POLITICAL RISK IN EMERGING MARKET ECONOMIES:

Democratic politics, sovereign debt and financial market volatility in Brazil and Mexico

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UMI Number: U228820

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ABSTRACT

While the literature on the globalisation of financial flows has focused on the impact of highly mobile capital on domestic political choice and policy variation, less has been said about the impact of democratic politics on financial market performance. Existing studies have tended to limit their analysis to the impact of elections on markets. This thesis re-examines standard notions of political risk, hypothesising that political risk arises from the contours of democratic institutions, and suggests that institutions play a direct, rather than secondary, role in generating financial market volatility through the production of political news. A quantitative approach is adopted to examining both static and dynamic perceptions of market risk across emerging market countries, with particular focus on Brazil and Mexico.

Democratic political risk is defined as the uncertainty and instability arising from contestation over power and policy, which is more likely to occur in states with many veto players who have diverse policy preferences and low internal cohesion. States with such institutions are more likely to produce high levels of political news, in turn interpreted by market participants as political risk. The impact of such news is likely to be greater than that of other information significant to the market given the unpredictability and uncertainty of political information, as well as the difficulties in quantifying its impact. By examining the empirical determinants of sovereign bond spreads, as well as the causes of volatility in Brazilian and Mexican bond markets, the thesis demonstrates that political variables add significant explanatory power to models of sovereign debt premiums and that financial markets are highly reactive to democratic politics in emerging market countries.

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LIST OF ABBREVIATIONS

AMLO: Andrés Manuel López Obrador
BIS: Bank of International Settlements
BNDES: National Development Bank of Brazil
BP: Basis Points
CPIs: Parliamentary Inquiry Commissions (Brazil)
CPI: Consumer Price Index
DPI: Database of Political Institutions
EMBI: Emerging Market Bond Index (JPMorgan)
EMBIG: Emerging Market Bond Index Global (JPMorgan)
EMH: Efficient Markets Hypothesis
EU: European Union
EZLN: Zapatista National Liberation Army
FDI: Foreign Direct Investment
FOBAPROA: Fund for the Protection of Banks and Savings (Mexico)
FT: *Financial Times*
FX: Foreign Exchange
GDI: Global Development Indicators (World Bank statistics)
GDP: Gross Domestic Product
GNP: Gross National Product
IFES: The Institute For Electoral Studies
IFIs: International Financial Institutions
IFS : International Financial Statistics (IMF statistics)
IID: Independent and Identically Distributed (written i.i.d.)
IIF: The Institute of International Finance
IMF: International Monetary Fund
LIBOR: London Inter-Bank Offered Rate
Lula: Luis Inácio da Silva
MP: Provisional Measure (Brazil)
NAFTA: North American Free Trade Agreement
NASDAQ: National Association of Securities Dealers Automated Quotation system
NIE: New Institutional Economics
OECD: Organisation for Economic Cooperation and Development
OLPR: Open List Proportional Representation
OLS: Ordinary Least Squares
PAN: National Action Party (Mexico)
PBC: Political Business Cycle
PMDB: Brazilian Party of the Democratic Movement
PP: Popular Party (Brazil)
PRD: Party of the Democratic Revolution (Mexico)
PRI: Institutional Revolutionary Party (Mexico)
PSB: Brazilian Socialist Party
PSDB: Social Democratic Party of Brazil
PT: Workers Party (Brazil)
PVEM: Green Party (Mexico)
SDRM: Sovereign Debt Restructuring Mechanism
SELIC: Special Settlement and Custody System (Brazilian interest rates)
S&P: Standard and Poor's
SHCP: Secretaría de Hacienda y Crédito Público de México
WTO: World Trade Organization

ACKNOWLEDGEMENTS

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CHAPTER I

GLOBAL FINANCE AND DOMESTIC POLITICS IN EMERGING MARKET COUNTRIES

1.1 INTRODUCTION

Financial globalisation is one of the most striking characteristics of economic globalisation, and understanding its consequences for both market performance and national policy is central to current investigations of international political economy. The amount of money invested through and traded on financial markets has increased dramatically as the process of globalisation has increased and intensified: the Bank of International Settlements (BIS) estimates that the average daily turnover of the foreign exchange markets in April 2004 was $1.9 trillion and the daily turnover for foreign currency derivatives was $2.4 trillion – both of which represent an increase of more than 50% since 2001.[1] Daily trading volumes of emerging market currencies routinely reach billions of dollars – the daily turnover of the Mexican peso was $15 billion in 2004.[2] In 2004, emerging market countries issued $152 billion of international bonds, and the total value of outstanding bonds from developing countries was approximately $700 billion.[3] While flows of portfolio capital are perhaps an imperfect measure of financial globalisation, there is little doubt that the current period of economic

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[1] The Bank of International Settlments's 'Triennial Central Bank Survey of Foreign Exchange and Derivatives' (BIS 2005).

[2] Ibid

[3] Includes major issuers in Africa, the Middle East, Asia, the Pacific, Europe and Latin America (BIS 2004).

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globalisation has changed the way that money is raised and traded on the international capital markets, and has had strong impacts on emerging market countries.[4]

One of the most frequent hypotheses put forward by political economists about financial globalisation is that it has tended to exert a disciplinary effect on national policy makers, reducing the scope of cross-national variation in macroeconomic policy making, as capital flows out of countries in which macroeconomic policy is imprudent (Andrews 1994; Cerney 1995; Stiglitz 2000; Rodrik 2001). Rodrik explains this situation by reformulating the 'impossible trinity' of monetary relations to describe the tradeoffs facing today's policy makers, who can choose two but never three of the following: integration with the global economy, formal state sovereignty or effective domestic policy making. While the interaction between international finance and domestic politics has always been contentious, exemplified by Hirschman's 'intrinsic conflict' between the economic power of exit and the political power of voice (Hirschman 1970), the recent literature on the political economy of global financial flows has argued that as portfolio capital increases and becomes more liquid, the relative power of holders of that capital increases because the threat of their exit becomes more severe, and thus economic policies that are favourable to these important actors are increasingly pursued by governments (Minushkin 2004).

Dissenting voices have argued that the threat to policy independence has been exaggerated, or is at least more nuanced, and that there remains a large degree of variation of economic policies in globalised polities (Boyer 1996; Wade 1996; Garrett

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[4] Throughout this work, the terms developing countries and emerging market countries (more common in financial market parlance) are used interchangeably.

1998; Garrett 2000). Nonetheless, it is clear that in the developing world at least, there has been a high level of convergence around economic models that can broadly be described as neo-liberal, categorised by a reduced amount of state intervention in the economy and liberalisation of capital flows, and that one of the major consequences of financial liberalisation has been an increasing volatility in consumption, partially as a result of financial crises (Prasad, Rogoff et al. 2003). As Walter notes: "The emergent international financial structure constrains governments, but very unequally: most of the costs and risks it entails falls largely upon developing countries" (Walter 2002: 1).

A related but often overlooked consequence of financial globalisation and the financial crises of the late 1990s is that as financial market participants have become more interested in evaluating convergence of national macroeconomic policies in emerging market countries, they have additionally placed greater emphasis on evaluating the underlying political processes that result in such policies. As a consequence, the concept of political risk has increasingly entered into the lexicon of financial market participants. The increasing emphasis placed on political variables such as the quality of institutions and governance by international policy makers and economists, an indirect result of the financial crises of the 1990s and the Asian financial crisis of 1997-98 in particular, has generated a growing concern amongst investors with the day-to-day politicking in emerging market states. The primary result demonstrated in this thesis is that asset value, risk premiums and financial market volatility are driven by political variables in addition to macroeconomic fundamentals, and that investor-

oriented research on emerging market assets increasingly includes information about political variables.

Because many developing countries liberalised their economies at the same time that their political systems underwent a process of democratisation, the increasing interest in politics and institutions in emerging market countries has meant an increasing interest in democracy. The impact of democracy on the quantity and stability of financial flows is complicated. Significant research has been dedicated to demonstrating that democracy and economic prosperity are positively correlated.[5] Additionally many have found a positive relationship between democracy and financial flows: for example between democracy and a country's ability to attract foreign direct investment (Rodrik 1996; Harms and Ursprung 2002; Busse 2003), and between democracy and commercial bank flows (Rodriguez and Santiso 2005). Others have argued that that the 'institutionalised uncertainty' of democracy is at odds with the desire of investors to find stable environments in which to place their money (Haley 1999) and that a proliferation of veto players can be bad for financial market stability (MacIntyre 2001). I argue that while moving from autocracy to democracy may enhance credibility, a different dynamic might be at play amongst democracies. In democracies in which there are high levels of contestation – i.e. many veto players with diverse preferences and low cohesion – credibility is adversely affected. Similarly, while autocratic regimes are likely to experience extreme volatility driven by political risk during periods of political unrest, these event periods are less frequent; in

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[5] While this literature is too voluminous to cite in full, the first notable modern work on the topic is (Lipset 1959). A recent overview of the empirical evidence, with complete citations of the theoretical literature, can be found in (Leblang 1997).

democracies, political risk affects market performance more frequently but with less intensity.

