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THE FINANCIAL AND ECONOMIC DANGERS OF DEMOCRATIC BACKSLIDING

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The Financial and Economic Dangers of Democratic Backsliding

Layna Mosley[1]

In the November 2022 elections in the United States, election-denying candidates had modest success in statewide races for governor, attorney general, and secretary of state. Thirty-three percent of election-denying candidates (15 out of 46 in the general election) prevailed in their statewide races.[2] An additional eight election deniers occupy those offices but were not up for re-election in 2022.[3]

The decentralized nature of U.S. election administration, however, means that the actions of even a single state-level official could wreak significant havoc on national electoral processes. Although the nature of political institutions in the United States has not changed substantially in recent years, some political actors have grown more willing to use these institutions to undermine democratic practices.

The high-profile losses in statewide races also conceal more ominous signs at other levels. Counting statewide elected officials, candidates for the House and Senate, and state legislative candidates, 226 election-denying candidates prevailed, or about 66%.[4] Many members of the majority party in the U.S. House of Representatives are election deniers. Election-denying officials also have assumed important positions in many state legislatures. Thus, the erosion of democratic practices and norms remains a serious threat in the United States.

Moreover, the behavior of election deniers and insurrectionists in the United States serves to inspire anti-democratic forces abroad. The Jan. 8, 2023, attacks on Brazil's Congress, presidential palace, and Supreme Court appeared directly inspired by the Jan. 6, 2021, attacks on the U.S. Capitol. Brazil's former president, Jair Bolsonaro, refused to concede defeat in the October 2022 presidential election; during the campaign, he stated that were he to lose, falsified election results would be to blame.[5] "#BrazilWasStolen" spread on social media. U.S. elections also provide an example to anti-democratic forces abroad.[6] Direct links among far-right groups in the U.S., Europe, and Latin America likely exist; but even absent those links, anti-democratic practices and views may diffuse transnationally.[7]

As attention shifts toward 2024 U.S. electoral contests, it is important—for the American public generally and for U.S.-based institutional investors specifically—to remain cognizant of the very real threats to U.S. democracy. Investors often treat the United States as an exceptional market, by virtue of its size, liquidity, and global role. Indeed, cross-national academic analyses in political economy and finance often exclude the United States, because it is an outlier in many ways.

Yet these same features also heighten the potential impact on investment portfolios of political shifts in the United States. Most institutional investors' portfolios are overweight in U.S. investment, the result not only of the United States' important global position, but also of a more general "home bias" among investors.[8] A large negative shock to U.S. assets and markets would heavily impact these overweight portfolios. Moreover, given the position of the United States globally, U.S.-based shocks would likely reverberate throughout the global economy. This spillover, as evidenced by the 2007-2008 U.S. subprime crisis, would likely generate far-reaching effects. It therefore is difficult to "flee to safety" when the United States—typically viewed as a safe haven when political risk elsewhere increases—experiences heightened political risk.

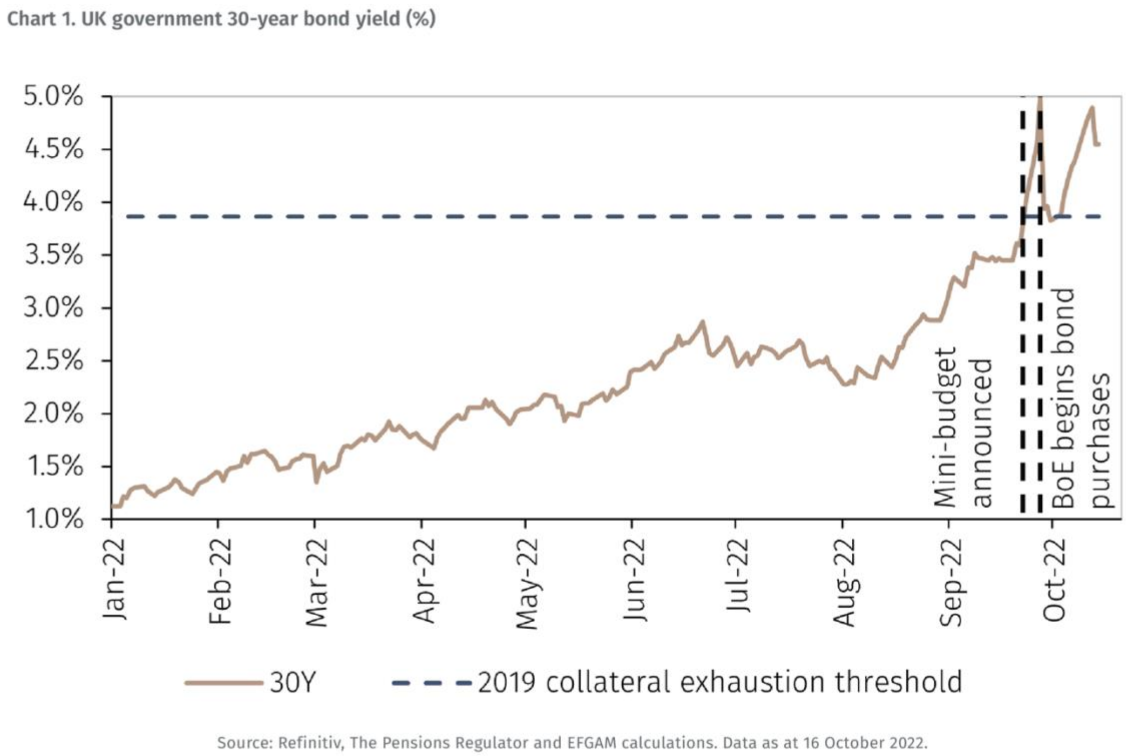
Polities in which the rule of law is less well-respected often experience a decline in firms' activities and innovations. The uncertainty associated with an erosion of democratic values can generate volatility as well as higher costs of capital, for business as well as for municipal and sovereign borrowers. When the institutions of democracy are strong, volatility in economic policy appears less worrying to investors; in the face of institutional decay, however, weak policy is likely to have more negative effects. And, to the extent that democratic backsliding is associated with populist—nationalist, anti-foreigner, and anti-cosmopolitan—ideologies, it threatens the liberal international order on which so much U.S. prosperity has rested.

This report therefore argues that U.S. institutional investors have a fiduciary duty to continue to closely monitor the political risks associated with potential democratic erosion in the United States. The paper begins by conceptualizing democratic backsliding and summarizing the state of democracy, both globally and in the United States. The report then discusses existing academic scholarship on the ways in which political risk matters for economic and financial outcomes, including fixed income, equities, and longer-term investment. The bulk of this work analyzes political risk in other countries and regions, including advanced as well as emerging and frontier market economies. The report then discusses what lessons these analyses hold for the United States. It concludes with a discussion of what institutional investors can do to monitor and respond to these risks.

I. The Threat of Democratic Backsliding

Democratic backsliding[9] is the "state-led dehabilitation or elimination of the political institutions sustaining existing democracy."[10] As David Waldner and Ellen Lust describe it, "backsliding makes elections less competitive without entirely undermining the electoral mechanism; it restricts participation without explicitly abolishing norms of universal franchise seen as constitutive of contemporary democracy; and it loosens constraints of accountability."[11]

In established, stable democracies, democratic erosion typically doesn't take the form of open-ended coups or blatant election-day fraud; rather, it often happens via executive aggrandizement and strategic electoral manipulation and harassment. Executive aggrandizement could include government executives—at the national or subnational level—weakening checks on executive power, within or outside the executive branch. They do so, for example, by making institutional changes that reduce the power of the opposition or the judicial branch to hold the executive accountable. When legislatures are controlled by supporters of the executive, they also may be used as a vehicle to effect backsliding.



