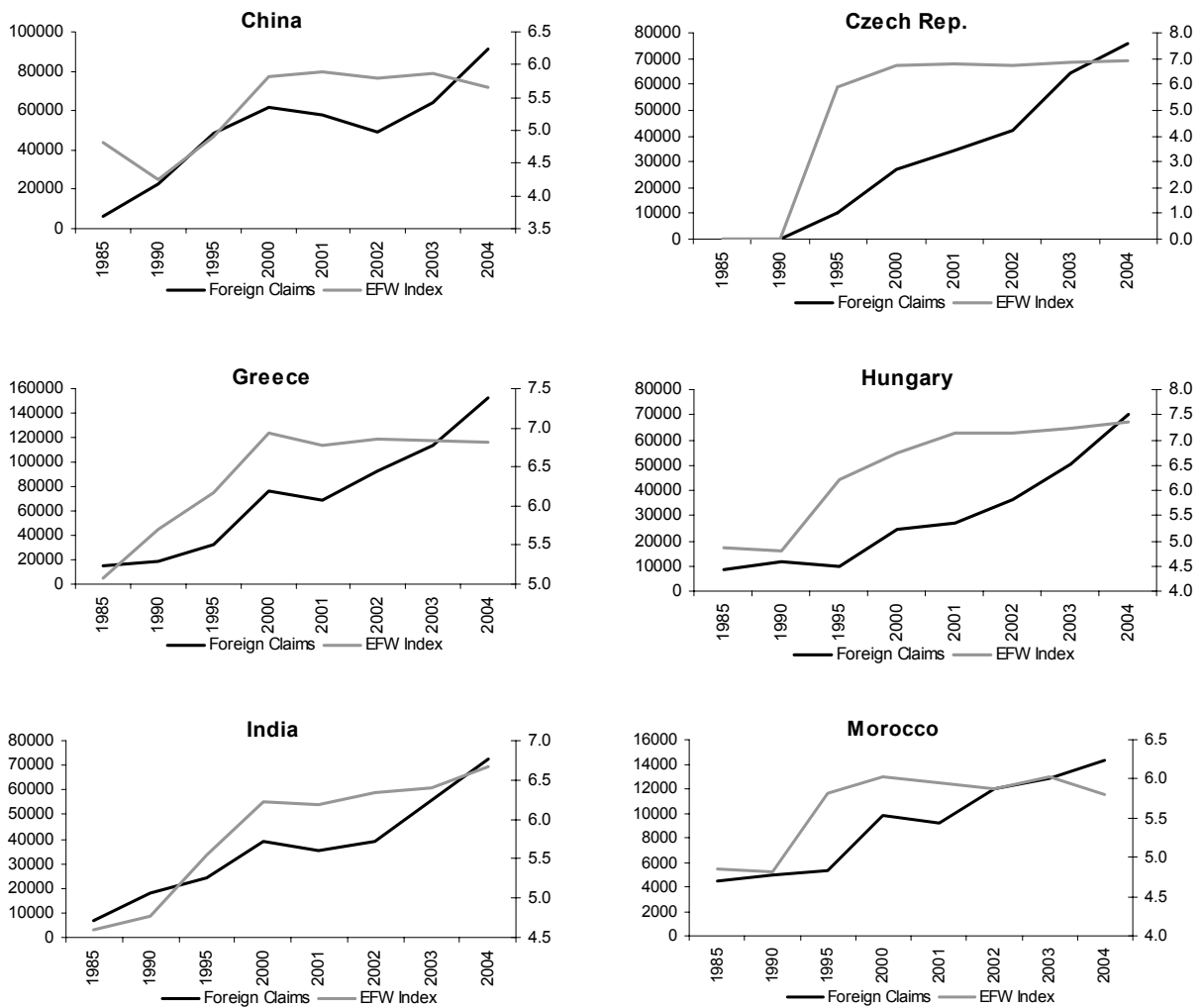
Figure 3. Foreign Claims (\$ millions) and Democracy Score Indicator for Other Countries