The reaction of global financial markets to political risk in emerging market economies is the central focus of this thesis, adding to a small but burgeoning literature on the ways in which financial markets respond to political events (Armijo 1999; Bernhard and Leblang 2002; Mosley 2003; Santiso 2003; Schamis and Way 2003). I investigate the way that the perception of political risk affects 1) the price at which emerging market countries can borrow money on the international capital markets, and 2) the volatility that such assets face. Both increased political risk premiums and high financial market volatility make it difficult for emerging market governments to borrow and to 'graduate' to investment grade credits. Volatility has other negative impacts, such as making access to credit more unpredictable, thus complicating economic planning. Political risk reinforces the existence of the emerging market asset class by justifying risk premiums.

As is discussed at some length in Chapter II below, there is a limited theoretical literature on political risk. Studies of political risk are generally more business and user oriented – practical guides to avoiding political risk and hedging against it. In contrast, the definition of political risk that is generated and utilised in this thesis is explicitly institutional, focusing on the extent to which power is concentrated and therefore politics is contentious: the uncertainty and instability arising through the turnover of administrations (elections and other types of regime collapse such as dissolution of

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governments) as well as the extent to which political power is diffused along horizontal and vertical dimensions.

Consistent with financial market theory that emphasises the market's rationality (but taking into account strains of theory that question this assumption, such as various strains of behavioural finance), I argue that the reaction of financial markets to political risk is dependent upon the availability and content of political information. Building on the extensive literature on the markets' reaction to macroeconomic news, I construct a theory of political news, which argues that political news may have a particularly strong impact on financial market performance because it is generally unquantifiable, released in non-standardised ways at unexpected times, and fraught with uncertainty. This assertion has implications for institutional theories of political economy, as I argue that there is a direct link between political institutions and the performance of financial markets through the production of political news. The veracity of these hypotheses is tested through a mixture of quantitative and qualitative methods including content analysis of investor press, survey data, econometrics and comparative case studies of two large emerging market countries, Mexico and Brazil. These two countries, whose political and economic liberalisation in the 1990s are comparable though differently timed and sequenced, have experienced differing levels and sources of political risk. These differences are attributed to variations in their institutional settings, in particular the distribution of veto players across branches of government and amongst layers of government. As discussed in some length in section 1.5, the fact that Mexico's political system transitioned from an autocratic to a

democratic regime over the period of study also allows for an inter-temporal investigation about the level and nature of political risk during both periods.

Thus, while the thesis is situated broadly in the field of international political economy among discussions of globalisation and financial flows, literature, ideas and methods spanning several fields are called upon to come to a reasonable definition of what political risk is and why it is relevant for financial market performance. Insights from the large political economy subfield of institutionalism, for example, are heavily utilised, as are hypotheses from the field of finance. Economic theories of sovereign debt credibility are drawn on in order to design an econometric model of sovereign debt pricing which includes political variables. Finally, methods and ideas from the field of comparative political science are used, particularly in the chapters on Brazil and Mexico.

This chapter is an overview of the thesis as a whole and in it I provide initial insight into findings and implications of the work. First, in section 1.2, I attempt to explain the intrinsic connection between politics and sovereign debt, as sovereign bonds are the primary dependent variable throughout this thesis for measuring the impact of political risk. In section 1.3, I set out a primary research question and several sub-questions and present initial hypotheses. In section 1.4, I define the objects of inquiry for the thesis: emerging market countries, sovereign bonds, debt spreads and volatility. Section 1.5 introduces the two case studies, Brazil and Mexico, and discusses the appropriateness of their selection. Section 1.6 outlines the methodologies employed to answer the

research questions. The final section, 1.7, describes the structure of the thesis as a whole.

1.2 THE POLITICS OF SOVEREIGN DEBT

The history of sovereign debt is one of successive waves of credit expansion and default. The first 'emerging market' bond crisis occurred in the early 1800s when Latin American states defaulted on debt used to finance wars of independence.   While sovereign default in both emerging market and industrialised countries has been widespread since the origins of sovereign borrowing, there is still relatively little clarity about the determinants of creditworthiness, most of which are driven in the long run by reputation. Nonetheless, it is possible to identify sovereign creditworthiness as having two component parts. At the most basic level, creditworthiness is determined by the ability of a country to repay its debts. However, creditworthiness is also determined by the political will of the government to continue utilising resources which could be applied for any other purpose, including domestic spending.   More will be said about this feature below.

Political willingness to repay debt has been a crucial component to formal models of debt spreads, creditworthiness and debt default (see for example Eaton and Gersovitz 1981; Eaton, Gersovitz et al. 1986; Bulow and Rogoff 1989; Fishlow 1989). The rationale for incorporating political will into debt pricing models is two-fold. First, sovereign debt is difficult to collateralise: under today's borrowing conditions, it is rarely acceptable to hold a state's revenues or other saleable assets as collateral for debt

repayment.[6] Additionally, given the high value of today's sovereign debt portfolios,

collateralising sufficient assets to cover liabilities is difficult from a logistical

standpoint. To provide an example, the total value of the senior foreign debt the

Argentine government defaulted on in 2001 was $82 billion. Given the large

privatisation programme the government undertook in the 1990s, even a fraction of this

sum has proven nearly impossible to seize in publicly owned assets.[7]

The difficulty and unacceptability of modern day sovereign collateralisation (and of

previous methods of recovery such as so-called 'gunboat diplomacy') means that

creditors have only two mechanisms by which to ensure that their money will be

repaid: litigation and the threat of imposing financial autarky.[8] Neither, however, is

particularly effective. Although bondholders have rights to litigate to enforce payment,

they are used relatively rarely. [9] Domestic courts are often loath to grant rights to

foreign creditors during times of financial crisis, and compliance with international

rulings is more often motivated by concerns about loss of reputation than

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[6] There are some exceptions: loans to oil producing sub-Saharan African states, for example, have occasionally been collateralised via future oil revenue streams in recent times. The US bilateral loan to Mexico in the wake of the 1994 peso devaluation was to be tied to national oil revenues as well, causing significant domestic protest in Mexico. However, Bulow and Rogoff have called collateral for modern day sovereign debt 'irrelevant' (Bulow and Rogoff 1989). This is partially because an increasing number of states borrow primarily from private sources, where collateralisation is largely absent.

[7] EM Corporation, owned by US investor Kenneth Dart and his family, won an appeals court judgment against Argentina for $740 million for payment of defaulted Argentine bonds in September 2003. The Darts, however, have had difficulties in receiving payment: they attempted to seize cash from the Argentine postal service (which was privatised in the 1990s but was expropriated by the state in the wake of the crisis in 2002) in a US bank account and were unsuccessful. The Argentine government has successfully 'hidden' those public assets that would be easy to seize.

[8] Multilateral lenders effect a kind of collateralisation by placing high economic and policy conditions on loans and making the full amount available only in tranches, after a sufficient degree of compliance with the conditions has been demonstrated.

[9] A notable exception was in the Peruvian restructuring of 1997. Displeased with an agreement between international private creditors and the Peruvian government that favoured larger creditors, Elliot Associates, a small investment fund, sued the government of Peru for payment and was awarded the right to seek $58 million in October 2000. The fund had previously brought similar suits against Vietnam and Panama. See also footnote 7 on the failure of litigation in the more recent case of the Argentine default.

acknowledgment of foreign courts' ability to dictate the terms of restructuring. There is nothing akin to an international bankruptcy court to ensure that creditors are repaid. The International Monetary Fund's (IMF) recently proposed Sovereign Debt Restructuring Mechanism (SDRM), which failed due to large-scale opposition from private creditors as well as lender and borrower governments, was described by the IMF as an 'international bankruptcy court' in order to emphasis its role in adjudicating defaults.[10] Recent attempts by the Institute of International Finance (IIF) and several large emerging market countries (led by Brazil and Mexico) to create a set of policy guidelines on debt restructuring and default processes have similar aims to organise the debt process more efficiently.[11]

Additionally, the threat of financial autarky is relatively weak because it is infrequently observed. While debt default restricts flows of foreign capital from private lenders in the short term, empirical research has demonstrated that when sovereign defaults are widespread, credit resumption to countries in default is relatively rapid (Jorgensen and Sachs 1989). Thus, the primary motivator against default is not financial loss but damage to a country's reputation – something which takes a long time to rebuild (Tomz 2001; Reinhart, Rogoff et al. 2003). Political will to repay sovereign debt is critical in avoiding default.