Source: V-Dem Institute.[12]

The V-Dem Institute, a premier source of research and data on political regimes worldwide, reports that, in 2021, the level of democracy enjoyed by the average global citizen had receded to a level last seen in 1989.[13] The improvements in governance of the last three decades have, on a global scale, been erased. Similarly, V-Dem notes that the presence of liberal democracy worldwide peaked in 2012, with 42 countries considered fully liberal democracies.[14] Today, there are just 34 countries characterized as fully liberal democracies, the fewest in 25 years, and accounting for only 13% of the world's population.[15]

At the same time, dictatorships are on the rise worldwide, now accounting for 70% of the world's population (5.4 billion people).[16] According to the V-Dem Institute, in 2021, a record 35 countries experienced significant, government-sponsored deteriorations in freedom of expression; a decade ago, only five countries experienced a similar erosion of democratic practices.[17] Even the European Union, long a bastion of democratic institutions and a promoter of democracy in other regions, has experienced a rise in autocratic practices in member states including Hungary and Poland.

Many (but not all) political actors engaged in democratic erosion espouse populist claims. Populism is a long-standing phenomenon, present in many countries and eras, and with left- as well as right-wing variants. Contemporary populists include Hungary's current president, Viktor Orban, and Brazil's recently defeated one, Jair Bolsonaro. Populism's core attributes include a claim that "the people" are in a morally charged battle against (insider) elites.[18]

Populists' economic nationalism, as well as their desire for more local control, generates hostility not only toward "global elites," but also toward participation in intergovernmental entities ranging from the Paris Agreement on climate change to the World Trade Organization. Empowering "the people" typically entails taking control back from supranational entities—even when those entities have served to improve material conditions.[19] Interestingly, some populists also have linked their appeals to a denial of climate change, or at least a refusal to direct public resources to mitigating and adapting to it.

II. Democracy and Political Risk Around the World: What Do We Know?

An erosion of democratic practices—the expansion of executive branch authority, the decline of government accountability, and an interference with regular electoral processes—is worrying for many reasons. From the point of view of institutional investors, democratic erosion and political instability pose a significant risk to investment performance. Indeed, peer-reviewed research in finance, economics, and political science reveals the risks to markets of political instability, weak rule of law, and democratic backsliding.

Surges in political risk sometimes are obvious: Rival elites may carry out a coup d'etat against the head of state, seizing power outside of the regular political process. Such events certainly have negative effects on investment performance.[20] And, indeed, the United States House Select Committee to Investigate the January 6th Attack on the United States Capitol (the January 6th Committee) has referred to the events surrounding the 2020 election as an “attempted coup.”[21] In March 2022, U.S. District Judge David Carter noted that former President Donald Trump’s efforts to overturn the election results were “not confined to the ivory tower—it was a coup in search of a legal theory.”[22] Such direct efforts to undermine democratic institutions in the United States may occur again, as some experts have warned.

But increased political risk does not require the actual or attempted overthrow of a government, nor is it present only in fragile or failing states.[23] Rather, political risk results when the rule of law deteriorates; when political processes generate uncertainty about future outcomes and policy; and when government actors seek to reverse cross-border trade and financial integration, which have been important drivers of economic growth.

Social scientific analyses based on other countries—those with less democratic and open political processes than the United States, as well as those whose democratic institutions have eroded in recent years—are instructive in considering the likely consequences of the further erosion of democratic norms and practices in the United States. The findings summarized below are based on theoretical models as well as empirical analyses, conducted using a range of empirical samples, estimation techniques, and robustness checks.

Democracy, rule of law, and long-term investment. A long literature suggests that firms’ investment allocation decisions—domestic as well as foreign—reflect attention not only to economic opportunities and market structures but also to political and legal institutions. Most generally, investors prefer political systems in which they can form stable expectations over future policies; in which they can trust that legal systems are free from bias; and in which governments facilitate the operation of markets (via, among other things, a respect for the rule of law).

When the rule of law is weaker, firms worry more about the security—and the risk of direct or indirect expropriation—of their investments. When respect for the rule of law is weaker, all else equal, foreign investment falls.[24] The effects of deteriorating rule of law may be most pronounced for owners of fixed capital. For assets that are easy to liquidate, investors may be willing to adopt a "wait and see" attitude, convinced that they can exit markets if government policies deteriorate. But for assets that involve heavy capital investments, or that do not have a ready secondary market, political risk is especially salient.[25]

Up to some limit, firms may continue to invest in the face of heightened political risk. For instance, they might partner with local firms in response to political hazards.[26] But joint ventures and other partnership arrangements can only do so much: The greater the degree of political risk, the more foreign firms worry that domestic firms are captured by the state and, therefore, are not reliable partners.

International investment agreements also can ameliorate concerns related to political risk. Indeed, international investment agreements (stand-alone bilateral investment treaties or chapters in preferential trade agreements) have expanded markedly over the last two decades. But the success of these agreements in addressing political risk—and in maintaining investment activity—rests on governments' commitments to investor-state dispute settlement and other legal mechanisms. To the extent that governments become unwilling to uphold international commitments—a position often taken by those who seek to undermine the rule of law domestically—these agreements do little to reassure investors.

This is not to suggest, of course, that weak political institutions do not benefit some firms and some investors in some countries. Where democratic legal and political institutions are not present or have eroded, some firms stand to gain via their connections to powerful actors. When public policy provides some firms with access to excess profits, those firms are likely to offer political support to the incumbent government. Hence, a vicious circle of corruption develops, from which a narrow set of firms benefits materially, and a small set of elites gains politically. But it is only a subset of firms—rather than the economy and its citizenry as a whole—that benefits from weak political institutions. Clientelism, crony capitalism, corruption, and rent-seeking have negative effects for economies as a whole.[27] Cronyism also is linked with weak financial regulation and, therefore, with systemic banking crises.[28]

Moreover, cross-national evidence suggests a strong connection between the overall strength of democratic processes and institutions and the extent to which governments disclose information about economic and financial performance. All else (including capacity) being equal, autocracies and mixed regimes feature lower levels of information disclosure. This pattern is aptly illustrated by the Chinese government's recent decision to delay the release of data during its Party Congress[29]—presumably because President Xi Jinping believed that better information could increase threats from those in the opposition.

But a lack of transparency is an issue not only for autocracies like China. Rather, as countries experience democratic erosion, we can expect their levels of economic and financial transparency to fall. Higher transparency predicts higher levels of investment, domestic as well as foreign, and lower levels of investment volatility. The effects of transparency on investment are greater in democracies than in autocracies.[30] When investors are unable to form expectations about the future state of government policy or the economy, as well as about the expectations of other investors, they tend to invest less, to charge higher premiums for capital, or even to engage in a "rush to the exits," setting off financial crises.

Again, this is not to suggest that some firms and investors do not benefit from a lack of transparency. If information is generally difficult to obtain, but a few (politically well-connected) firms have access to it, they may profit from their insider knowledge. Hollyer et al.'s analysis finds, for instance, that greater transparency generally is associated with higher levels of foreign direct investment.[31] But this does not hold in all sectors. In the extractive sector, where government-business connections often are tight, and sometimes reflect corrupt business practices—economic policy transparency is associated with ***lower levels*** of foreign direct investment.

In general, however, we can expect firms to increasingly refrain from, or to demand higher returns to continue to make, investments in polities with weak and eroding political institutions. Put differently, weak performance on the "G" portion of "ESG" is bad for business. Democratic erosion weakens the rule of law, the reliability and impartiality of judicial authorities, and the provision of information.

Asset markets, political uncertainty, and political institutions. Political processes such as elections often create uncertainty among investors as well as among the general public. This uncertainty relates to the future course of government policy (will a given piece of legislation be enacted? Will the government cut spending?); to the identity of future governments (will an incumbent win re-election? What sort of policies will a newly elected executive seek to implement?); and even to the stability of institutions themselves (will a country remain a consolidated democracy? Will a democratizing country slide back toward authoritarianism?).

A large set of academic analyses consider how various types of political events—especially elections and government change—affect financial market outcomes. These analyses also investigate the role of political institutions (including the rule of law) in ameliorating investors' concerns about shorter-term political uncertainty. Studies of the connection between political institutions and asset market outcomes, as well as analyses of the links between political events and market activity, provide insight into how democratic erosion in the United States can affect investors' portfolios.