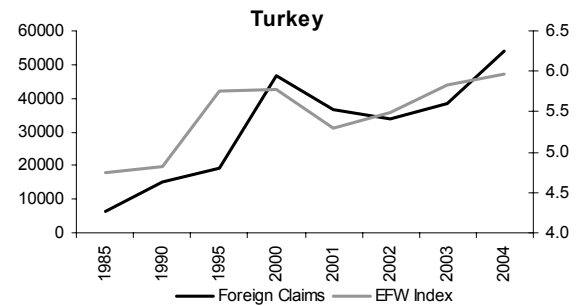
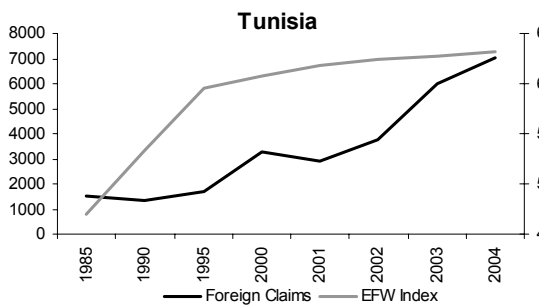
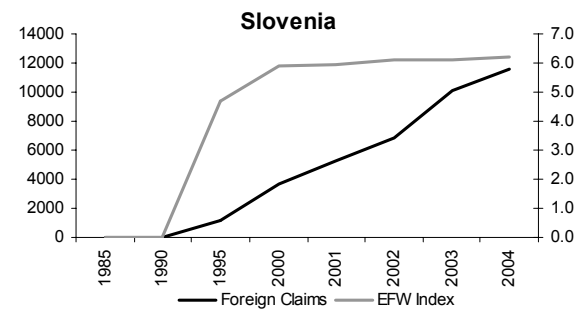
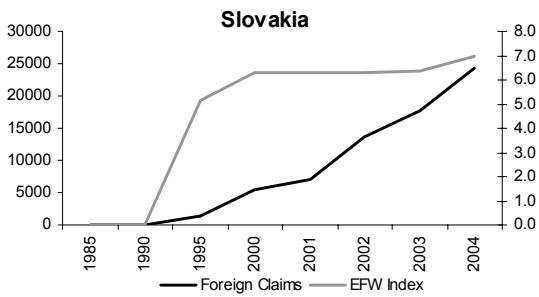
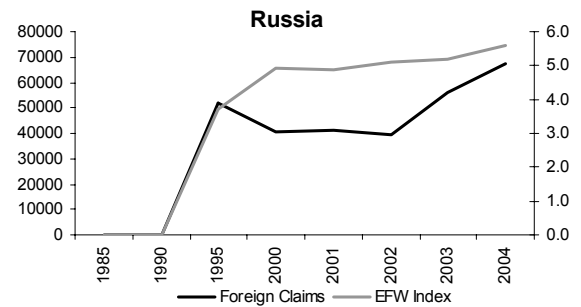
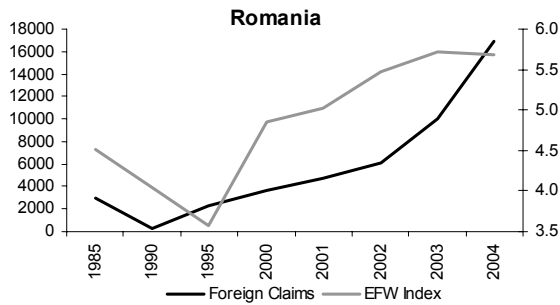
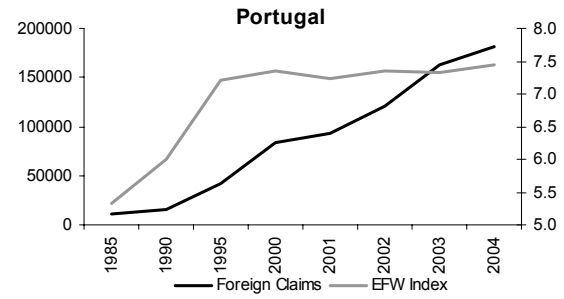
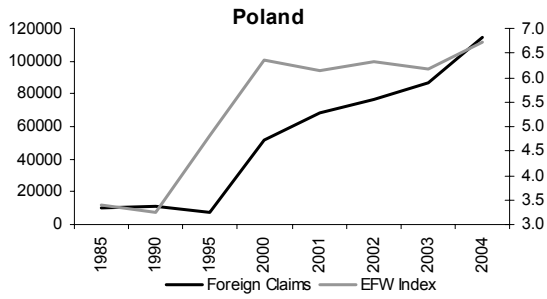


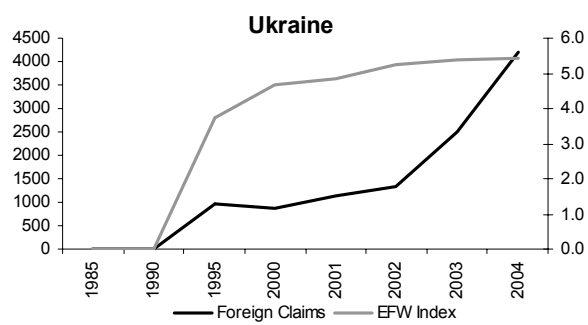
Source: Authors based on BIS, 2006; Schmitter and Schneider (2004), Giavazzi and Tabellini (2004), IADB (2004) and Przeworski *et al.* (2000).

APPENDIX 3. FOREIGN CLAIMS AND ECONOMIC POLICY STABILITY

Figure 1. Foreign Claims (\$ millions) and Economic Policy Stability Index for Other Countries







Source: Authors based on BIS and The Fraser Institute., 2006.

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