There is no hard rule about the timing of crises. It is surprising how long basically unsustainable situations can be given extra lives, notably if an election is in sight. With an election on the horizon, creditors are willing to believe that much or anything will be done to hold off a crisis or a corrective devaluation. Governments will do anything, including high interest rates or preferably a shortening of maturities and re-denomination into foreign exchange of claims. As a result, crises happen after elections, not before. This is akin myopic political business cycle but no less real.

Rudiger Dornbusch

The interaction between politics and economics is central to an understanding of financial crises in Latin American emerging markets. The paradox is that, in spite of the evidence, very few studies have been devoted to an analysis of the links with, and importance of, political variables in the empirical literature on currency and financial crises. One of the reasons might have been the difficulty in formalizing political variables. But whatever the reasons behind this lack of integration of political variables, they are indeed significant explanatory factors of emerging market crises. As underlined by a recent study, structural political variables are significantly correlated to currency crises. Left-wing governments seemed more conducive to currency crises, democracies were in general less vulnerable than nondemocratic regimes and strong governments with legislative majorities and fragmented oppositions tend to be less vulnerable.
Among the three latest and largest financial crises in the area, Mexico in 1994, Brazil in 1999 and Argentina in 2001, financial crises took place within presidential or parliamentary electoral years. The same is true also for other emerging markets as nine of the emerging market financial crises of the 1990s happened during periods of political elections or political transitions. Moreover, among the three types or risk—financial risk, political risk and policy risk—political risk appears to be the major driver behind capital flight from emerging markets. Elections in emerging countries are associated with significant effects on market spreads and sovereign rating agencies. As underlined by an empirical test, on average elections in emerging markets tend to be associated with a decline of one rating level on a 17 (0–16) point scale. Similarly spreads on emerging market sovereign debt over the U.S. Treasuries Bills tend to increase by 21 percentage points two months after a major election compared to the same period without an election. “Together, underlines Steven Block in his stimulating study, these results suggest that at least two key actors in international credit transactions, agencies and bondholders, view elections in developing countries negatively and exact a substantial premium on developing sovereigns and sub-sovereign individual seeking capital.” Together also these results question the apparent cost that democracy and elections entail for developing countries.

In fact, for countries with already weak economic fundamentals, political instability tends to have a stronger impact on financial vulnerability. This is particularly relevant in emerging countries where political institutional instability tends to be higher. As measured by Philippe Aghion, Alberto Alesina and Francesco Trebbi, the total number of institutional political changes in a 20-year period for a large sample of 177 countries is concentrated in emerging countries. Of a total of 294 significant changes (almost two per country on average), Africa and Latin America concentrated the highest degree of politico-institutional instability with respectively 138 and 59 institutional changes (compared with 15 for industrial countries). In other terms, Africa alone concentrated nearly half of all the politico-institutional changes that occurred over the period and Latin America 20 percent.

Obviously, the fact that democratic politics affect currency or bond markets is not specific to emerging markets. Expectations and uncertainty about electoral outcomes and government survival affects the financial markets of OECD countries where political processes, elections, polls, cabinet formation and dissolutions, make it more difficult for traders to forecast exchange rates resulting in exchange rate volatility. However the impact of electoral outcomes is particularly significant for