With respect to the nature of political institutions, many academic studies establish the existence of a "democratic advantage" in the realm of sovereign borrowing:[32] Countries with democratic political institutions are, all else equal, better able to access capital markets and to do so at lower rates of interest, at longer maturities, and/or in their own (versus in foreign) currencies. The mechanisms behind this effect are varied: They include stronger constraints on the executive's fiscal policy behavior as well as greater policy and outcome transparency in democracies.[33]

Another mechanism is the rule of law, as it relates to sovereign bond contracts: Investors tend to assume that democracies will keep their commitments, to domestic as well as foreign investors.[34] In established democracies, these features typically co-occur, making it somewhat difficult to disentangle the specific pathways through which democracy is associated with better access to credit markets. The association, however, is robust.[35]

"Democratic advantage" research strongly suggests that democratic backsliding will generate higher costs of capital for governments: Sovereigns may have greater difficulty in rolling over existing debt or in accessing new credit, and they are likely to experience credit rating downgrades. And populist governments may be tempted to engage in behaviors—such as threatening default on their debts—that promise to help the person on the street at the expense of financial elites (who often hold government debt).[36]

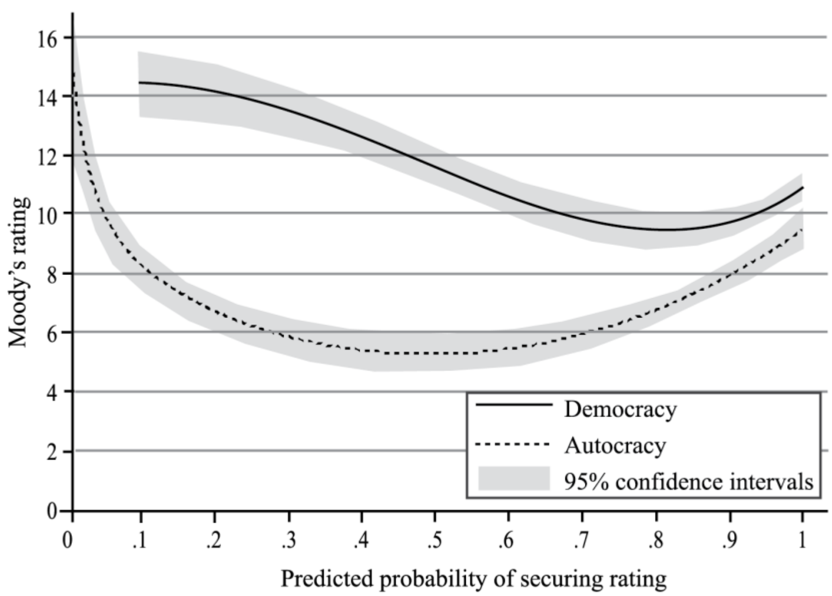


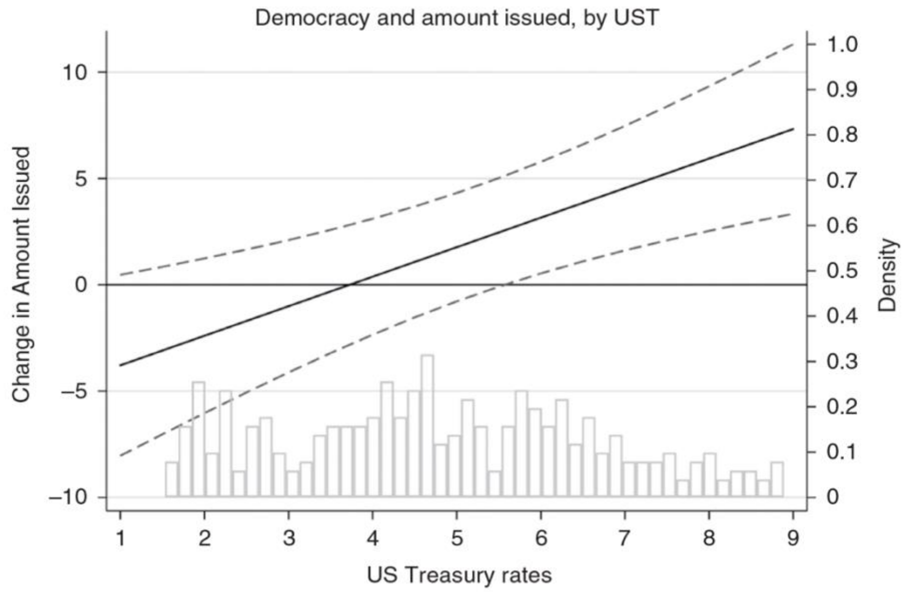
FIGURE 2. *Countries' actual ratings as a function of their predicted probability of being rated, by political regime (fractional polynomial)*

This figure, from Beaulieu et al., summarizes the impact of democratic (versus non-democratic) political institutions on governments' propensity to receive a sovereign credit rating.[37] *(And, in the second stage of their analyses, on the content of the rating itself.)*

The statistical patterns reported in Ballard-Rosa, Mosley, and Wellhausen[38] are especially relevant in the context of current global market conditions. Their analyses, based on monthly data on sovereign bond issuance during the 1990–2018 period, and covering up to 130 sovereign nations, confirm the presence of a "democratic advantage." The effects of democratic political institutions on access to capital are strongest when global capital markets are tight and investors' risk aversion is high. As financial market participants become more attuned to guarding against risk, they draw greater distinctions among countries with democratic versus non-democratic political institutions.

Current global conditions—resulting from war in Ukraine, supply chain bottlenecks, high commodity prices, and monetary authorities' efforts to combat inflation—fit this pattern. Interest rates are high, capital is scarcer, and investors are more attuned to political risk. Hence, increases in risk premiums in response to democratic erosion would likely be relatively large.

Analyses of sovereign bond issuance also reveal that governments are better able to issue new debt, all else equal, when their electoral processes are proceeding as mandated ("on track," in V-Dem's coding).[39] On the other hand, when corruption is high, or when the regular process of executive succession is interrupted, governments are less able to issue sovereign bonds. Again, these patterns are most pronounced during periods of high global risk aversion.



This figure[40] illustrates that countries with more democratic political institutions are generally better able to access credit; and that this effect is more pronounced when global market conditions (proxied by U.S. Treasury rates) are tighter.

Elections and government change can be another source of uncertainty and volatility in capital markets. To the extent that market participants are less certain about political outcomes, they may exit from markets; require higher returns to continue to invest in markets; and/or have divergent expectations, generating volatility. In some instances, these effects are relatively short-lived; at other times, they are more persistent.

Election-related uncertainty takes several forms. Market participants may have difficulty predicting which candidate or party will emerge victorious; this is especially true when elections are close, or when proportional electoral rules create a need to form coalitions among various political parties.[41] Białkowski et al.[42] find that uncertainty over national election outcomes generates excess stock market volatility; Girardi[43] establishes a significant and negative relationship between stock market valuations and election-related uncertainty. Similarly, Kelly et al.'s study finds that elections generate high-risk premiums in option markets.[44] And, in currency markets, Leblang and Satyanath identify a link between electoral uncertainty and speculative attacks.[45]

Even when the election outcome itself is fairly certain, investors may be less confident about the course of future government policy. For example, Brooks, Cunha, and Mosley's analysis of sovereign bond markets in emerging economies reveals that when political parties with little recent governing experience win elections, market volatility is greater.[46] This effect is especially salient for left-leaning governments, where investors' prior beliefs about their likely economic policy choices are wider-ranging.

In more extreme cases, election-related uncertainty and volatility persist long after the election date, and after the point at which vote shares are known. If investors must worry about whether incumbents will respect election outcomes, then they have less confidence about when election-related uncertainty will be resolved, as well as about the future course of government policy. Hence, elections that occur with a backdrop of democratic erosion may generate greater market reactions.

