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2008

Online at <http://mpa.ub.uni-muenchen.de/12907/>
MPRA Paper No. 12907, posted 21. January 2009 / 12:48



Banking on Democracy: The Political Economy of International Private Bank Lending in Emerging Markets

JAVIER RODRÍGUEZ AND JAVIER SANTISO

ABSTRACT. Clearly, a new agenda is emerging for private international banks. Political issues such as human rights seem to be a current concern. But what about democracy? What about political regimes? Are they taken into account by private banks when they decide whether to invest in a country? Put another way, do private banks have democratic political preferences? In this article, we focus on cross-border lending from international bank(er)s. The questions asked are as follows. Do bank(er)s react positively (that is by increasing their lending) when an emerging democracy appears? Do we witness increased bank lending after democratic transitions? Lastly, is there any relation between democratic consolidation and bank lending?

Keywords: • Banks • Capital flows • Democracy • Emerging markets

Introduction

Wall Street and the City are starting to take a fresh look at emerging markets. During the 1990s, financial and economic variables dominated their analysis. In the 2000s, political, social, and ethical variables are becoming increasingly relevant.

Examples of this interest abound. Pension funds such as Calpers (a major US pension fund with more than US\$230 billion in assets under its management in 2007 and which started to invest in emerging markets by the beginning of the 2000s) are considering, when investing in emerging markets, nonfinancial criteria such as political stability, transparency, and labor rights (along with four other more traditional financial criteria). One of the effects of this approach has been an improvement in ratings, with the scores of the 27 countries included in Calpers' financial screening improving overall. Among them, Morocco, Malaysia, Sri Lanka, and Jordan, all of which were excluded from the list of countries suitable

DOI: 10.1177/0192512107085613 © 2008 International Political Science Association
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for investment in 2002, topped the list for country improvements in 2003. When excluded from foreign investment, emerging-market countries tend to improve their governance practices and standards in order to attract investment (Hebb and Wojcik, 2004).

Meanwhile, as in the case of asset managers, bankers also started to take into account other variables to assess their investment decisions around the world. In 2003, a leading group of global bankers launched the Equator Principles, an unprecedented initiative led by 10 of the world's largest banks to address the social and environmental impacts of the projects that they finance.¹ Since then, all the big names in project finance (41 in total by mid-2007) have signed up for this series of guidelines (based on those used by the International Finance Corporation, the World Bank's private financing arm) for assessing their project finance deals. Banks with such impeccably capitalist credentials as Citibank, BBVA, ABN Amro, and HSBC are all lining up to prove that their operations can measure up to sustainability goals. In 2006, a revised set of guidelines (Equator II) was approved, expanding requirements for labor conditions, community health, and safety and security.

Human rights issues, which in the past have mainly been a focus of industrial companies (Colonomos and Santiso, 2005), have also been increasingly scrutinized by the financial sector.² Because the banking sector is increasingly coming under scrutiny from nongovernmental organizations for its role in financial projects that might involve human rights issues, banks can no longer afford to be perceived to be complicit in ethical, social, and environmental abuses of their customers. Institutional investors, particularly those involved in active management and socially responsible funds, are asking more questions about political governance and human rights, with both issues being included in the agendas of bankers. Litigation risks have also been rising, as exemplified by claims for more than US\$100 billion faced in the USA in 2003 by more than 30 of the world's leading international banks and corporations for their role in supporting apartheid in South Africa. Over past years, the US lawyer Ed Flagan has also become famous for suing Swiss banks on behalf of Holocaust survivors.

All in all, we have been witnessing a proliferation of initiatives. These include the 160 financial institutions that are part of the UN Environment Programme Finance Initiative (UNEP FI),³ the 120 companies that developed specific statements on human rights (among them asset managers such as Aberdeen Asset Management, insurers such as AGF, and banks such as Barclays, Standard Chartered, and Citigroup), the 2300 business finance and noncommercial participants in the UN Global Compact, the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises, and many more.

At the same time, one after another, foreign banks are rushing toward China. Lured by the huge market size of China's agglomeration economy, foreign direct investment (FDI) has been running as high as US\$60 billion a year during the 2000s, bank(er)s being part of this rush toward the Chinese gold mine. Most mergers and acquisitions by foreigners have involved buying minority stakes in state firms, mainly China's banks. So far, China has collected more than US\$20 billion for stakes in banks, investment boutiques, and fund management companies.⁴ By mid-2007, a total of 74 foreign banks had branch operations and a further 186 had representative offices in China. All in all, foreign banks still represent a meager 2 percent of the Chinese market share (PricewaterhouseCoopers, 2007).

Clearly, a new agenda is emerging for private international banks. Political issues such as human rights seem to be a current concern. But what about democracy? What about political regimes? Are they taken into account by private banks when they decide whether to invest in a country? Put another way, do private banks have democratic political preferences? The Chinese rush might suggest a mixed answer. However, as we want to underline, it seems that bank(er)s tend to love democracies more than initially suspected, and particularly emerging ones.

Private capital movements have been on the rise over the past few decades and bank flows have been part of this story. Such capital movements have been considered both as a panacea and an anathema by academics and policymakers. Some empirical studies have been devoted to analyzing the political drivers of this international liquidity, but paradoxically, very few have been devoted to the political economy of banking. Hardly any research exists on the role of politics in explaining cross-border banking movements. In particular, the democratic preferences of bank(er)s are under-researched. We need to know more about bank(er)s' political preferences and the potential impact they can exert on both economic and political development.

A separate study is devoted to foreign direct investors, addressing the same question concerning political preferences (Neut and Santiso, 2008), and we have also dedicated another separate study to the political economy of portfolio investors (Nieto and Santiso, 2008), covering therefore the three major types of private capital flows: bank flows, FDI flows, and portfolio flows. In this article, we will focus only on a specific set of private flows: cross-border lending from international bank(er)s.⁵ The questions raised will also be narrower: do bank(er)s react positively (that is by increasing their lending) when an emerging democracy appears? Do we witness increased bank lending after democratic transitions? Lastly, is there any relation between democratic consolidation and bank lending?

The question is not therefore whether private bank(er)s prefer democracies worldwide, but whether they contribute to political development by lending to emerging democracies. The democratic preference of bank(er)s is in fact quickly assessed if we analyze banks' cross-border claims. By the end of 2005, the stock of cross-border claims of Bank for International Settlements-reporting banks was US\$21,450 billion. Of this total, the bulk was directed to developed, OECD economies, all of them democracies. Only US\$2396 billion went to emerging countries, therefore roughly less than 11 percent of the total goes to emerging-market economies, mostly to emerging democracies such as South Korea, Brazil, and Mexico. A country like China only concentrates a stock of US\$114.6 billion in cross-border bank claims, which is less than 0.53 percent of the world stock. Bank(er)s therefore seem to have a clear preference for concentrating their lending activities (by more than 99 percent) toward democracies.⁶

It is therefore more interesting to look at whether bank(er)s tend to prefer to lend to new emerging democracies. In other words, do they react to democratic transitions and are they sensitive, once the transition is achieved, to democratic consolidation? These questions are interesting from a theoretical point of view as a body of research has been devoted to the contribution of banking to economic development, but not to political development.

In the present article, we use a newly compiled set of indicators on democracy, political stability, and policy, certainty linking these datasets with those for international bank flows developed by the Bank for International Settlements (BIS).

This provides therefore an empirical investigation of the political economy of cross-border bank flows in emerging markets, contributing to the rapidly growing body of literature on the determinants of international private capital flows and the overall analysis of the political preferences of bankers regarding the issue of democracy.

The article proceeds as follows. First, we review the literature on the issue and develop a theoretical argument on why bank(er)s should prefer emerging democracies. Second, we underline the hypothesis and arguments regarding the potential preference of bank(er)s for emerging democracies. Subsequently, we focus on the empirical evidence concerning the political economy of bank flows in emerging markets in order to gauge if bankers have a political regime preference. We specifically discuss banking activity in Latin American countries (a region where democratic transitions have been very dense over past decades) and rival political hypotheses, such as the influence of policy instability. All in all, “banking on democracy” underlines the importance of bank(er)s not only in economic, but also in political development.⁷

The Political Economy of Private Bank Flows Toward Emerging Markets: A Review

Over the past few decades, private capital flows toward emerging economies have surged, far surpassing public, official flows. OECD-based banks invested in and acquired major banks in developing countries, boosting the share of foreign bank credit in total domestic credit, which jumped from less than 6 percent in South America, for example, to nearly 40 percent in 2005. US and Spanish banks have been the most active in developing countries among OECD-based financial institutions: between 1990 and 2003 they invested, respectively, US\$74 billion and US\$68 billion in developing countries, far ahead of UK (US\$38 billion), German (US\$34 billion), or French (US\$32 billion) banks (Goldberg, 2007).

The paradox is that, until recently, little empirical research has been devoted to analyzing what have been the drivers of this global private liquidity (Levy-Yeyati et al., 2003; Obstfeld, 1998; Obstfeld and Taylor, 2004; Santiso, 2003). This is true, in particular, of private international bank activity around the world (Sapienza, 2004). Even if we have surveys and empirical studies that examine the factors behind international banks' decisions to establish operations overseas, in particular in developing countries (Arena et al., 2006; Buch, 2003; Cerutti et al., 2007; Galindo et al., 2003; Levy-Yeyati and Micco, 2007; Moreno and Villar, 2006; Wezel, 2004), and on the economic determinants of cross-border claims (Buch and Lipponer, 2007), we lack studies focusing on the role of political variables and institutions that might explain private, cross-border bank movements.

