# What do 2024's elections spell for sovereign debt markets?

*Fiona Bare (PhD Candidate, Princeton University and Graduate Fellow, PSFL)*

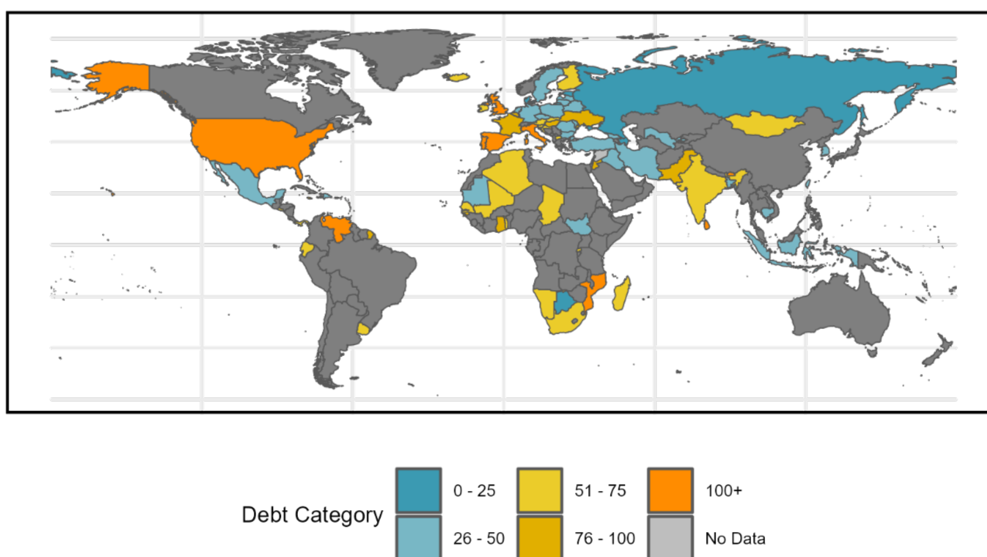
April 2024

---

Nearly half of the world's population is eligible to cast a ballot in a national election during 2024. Bangladesh, Pakistan, and Indonesia have already voted. Still, many have yet to vote in countries like India, Mexico, the United States, South Korea, Sri Lanka, and South Africa. The UK also is likely to have an election later this year. Such elections are important for policy. For example, European Parliament elections will be decisive for determining the European Union's climate policy trajectory, and Mexico's election will affect its cooperation with the US on trade and migration.

Election years are full of uncertainty. They have consequences for the ability of sovereigns to borrow, for stock market volatility, and ultimately, for global financial stability. Furthermore, if any of these elections, especially in the United States, result in efforts to undermine democratic institutions, they could bring trouble to markets globally. Figure 1 summarizes the public debt to GDP ratios of all countries (other than Syria) with elections in 2024 using most recent data available from the IMF and Trading Economics. Countries in

*Figure 1: Government Debt to GDP for Countries with Elections in 2024*



orange and yellow have higher debt levels, suggesting their elections may be more likely to have financial consequences. Those in dark gray do not have elections this year.

For example, there was much attention on Pakistan after its February 2024 election, in which the jailed former Prime Minister Imran Khan's Pakistan Tehreek-e-Insaf (PTI) party surprisingly won a plurality of seats. Khan is barred from holding elected office, and it was unclear whether PTI would be able to form the next government. Instead, the Pakistan Muslim League (PML-N) and Pakistan People's Party (PPP) worked to form a coalition. The country's sovereign dollar-denominated bonds lost value during this time, with expectations that political uncertainty could exacerbate economic instability, especially given external and internal debts totaling over $270 billion. The new government is working to negotiate a new plan with the IMF that will be critical for addressing economic uncertainty and the threat of default.

As Pakistan illustrates, elections can affect governments' financing capabilities. Election years bring policy uncertainty. First, there is the simple question of who will win and what policies they will pursue. These uncertainties may be especially pronounced when differences between candidates generate concerns about major changes, or reversals, in government policies. Uncertainty also tends to be greater in countries that have recently undergone a regime change (Frye 2010); where elected officials face few institutional constraints (Sattler 2013); or where new parties and candidates without clear track records are running for office. Outcome-related uncertainties also are more common in countries where major parties are polarized (as in the US at present), as well as where major policy shifts are likely if a newcomer takes office (as in Argentina in late 2023).