	Emerging Markets Bond Index (EMBI Global)	Credit Default Swap Spread
Changes in Spreads		
Left Executive	*Negative*	*Positive*
Months in Office	*Negative*	*Positive*
Left Executive * Months in Office	*Positive*	*Positive*
Volatility of Spreads		
Left Executive	Positive	Positive
Months in Office	Negative	Negative
Left Executive * Months in Office	Negative	Negative

This table summarizes the results—based on spreads and volatility in emerging-market sovereign debt markets—reported in Brooks, Cunha, and Mosley.[47] *Elections in which new governments, especially left-leaning ones, take office are associated with greater volatility that diminishes as investors learn more about government policy choices. The estimated effects on spreads, however, are not statistically significant at the conventional level. Note that this analysis also considers ideology (left versus right), so it is reporting an election as well as a partisanship finding. Estimates are based on standard errors clustered at the country level.*

The case of Brazil offers some potential lessons. Investors viewed the 2022 presidential election contest as one between two known quantities: Jair Bolsonaro, the incumbent, and Luiz Inácio Lula da Silva, who served as president from 2003 to 2010. Although Lula was favored to win, no candidate won a majority of votes in the first round on Oct. 2, 2022, so the election moved to a runoff between Lula and Bolsonaro. Bolsonaro threatened not to respect the election results if he lost. While he did not concede that Lula had prevailed in the second round, Bolsonaro did leave office, skipping the ceremonial handover between presidential administrations. Bolsonaro's political allies also accepted the outcome.

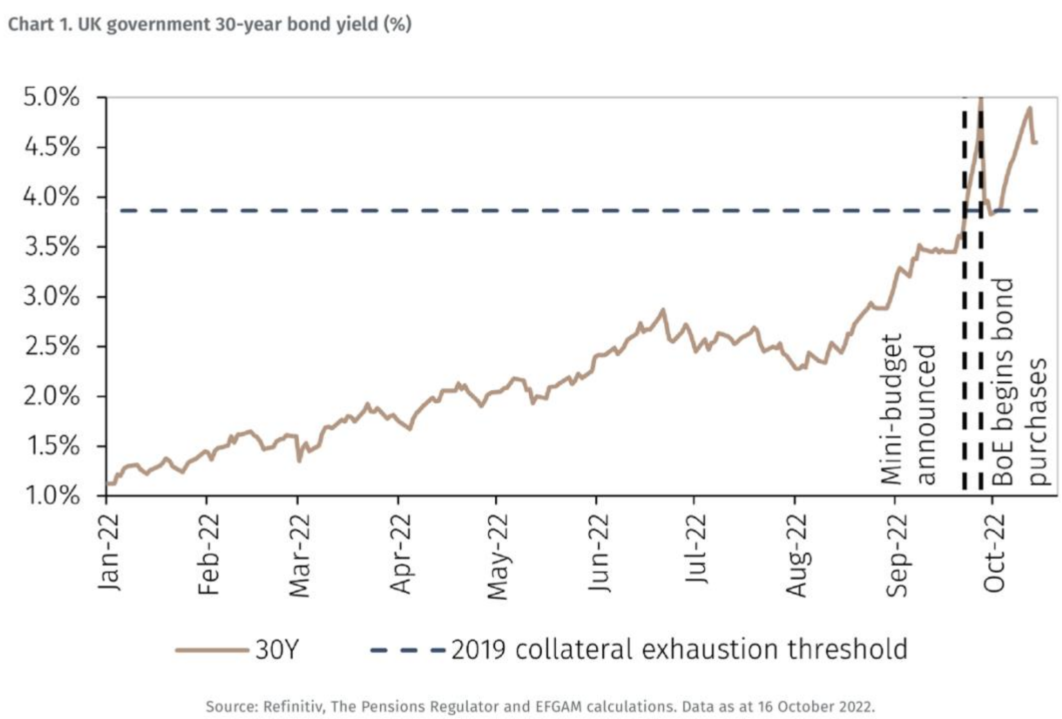
On Jan. 8, 2023, however, Bolsonaro's supporters stormed a variety of government buildings (the Congress, the presidential palace, and the Supreme Court) in Brasília. Brazilian security forces repelled their attacks, and the rule of law was upheld. The attacks followed weeks of protests by extremists, who had been calling for a coup. And they demonstrated the continued threats to democratic institutions in Brazil. As the Financial Times opined the next day on its editorial page, these events illustrated "the enduring threat to democracy from far-right extremism."[48] The editorial went on to note the similarities and intersections between Brazil's attack and the Jan. 6, 2021, attack on the U.S. Capitol.

Immediately after the attacks, the financial press noted that "such insouciance may turn out to be misplaced. Investors would be right to wonder what lasting effects might play out in Brazil."[49] Among these lasting effects might be a concern that, in the context of real threats to the stability of political institutions and the democratic process, it is difficult to effect economic reform, or to deal with existential threats related to climate change. That is, in the face of weaker institutional structures, concerns over policy typically are more pronounced.[50]

In another recent case, asset markets reacted strongly to the content of government politics, rather than to the content or stability of political institutions. In late September 2022, the government of former U.K. Prime Minister Liz Truss released an economic plan, which included a proposed $48 billion tax cut, targeted at wealthy individuals. This proposal arrived at a time when the U.K.'s public debt burden was already substantial. Inflation was high, and a recession seemed imminent. Global energy prices also were high, contributing to high levels of risk aversion in financial markets.

In this context, U.K. bond yields—which had been steadily rising throughout 2022—skyrocketed. The yield on 30-year gilts increased by 120 basis points over three days. The pound's exchange rate plummeted. And many of the U.K.'s liability-driven investment (LDI) funds found themselves on the verge of collapse.

On Sept. 28, 2022, the Bank of England intervened via a two-week emergency purchase program for long-dated U.K. sovereign bonds.[51] Financial markets continued to take a negative view of the Truss government's economic plans; after reversing course on the "mini-budget," Truss ultimately resigned.



Source: EFG International.[52]

The strong financial market reactions, and the 44-day duration of Truss' tenure as prime minister, illustrate how dramatically asset markets can react to shifts in political risk, and how these reactions can quickly threaten broader economic and financial stability. Of course, these reactions were related to policy, rather than to political institutions; they nonetheless highlight how—especially in the context of global risk aversion and high public debt burdens[53]—even established, wealthy democracies can experience dramatic shifts in market risk perceptions.

A final point regarding asset markets concerns government ideology. There is a distinction, conceptually as well as empirically, between political institutions (rule of law, constraints on the executive) and government or governing party ideology (left-leaning, centrist, right-leaning). The findings summarized above focus on political institutions; they suggest that democratic erosion is—regardless of the political party in office—likely to have negative consequences for financial markets.

Other analyses have considered whether financial market participants' evaluation of government policy and political risk is driven in part by government ideology. Here, the evidence is much more mixed. There are few systematic associations, for example, between the interest rate premiums on government bonds and the ideological leaning of the government.[54] While some studies find that stock market reactions to elections vary with the ideology of election victors, other studies find little evidence of a partisan effect.[55] Attention to the political risk generated by democratic backsliding is, therefore, quite orthogonal to taking a stance favoring specific political parties.

Populism, economic integration, and growth. Democratic erosion also threatens financial and economic outcomes via a policy channel. The political actors who attempt to undermine democratic processes often advocate a set of economic policies that are broadly populist in nature. These actors base much of their appeal to mass publics on claims of economic nationalism, as illustrated by the anti-European Union stance of populist right parties in countries including France, Hungary, Italy, and Spain.