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[10] Deputy Managing Director of the IMF, Anne Kruger, the primary architect of the mechanism, mentioned on several occasions that the SDRM would serve as a kind of international bankruptcy court. The IMF website has several pages on this topic with a wealth of information, among which are a number of her speeches: http://www.imf.org/external/ns/cs.aspx?id=26

[11] "IIF seeks extra support for fair debt restructuring 'principles'" (Balls 2005).

Given the above, how do political variables affect the rate of interest that borrowers pay on the international markets? The price of a country's sovereign debt at any given time has several components, only one of which corresponds to the political willingness to pay described above. This political component is akin to what is broadly perceived as political risk of sovereign default. The interest rate is made up of two macro-components: the risk-free rate and the risk premium. The risk-free rate is the prevailing international interest rate, approximated by either the price of a US Treasury Bond of similar size and maturation or the London Inter-Bank Offered Rate (LIBOR). The risk premium captures the perceived probability of default for the sovereign bond in question. This premium also commonly referred to as the 'spread' itself has two components corresponding to ability and willingness to pay. Ability to pay is determined by a country's liquidity and solvency, as measured by economic indicators such as reserve rates, debt to GDP rates, etc. There is little consensus on what political variables indicate a willingness to service debt. Thus, while a number of empirical studies have sought to identify the macroeconomic variables significant for determining the ability to pay (liquidity and solvency variables), far fewer studies have attempted to define or measure the variables that determine political willingness to pay. The discussion of political risk in section 1.3b below provides initial insight into the sources of political credibility.

1.3 THE RESEARCH QUESTION AND HYPOTHESES

The central research question of this thesis is: How does political risk in emerging market countries affect sovereign bond premiums and incidence of volatility in

sovereign bond markets? In order to arrive at an answer, I propose three additional research questions that help to structure the argument:

1) What is political risk?

2) What role do institutions play in determining political risk?

3) What is the impact of political risk on financial markets?

The central hypothesis advanced to answer the research question has two component parts. The first is that political risk is higher in democracies with numerous and diverse veto players because contestation in such polities is higher.[12] The second is that higher levels of contestation increase the incidence of political news, which due to its unique characteristics vis-à-vis economic news, will have a strong and typically negative impact on sovereign bond spreads and sovereign bond market volatility.

In the this section, I review the rising importance of political risk in the perception of asset value (1.3a) before proceeding to outline the argument of the thesis (1.3b-1.3d). The argument is constructed around the three research questions articulated immediately above: What is political risk? What role do institutions play in determining political risk? And what is the impact of political risk on financial markets?

1.3a The increasing importance of political risk

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[12] As explained on page 12, political risk in autocracies and democracies is different, and there are credibility gains from democratisation. This point is explained in greater detail in later sections of the thesis.

In what Beck has called the 'world risk society,' political risk is one of many types of risks facing individuals, corporations and governments. Beck's sociological definition of risk, first articulated in his seminal book *Risk Society*, which was primarily concerned with ecological risk, is as follows:

> Risk may be defined as a systematic way of dealing with hazards and insecurities induced and introduced by modernization itself. Risks, as opposed to older dangers, are consequences that relate to the threatening force of modernization and to its globalisation of doubt. They are politically reflexive. (Beck 1992: 21).

Such risks are not tied to the place in which they are produced, which is as true of financial risks in an era of global financial capital as it is of the ecological problems Beck was originally describing. As he argues in a later book, financial risk is a large component of the risk facing global society, epitomising his principle of "organized irresponsibility," or the divorce of risk from responsibility. Thus the financial market is seen as "an institutional form so impersonal as to have no responsibilities, even to itself..." (Beck 1999: 6). Further, while his work is not specifically interested in political risk in the context of the financial markets, he does note that participants in global financial markets have failed to account for the increasingly democratic nature of global politics, where voters are likely to prefer policies that are not consistent with the preferences of the market, due to their interest in improving their short-term situations rather than in investing in long-term gains. He asserts that the ideology of free markets is being supplanted by the "politicization of the global market economy." (Beck 1999: 7).

The importance of political risk to investment is demonstrated by the proliferation of firms that study and quantify political risk (e.g. the Economist Intelligence Unit, the Eurasia Group, the International Country Risk Guide),[13] the number of guides and studies that have sought to identify and mitigate political risk (Bouchet, Clark et al. 2003; Wilkin 2004) and the increase in the number of trained political scientists hired to emerging market research teams in major investment banks.[14] Uncovering the explicit reasons for the rising importance of political risk is generally outside the scope of this thesis, but there are several changes in the global political economy that may have facilitated this rise.

A number of factors have contributed to the increasing acceptance by economists, policy makers and investors that politics and institutions are central to economic performance and creditworthiness. The financial crisis of the 1990s, and in particular the East Asian crisis of 1997-98, were largely blamed on political factors such as corruption, cronyism and poor governance, by policy makers as well as major researchers in the field of political economy (see for example Corsetti, Pesenti et al. 1999; Eichengreen 1999; Haggard 2000; and see discussions in Wade 2000; MacIntyre 2001; Walter 2003). This focus on the role of politics in precipitating the crisis has in turn reinforced a changing focus within the international financial institutions (IFIs) on the importance of governance to economic success. Political reforms have become

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[13] According to the survey on political risk perceptions presented in section 3.4 of Chapter III, 25 out of 41 respondents (61%) said that they routinely use political risk analysts or consultancies to gauge political risk. Top political risk consultancies are routinely quoted in publications such as the *Financial Times* and the political risk index of the Eurasia Group appears monthly in the *Economist* magazine.

[14] According to survey results presented later section 3.4 of Chapter III, some 56% of all investment bank research teams have at least one member who has formal, university-level training in political science, international relations or related disciplines. One survey participant noted he held a PhD in political science.

both a priority for the IMF and the World Bank, as well as pre-conditions for debt forgiveness and loans. Both institutions have increasingly relied on political economy arguments to explain success or failure of development goals such as poverty reduction, reflected in the 'post Washington Consensus' which focuses on building strong institutions and good governance, among other goals, as prerequisites to the development process (Stiglitz 1998; Kapur and Webb 2000; Leftwich 2000; Williamson 2000; Fine 2001; Babb 2003). Working papers from both institutions have argued that domestic political conditions are critical to the success of their lending efforts (Dollar and Svensson 2000; Ivanova, Mayer et al. 2003).[15] The theoretical rationale for the increasing focus on the political determinants of economic success is 'New Institutional Economics' (NIE). NIE places institutional arrangements squarely at the centre of the economic research agenda (e.g. Drobak and Nye 1997; Furubotn and Richter 1997), providing intellectual currency for the trends discussed above.

1.3b What is political risk?

Thus, institutions and politics have returned to the forefront of economics and development.[16] But what do politics mean for investors and traders? In other words, what is political risk? Practical guides to risk have tended to focus on the uncertainty and instability arising from government and policy changes (Vu Le and Zak 2001;

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[15] This change in focus towards more political and governance-related conditions for economic success is an oft cited example of the IMF and World Bank's continued 'mission creep' (Einhorn 2001; Stiglitz 2002; Babb and Buira 2004).

[16] Adrian Leftwich recently used a telling metaphor to describe the re-emergence of politics in the fields of economics and development. He likened politics to 'Victorian piano legs:' academics and development practitioners have long known that politics existed, but preferred to keep them covered so as not as to be embarrassed by them (Leftwich, A. "Developmental States: What they are and why we need them." Speech given at the Overseas Development Institute: London, 1 February 2006). This sentiment is more formally expressed in his book (Leftwich 2000): see especially chapters 1, 5 and 7.

Zonis and Wilkin 2001; Brink 2003). Traditionally, authors have attributed uncertainty and instability to varying types of political violence – that is to say, violent regime overthrow, protest, rebellion and war (Citron and Nickelsburg 1987; Brewer and Rivoli 1990; Balkan 1992). Democratic sources of political risk are less well explored: scholars have tended to focus on elections and other types of democratic regime change (e.g. cabinet dissolutions) as sources of political risk (Block and Vaaler 2001; Hays, Freeman et al. 2001; Bernhard and Leblang 2002). Nonetheless, it is not unreasonable to assume that political instability and uncertainty can arise in an array of other ways. Contestation over policy choices through the democratic process generates both instability and uncertainty. One useful theoretical method for understanding the conditions under which contestation is high and policy and government or regime instability is likely is to examine a country's veto players. Veto players are "individual or collective actors whose agreement is necessary for a change of the status quo" (Tsebelis 2002: 19). The greater the number of veto players in a given political system, the less likely policy is to move from the status quo (generating policy stability) but the more likely are government and regime instability.