Much more research has been devoted to the economic impact of private bank flows around the world. Recent empirical studies, for example, have emphasized that banking liquidity has a positive effect on economic growth. Other studies have highlighted that capital inflows are not risk-free assets and that, in particular, there is a strong relation between the volume of capital (bank flows included) and some recent financial crises characterized by sudden crashes and highly dollarized economies (Calvo et al., 2004; Eichengreen and Hausmann, 2005; Van Rijckeghem and Weder, 2003).

We know, however, that the institutional and political environment can strongly influence international capital transactions. There is growing interest by scholars regarding how strongly law and politics are key drivers of international private capital flows (Rajan and Zingales, 2003) and financial crises (Martínez and Santiso, 2003; Santiso, 2006; Stein and Streb, 2004; Whitehead, 2004). Both portfolio investments and foreign direct investments in emerging countries are sensitive to political variables (Neut and Santiso, 2008; Nieto and Santiso, 2008). Democratic transitions tend also to be followed by an increase in financial development (Huang, 2005).

The paradox of Lucas (1990) (that in theory capital should flow from rich to poor countries, but in practice we observe the reverse) has been explained as resulting from the quality (or lack of quality) of institutions. Empirical evidence for the period 1971–98, based on cross-country regressions using a sample of 50 countries, shows that the most important variable in explaining the paradox is institutional quality, as measured by the extent to which secure property rights and non-corrupt governments shape international capital flows (Alfaro et al., 2003). Good institutions and bad monetary policies are also important factors in explaining the high volatility of capital flows during this period (Alfaro et al., 2005). The quality of legal systems has a strong impact on financial development (Djankov et al., 2003; Mauro, 1995; Wei, 2000a, 2000b), and particularly on merger and acquisition activity (Rossi and Volpin, 2004) and project finance deals (Esty and Megginson, 2003).

Regarding FDI capital flows, empirical evidence suggests that political variables are important and that multinational firms prefer to invest in democracies (Harms and Ursprung, 2002; Jensen, 2003, 2006a, 2006b; Rodrik, 1996). In sharp contrast with official capital flows (official development assistance by western governments), which registered negative net flows to newly democratic regimes in the three years after transition, FDI private investors have significantly increased their investments in the three years following the shift to democratic rule in 23 countries since the mid-1970s (Pei and Lyon, 2003).

As regards the more direct impact on banking dynamics, politics also matter. Governments are not disinterested parties in financial systems. We know that the decision to privatize banks is highly political (Clarke et al., 2004) and that, in emerging economies, bank ownership (public versus private) matters for their performance – in other words, politics interfere in banking performance (Micco et al., 2005). In another recent empirical analysis, using quarterly data on gross, bilateral, private banking transactions from 19 “source” to 51 “recipient” countries from the mid-1980s until the early 2000s, it was highlighted that politics and institutions are key determinants of international private banking activities (Papaioannou, 2006). This research, including not only interbank loans, but also significant amounts of portfolio and foreign direct flows related to bank activity, shows that a fall of 5 percent in the political risk of the recipient country is accompanied by a 2 percent rise in the volume of bilateral bank lending. The results are quite impressive as they show that all forms of risk identified in previous studies, such as “economic,” “financial,” and “political” risk (Erb et al., 1996), are significant. But the most important of the three in explaining the drivers of foreign bank capital movements is “political risk” (Busse and Hefeker, 2007).

Other studies have emphasized 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, weaker protection of property rights, lower productivity, weaker bank performance, and low levels of financial development (La Porta et al., 2002). As suggested by García-Herrero and Martínez-Peria (2007), the claims of US, Spanish, and Italian banks in 90 countries tend to be sensitive to transaction costs (that is informational costs), but also to the role of 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 are in line with other studies that have emphasized economic and political determinants of foreign banking activity (Martínez-Peria et al., 2005).

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

Bank(er)s are not a homogenous category and their activities worldwide are quite diverse. Here we consider only private banks, and not multilateral development banks, which deserve a separate analysis.⁸ The BIS international banking database that we use only tracks private bank lending, not multilateral bank lending. We therefore limit the analysis here to private bank(er)s, focusing on a specific set of their activities (that is lending flows) for which there is a large and complete dataset available through the BIS. Banks are, in fact, very large entities and their activities range from bank lending to portfolio investments, through, for example, their fund management subsidiaries. Some are also involved in remittances business or insurance activities.

The present article focuses therefore on the lending activity of private international banks. It builds on the concepts and dataset developed by the Bank for International Settlements, focusing on BIS-reporting banks' cross-border activity. This institution monitors the foreign claims held by mostly OECD countries vis-a-vis the rest of the world. It is the most comprehensive data monitoring of international banking activity. Claims defined by the BIS are those extended by international banks to residents outside the country 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 allows one to study stocks or flows and claims or liabilities, and to differentiate by country (not, however, by public and private borrowers in a specific country). We centered the analysis on flows, that is on new claims rather than stocks, in order to test if international private banks tend to react positively or negatively to a democratic transition and, once democracy is achieved, if they tend to increase or decrease their lending activity with the consolidation of democracy. This question is particularly important as it will enable us to evaluate 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 the political development of emerging countries?

This question is even more relevant if we consider recent political and historical trends. Between 1980 and 2005 more than 80 countries took significant steps toward democracy, particularly in Latin America and Eastern Europe. For that reason, because we want to test if there is a democratic transition or consolidation effect on private bank lending, we pay special attention to Latin American and Eastern European countries where most of the democratic transitions have taken place over past decades.

In the case of Latin America, the number of countries that function as democracies (defined as regimes in which a government comes to and remains in power as the result of contested elections) peaked at more than 80 percent in 1989, and has remained at that level ever since. Regarding democracy, we also take into account the gray area that Guillermo O'Donnell (1992) labeled "delegative democracy," that is "democracies neither consolidated nor unconsolidated." Eastern European countries also experienced a massive shift in their political regimes, all of them becoming emerging democracies over the past two decades. Over the same period, private capital flows toward emerging markets skyrocketed. This is true in particular of private international banks, which have poured large amounts of money into emerging markets through their lending operations.

Bank(er)s' Preference for Emerging Democracies: Hypothesis and Arguments

Why, however, would bank(er)s prefer emerging democracies? In other words, why would emerging democracies be good business for bank(er)s? We examine this question from the point of view of key policies for bankers, such as fiscal policy, monetary policy, and trade policy. We also take into account, more generally, other variables that have been identified as key drivers of banking activity and entry into countries, such as privatization and growth, and we have centered our attention on young democracies.

Let us look first at key policies such as fiscal, monetary, and trade policies. Empirical research on the relationship between democracy and fiscal policy is complex. Democratically elected politicians are supposed to be prone to seeking to minimize taxation and maximize 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). Other studies (Converse and Kapstein, 2006; Keefer, 2005; Tavaré and Wacziarg, 2001) tend, however, to indicate that young democracies exhibit initial increases in public spending with current expenditure picking up in particular in election years (while it is followed later by a long-term decline). Brender and Drazen (2005) find also that political budget cycles are strongly (and only) present in newly democratized countries. In a sample of 68 democracies from 1960 to 2001, the traces of a political budget cycle are particularly present in the first four elections following democratization. In other words, financial needs from emerging democracies 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 bank(er)s.

Let us turn to monetary policy. Given its importance to the economic well-being of banks, it is also interesting to question whether young democracies also present a specific pattern in this regard. Several studies underline that democratic institutions tend to enhance the quality of monetary policymaking. Young democracies tend to perform quite impressively in terms of inflation: from an average of 125 percent in the year of the democratic transition, consumer prices reach levels of around 50 percent, on average, in four years. This pattern is not, however, uniform among regions (Converse and Kapstein, 2006). In Latin America, where hyperinflation processes have been very damaging, levels of inflation, while reduced, have been left very high four years after the democratic transition: on average they reach levels of 390 percent in the year of the transition and 123 percent four years later, which is still a high and damaging level for bank(er)s. That said, if we only focus on the major recipients of bank lending, in other words the major countries of the region, we come back to the more general trend. In countries such as Mexico, Brazil, and Argentina, the reductions of levels of inflation have been dramatic in the years following democratic transition and above all after democratic consolidations, helping to set a friendly market environment for bank(er)s.

Trade policy is also another channel leading to more banking activity, and particularly to increased lending operations through trade finance deals and export credit operations. Several studies corroborate that democracies tend to increase trade openness, Milner and Kubota (2005) showing, for example, that higher levels of democracy are associated with more liberal trade regimes, this being particularly true in newer developing-world democracies. These findings are also consistent with other studies showing that a greater degree of democracy is significantly associated with a greater trade-to-GDP ratio. Converse and Kapstein (2006) also underlined in their 114 cases of democratization between 1960 and 2003 that trade ratios in terms of GDP tend to increase by nearly 10 points in the three years following a democratic transition, jumping from an average of 59 percent of GDP in the year of transition to 69 percent of GDP three years later.⁹

In terms of privatization, young democracies tend to favor increasing banking activity. Privatization operations are highly attractive for banks, implying high fees for those involved as advisers and also, in terms of credit, lucrative lending operations in order to finance the takeovers by private operators. Several empirical studies document that democracy is substantially and significantly associated with the extent of privatization.¹⁰ Democracies privatize more than non-democracies and young democracies engage in heavy privatization programs in order to cash in resources to meet increasing social demands. Privatization programs have been particularly intensive in Latin America and Eastern Europe. Latin America, for example, accounted for 55 percent of total privatization revenues in the developing world in the 1990s, the proceeds reaching nearly US\$180,000 billion (Chong and López de Silanes, 2004).