While populist politicians claim to represent the interests of the mass public, they are also often strategic in their behavior. They generate salient issues such as immigration, trade, and national sovereignty. Although populists' critiques of economic globalization sometimes note its negative effects on some groups (for instance, job loss for those working in the U.S. manufacturing sector), their appeals also are based on non-material factors—tapping into latent attitudes regarding culture, religion, and race.[56] In many cases, this has been an effective political strategy for elites: They have succeeded in making trade policies (and international economic governance more broadly) more important to voters' decisions.[57] And elites often have succeeded in framing economic woes as the result not so much of technological change or of national governments' policy choices, but of foreign workers, firms, and investors.[58]

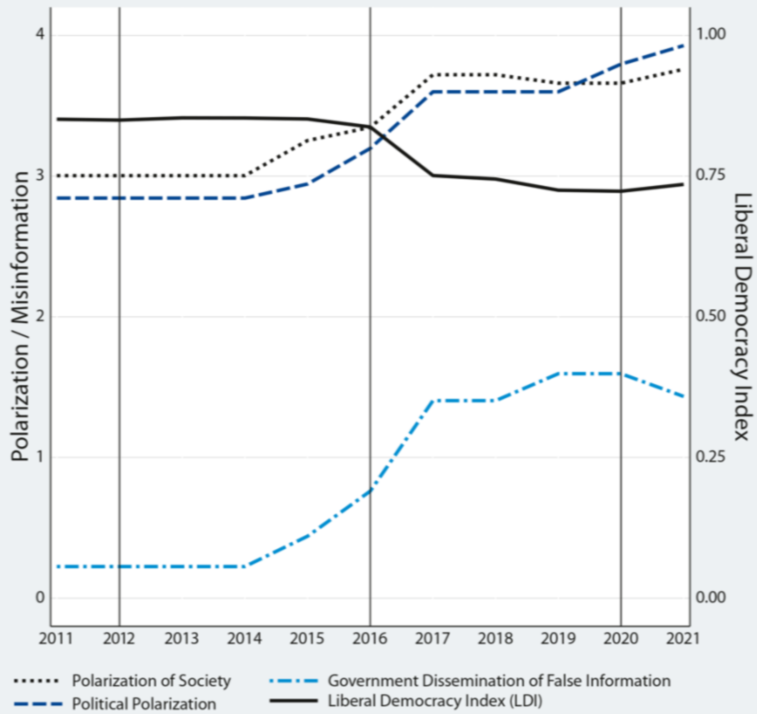
Populists' disdain for intergovernmental institutions and external commitments allows them to reduce further their accountability (in this case, to international courts or to foreign governments). Their complaints about economic globalization and intergovernmental organizations (such as the World Trade Organization and the European Union) have been effective strategies for winning support from some segments of the electorate. They also have directly informed populists' policy choices; and here, they threaten to undermine further much of the global integration that has developed over many decades. Certainly, populist-motivated policies (including trade barriers) are not the only threat to contemporary economic globalization; concerns about the national security implications of trade and investment (especially with and from China) as well as the dynamics of Russia's invasion of Ukraine also play a role. But one might expect that a further erosion of democracy worldwide would likely lead to a slowdown in global economic integration, undermining a major driver of growth during the last three decades.

III. Political Risk in the United States

For many other countries, emerging and frontier as well as advanced, weak domestic political institutions and political uncertainty increase country risk for institutional investors. Analyses of the links between political institutions and events and financial market outcomes at the international level suggest that U.S. institutional investors should pay greater attention to political risk in their home market. Investors should develop or maintain an awareness of the risk stemming from electoral uncertainty, executive aggrandizement, and deteriorating rule of law. Because such phenomena have largely been absent from the United States political system, and therefore largely absent from most market research, it is important now to draw lessons from other countries' experiences.

The V-Dem Institute continues to classify the United States as a liberal democracy, while noting "substantial autocratization."[59] It documents weakened constraints on executive branch behavior during the Trump administration, the use of disinformation strategies by government officials (at the state and local as well as federal level), and heighted political polarization.

FIGURE 1: POLARIZATION AND AUTOCRATIZATION IN THE U.S.

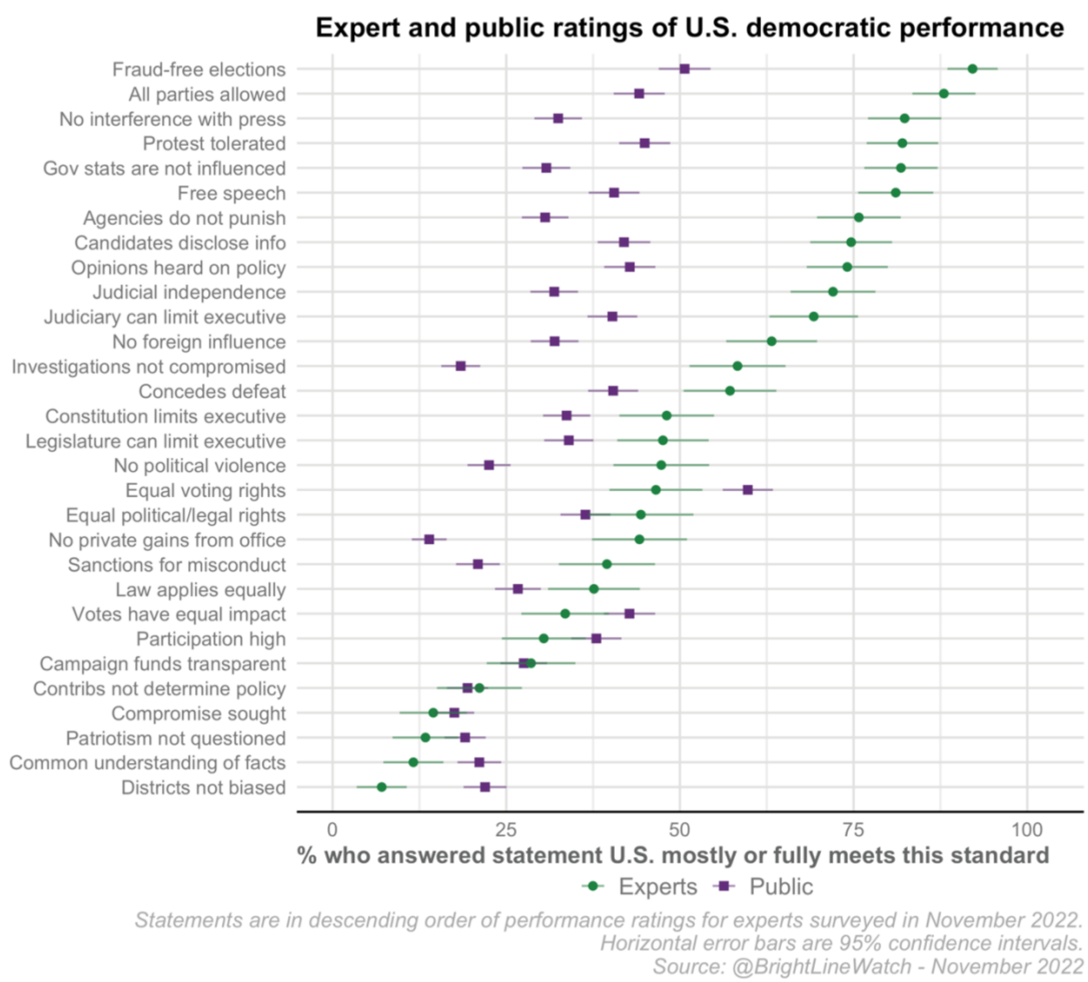


The left y-axis indicates the score for the indicators (Polarization of Society, Government Misinformation, and Political Polarization). The right y-axis represents the scale for the LDI (0-1). The large scores for polarization indicators indicate the highest levels of polarization. The highest score for "Government Dissemination of False Information Domestic" indicator represents that the political parties often use hate speech as a part of their rhetoric. Both the scores for the Polarization of Society and the Government Misinformation Indicators are reversed for presentation purposes.