1.3c What role do institutions play in generating political risk?

Building on the above, institutions play a role in generating political risk by determining the process and extent of political contestation. For example, as legislation passes through numerous veto players, the markets have more opportunities to discount the uncertainty of its passage. Additionally, in line with Tsebelis's theory, regime instability, a by-product of multiple and divergent veto players produces further

negative reaction from financial markets. Thus, institutions condition the way in which the policy process is viewed by investors. The greater the number of veto players, the more contentious and therefore risky the policy process is likely to appear to observers. Whether such policy contestation results in a change to the status quo may be irrelevant from the standpoint of investors – the contestation in and of itself generates political news which is interpreted as risk.

Thus, in order to understand the sources of political risk in democracies, institutional attributes such as the horizontal and vertical distribution of power must be taken into account. If such variables are of interest to investors in emerging market assets, information about such variables should be readily available in dedicated research, and investors and analysts themselves should cite such variables as central to their analysis. Additionally, institutional variables should have two impacts on the performance of markets. First, political variables should help to explain the cross-national variance in sovereign risk rates above and beyond that explicable by reference to macroeconomic conditions. Second, volatility in financial markets will be explained to a significant degree by the process of policy contestation amongst diverse veto players.

1.3d What is the impact of political risk on financial markets?

The process of contestation described in 1.3b and 1.3c will create news of a political nature that sends signals to investors about a sovereign borrower's credit quality. The reaction of the markets to that information will depend on the ability of investors to accurately gauge its impact. The argument put forward in this thesis is that political

news may have a particularly strong impact on the performance of financial markets because of several of its unique characteristics. Financial theory argues that markets quickly and efficiently incorporate information that is significant to asset pricing (Fama 1970), and relevant news of a political nature should in theory be no different. However, scholars of financial markets have found that the reaction of markets to news varies depending on how the information is released. Information that is both expected and disseminated in standardised ways has very little impact on markets, whereas unexpected information disseminated in a random or *ad hoc* way has a strong impact on markets (Almeida, Goodhart et al. 1998; Gai and Shin 2003). In comparison to economic information, political information is generally not expected and is rarely presented in a standardised way. Additionally, political information is difficult to quantify, making it harder for investors to accurately assess its relevance for pricing. Finally, political information has a higher degree of uncertainty than does economic information, which also may condition its impact on market performance. In sum, the nature of political news may make it more likely to produce high volatility than other types of market significant news, such as macroeconomic information. Given this hypothesis, the high levels of volatility experienced in emerging markets since the early 1990s may have to do with the rising relevance of political risk, broadly defined to take into consideration democratic political risks.

1.4 OBJECTS OF INQUIRY

Throughout this thesis, I focus on the impact of political risk on the premiums and volatility of emerging market sovereign bonds. In this section, I seek to explain why I focus exclusively on emerging market countries, why I have chosen sovereign bonds as

my dependent variable rather than other types of emerging market assets such as currencies and why I analyse the impact of political risk on financial market performance on both risk premiums and volatility.

This thesis is concerned with how the perception of political risk impacts emerging market or middle income developing countries to the exclusion of highly industrialised countries. Though some scholars have demonstrated that markets in advanced industrial countries react to political variables (Bernhard and Leblang 2004), the bulk of the evidence suggests that market volatility in response to political variables is much higher in emerging market economies.[17] Mosley, for example, demonstrates that the pressures that developed countries tend to face from the financial markets are 'narrow': only major economic policy decisions and macroeconomic indicators tend to arouse the volatile 'wrath' of the financial markets (Mosley 2003). Research by other scholars has corroborated these findings – Bronk for example demonstrates that the volatility of and premiums on Southern European bonds, which were partially attributable to politics in prior periods, decreased as these countries integrated into the euro (Bronk 2002). Additionally, anecdotal evidence of the market's willingness to overlook politics in advanced industrial countries, like European Union (EU) member states, abounds: despite the repeated failure of European nations to keep budget deficits within the guidelines set by the growth and stability pact, markets failed to respond. As the *Financial Times* notes: "Europe's political crisis comes as the performances of the continent's main economies are again proving disappointing – but it has failed to

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[17] This is consistent with the literature reviewed in Section 1.1 which demonstrates that the policy constraint of global financial flows for emerging market leaders is greater than for that of industrialised countries.

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produce a matching crisis in financial markets... Political developments often appear irrelevant from a financial market perspective."[18]   Further rationale for concentrating exclusively on the impact of political risk in emerging markets is provided in Chapter III, section 3.2b.

The second required clarification is why I have chosen to analyse sovereign bonds rather than other types of emerging market assets.   While the discussion of sovereign debt in section 1.2 above illustrates the link between politics and debt, nothing was said about why political risk is not considered in the context of other emerging assets, such as currencies or equities. Emerging market portfolio investment can be broadly broken into several categories: sovereign debt, currencies, corporate debt and equity. The reasons for excluding corporate bonds and equities from the analysis are straightforward from a theoretical standpoint, but the reasons for excluding currencies are more complex. With regards to emerging market equities and corporate bonds, the impact of political risk on such assets is necessarily secondary to the underlying value of the company (Pantzalis, Strangeland et al. 2000). Thus, analysing the impact of political variables on equities is a secondary rather than primary concern.

The justification for excluding currencies from the study is more practical than theoretical. The value of currencies is strongly influenced by politics and policy, as policy makers have many tools by which to exert control over the value of the currency. Choices of exchange rate regimes, and their stability, are also highly political − as demonstrated by the large amount of empirical evidence that shows

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[18] "Poor record of main economies is a side issue for investors" (Atkins 2005)

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currency crises are more likely to occur during electoral periods or other periods of political turmoil. Thus the primary reason to focus on emerging market sovereign bonds rather than currencies is practical: there are far less time series data on currencies than on bonds. Most major emerging market countries only allowed their currencies to float in the later half of the 1990s (e.g. Mexico in 1995, Thailand in 1997, Brazil in 1999, Argentina in 2001, etc), while the sovereign bond market became active again in Latin America in 1991 with other developing countries following shortly thereafter. Additionally, the currency market is notable for the extent to which it is dominated by speculative trading which may obscure the extent to which value is driven by economic or political fundamentals: the BIS estimates that of the trillions of currency traded every day, a large percentage is driven by speculative strategies amongst both 'real' money managers and hedge funds (Galati and Melvin 2004). Sovereign bond markets thus provide a richer and more reliable source of time series data for analysis.

Finally, I have chosen to measure the impact of political risk on emerging market sovereign bonds in two ways: through debt premiums and through volatility. The premium that emerging market governments pay on their borrowing (debt spreads) is a metric of relatively static perceptions of both political and economic risk whereas the existence of market volatility provides an instantaneous picture of the impact of political risk on markets. Both are central to country's ability to borrow. While sovereign debt premiums affect long-term ability to borrow, volatility affects the proclivity of an economy to face a sudden stop of financing, and therefore the risk of

being forced into default by liquidity problems. The origins of a number of financial crises of the 1990s can be traced to market volatility.

1.5 CASE STUDIES

The impact of political risk on financial market volatility is primarily tested through two in-depth case studies of large emerging market economies: Brazil and Mexico. This section details how these two cases are used to advance the claims of this thesis, and also provides some descriptive statistics which further justify their selection.

The first and most obvious reason to study Mexico and Brazil is their importance in terms of emerging market finance and Latin American economics, which makes them the two giants of the emerging market world. Together, the two countries make up some 66% of Latin America's GDP and 54% of its population.[19] Consequently, they are the top two destinations for foreign direct investment as well as portfolio capital flows in the Latin American region, and are two of the leading emerging markets in the world in terms of size of investment flows. In 2004, Brazil and Mexico accounted for 65% of Latin American FDI.[20] While this represents only 6% of total global FDI, their combined proportion of emerging market bond debt is far greater. Brazil's debt trading volume *alone* accounts for 33% of all emerging market debt (a reported total of $448 billion, which includes both international and local bonds), while Mexico's accounts

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[19] Real 2003 GDP was $626 billion for Mexico and $498 billion for Brazil. Total Latin American GDP (18 countries excluding Cuba) was $1,694 billion (IMF 2004). According to the Population Reference Bureau's 2004 World Population Data Sheet, Brazil's population was 179 million and Mexico's was 106 million out of a regional total of 526 million (PRB 2004).