Second, there may also be pre-election policy concerns due to the political business cycle as incumbent governments may hesitate to impose austerity, instead using public spending to improve their electability (Block 2002). Policy uncertainty affects financial markets: it is associated with foreign exchange speculation (Bernhard and Leblang 2006, Bernhard and Leblang 2002, Eichengreen et al 1995); declines in sovereign credit ratings (Block and Vaaler 2004, Vaaler et al 2006); increased spreads on sovereign debt (Martinez and Santiso 2003); and stock market volatility (Leblang and Mukherjee 2005).

This was evident in the run-up to Argentina's 2023 election, as uncertainty about its outcomes worsened the economic situation for a country already

suffering from deep fiscal deficits and growing debt. GMA Capital summed up the view of many investors: "international weakness, electoral policies to stimulate demand at the cost of a bigger deficit and more monetary issuance, plus the very uncertainty that elections radiate, have formed the perfect storm." Elections also can lead to prolonged uncertainty about who will govern, especially in proportional representation electoral systems, where coalition governments are the norm. When elections are contentious and polarization is high, coalition formation may be protracted, and involve policy compromises.

***Results, Results, Results***

How exactly do election outcomes matter? The most important government decisions affecting sovereign credit ratings or borrowing spreads pertain to debt servicing. Governments may sometimes choose to default on their obligations, rather than to impose austerity on their publics. Investors may especially worry that left-leaning governments will be less committed to repayment because they may want to prioritize social spending programs.

As Cameron Ballard-Rosa describes (2020), governments make decisions about whether to default based on the anticipated demands of the constituencies about which they care the most. Costa Rica's default in the 1980s offers a historical example. In the 1970s, the Partido Liberación Nacional (PLN), a social democratic party, came to power in Costa Rica by emphasizing expansion of the welfare state, especially rural agricultural development. When rising oil prices and falling coffee prices generated an economic shock and a rising debt burden, the government hesitated to cut spending, given the importance of agricultural subsidies to its political support. Despite pressures from the World Bank and the IMF, Costa Rica refused to cut farm support programs or public wages, instead eventually defaulting on its international debt obligations.

The domestic politics related to winners and losers from default, versus from debt servicing, persist. Investors may especially worry that left-leaning governments will be less committed to repayment because they may want to prioritize social spending programs. For instance, during Greece's debt crisis, the left-leaning Syriza-led coalition that took office in 2014 had campaigned on a platform of anti-austerity, objecting to many of the cuts endorsed by Greece's creditors.

Left-wing governments also may be more likely to defend currencies from speculative attacks while right-leaning governments are associated with

looser bank regulations (Broz 2013, Walter 2009). These differences in policy imply that election outcomes are closely watched by investors, although there are mixed findings about the effects of government ideology on debt-related outcomes. Some research indicates that a switch from right-leaning to left-leaning leadership is likely to increase risk assessments (Block and Vaaler 2004), although others find evidence of partisan effects only on volatility, rather than on bond spread levels (Brooks et al 2022).

Left-right ideology also affects the ways in which governments access credit. Right-leaning governments are more likely to choose foreign currency denominated bonds, which minimize borrowing costs, while left-leaning governments prefer the flexibility of domestic currency denominated debt instruments (Ballard Rosa et al 2022). Investors may also be concerned to observe a contentious election in a proportional system, where electoral rules then imply the need to form coalitions among various political parties that may prove difficult or lead to unexpected policy compromises.

### *Context Matters*

While elections can disrupt financial markets, not every election that leads to changes in governments (and to changes in the partisanship of executives) generates negative market outcomes. A recent study of elections in emerging market economies suggests that approximately one quarter of elections, and just over one third of elections with executive turnover, generate significant shifts in secondary markets for government debt (Brooks et al 2022).

What do we know about when national elections affect bond market returns? Sometimes government partisanship is not a very good source of information about governments' likely policy actions. Even though broad generalizations about left- and right-leaning governments may be accurate, there remains significant macroeconomic policy heterogeneity among political parties, especially those on the left. Investors appear to be aware of this, such that left governments do not always pay systematically higher borrowing costs than their centrist and right-leaning counterparts.