All policies examined (mainly fiscal and trade) tended to support greater bank lending activity in emerging democracies. The results are more mixed for monetary policies. Young democracies also tend to grow at higher rates in the first years following their transition, as shown by Rodrik and Wacziarg (2005), who underlined, with an extensive empirical sample of 154 countries, that the first five years following democratic transition are significantly associated with higher economic growth and with lower variance in growth rates.

From the point of view of economic growth, however, the answer might not be as clear as it appears at first sight. Some scholars have questioned “development”

theories, arguing that democracy has a slight, questionable, and statistically insignificant effect on economic growth (Przeworski et al., 2000).¹¹ The literature is also divided regarding the effects of democratic transition on economic development (Boix, 2003; Boix and Stokes, 2003; Przeworski, 2004b). Interestingly, Feng (2003) shows that the effect of democracy on growth is statistically insignificant, but he also finds that the degree of political democracy has a significant impact on private investment: a reduction in political instability and policy uncertainty has a positive impact on the economy.

Others have established a strong link between democracy and growth and between the quality of institutions and long-term growth (Persson, 2004; Persson and Tabellini, 2003, 2005; Rigobón and Rodrik, 2005). Moreover, growth under democracy appears to be more stable than under authoritarian regimes. Dani Rodrik and Romain Wacziarg's (2005) research also reveals that major democratic transitions had positive effects on economic growth in the short run and tend to be associated with a decline in growth volatility. Papaioannou and Siourounis arrive at a similar conclusion by analyzing the evolution of GDP growth before and after permanent democratization in the period 1960–2000. According to their estimates, democratization, on average, leads to an approximate increase of 0.7–1.0 percent in real per capita growth. Democratization is associated not only with higher growth, but also less volatile rates of growth (Papaioannou and Siourounis, 2005), confirming previous findings that democratic societies experience less volatile growth rates (Rodrik, 1997, 1999). Democratization has the strongest impact on growth volatility in highly unstable countries such as those in Latin America.

Decisive research, underlining that democratizations induce accelerations of growth (and are therefore good for banking business), has also been conducted by Torsten Persson and Guido Tabellini (2004). Drawing on previous and complementary research and considering different forms of democracy, they show empirically that becoming a democracy accelerates growth by 0.75 percentage points (Persson, 2004; Persson and Tabellini, 2003). The findings are based on a large sample of about 150 countries, include 120 regime changes over the period 1960–2000, and are consistent with previous studies (Papaioannou and Siourounis, 2004). An interesting result achieved by Persson and Tabellini is that new presidential democracies grow on average 1.5 percentage points more than new parliamentary democracies. This is particularly interesting for Latin American countries, where presidential regimes dominate. In a later work, they also find an average negative effect on growth of leaving democracy in the order of –2 percentage points (Persson and Tabellini, 2007).

There are therefore strong economic arguments, already tested empirically, that would help to explain a potential political preference for emerging democracies by bank(er)s. The empirical test of this preference remains, however, an open question. Is there empirical evidence to support a positive answer to the question: do bank(er)s tend to prefer emerging democracies?

Bank(er)s and Emerging Democracies

Proximity and cultural factors seem to be some of the variables behind trends in bank flows (Rodríguez and Santiso, 2007b). GDP, population, surface area in square kilometers, interest rates, and even the level of corruption of the country in question are some of the other key drivers of bank flows (Papaioannou, 2006).

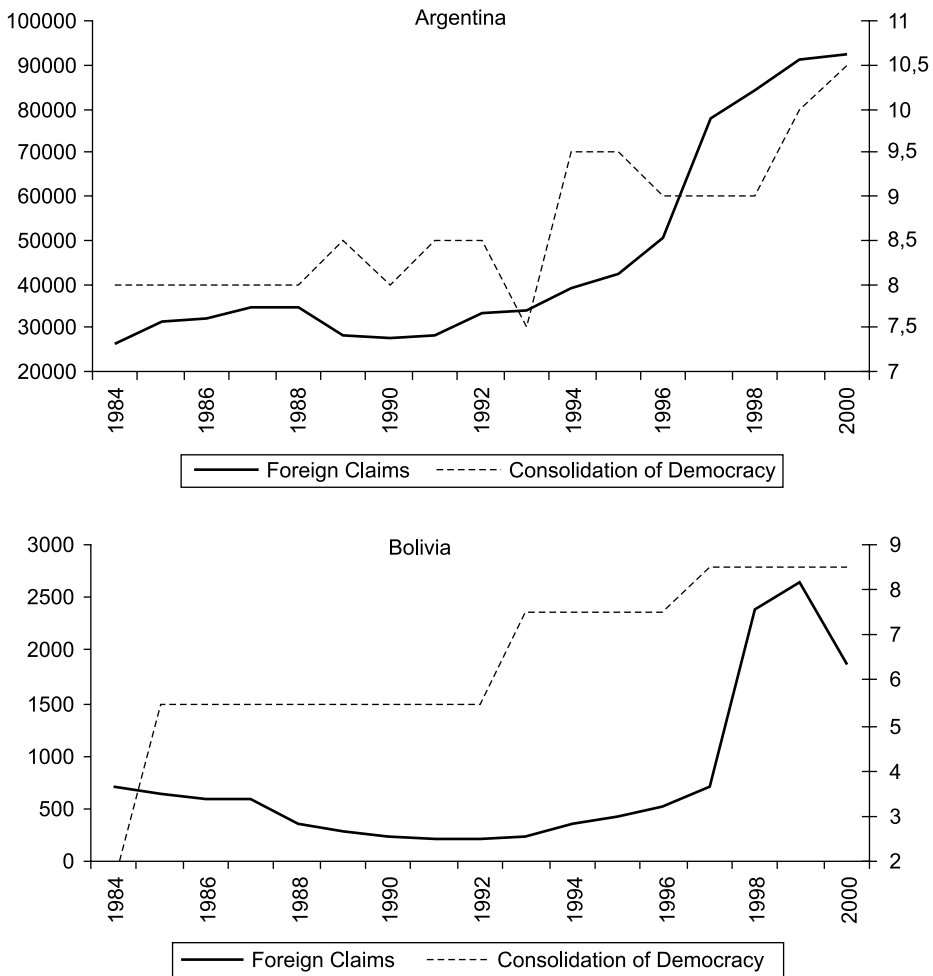
This section, and the article as a whole, does not focus on these variables, but on determining if political factors make some difference in the granting of international bank financing. In order to do so, we have studied different variables, such as the democratic transition year, the level of democratization of an emerging economy, the stability of economic policy, the political stability of ministries, and the differences between different presidencies in different emerging countries.

As highlighted by many researchers, a number of different methodological issues are raised when we consider the analysis of democratization and private bank flows. The availability of data is one issue, as well as the measures used to gather data. Most of the datasets present weaknesses with respect to the availability of items, but more importantly, the hypothesis, concepts, and definitions behind each dataset are open to question. One important issue regards causality. In simple terms, private bank money may flow toward emerging democracies mostly because economic windows of opportunity such as privatizations have suddenly opened. Banks rush toward emerging democracies not because they are democracies, but because they are emerging economies that have privatized their banking assets.

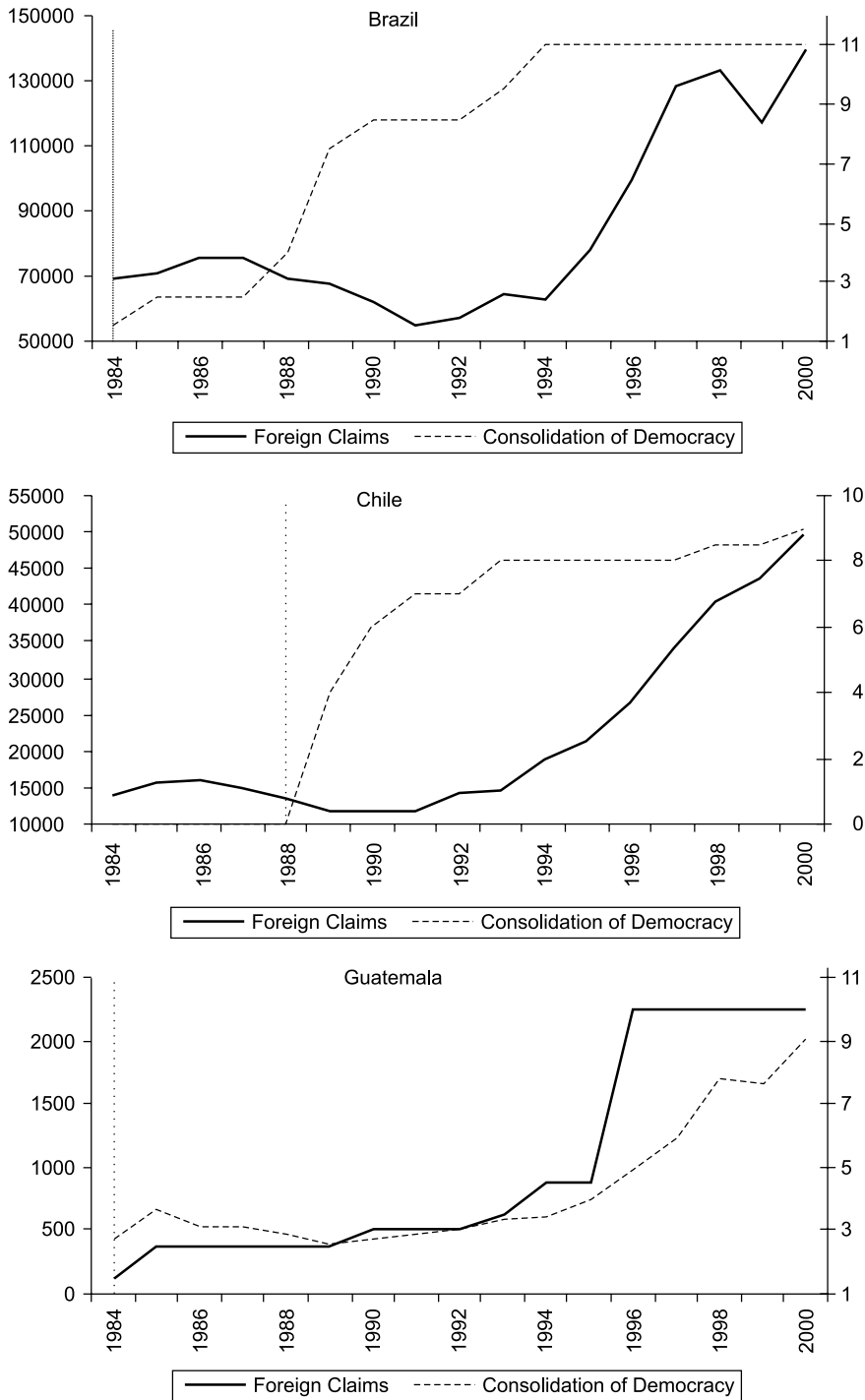
It happens to be the case that democracies (at least in Latin America) had during the last decades of the 20th century a strong propensity to privatize. Democracies tend to prefer to privatize assets fully while autocracies tend to maintain control over their economies. In the end, as highlighted by Giavazzi and Tabellini (2004), political and economic liberalization have been closely connected. Economic and political liberalization feed off each other, so that it is difficult to tell in which direction the causality runs. Analysis of the timing of different events tends, however, to indicate that the causality is more likely to run from political to economic reforms. Democratization appears to lead to economic liberalization, with the extent of economic liberalization gradually increasing in the years following the transition to democracy. This would suggest that political liberalization induces economic liberalization to a far greater extent than the other way around. This is true in particular for Latin American countries, where in most cases political liberalization took place before bank privatization.