[20] According to the UN Economic Commission for Latin America, Brazil's 2004 FDI was $18.2 billion and Mexico's was $16.6 billion (ECLAC 2004).

for 23% ($204 billion).[21] No other single country comes close to these totals – Russian bonds, which are the third most actively traded, account for 8% of global volumes. Argentina accounted for only 3% of the total in the third quarter of 2004.[22]

Additionally, both countries regained access to the international capital markets in the early 1990s through the US-backed Brady Plan, which allowed them to convert defaulted debt instruments into new bonds with the implicit backing of the US Treasury. Along with several other countries such as Venezuela and Agrentina, Mexico and Brazil were the first 'emerging market' counries. Additionally, both were to suffer severe financial crises in the 1990s as a result of their decision to change their currency regimes from fixed to floating: Mexico at the end of 1994 and Brazil at the beginning of 1999. Both countries have suffered massively from financial crisis contagion within Latin America and from the East Asian financial crisis of 1997-98.

Their size and importance within the emerging market world make them good objects of inquiry generally, but there are two primary reasons to use these two cases to advance the claims of this thesis. First, their democratisation processes were different sequenced. While the military regime that had goverened Brazil since 1964 began to release its grip on power in the early 1980s, resulting in democratic elections and a new democratic constitution in 1988, Mexico's transition from one-party rule occurred significantly later. While the ruling party's control over Mexican politics had been slowly delclingin since at least the early 1908s, substantial political reform and transition to opposition rule did not occur until the mid 1990s under the presidency of

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[21] According to the UN Economic Commission for Latin America (ECLAC 2004)
[22] Emerging Market Trade Association Survey (EMTA 2004)

Ernest Zedillo. Thus while the Brazilian case analyses the impact of political risk on financial market volatility under conditions of democracy, the Mexico case study allows for inter-temporal variation between autocratic and democratic regime. Thus, it is possible to compare the impact of political information prior to democratisation and afterwards, in order to confirm the hypothesis that the nature of political risk changes under the context of these two regime types: from low probability higher impact events to high frequency lower impact events.

Second, the selection of Brazil and Mexico is advantageous because many recent articles on the reaction of financial markets to political risk have focused on the case of Brazil (Martinez and Santiso 2003; Miller, Thampanishvong et al 2004; Hardie 2006). However, it is relatively easy to dismiss this case as 'exceptional' (especially when the period of investigation includes the highly unusual 2002 election) therefore making it more difficult to generalize from the conclusions. In contrast, most would expect that political risk currently plays little role in driving Mexican financial market volatility given both the fact that the country is rated as investment grade by Moody's (since 2000) and the extent to which the country is integrated to the US economy through the North American Free Trade Agreement (NAFTA). Thus, demonstrating that institutionally determined political risk plays a strong role in driving financial market volatility in Mexico should go some way to generalizing the findings that the democratic policy making process is a highly significant determinant of emerging market volatility.

Thus the work on Brazil and Mexico has two purposes: to articulate in greater depth the impact of horizontal and vertical distributions of power on the perception of political risk (and in the case of Mexico to look at the evolution of political risk from extra-constitutional to democratic) and to look more carefully at the impact of political news on market performance. Thus, for each country, an institutional analysis is completed which focuses on the characteristics that make it likely to suffer from political risk (sections 5.2 and 6.2). In Brazil, the political party system is used as a lens through which to understand the diffused nature of power between the branches of government; this is complemented by an analysis of the distribution of power away from Brasilia and towards state and local government (governors and mayors). In Mexico, the presidency is used to understand the distribution of power across the political system; attention is placed on the transformation of Mexico from a system dominated by a presidency with 'meta-constitutional' power (Philip 1992) to a system with a high number of diversely oriented and highly fractionalised veto players in the late 1990s. Additionally, an analysis of Mexican federalism is completed.

1.6 METHODOLOGY

In order to best understand how sovereign bond markets react to political risk in developing countries, one must investigate the mechanisms through which this is possible, the how of the question. As Mosley points out, there has been a serious lack of investigation into the specific ways in which the financial markets exert pressure on national polities; she notes that most scholars have simply assumed that the market mechanism is an effective discipliner (Mosley 2003). Complex work on whether the

behaviour of financial markets tends to be random or disciplined has been left to students of finance, economics and econometrics, but this work has not been tied back to the political implications of such behaviour. Thus, it is necessary to have an in-depth understanding of the way that financial markets function, and in particular, how they regard politics and process information of a political or policy-oriented nature, in order to understand whether market volatility is related to politics. If it can be established that financiers are indeed interested in politics and policy, increasingly demand information of a political nature about emerging market countries and subsequently act on that information, then the way that these actors accumulate and utilise political information will be of interest.

I answer the research questions and evaluate the central hypothesis set out in section 1.3 through both quantitative and qualitative methods. This section briefly reviews those methods. I provide support for my definition of political risk and demonstrate the importance of political information to investors of emerging market sovereign bonds (part one of the central hypothesis outlined in section 1.3) through two studies. First, the content of investment bank research reports were analysed to determine how large a role political analysis plays in recommendations of asset attractiveness. Nearly 1,000 reports from JPMorgan covering some 40 countries from 1998 to 2003 demonstrate that 1) coverage of politics has increased and currently accounts for more than one half of variables considered significant for market pricing; 2) the political variables of interest are highly complementary to the definition of political risk suggested and that complex democratic institutional variables receive a high proportion

of all political coverage; and 3) that analysts, and therefore it is assumed traders, have an appreciation of the importance of complex democratic institutions.

The findings from this research were complemented by a questionnaire that was sent to more than 200 investment bank analysts, asking them to elaborate on the importance they place on political risk when analysing emerging market assets. More than 40 analysts responded, and their responses demonstrate clearly that 1) political variables are at least as important as economic variables when assessing country risk; 2) analysts are interested in complex political variables as components of political risk; and 3) the means by which analysts seek to quantify political risk are limited. Thus, the findings of the survey and the content analysis provide strong support for both the definition of political risk suggested and the hypothesis that the breadth and depth of political information available for market participants has increased. It also provides some initial support for the hypothesis about the difficulty of incorporating and accurately pricing political risk.

While qualitative research is the most appropriate manner to determine the nature of democratic political risk, in order to determine whether sovereign bond risk rates contain a strong political element econometric methods must be used. Thus, traditional econometric models that have sought to determine the macroeconomic determinants of sovereign bond spreads (Edwards 1984; Edwards 1986; Min 1998; Goldman Sachs 2000; Ferrucci 2003) were adapted to include institutional political variables. The sovereign debt spreads of seventeen emerging market countries between 1998 and 2002 were tested, and the model demonstrates that including metrics related to veto

players (the number of checks and balances, the degree of polarisation of veto players, their cohesion and the presence of fiscal federalism) is better suited to explaining cross-country variation of sovereign bond spreads than purely economic models. The explanatory power of the model that incorporates both political and economic variables is higher than the purely economic models reviewed. Additionally, the model demonstrates that institutional variables are not serially correlated with economic indicators such as fiscal deficits, suggesting that the importance of such variables may lie in their direct impact on the market's perception of political risk rather than their ultimate economic outcome.

In order to prove the second part of the central hypothesis presented in section 1.3, that political information has a strong impact on financial market volatility, I undertook an analysis of the causes of financial market volatility in Brazil and Mexico from 1991 to 2002. Content analysis was completed on more than 8,000 articles on Brazil and Mexico that appeared in the newspaper the *Financial Times* from 1991 to 2002. Articles on each country were 'matched' to the performance of their sovereign bonds during the period on a day-by-day basis. Volatility was defined as any day-on-day change in spreads greater than the annual standard deviation. Ultimately, only news that occurred on a day in which there was 'volatility' was considered to relevant. I analysed the aggregate impact of news of a political and economic information and also looked at the individual impact of political and economic news on market volatility. The results were striking. I found that while contagion was the strongest determinate of volatility, contestation between the executive and the legislature (horizontal checks and balances) was the second most important determinant of

volatility. Further, political news was a far stronger cause of volatility than economic news, which had almost no net impact on market performance. Though economic news occasionally had a strong impact on daily volatility, the frequency with which political information generated daily volatility was far greater. Additionally, the content analysis demonstrates that in both Brazil and Mexico, the market's perception of sources of political risk changed as each country consolidated its democratic and economic reform programme over the course of these years.

1.7 STRUCTURE OF THE THESIS

To summarise, the thesis is organised to provide quantitative and qualitative support for the primary hypothesis about the relationship between financial markets and domestic political conditions in emerging market countries. Chapter II provides both a literature review and the theoretical foundations of the thesis. Section 2.2 reviews three strains of literature: first, prior work on the concept of political risk; second, literature on the impact of politics on financial market behaviour during crisis periods; and third, literature on the impact of politics on financial market behaviour during non-crisis periods. Section 2.3 describes how the theory of veto players can be applied to the concept of political risk and section 2.4 articulates a theory of political news. In this section, I discuss three characteristics of political news (unexpectedness, quantification and uncertainty) in sections 2.4a, b and c, respectively. The final section of that chapter (2.5) concludes.