This figure, from the V-Dem 2022 report, summarizes their experts' scoring of U.S. political institutions.[60]

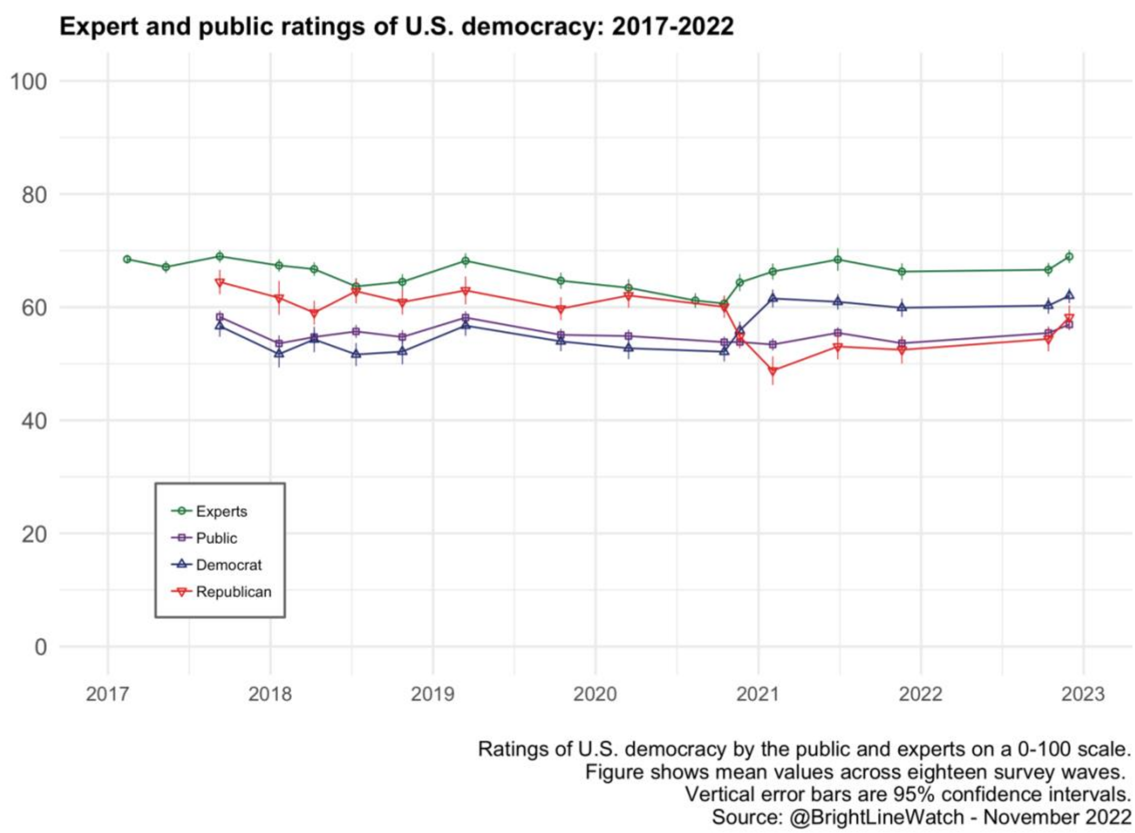
Bright Line Watch—a group of U.S.-based political scientists that regularly surveys academic experts as well as mass publics regarding the state of U.S. democratic institutions—finds continued cause for concern in its survey carried out just after the November 2022 election.[61] This survey asked respondents whether the United States currently meets standards for democracy across a range of elements, such as fraud-free elections, judiciary branch constraints on the executive branch, and election losers' conceding defeat. The study surveyed 707 political scientists as well as a representative sample of 2,750 members of the American public; it was fielded between Nov. 22 and Dec. 2.[62]

As the figure summarizes, experts—political scientists—are sometimes less concerned about the state of U.S. political institutions than are randomly sampled members of the mass public. It also is the case that, while some elements of U.S. democracy are perceived (by experts as well as the public) to be performing well, others suggest cause for concern.



Taken from November–December 2022 Bright Line Watch survey results.[63] Highlights that U.S. democratic performance varies, with some elements performing well and other elements indicating heightened political risk. Also reveals that experts are often, but not always, more optimistic about the state of U.S. democracy than the mass public.

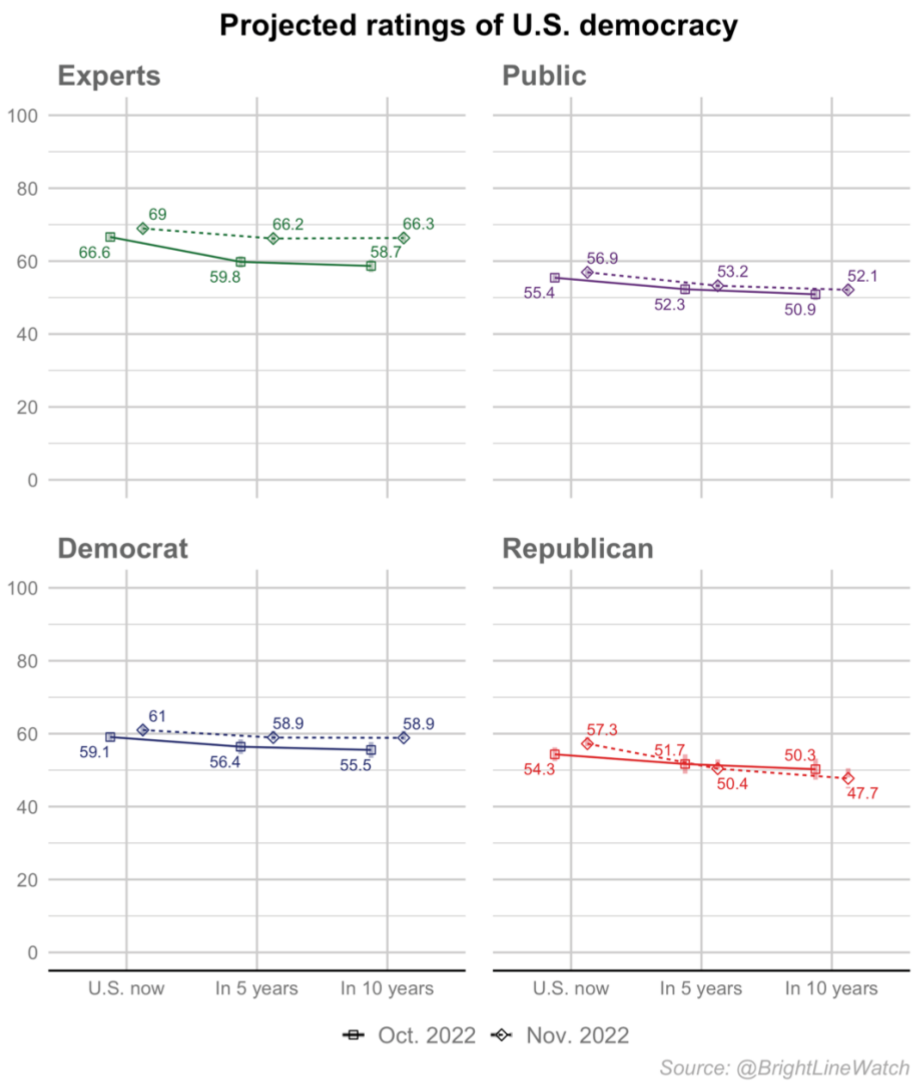
It is worth noting that the midterm elections were associated, at least in the short term, with an increase in assessments of the performance of U.S. democracy. That said, the average member of the mass public awards the U.S. a score of under 60 on a 100-point scale. Although experts award a slightly higher score on average, it remains under 70.[64] And, reflecting political polarization in the United States, Democrats and Republicans continue to view the state of U.S. democracy differently.



Source: Bright Line Watch November 2022 survey results.[65]

Moreover, respondents to the November 2022 surveys continue to express concerns about the future trajectory of democracy in the United States. All groups surveyed—Democrats and Republicans, as well as experts—expect that democracy in the United States will be weaker in five and 10 years than it is today. Data from the expert survey also evidences a serious concern with the prospect of former President Trump's capturing the Republican nomination in 2024. The experts' responses suggest an expectation of major declines in the quality of U.S. political institutions if Trump wins a second presidential term. A significant proportion of those queried in the mass public survey shares this concern.

What lessons, then, should U.S.-focused investors learn? In considering the consequences for the financial sector of democratic erosion, it is tempting to view the United States as exceptional. It may be appealing to assume that the country's democratic institutions and processes are less vulnerable than those in other jurisdictions. During the last decade, many scholars of comparative politics have warned otherwise: Were other countries to experience some of the events that have occurred in the United States—such as the Jan. 6, 2021, insurrection at the Capitol[66]—investors would increase their attention to political risk.



Source: Bright Line Watch November 2022 survey results.[67]

It also could be argued that the global importance of U.S. financial markets and the U.S. dollar insulates the economy from the negative effects of backsliding. While the U.S. has certain advantages in the global economy—for instance, in being a “flight to safety” destination for investors when conditions deteriorate elsewhere in the global economy, and in being the issuer of the (still) key global reserve currency—these advantages are insufficient to protect U.S. markets and U.S.-based investors from the threats caused by political instability and democratic erosion.