As a first approach to the question of whether bankers prefer democracy in emerging markets, we analyzed the correlation between the BIS data series and other political databases, using the standard classification of democracy of Przeworski et al. (2000).¹² We have chosen two series that indicate the level of democratization of an economy. The first indicator is called "Consolidation of Democracy" and was formulated by Schmitter and Schneider (2004) (used for the series of graphs shown in Figure 1 below). This indicator measures the extent to which democracy consolidates itself in a country. We have used the yearly figures for a series of countries. The greater the value of the consolidation indicator, the stronger democracy is rooted in the country. The second indicator is one that is more commonly used in the economic literature, namely the "Democracy Score" formulated by Polity IV (used for the series of graphs shown in Figure 2 below). This indicator is a measure of the existing level of democracy of a given country. We have also used an annual series here, but in this case the value of the indicator ranges from zero to 10 (proximity to 10 means a greater level of democratization, and vice versa). Both series of indicators are used in order to check the accuracy of our results with two different measures of democratic transition and consolidation.

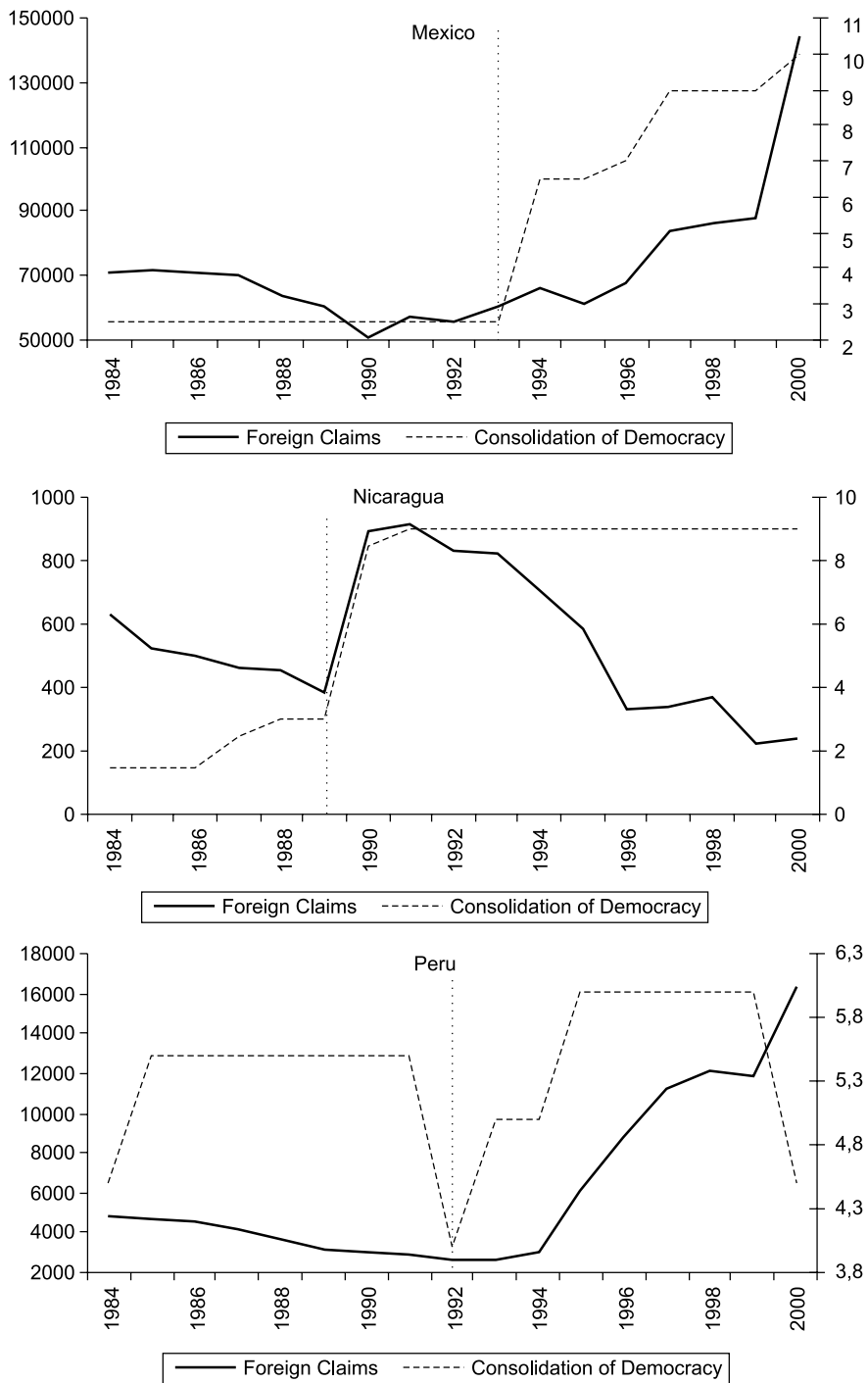
We have also made use of the years in which democratic transition has taken place over the past few decades in different countries in order to gauge whether banking flows increased after transition. The figures were obtained using empirical research developed by Giavazzi and Tabellini (2004) and Carrillo et al. (2003), as well as the Przeworski et al. (2000) series. In line with Persson (2004), Persson and Tabellini (2003), and a large body of literature on the topic, we define a country as a democracy if it has strictly positive values for the POLITY2 indicator in the Polity IV database. In line with Giavazzi and Tabellini (2004), we refer to democratization as an event in which a country becomes a democracy when this was not the case in the previous year. We have verified and cross-checked the Giavazzi and Tabellini timing with the one developed by the Inter-American Development Bank (IADB) in 2004 for Latin America and the overall one developed by Przeworski et al. (2000).



(FIGURE 1 continued)



(FIGURE 1 continued)



(FIGURE 1 continued)