In Chapter III, section 3.2, I nuance the theory presented in Chapter II in two ways. In sub-section 3.2a, I discuss the difference in the way that political news impacts market performance in democracies and autocracies. In sub-section 3.2b, I discuss the difficulty of 'graduating' from the emerging market asset class, and introduce the concepts of 'debt intolerance' and 'original sin.' The main purpose of Chapter III, however, is to consider initial empirical evidence about the role of politics in perceptions of asset value. Section 3.4 and 3.5 present evidence from investment bank research reports and a survey of investment bank analysts, respectively. Section 3.5 concludes.

Chapters IV, V and VI provide the bulk of the support for the central hypothesis of the thesis. Chapter IV is an econometric investigation of the sources of sovereign bond risk premiums. Previous models of sovereign debt spreads are reviewed in sections 4.2 and 4.3, and a model that includes political variables is designed in section 4.4 and tested in section 4.5 Chapters V and VI are in depth case studies of democratic political risk in Brazil and Mexico, respectively. As explained in section 1.5 above, each chapter first provides an institutional analysis of the country (sections 5.2 and 6.2). Those sections outline the distribution of power across branches of government (5.2a and 6.2a-b) and among layers of government (5.2b and 6.2c). In the case of Brazil, the party system and delegation of political and economic authority to states and cities is reviewed, in order to provide a base for the volatility analysis. In the case of Mexico, the institutional focus is on the Mexican presidency, and how checks and balances in the Mexican constitution were utilised in practice before and after the country's democratisation. Additionally, the system of fiscal and political federalism

is analysed. Section 5.3 outlines the methodology used in both chapters for the volatility analysis. The remaining sections of these chapters demonstrate the impact that political news has had in generating volatility in sovereign bond markets (5.4-5.7 and 6.3-6.6). The concluding sections of these chapters provide a sense of how political risk in each country is likely to progress in the coming years: perhaps counterintuitively, while there is some hope that political risk in Brazil is on a downward trajectory, political risk and accompanying financial market volatility in Mexico seem to be on the rise.

The findings on the potential trajectory of political risk in Brazil and Mexico make a good starting point for the conclusions of this work, contained in the final chapter (Chapter VII). First, the chapter provides a summation of the findings (7.2), and attempts to generalise the applicability of the findings in the Brazilian and Mexican cases to other emerging market economies within and outside Latin America. Second, it lays out a number of policy implications of this thesis, which are broadly broken into implications for three audiences: politicians and policy makers in developing countries (7.3a), policy makers in international institutions (7.3b) and investors in emerging market economies (7.3c). Section 7.4 provides a multi-part agenda for future research and 7.5 finishes with concluding thoughts.

CHAPTER II

(RE)DEFINING POLITICAL RISK AND ITS IMPACT ON FINANCIAL MARKET BEHAVIOUR

2.1 INTRODUCTION

In this chapter, I articulate a theory of political risk and financial market behaviour that helps to lay the groundwork for the empirical chapters of this thesis. I ask three questions: first, what is political risk? Second, what role do institutions play in generating political risk? Third, what is the impact of political risk on financial markets? To answer these questions, I first look at the previous literature on both the definition of political risk and on the impact of political events on financial market performance. Political risk has traditionally been defined as the uncertainty and instability arising from government actions and policies. While this definition is broad, many studies have interpreted instability and uncertainty to mean extra-constitutional or democratic regime change through coups, regime collapse, elections, cabinet dissolutions and votes of no confidence. I suggest that several institutional characteristics also contribute to the market's perception of political uncertainty and instability. The process of contestation over policies and resources can be both uncertain and unstable, especially in democracies where there is a broad divergence of policy preferences or where power is highly dispersed amongst a wide range of actors.

Thus, I utilise the theory of veto players to determine which democratic regimes are most likely to be perceived as having high levels of political risk.

After articulating the role of veto players in determining political risk, I suggest that political institutions and financial market performance are closely linked through the creation of 'political news.' In emerging market democracies which have a large number of veto players (and where policy preferences are dispersed and cohesion is low), contestation is higher, and thus more political news is generated. But how do financial market participants react to such news? As long as it is relevant to perceptions of ability or political willingness to pay sovereign debt, some reaction is expected, but the extent to which political news is expected to generate volatility depends on assumptions about the behaviour of financial markets.

There are two potential hypotheses. First, it is possible that relevant political information is incorporated quickly and efficiently into the underlying asset price, as is hypothesised by the Efficient Markets Hypothesis (EMH). In this context, efficiency implies that the news is priced in accurately, without unwarranted volatility. However, the EMH has been strongly contested by hypotheses which fit broadly into a branch of financial theory called behavioural finance. A growing literature has sought to demonstrate that rather than reacting quickly and efficiently to relevant information, markets are likely to herd, cluster and experience contagion, none of which is fully consistent with the EMH, due to non-rational behaviour on the part of financial market participants (Shiller 1998). If this perspective is applied to political information, then

the results are less predictable – markets may under or over react to a given piece of information.

While I do not dismiss the underlying assumptions of rationality in the financial markets, I suggest that there are certain attributes of political information that make it particularly likely to lead to high levels of volatility, that is to say, to create a reaction stronger than that which may be warranted by the actual threat to asset value. There are three characteristics of political news which I highlight as potentially problematic for the efficient functioning of financial markets. First, political news is released to market participants at unexpected times and in unexpected ways. The extensive literature on the market's reaction to macroeconomic news has demonstrated that distinct from content, the manner, timing and content of news releases determines the extent to which the market reacts to such news. Second, political news is difficult to quantify, which makes it difficult to incorporate into standard pricing models of sovereign debt, and increases the extent to which reactions to political news are subjective. Third, political news is more uncertain than economic information because politicians may have an incentive to act in a time inconsistent manner for short-term electoral or other gains, making policy promises that they do not intend to or cannot keep.

This chapter is structured into three broad sections: a literature review, a discussion of the impact of veto players on political risk and a theory of political news. The literature review has two sections: one that reviews prior definitions of political risk and a second that provides an overview of studies analysing the impact of political risk on financial market behaviour (sections 2.2a-2.2c). In section 2.3, I explain why

institutional distributions of power and contestation are expected to have an impact on investors' perceptions of political risk. Section 2.4 details the mechanism through which contestation is relayed to market participants (via the creation of political news), and sub-sections 2.4a-2.4c discuss the impact of political news on market behaviour. The final section (2.5) concludes.

2.2 LITERATURE REVIEW

2.2a Political risk

Political risk is an under-theorised concept. Many studies of political risk offer rather vague definitions of it, and are more interested in telling business-oriented readers how to mitigate political risk when investing. *The Economist* magazine, which published a guide to different kinds of risk several years ago, dedicated a chapter to political and regulatory risk (Pickford 2001). Zonis and Wilkin, whose study within that edition focuses more specifically on political risk, define it as follows:

> Political risk is uncertainty that stems, in whole or in part, from the exercise of power by governmental and non-governmental actors. Political instability and politicized government policy pose the best-known political risks. Political violence, expropriation and creeping expropriation, contract frustration, and currency inconvertibility are among typical hazards (Zonis and Wilkin 2001: 177).

The 'problem' with political risk, the authors admit, is that it carries "very different connotations for different companies" and "covers a variety of threats, with a variety of impacts" (ibid). Similarly, Vu Le and Zak, who distinguish policy risk and political risk as two of three types of risk affecting all assets (the other being financial risk), similarly categorise political risk as being composed of the longevity and stability of the ruling regime as well as the occurrence of political violence (Vu Le and Zak 2001:

10). Brink offers a consensus definition of political risk that is highly complementary to both of the above. Political risk, in the view of "most political risk authors" consists of two component parts: uncertainty and instability. She further defines each component: "Political uncertainty... results from an inadequacy of information... Political instability refers more to unexpected or unforeseen changes in leadership succession, government policy or in a government's implementation of power." (Brink 2003: 19).

The meaning of political risk to financial market participants can also be inferred from studies that have sought to quantify its impact on investments. Rating agencies, for example, routinely use the concept of political risk to value sovereign debt. In fact, the first of ten analytical categories in Standard and Poor's rating methodology for sovereign debt is political risk. The agency highlights the following aspects of politics as relevant for debt pricing:

> The stability, predictability and transparency of a country's political institutions are important considerations in analyzing the parameters of economic policy making, including how quickly policy errors are identified and corrected. The degree to which politics are adversarial and changes to government are frequent are examined, as well as any public security concerns (Beers, Cavanaugh et al. 2002, emphasis added).