Sarah Brooks, Raphael Cunha, and Layna Mosley's (2022) study of 74 emerging market economies from 1994 – 2015 examines the conditions that predict greater sovereign bond market reactions to elections. They find that elections generally, and elections that result in left governments specifically, are not associated with systematically higher spreads on sovereign bonds. But newly elected left-leaning governments are linked with greater volatility

in sovereign bond market spreads, perhaps indicating greater uncertainty among investors about future policy directions – and with potential consequences for private sector investment as well. However, as new governments' time in office increases, this effect disappears. As investors learn more about the country's leadership, they form more certain policy expectations.

### *Democratic Dividend?*

Not all elections occur free and fairly, without interference, violence, or intimidation. The electoral process may signal deeper features of a country's institutional environment, including respect for the rule of law. According to VDem's 2024 Democracy Report, more countries are experiencing declines in democratic practices than are experiencing improvements, relative to a decade ago. Clean elections deteriorated in 23 countries in 2023, and of the countries holding elections this year, 31 have declining democracy levels compared to just three that are improving.

For example, in Indonesia, Defense Minister Prabowo Subianto declared victory on February 14 – a result that some viewed as a signal that democratic values were under threat, given Subianto's record of human rights violations and his inclusion of the sitting President Joko Widodo's son on the ballot. In Bangladesh, Prime Minister Shiekh Hasina won a fourth consecutive term in January in an election that was boycotted by the country's main opposition party. This result has led some to argue that Bangladesh is an electoral autocracy with little room for dissent. President Paul Kagame announced that he will run for a fourth term in Rwanda's election later this year, stating that "what the West thinks is not my problem," in response to criticisms of the country's electoral processes.

To the extent that democratic backsliding continues in many places, it is likely to have consequences for sovereign debt markets. Research by Cameron Ballard-Rosa, Layna Mosley, and Rachel Wellhausen (2021) demonstrates a conditional "democratic advantage" for government borrowing. They show that the more democratic a country, the more easily they can access sovereign credit markets. There are many reasons for this: stronger constraints on executive branch behavior; and greater respect for the rule of law. When governments of democracies violate their commitments – including their bond contracts – they may face punishment from their publics. The democratic advantage in borrowing is especially present when global capital markets are tight.

Given the advantages of democratic institutions, what are the possible consequences of their weakening? Most directly, backsliding implies greater borrowing costs for governments. More broadly, because investors prefer political systems which allow them to form stable expectations over future policies, backsliding can also lead to declines in longer-term foreign direct investment.

Furthermore, many political actors who seek to erode democratic governance adhere to populist economic principles, eschewing trade and financial integration, despite its material benefits to national economies. Finally, the conditional nature of the democratic advantage suggests that non-democracies that had easier access to credit in the second half of the 2010s may find themselves less able to access new or roll over old debt. Hence, non-democratic regimes are likely to be riskier prospects for sovereign creditors.

Recent election outcomes in Argentina, Bangladesh and Pakistan, among others, may offer reason to worry about the implications of the 2024 elections. Many countries with elections this year are likely to experience some financial volatility, especially if the outcomes are uncertain or surprising. These negative effects may be exacerbated when election winners threaten democratic institutions such as the rule of law and the transparent provision of information.

And to the extent that elections bring populists into office or retain them, the effects on economic outcomes may be more sustained. Manuel Funke and coauthors (2023) show that economies perform much worse under populist leaders. Analyzing over 50 populist presidents and prime ministers since 1900, they find that GDP per capita is 10 percent lower after 15 years, due to factors like decreasing macroeconomic stability and the erosion of institutions.

Even in established democracies, elections can be a source of sovereign risk. Investors may especially stand to lose from democratic erosion in the United States. Institutional investors tend to overweight US investments in their portfolios, suggesting that sharp increases in risk or volatility will have pronounced effects. Furthermore, the centrality of the dollar implies that financial volatility in the US is likely to spread to other countries (Mosley 2023).

***The Princeton Sovereign Finance Lab conducts policy-relevant research on the political economy of government borrowing. The Lab is part of the Niehaus Center for Globalization and Governance in the School of Public and International Affairs at Princeton University; Professor Layna Mosley directs the lab.***