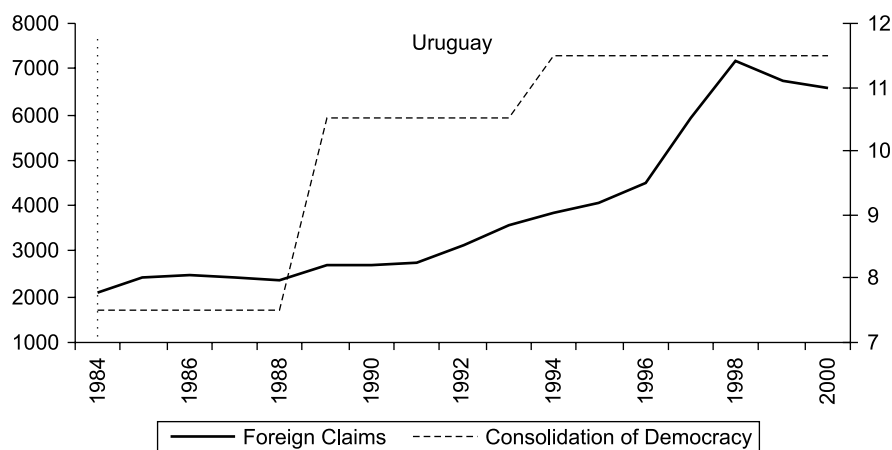


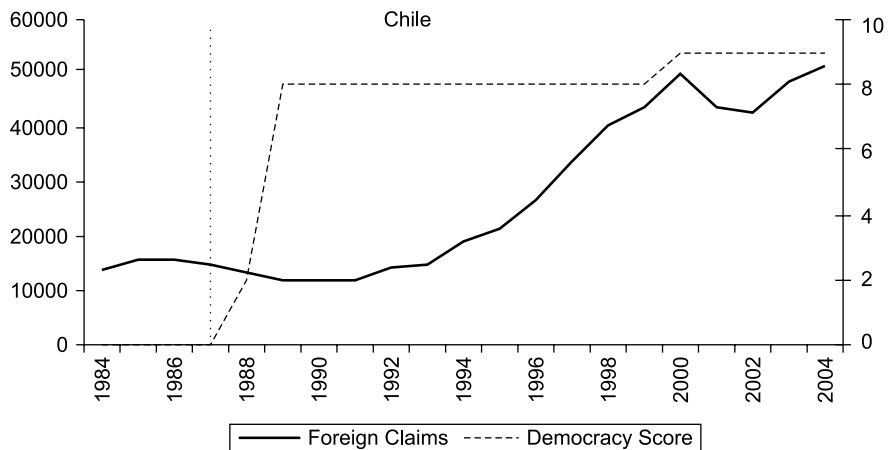
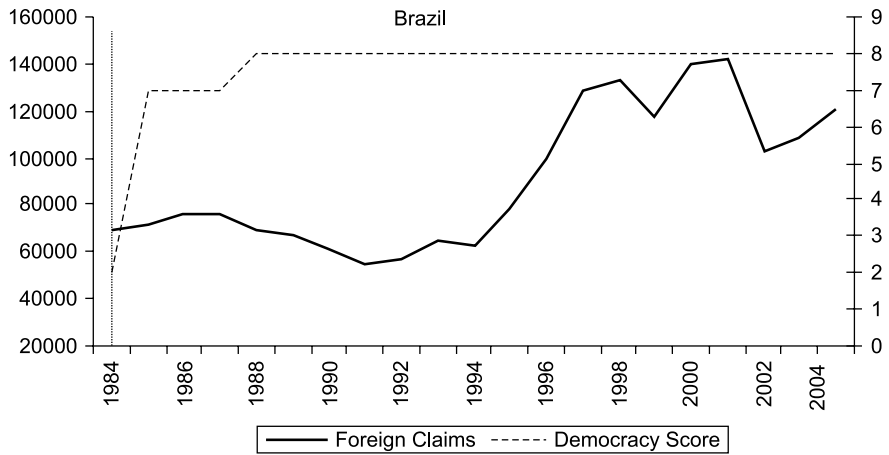
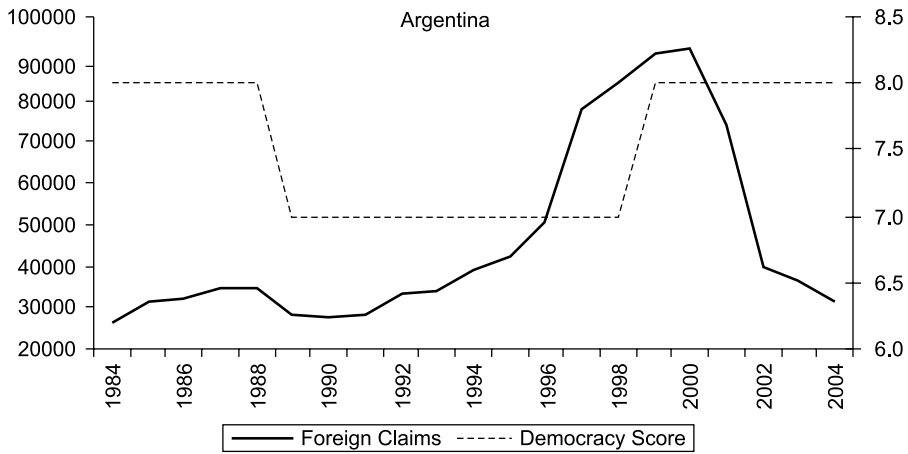
FIGURE 1. *Foreign Claims (millions USD) and Consolidation of Democracy Indicator*

Source: Authors, 2007; based on BIS, for private bank flows; Schmitter and Schneider (2004), Giavazzi and Tabellini (2004), IADB (2004) and Przeworski et al. (2000) for political indicators.

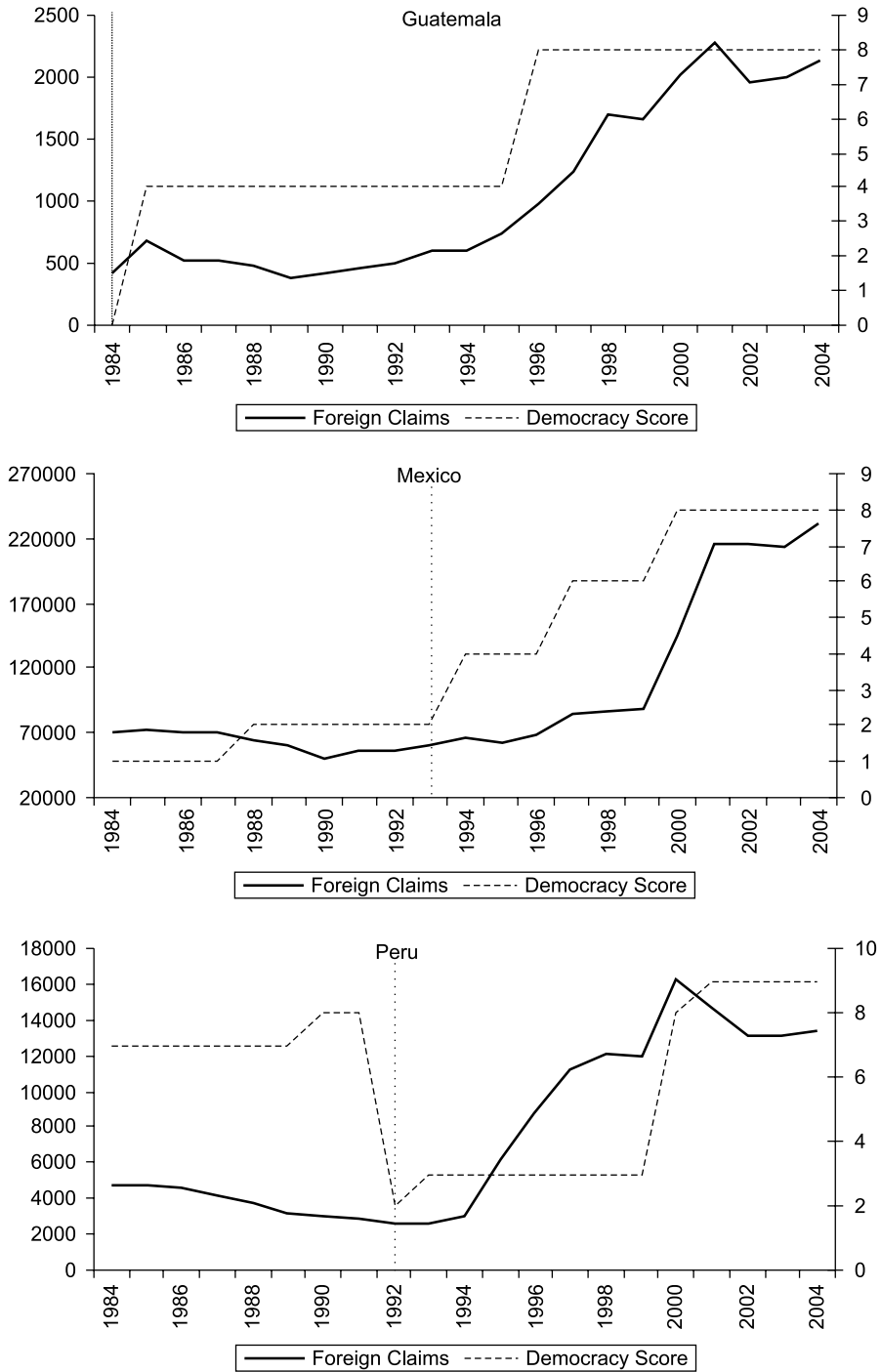
The graphical analysis of foreign claims by country, in combination with the democracy indicators, shows a common pattern for countries and indicators. Bank lending tends to increase after a democratic transition. An increase in the democracy indicators has a positive impact on the entry of private foreign claims, although in some countries there is a lag of two or three years. The graphs in Figure 1 show the relationship between the two series. Because of lack of space we only reproduce the Latin American examples, where the pattern is particularly relevant. Latin America is one of the regions in the world that has experienced the most impressive democratic transitions over the past decade, along with Eastern Europe (where the relation also looks strong¹³). In addition, in some cases a vertical line has been added in order to show the year in which the transition took place in the country in question.

Next, we take those countries for which we have data available and which have undergone a democratic transition (mostly Latin American and Eastern European countries). We examine how the democratic transition affects the country's private bank inflows. Taking the year of transition as $t = 0$ for all countries, we observe the growth rate of banking flows before and after the transition in each country. The results are striking.