The above quote highlights two additional aspects of politics that are discussed at some length in the literature review and the discussion of veto players below: the adversarial nature of politics and the incidence of regime change. The definition also suggests that political institutions are important for gauging political risk.

The literature reviewed above provides a broad definition of political risk, focused on uncertainty and instability, but few insights into the actual sources of political risk. By reviewing the small but burgeoning literature that has sought to link political variables to financial market performance, it is possible to expand upon the list of political variables which are deemed to be significant. Most of these studies have focused on political events: coups, elections, cabinet dissolutions, etc – all of which are periods of uncertainty and a source of instability due to regime change. These studies can be subdivided into two broad groups based both on the periods in which they analyse political variables and the explanations they provide for the impact of politics on market behaviour. The first group of studies looks at the impact of political events during periods of 'normal' market trading, and generally uses institutional theories of political economy to explain why financial markets respond to political events. The second set of studies looks at the impact of political events during financial crises, and uses theories of financial market behaviour to explain the relationship between political events and market volatility. Section 2.2b immediately below reviews the first; section 2.2c reviews the second.

2.2b The role of politics during non-crisis periods

There are a number of studies that address the impact of political variables on the price of currencies, equities and sovereign bonds through econometric methodologies. An first set of literature in the late 1980s and early 90s looked at the impact of 'extra-constitutional' political risk: regime instability taken to mean coups and other types of non-constitutional regime turnover as well as political violence in the form of social unrest, civil war or inter-state warfare. As these authors compiled their classifications

of political risk based largely on surveys of bankers and investors, they are particularly telling about how political risk was defined by investors. Citron and Nickelsburg find that political instability relating to regime change is highly significant in determining default probabilities (Citron and Nickelsburg 1987). Brewer and Rivoli find that temporal regime instability (e.g. coups or elections) is predictive for a decrease in creditworthiness, as measured by surveys of bankers and independent agencies (Brewer and Rivoli 1990). Finally, Balkan finds political instability (measured both as changes in the regime and political violence) to be statistically significant in predicting the probability of default (Balkan 1992).

In a more recent set of literature, political economists have focused on the impact of democratic politics on market behaviour. Block and Vaaler demonstrate that elections in emerging market countries cause both the deterioration of sovereign credit ratings and an increase in bond spreads. Elections in 14 emerging market countries between 1987 and 1999 were on average responsible for a decline in creditworthiness ratings equivalent to one grade (on a 17 point scale) and a 21% increase in debt spreads in the period just subsequent to an election in comparison to a non-electoral period, controlling for significant changes in macroeconomic variables (Block and Vaaler 2001). The theoretical justification for this empirical finding is the 'political business cycle' (PBC) – a hypothesis that governments increase spending in the lead-up to an election so as to gain broader support. The authors argue that markets incorporate expectations of fiscal imbalance into borrowing prices in the run-up to elections.[23]

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[23] Block and Vaaler use the opportunistic strain of PBC theory, which incorporates the assumption that actors are rational. This means that the theoretical underpinnings of their work are more in line with PBC theory completed by Rogoff (Rogoff 1990) than either earlier works relying on voters with

Several other authors find that elections have an equally strong impact on currency prices and equity markets – causing forward premiums or stock prices to rise (Pantzalis, Strangeland et al. 2000; Hays, Freeman et al. 2001; Schamis and Way 2003). Additionally, Roberts studies the impact of the politics on market performance in industrialised countries by analysing the impact that the 1980 US election had on the equity performance of defence companies (Roberts 1990).

Bernhard and Leblang find similar results for a wider array of political variables: the forward risk premium on currencies and bond spreads tends to rise during periods of ongoing 'political processes' including elections, cabinet formations and cabinet dissolutions (Bernhard and Leblang 2002; Bernhard and Leblang 2004). Austria is used as a case study in the later piece, while the 2002 piece evaluates the results for eight industrialised countries. In an earlier study, the authors emphasise the role of partisan politics in predicting financial market collapse and volatility. While partisanship and party structure is still hypothesised to be important (because investors will anticipate changes in cabinet structures and elections based on the underlying party system), the authors add that investors will perceive risk based on the level of polarisation of policy between parties because of the risk that a new government will change policy in a manner considered to be adverse to market interests (Bernhard and Leblang 2000). Thus, this study is closest to the understanding of political risk I outline in section 2.3.

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adaptive expectations (Nordhaus 1975; Tufte 1975; Lindbeck 1976) or the partisan strain of the PBC literature developed by Alesina (Alesina 1987).

2.2c The role of politics in exacerbating financial crises

Studies on the causes of financial crises have also considered the role of politics in triggering and exacerbating speculative market behaviour. Political variables have been discussed in the context of empirical models of financial crises as well as in more qualitative analyses of particular crises: the East Asian financial crisis, the Argentine devaluation and default of 2001 and the Brazilian crisis of confidence during the electoral campaign of 2002 resulted in a number of studies that consider how political institutions and events contribute to or exacerbate the predisposition of a given economy towards financial crisis. Both types of studies will be briefly reviewed as they provide insight about the direct impact of political variables on financial market performance, confidence and crisis management and recovery, focusing on both institutional arrangements (e.g. the distribution of veto points) and regime change variables (e.g. elections). It is worth noting that the emphasis placed on political variables in explaining such crises has tended to increase over time.

The financial crises of the 1990s led to a proliferation of studies which sought to explain how speculative financial crises (and currency crises in particular) occurred. While traditional models of financial crises explained the occurrence of a crisis as the natural result of a balance of payments or liquidity problem, so called 'second' or 'third' generation models have sought to explain why financial flows to crisis economies experience a 'sudden stop' which exacerbates or creates macro-prudential weaknesses. Such models have routinely considered the role of politics in determining the onset of financial crisis. One of the most notable early papers in this model is a

study of the Mexican 'tequila' crisis (Sachs, Tornell et al. 1996). The authors conceive of financial markets as having multiple equilibria, one of which is crisis equilibrium. Politics and political events are considered as important triggers in moving a financial market towards crisis equilibrium. As the authors state: "In situations with indeterminacy, rumours become all-important and events can become focal points for drastic shifts in expectations" (Sachs, Tornell et al. 1996: 2). In the case of Mexico, the assassination of PRI presidential candidate Luis Colosio at the end of March 1994 is cited as a trigger moving the currency market towards a crisis equilibrium and therefore towards the impending devaluation. Thus, while Sachs, Tornell et al do not explicitly examine the role of politics in generating a financial crisis, it sets the foundation for later papers where politics are seen as a trigger for a sudden stop in international liquidity, or as an catalyst for capital flight (see for example Christodoulakis and Kalyvitis 1997; Morris and Shin 1998; Corsetti, Guimaraes et al. 2004).

Additional insights about the role of politics during crisis periods come from qualitative analyses of financial crises. I will briefly review studies from East Asia, Argentina and Brazil that utilise political variables to explain the emergence of a crisis. MacIntyre focuses on the political determinants of the levels of capital flight experienced by four countries during the Asian financial crisis: the Philippines, Thailand, Malaysia and Indonesia (MacIntyre 2001). According to MacIntyre, most previous studies of the East Asian crisis had fallen into one of three categories: those that blamed the onset of the crisis on imbalances in macroeconomic fundamentals, those that used some variant of a 'rational panic' model and the inherent instability in

the international capital markets to explain the crisis, and those that emphasised the role of moral hazard and so-called 'crony' or relationship-based capitalism. He argues instead that government policy during the crisis was the most important variable in determining the severity of the crisis, hypothesising that the distribution of veto authority in a given political economy has a U-shaped relationship to the policy risk perceived by investors – extreme distributions of political authority, either too centralised or too dispersed, are risky.[24] His use of veto players as the primary explanatory variable in determining policy during a crisis is significant for the argument in section 2.3 below.