Indeed, the erosion of democratic practices and the heightening of political risk in the United States may represent a **greater** threat to institutional investors than political risk in other countries. The primary effect of democratic backsliding on investment portfolios could be dramatic, given the weighting of U.S. assets in most portfolios. A secondary effect also is likely to materialize, due to the centrality of the U.S. to the global economy. Shocks to U.S. bond and equity markets, the U.S. banking system, and the U.S. dollar would be transmitted throughout the global economy.

Primary effects. With respect to the primary effect of democratic backsliding, studies from other markets suggest that uncertainty about election outcomes, and especially about institutional changes (to, for instance, constraints on executive behavior), would have negative effects throughout the financial system. In a study considering earlier U.S. presidential elections, Waisman et al. found that election-related uncertainty predicted a 34-basis-point increase in corporate bond spreads.[69] When elections were closer, the increase in spreads was even greater. This analysis, however, ends in 2012; it does not account for more recent elections in which threats to democratic processes (compared with uncertainty regarding the eventual winner) are more salient.

Heightened political risk in the U.S. also could raise the costs of financing the U.S. federal budget deficit, which relies on the issuance of Treasury securities. U.S. Treasury bonds and bills typically are considered risk-free (in that there is near certainty that the U.S. government will repay its debts), with highly liquid markets. These assets have been an important holding not only for institutional investors, but also for foreign central bank reserves.[70] Indeed, continued global demand for U.S. Treasuries keeps financing costs low for the U.S. government (and for other entities whose debt is priced relative to Treasuries). The erosion of this “exorbitant privilege”[71] would have pronounced effects across the U.S. economy.

Earlier political tensions over U.S. fiscal policy did little to stem demand for U.S. government securities. In August 2011, in response to executive-legislative tensions around the debt ceiling, Standard & Poor’s downgraded its U.S. rating from AAA to AA+. This downgrade, however, had little impact on demand for Treasury assets, likely reflecting the U.S.’s global role. But 2011 was a time of generally low global interest rates and modest risk aversion, with less attention to political risk. And this downgrade was prompted by fiscal policy considerations, rather than by a deeper risk of democratic erosion.

In the contemporary period, by contrast, risk aversion in global markets looms larger, and (for geopolitical reasons) some asset-holders are seeking alternatives to U.S. dollar securities. Indeed, in May 2023, deadlock over raising the U.S. debt ceiling[72] led to noticeable increases in the price of credit default swaps (to insure against U.S. default risk).[73]

What has changed? The broader context of partisan polarization, over economic policy as well as with respect to the importance of democratic practices, generates greater risk. When political institutions are strong and stable, policy volatility and policy uncertainty are less worrying. But when political institutions face challenges, investors may lose confidence over policy as well.

As a result, the financing costs for U.S. federal debt could increase notably, leading to greater worries about the long-term appeal of the U.S. as a "safe haven." The current impasse over the U.S. debt ceiling, especially in the broader context of partisan polarization, may add to these concerns. Additionally, to the extent that U.S. Treasuries serve as an important baseline for U.S. capital markets, increases in perceived U.S. sovereign risk are likely to spread to the U.S. corporate sector, as well as to municipal and state-level government bonds.

U.S. firms and markets also face the risk that those political actors who would engage in undermining democratic institutions are inclined toward economic policies that undermine trade and financial openness. Foreign firms may be less inclined to transact with and invest in the United States, as they worry about the credibility of U.S. commitments to liberalization and investor protection (often via preferential trade agreements, international investment treaties, and global trade organizations). Similarly, U.S. firms may be less inclined—and sometimes less able, if foreign governments retaliate against U.S. policies—to invest abroad. U.S. involvement in the global economy and participation in international trade and financial institutions has been an important driver of growth and innovation, bringing benefits to many U.S. households, firms, and investors.

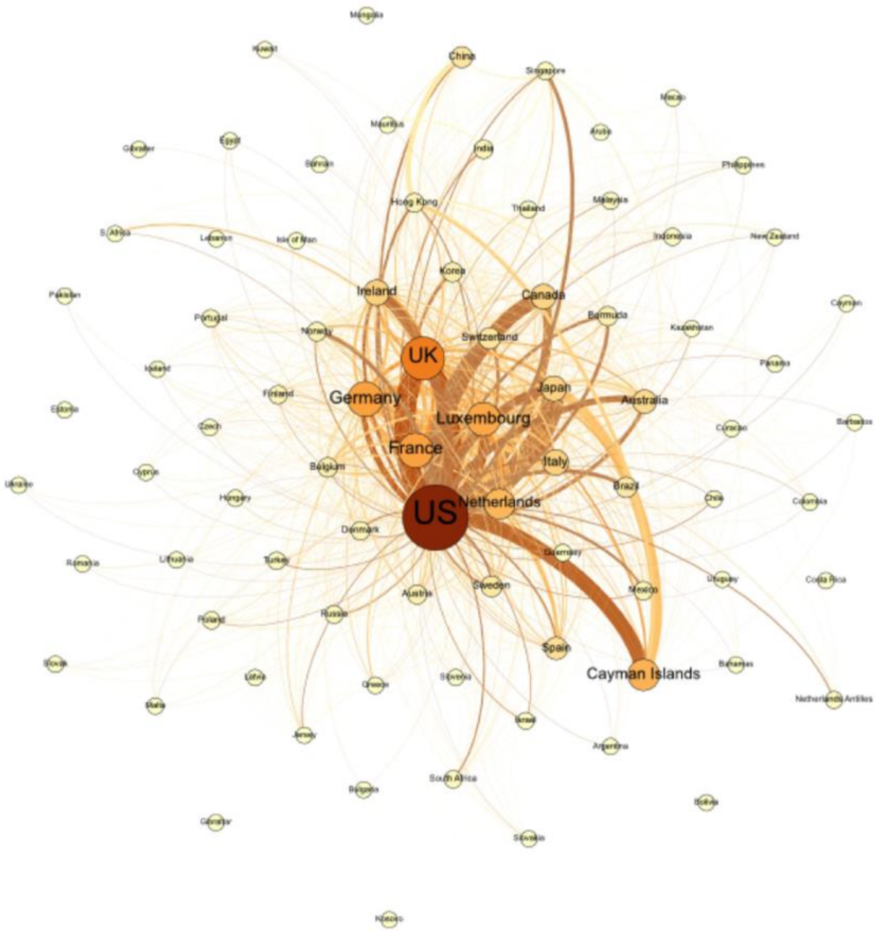


Figure 2. The global financial system in 2012, as measured by the IMF's Coordinated Portfolio Investment Survey.
Note: The darkness of nodes indicates greater degree centrality, while the thickness of ties among countries indicates the strength of a portfolio financial relationship. The United States is clearly at the core of the global financial system, which is hierarchically organized.

Figure: Bauerle Danzman et al. note the central role of the U.S. in global financial flows.[74] *This centrality is a transmission channel for financial shocks.*

Secondary effects. Added to the potential primary effects of democratic erosion on the U.S. financial sector is a set of secondary effects. These secondary effects stem from the U.S.'s central position in the global economic and financial system.[75] This centrality means that disruptions in the U.S. easily spread to other markets, as has been the case in previous (economic) crises. For instance, from 2007 to 2009, a U.S.-based crisis spread to the rest of the world economy. This happened via two primary channels: a liquidity channel, the primary transmission mechanism to other wealthy economies; and a risk appetite channel, the main transmission mechanism to emerging markets. It is worth noting that the U.S. crisis "affected not only economies that shared similar vulnerabilities … but it spread to virtually all economies, advanced and emerging alike."[76]