Before democratic transition, the annual growth of flows in the three previous years has a mean equal to 1.04 percent (at a global level). After transition, the entry of banking flows in the following three years accelerates, growing at an average of 4.37 percent. For Latin American countries alone, the study concludes that in the three years prior to transition the annual average growth rate was negative, at -1.53 percent, and stood at 4.28 percent for the three years after democratic transition. Clearly, at least in Latin America, bankers tend to love new, emerging democracies, increasing their lending to this type of borrower. A transition toward democracy tends to favor foreign bank inflows. The other side of this coin is



(FIGURE 2 continued)



(FIGURE 2 continued)

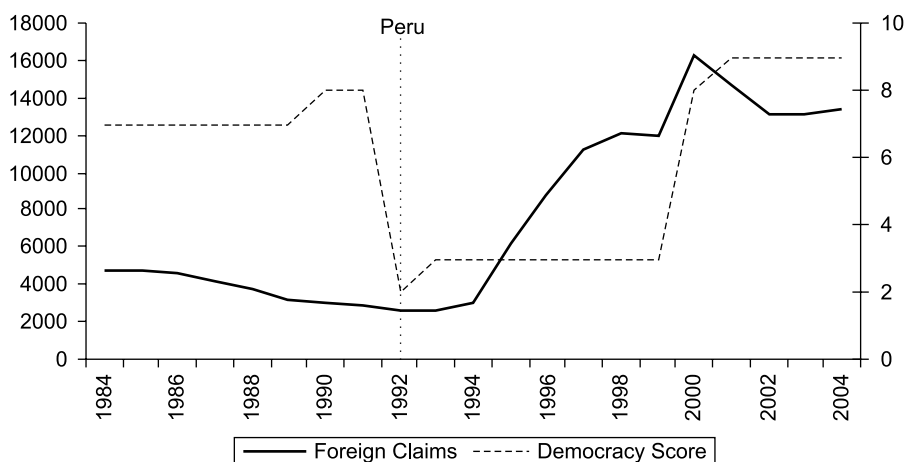


FIGURE 2. *Foreign Claims (millions USD) and Democracy Score Indicator (Latin America)*

Source: Authors, 2007; based on BIS; Schmitter and Schneider (2004), Giavazzi and Tabellini (2004), IADB (2004) and Przeworski et al. (2000).

that emerging borrowers seem to have had easier access to foreign, private bank lending once they became democracies.

Banks and Policy Instability in Emerging Democracies

Bankers tend, therefore, to prefer lending to emerging democracies and their lending consolidates as democracy also consolidates. In this section, we shift the focus of our analysis away from *political regimes* to *policy stability* in order to gauge whether bankers prefer policy stability. In other words, we want to test if the above-mentioned democratic preference does not mask a preference for political stability.

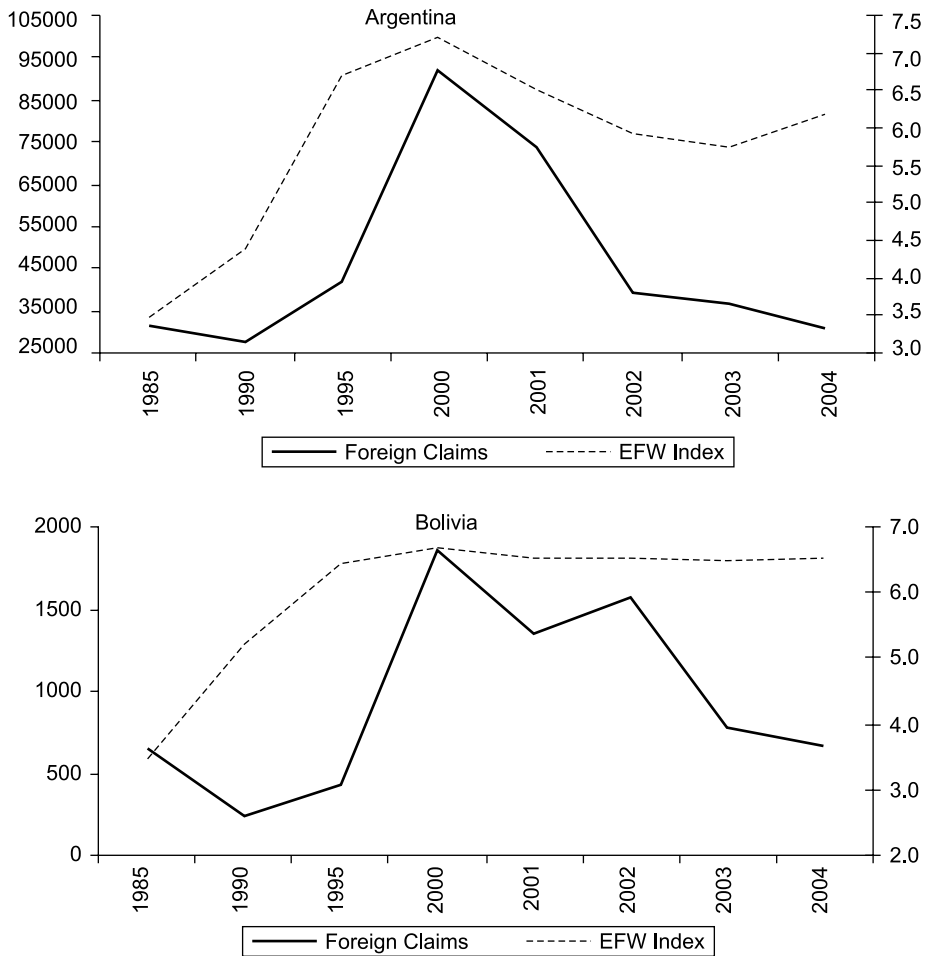
The common and generalized perception is that bankers tend to be averse to risk and that they avoid politically unstable countries for generally good reasons, since instability has a negative impact on the economy of a country, particularly on growth, debt levels, fiscal deficits, and on inflation rates. As previously indicated, in their core decision-making process on political risk, banks tend to be put off by political instability in general, as this increases policy instability, which in turn impacts negatively on growth and discourages private investment. However, they do not seem sensitive to all kinds of instability. In particular, they tend to be somewhat neutral to democratic political instability. In spite of *democratic* political instability, they have continued to invest in Latin America's emerging democracies.

Latin America is known to be one of the most politically unstable areas in the world. Between 1945 and 2000 there were around 160 occurrences of regime transition, that is shifts from non-democracies toward democracies and vice versa. While Latin America accounts for less than 10 percent of the countries in the world, it accounted for more than 35 percent of regimes undergoing transition over that period. In other words, Latin American countries experienced on average three

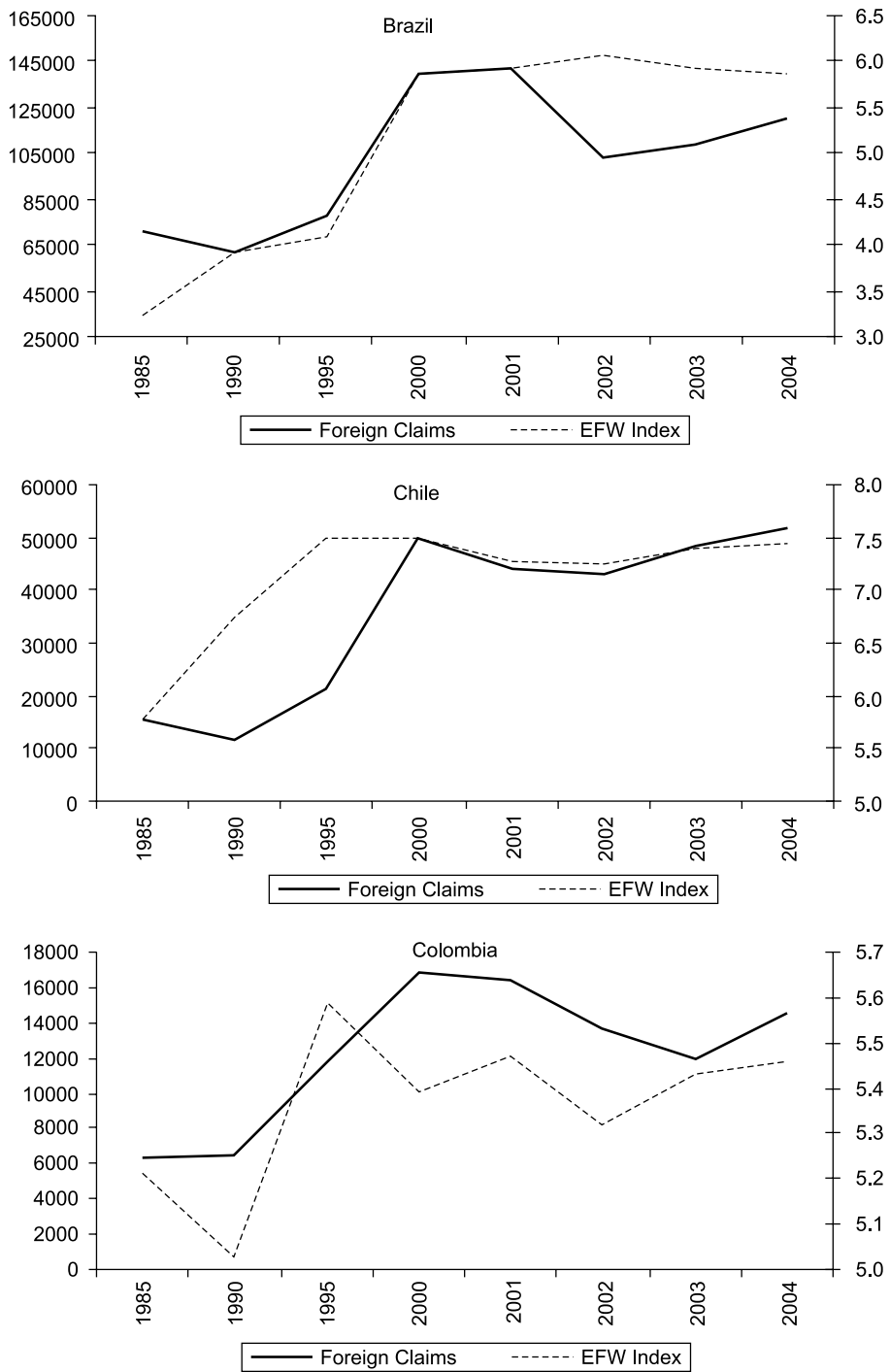
regime transitions during that period, while South Asian countries, in comparison, had 1.4 transitions per country during the same period (Cheibub, 2003).

Latin American democracies have tended to stabilize over past decades. In order to capture policy instability, we constructed what we call an “Economic Policy Stability Index.” The index draws on the Fraser Institute’s 2006 Economic Freedom of the World Index (EFW Index). A graphical analysis of foreign claims by country, together with the Economic Policy Stability Index, shows a strong relationship between both series. The greater the stability of an economy, the higher the amount of foreign claim inflows.¹⁴

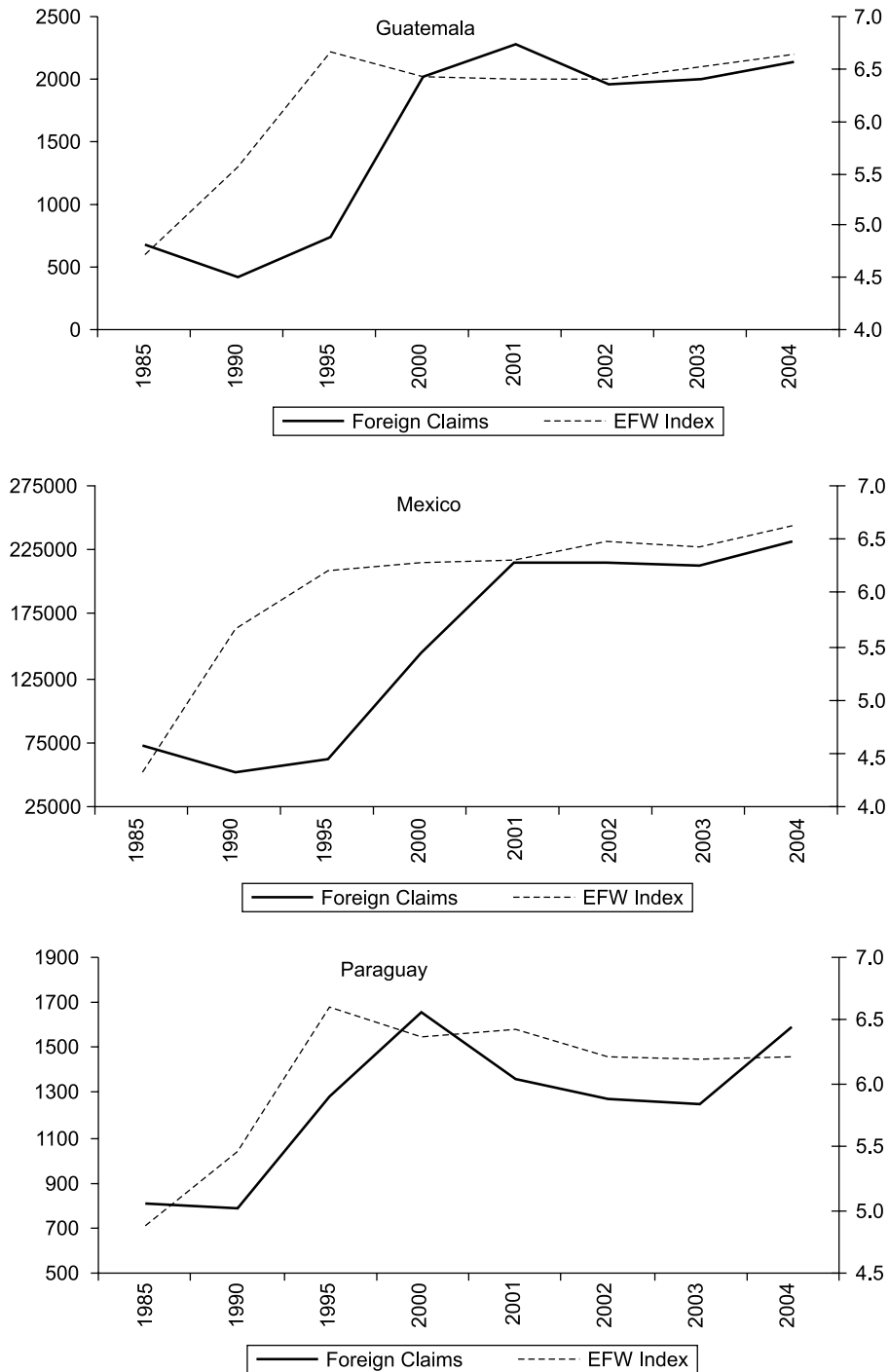
Contrary to the case with regard to democracy, in which the “possible” effect on foreign claims was observed mainly after abrupt changes in the indicator (as in the case of transition), bank flows are more sensitive to political stability. That is to say, less abrupt changes in the index also have effects on flows. In continuation,



(FIGURE 3 continued)



(FIGURE 3 continued)



(FIGURE 3 continued)

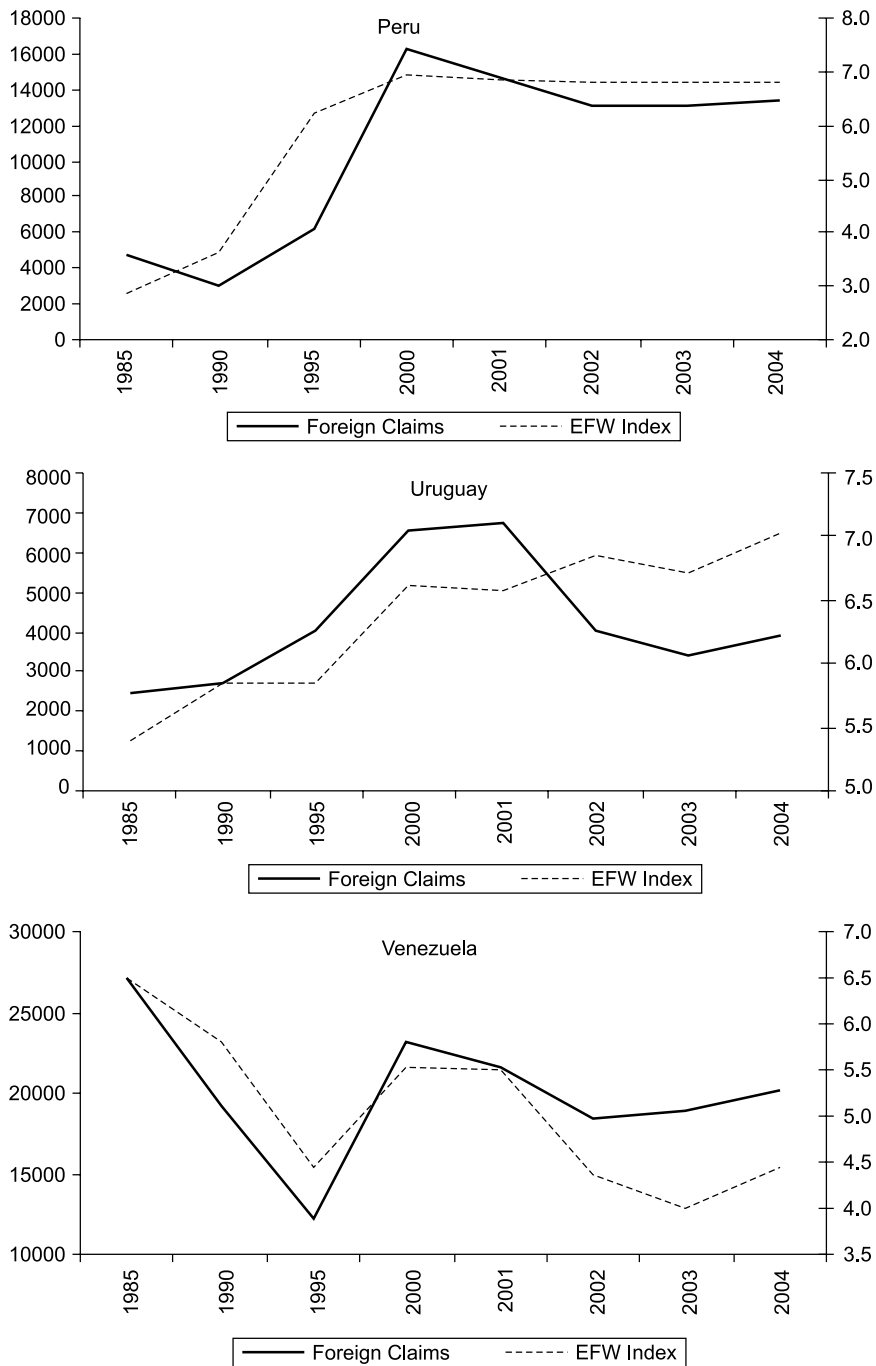


FIGURE 3. *Foreign Claims (millions USD) and Economic Policy Stability Index in Latin America*
 Source: Authors, 2007; based on BIS and The Fraser Institute, 2006.

correlations of the indicators of democracy and the Economic Policy Stability Index with respect to foreign claims are shown in Table 1. As has already been seen in the graphs above, in general terms the correlations are high with the stability index and lower with the democracy indicators (due to the effects on the series commented on in the previous paragraph). These have been made for each of the 30 countries included in the database for the period for which data is

TABLE 1. *Correlations of Foreign Claims with Economic Policy Stability Index, Consolidation of Democracy Index and Democracy Score*

	Correlations		
	Foreign Claims vs EFW 1985–2004	Foreign Claims vs CoD 1984–2000	Foreign Claims vs DS 1984–2000
	Russia	0.92	0.90
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
Grecia	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.

available. Algeria presents an exceptional case in which not only is the result not confirmed, but the greater the degree of economic policy stability, the smaller the amount of inflows.