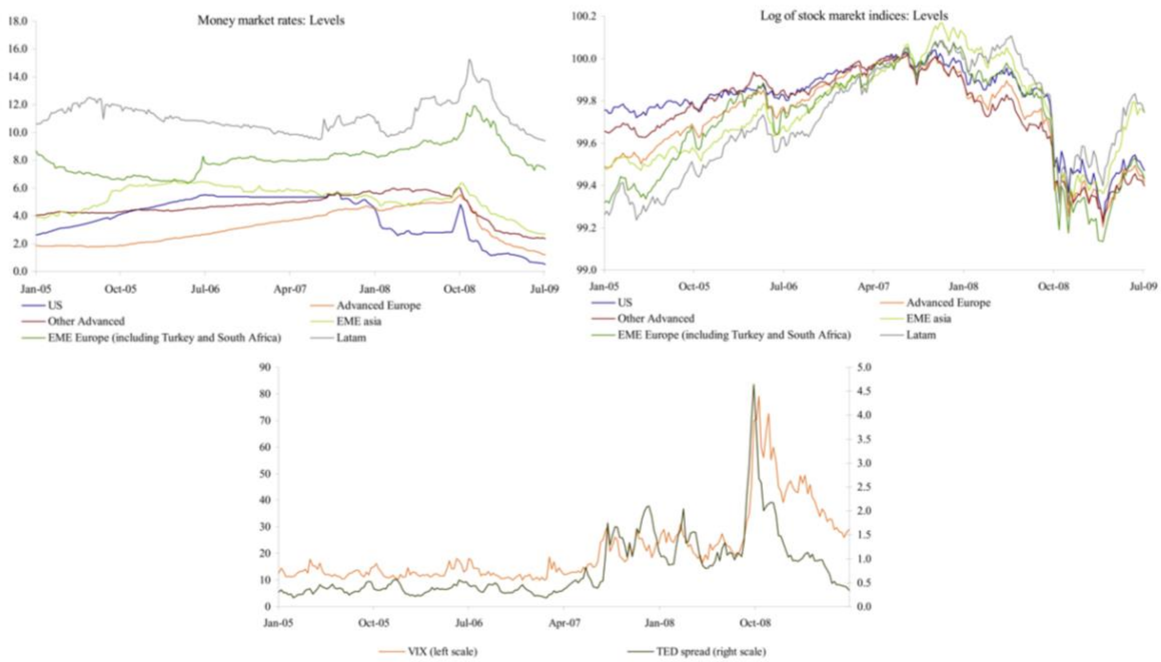


Figure 1: VIX, TED spread, stock market indices and money market rates - Unweighted averages of six groups: US, Advanced Europe, other Advanced, Emerging Asia, Emerging Europe (plus Turkey and South Africe), and Latin America.

Figure: Chudick and Fratscher describe the spread of the U.S.-based global financial crisis to other markets, including emerging as well as developed markets.[77]

As significant as the consequences of the 2007–2009 U.S. crisis were for the global economy, the effects were mitigated via cooperation among the U.S. Federal Reserve and foreign central banks, as well as via the International Monetary Fund, the G-20, and other international institutions.[78] If U.S. leadership of international economic institutions were absent—as it might well be in the context of democratic erosion, and a time of heightened geopolitical risk—the crisis spread and depth could be much more pronounced.

Finally, the dollar's importance in global markets also would exacerbate the effects of any U.S.-based crisis. Although the U.S. accounts for approximately one quarter of global gross domestic product and one sixth of world imports and exports, the U.S. dollar is widely used in financial transactions. Approximately half of cross-border loans, international debt securities, and trade invoices are dollar-denominated.[79] The dollar also dominates currency trades.

All told, political risk related to democratic erosion could be quite damaging for U.S.-focused investors. It is difficult for investors to "flee to safety" when risk stems from the United States: The market effects of U.S. political risk would quickly spread to other regions of the world.

IV. What Can Investors Do to Protect American Democracy?

Given the array of negative material effects that are likely to result from sustained democratic erosion in the United States, what should institutional investors do? There certainly appears to be a fiduciary duty to account for political risk in the U.S., just as investors consider political risks in other investment locations. When political risk increases in the U.S.—for instance, when state-level officials interfere with election administration, or when judiciary constraints on executive and legislative branch actors erode—investors may need to consider reallocating their assets away from U.S. markets. But, especially because of the difficulty of diversifying away from the U.S.—a difficulty stemming from home country bias as well as the central global position of the U.S.—taking a more public stance on the importance of democratic institutions also is important.

A range of mitigation tools are available to institutional investors. These include, but are not limited to, the following:

(1) **Investment frameworks.** Institutions should add U.S. political risk to the set of factors assessed when seeking to safeguard the assets of shareholders and beneficiaries. They can assure their

clients that they will undertake political risk assessment, not only elsewhere in the world but also in U.S. markets.

(2) Institutions can consider **making a more explicit statement of the political risk** resulting from democratic erosion in the U.S. For instance, "Threats to U.S. electoral integrity and rule of law could produce elevated probabilities of domestic political disorder and market instability. These therefore represent a material risk to the investments of those who entrust us with protecting and growing their savings. As a consequence, we affirm that it is within the scope of our fiduciary responsibilities to analyze U.S. political risk and, where appropriate, to seek pragmatic, nonpartisan, and constructive steps to mitigate such potential systemic risk." Institutions also might determine that such statements are more credible and effective when made in concert with other investing bodies.

(3) **Stewardship for equity investors, in public as well as private markets.** Institutional investors can identify an appropriate subset of U.S. portfolio companies (based on risk profiles, market impact, and responsiveness, among other factors) and focus mitigation strategies—including discussions of U.S. political risk—on them. As part of engagement with such firms, institutional investors can ask board directors and executives whether they consider U.S. political risk relevant to their business operation. These conversations can heighten firms' attention to U.S. political risk, while also providing institutional investors with a better sense of the quality of firm governance and forward planning.

(4) Engagement with portfolio firms also offers an opportunity to **convey support for business leaders who advocate electoral integrity** and respect for the rule of law. Institutional investors also can encourage firms that have thus far remained silent on these issues to join with corporations that already are championing fair elections and respect for constitutional integrity.

(5) Another aspect of engagement with portfolio companies concerns corporate political spending. Institutional investors can advocate **full disclosure of corporate lobbying expenditures**, as a means of ensuring that lobbying is consistent with corporate strategy, as well as with respect for democratic political institutions. Investors also can ask firms to terminate or avoid corporate-related political contributions to candidates or officials associated with election denial or with attempts to undermine the democratic process. These actions also could be taken collectively, by business, professional, and trade organizations.

(6) Investors can encourage portfolio company boards to consider political institutions when making location decisions in the United States, just as they often do when making investment decisions abroad. When seeking to acquire existing operations or open new ones, firms can consider the state's voting laws and assurances of full access to the ballot, as well as any state-level efforts to interfere with the democratic process. These considerations not only protect the firm from political risk; they also ensure that its employees are fully able to exercise their civil and political rights.

(7) When purchasing or underwriting bonds from U.S. subnational (state, county, and municipal) entities, institutional investors should consider the entity's legal and political institutions. For instance, they might avoid purchasing fixed income assets issued by entities that do not guarantee electoral integrity. Or they might set higher premiums and fees for transacting with such entities.

In 1970, economist Albert O. Hirschman wrote *Exit, Voice, and Loyalty,* describing the choices available to consumers when they faced deteriorating product quality: They could spend their money elsewhere (exit) or they could communicate their complaints and concerns, in hopes of repairing the situation (voice). To the extent that consumers were loyal to a brand or a firm, they might be inclined to choose voice. And voice could be effective, given that exit was also a possibility.

Exit—divesting in response to backsliding—allows professional investors to impose negative consequences on governments (as sovereign borrowers or as entities that care about the economic health of their region). This may be sufficient, in at least some cases, to get the attention of political elites. And, if mass publics view “the market” as a source of knowledge and expertise, exit might prompt them to reconsider their support of certain political actors.

Voice, however, may be an even more effective long-term strategy, and one that is more realistic given the U.S. market. That is, investors might remain involved in the U.S. market but exercise stewardship tools available to them to mitigate risk, for instance by expressing their concerns publicly or privately. One useful analogy is to index funds, which lock investors into a fixed portfolio of companies. Exit is not an option, so investors seek to reduce risk and enhance opportunity through the use of stewardship. Large investors have done this in response to other types of concerns (and in other markets), and it can be an effective means of capturing the attention of government officials as well as members of the public.

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