In order to complete the analysis of the banking preference for policy stability, we also analyze the possible relationship between bank lending and the stability of ministerial and gubernatorial office. In other words, we tackle the question of whether bank flows are affected by political instability in emerging democracies.

We have seen previously that banks have tended to boost their activity in Latin America over past decades, increasing their lending after the return of democracy in spite of the long track record of political instability in the region. Political *regime* instability has almost disappeared since the third wave of democratization, in the sense that we have not witnessed any major democratic breakdown in the region. This is in contrast 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 past half century alone and nearly one per year from the 1800s to the 1970s). However, this does not mean that political instability has disappeared. Regular events such as elections, cabinet reshuffles, and political crises still remain. What impact, therefore, does *democratic instability*, that is political change within a democratic regime, have on bank flows?

We have measured democratic political instability in terms of cabinet turnover, that is changes in the composition of a cabinet within a government's lifetime (Huber and Martínez-Gallardo, 2003). For a measure of democratic political instability, we used a dataset developed by Martínez-Gallardo which records all the changes in the composition of cabinets in seven Latin American countries between 1988 and 2000. Cabinet changes include both terminations, that is ministers who resign from their post in the cabinet and take up work elsewhere, and reshuffles, whereby ministers are moved from one portfolio to another. All such changes take place, therefore, *within* the rules of the democratic game.

We would expect that changes in ministerial tenures should have some impact on bank flows, to the extent that these could affect the quality of democratic policymaking and the performance of governments. The results confirm that ministerial cabinets are consistently more stable under situations of higher growth rates. They are more stable where the environment for law and order is more stable. Cabinet changes are, in one way or another, a political response to a shock. Ministers may be changed due to shifts in presidential strategy, opposition pressure, or an exogenous shock such as a financial crisis. After the 1994 devaluation in Mexico, for example, President Zedillo replaced his minister of finance with another cabinet member in an (unsuccessful) effort to overcome the crisis (Santiso, 1999).

Bankers seem indifferent as to whether center, left-wing, or right-wing governments are in power and whether they have an absolute majority or operate in coalition with other parties. It is even more interesting to note that when we consider political instability as measured by cabinet turnover, bankers also seem to be indifferent. 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. In other words, bank flows do not seem to be sensitive to ministerial turnover as measured by the amount of time ministers spend in office.

TABLE 2. 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
Paraguay	Wasmosy	<i>1993Mar-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/Jun-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).

In order to control all our results quantitatively, we carried out an econometric exercise to check the determinants of bank flows. There are several empirical studies that analyze the determinants of bank flows (for a survey, see Papaioannou, 2006). Our purpose here is, however, more simple: to verify the previous findings for political variables using another tool.

The analysis of the determinants of bank flows was made by means of an econometric analysis of panel data. We have a panel of annual data on 29 countries for the period 1984–2004. We use the following variables to explain the determinants of bank flows: GDP, population, human capital proxies, interest rates, a “Consolidation of Democracy” (CoD) indicator, a “Democracy Score” (DS) indicator, an “Economic Policy Stability” indicator, ministerial stability, and the composition of governments.

TABLE 3. *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
	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.

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

*Significance at the 5% level.

Sources: Authors, 2007; based on IMF, World Bank, The Fraser Institute, Polity IV, and Schmitter and Schneider.

The results show how foreign claims, apart from depending on GDP and on the population of an economy, are positively correlated to the level of democratization in the recipient country. The results with respect to the democracy variable are confirmed, first, by using the CoD indicator and, second, with the DS indicator. The Economic Policy Stability indicator (using the EFW) also influences the inflows of finance to a country (the results are less trustworthy due to the fact that the EFW data are only available every five years between 1985–2000, which means a smaller pool of information).

A country receives more finance when its gross domestic product increases, its population is higher, when more finance was received the previous year, and when it has higher levels of democratization and more economic policy stability. Here again, using this econometric verification, ministerial stability and the composition of governments or banks do not appear to be determinant factors, nor do interest rates or human capital.

Conclusions

Bank(er)s seem, therefore, willing to increase their lending operations to newly emerging democracies. They also tend to prefer emerging democracies where policies are stable and seem indifferent to political instability as defined by ministerial turnover. In regions such as Latin America, where democratic transitions have multiplied over the past two decades, the preference for emerging democracies is particularly striking, as cross-border bank lending tends to rise in the years following the breakdown of authoritarianism.

From an economic point of view, as we have underlined, we can understand why international bank(er)s might be right in preferring emerging democracies. There are solid economic reasons to explain why bank(er)s prefer emerging democracies, with fiscal and monetary policies or institutional quality in emerging democracies being favorable to the banking business. However, we might highlight that the answer may lie not only in economic considerations, but also in ethical ones. Bank(er)s might be right to prefer lending to emerging democracies not only because it is *good* business, in economic terms, but also from the point of view of ethics. Lending to emerging democracies may be no more than a pledge of support by banks for “all things living” on 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. These conjectures are an invitation to further research.

In the same vein, we can also make another invitation for further analysis, this one based on methodological precision. BIS data includes banking claims and liabilities, that is information on lenders and borrowers. In this article, we have focused on lending activity rather than on borrowing activity (liabilities being the counterpart of claims, and reflecting in the end the same kind of information). However, an interesting question is set aside because of a lack of data (the BIS dataset does not include disaggregated data on borrowers): in further research, using other datasets (probably country case studies), it would be interesting to test if bankers tend to differentiate between borrowers from non-democracies and borrowers from emerging democracies. This would allow us to deepen the question and test if bank(er)s differentiate between undemocratic governments and their subjects suffering from the lack of democracy when making credit decisions.

Notes

1. See <http://www.equator-principles.com>. For a critical monitoring of this initiative by a group of leading nongovernmental organizations, see BankTrack at <http://www.banktrack.org/>.
2. For a review, based on good practices and case studies, on how financial services are affected by and manage the challenges associated with human rights, see F&C Asset Management and KPMG (2004).
3. See <http://www.unepfi.org>.
4. For a systematic study, see Leigh and Podpiera (2006).
5. For a study of workers' remittances and democracy, see Biglaiser (2006). For studies on bond markets and democracy, see Archer et al. (2007), Cho (2006), Maxfield (2000), Saiegh (2005), and Schultz and Weingast (2003).
6. In terms of bank assets, the picture does not change, as bank assets vis-a-vis developed, OECD countries account for 37 percent of world GDP and bank assets vis-a-vis emerging economies less than 3 percent of world GDP.
7. As noted by one of the referees, "banking on democracy" was first used as the main title of an influential paper by John Freeman in the early 1990s. Freeman's paper, however, dealt with a very different set of issues. It was mainly about the relationship between international financial flows in general and political sovereignty. See Freeman (1990). We would like to thank the anonymous referee for this useful insight.
8. For an extensive review, see, for example, Santiso (2004).
9. López-Córdoba and Meissner (2005) found a positive relation between trade openness and democracy from 1895 onward. For a discussion, see also Papaioannou and Siourounis (2005) and Rigobón and Rodrik (2005).
10. For a review and analysis, see Biglaiser and Danis (2002).
11. For a critical analysis of the new institutionalism literature, see Przeworski (2004a).
12. In line with Przeworski et al. (2000), regimes are classified as democracies if during a particular year they satisfy simultaneously four criteria: (1) the chief executive is elected; (2) the legislature is elected; (3) more than one party competes in the elections; and (4) incumbent parties have in the past or will have in the future lost an election and yielded office. All regimes that fail to satisfy at least one of these criteria are classified as nondemocratic (Przeworski et al., 2000: 18–29). Hence the political regime classification is simplified and becomes a dichotomous variable that takes a value of zero if a country is a democracy and one if it is not, according to the four cumulative criteria.
13. This is shown in more detail in the working paper that helped to shape this article. See Rodríguez and Santiso (2007a).
14. For graphs relating to economic policy stability in non-Latin American countries, see Rodríguez and Santiso (2007a).

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Acknowledgments: Preliminary versions of this article were presented and discussed at the 10th Annual Meeting of the Latin American and Caribbean Economic Association (LACEA), Paris, France, October 27–29, 2005; at the 20th World Congress of the International Political Science Association, Fukuoka, Japan, July 9–13, 2006; and at the Annual Bank Conference on Development Economics, The World Bank, Bled, Slovenia, May 17–18, 2007. We would like to thank Fernando Carrillo, Alicia García-Herrero, Tessa Hebb, Alejandro Izquierdo, Ethan Kapstein, Elías Papaioannou, Andrew Powell, Eduardo Levy-Yeyati, Carlos Santiso, Ernesto Stein, and Francisco Veiga for the documents, conversations, and papers shared. We are particularly grateful to our OECD Development Centre colleagues Ki Fukasaku, Louka Katseli, Charles Oman, and Ken Ruffing for their stimulating comments and criticisms on previous drafts. Lastly, we would like to thank the anonymous reviewers of the earlier versions of the article, who helped to improve the manuscript substantially. Obviously, all the errors and views are the sole responsibility of the authors.