Similarly, at least one study has analysed the impact of Argentine politics on the occurrence of the 2001 'triple crisis.' Tomz hypothesises that the timing of the sovereign debt default was strongly influenced by domestic political considerations about the public's appetite for such a default (Tomz 2002). He argues that debt default is influenced by domestic audience costs: that is to say, the government takes into consideration the impact that defaulting will have on its credibility and future electoral prospects, not only its strict financial ability to pay its creditors. Further consideration of the link between financial crisis and politics came with the Brazilian 'quasi-crisis' of 2002, which was sparked by the election of Luis Inácio da Silva (Lula) a leftist trade unionist and leader of the Brazilian Workers Party. Martinez and Santiso demonstrate that Lula's poll popularity in the 1994, 1998 and 2002 elections overlaps with periods of volatility in overnight domestic interest rates (Special Settlement and Custody

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[24] MacInytre does not sensitise the distribution of veto authority to ideological orientation for two reasons: first, that parties in developing democracies are often not formed on the basis of solid ideologies, and second, that excluding ideology allows for the possibility of logrolling (MacIntyre 2001)

System or SELIC rates) as well as the spreads of foreign Brazilian bonds, thereby concluding that political risk was more important in determining market behaviour than either policy or economic risk during the electoral period (Martinez and Santiso 2003).

In a second paper related to this crisis of confidence, Favero and Giavazzi find a strong relationship between electoral uncertainty and interest rates in the months prior to the 2002 election, particularly in the summer months when Lula's popularity in the polls had increased significantly (Favero and Giavazzi 2002). In a final paper, Miller, Thampanishvong et al. consider whether the dramatic increase in Brazilian spreads in 2002 was related to Argentine-induced contagion, macroeconomic fundamentals, or an exogenous shock in expectations driven by the election. They argue that contagion and perception of political risk should not be seen as mutually exclusive: the fear that Lula's government would imitate the Argentine default created a process by which contagion conditioned the strength of perceived political risk (Miller, Thampanishvong et al. 2004).

2.3 VETO PLAYERS AND POLITICAL RISK

The literature on political risk and its impact on financial performance thus pays considerable attention to the role of political events in generating volatility or crisis, with fewer studies considering how the distribution of power impacts the perception of political risk and vulnerability to crisis. In the definitions of political risk reviewed in section 2.2a, the primary two characteristics highlighted in the majority of studies were

uncertainty and instability. Thus, a more complete definition of political risk should include all political attributes which contribute to uncertainty and instability. In fact, some types of democratic institutions may consistently generate a greater degree of political instability and uncertainty than others, and in turn, increase a perception of political risk. Identifying institutional features of political risk in emerging market democracies is critical because they are persistent features, rather than elections or periods of regime transition, which are intermittent events. Thus a definition of political risk that takes into account institutional settings is more likely to be predictive about the long-term experience of political risk premiums and financial market volatility in emerging market countries.

Rather than highlighting any particular constellation of political institutions as particularly prone to political risk, I utilise (and modify) the concept of veto players developed and elaborated by Tsebelis to explain why the perception of political risk is consistently high in some countries (Tsebelis 1995; Tsebelis 2000; Tsebelis 2002). My primary institutional hypothesis is that the greater the dispersion of power and preferences amongst veto players in an emerging market democracy, the greater the risk of policy uncertainty, governance instability and therefore perceived political risk and politically induced financial market volatility.

Veto players, as stated in section 1.3b, are "individual or collective actors whose agreement is necessary for a change of the status quo" (Tsebelis 2002: 19) and can be of two types – institutional or partisan. There are three characteristics of veto players that are of interest in determining policy and regime stability: the number of veto

players, the divergence of their policy preferences and the extent to which collective

veto players (e.g. legislatures) are cohesive. Tsebelis demonstrates that policy stability

increases the more veto players there are, the more diverse their policy preferences and

the greater the cohesion amongst collective players. Additionally, he predicts that

policy and regime instability are inversely related (see figure 2.1 below).

Figure 2.1 As veto players increase...
Source: Recreated from (Tsebelis 2002: 4)
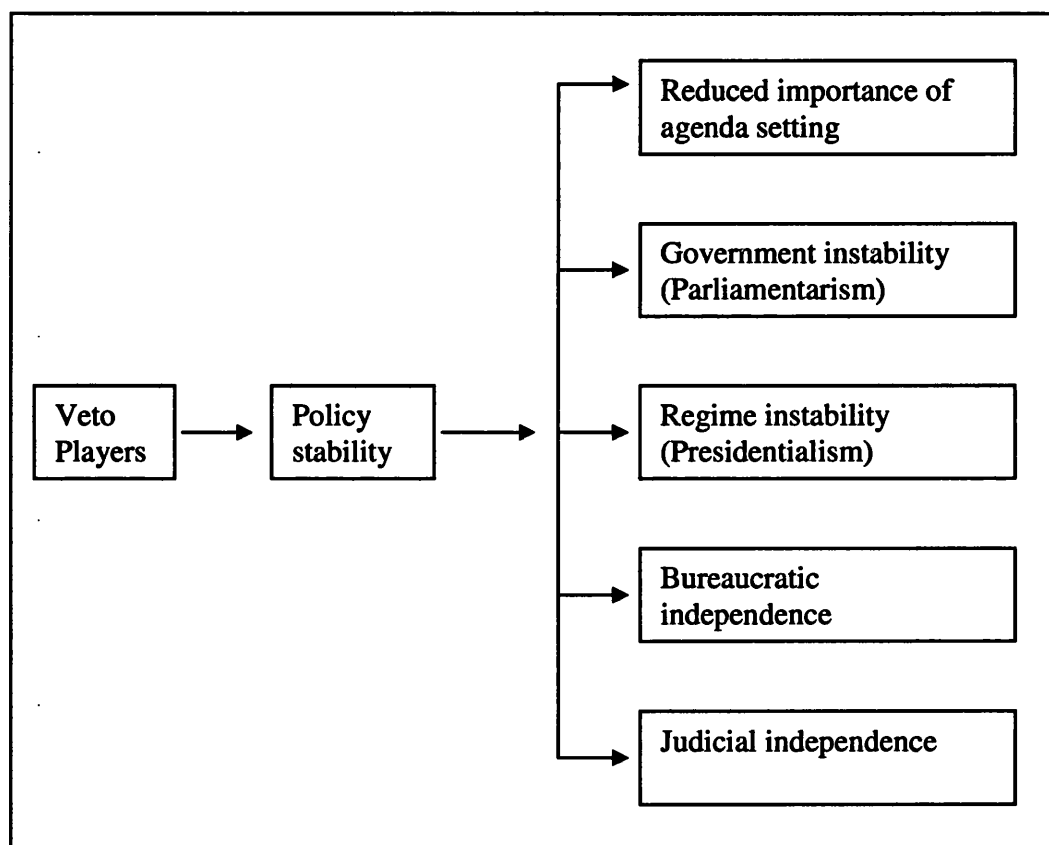
While there are a number of advantages of using veto player theory rather than other

types of theories of institutional comparative politics (e.g. it facilitates the comparison

of countries whose institutions vary across several metrics), veto player theory is

particularly well suited to the concept of political risk because it is concerned with the

degree of contestation in a given polity, which is turn related to the perception of uncertainty and instability. Policy is expected to be stable as the number and divergence of veto players increases precisely because there are more check points through which legislation has to pass before becoming law. There is higher contestation in systems with more veto players.

As discussed in section 1.1. of Chapter 1, the literature on the impact of democracy on credibility has tended to find that democracy enhances creditbility, and therefore democratic regimes attract more foreign capital than do autocracies (CITE, with Haley 1999 as a dissenting voice). However, these findings say little about the impact of increased veto players *within* democracies. There may in fact be some level of tradeoff in which neither limited nor profuse veto players are good for financial stability, consistent with the parabolic function posited by by MacIntyre in his case study of four political economy responses to the Asian financial crisis (MacIntyre 2001). Thus we would expect that democracies, on average, are perceived to be more creditworthy than autocracies, but that amongst democracies, those with an elevated number of veto players appear chaotic to investors. In such situations, veto playes use their gatekeeping power actively, blocking and changes the contours of legislation, debate and reform. The impact of veto players on levels of contestation is the primary institutional means through which political risk is hypothesised to affect financial market behaviour.

There is also a more subjective component to the impact of increased veto players. As Tsebelis notes and other scholars have been quick to point out, there is no a priori

reason to argue that policy stability is good or bad for economic performance or financial market behaviour, as its impact is completely determined by the status quo. As he states: "The point of view crucially depends on the position of the status quo. If the observer likes (dislikes) the status quo, then she dislikes (likes) change, and likes (dislikes) policy stability." (Tsebelis 2000: 443). In countries prone to high deficits, policy stability will be perceived as a negative outcome, and the contrary in countries where deficits are low. Note that the impact of veto players could also vary across different aspects of a single economy depending on the status quo in each aspect. The market may prefer an ability to easily change policy on spending, but favour the maintenance of the status quo on property rights. The general point however is that in democracies with more, diverse veto players, movement from the status quo, whether 'desired' or undesired by markets, is likely to create some level of market reaction because of the uncertainty generated. Utilising veto player theory in this manner makes no assumptions about the market's desire for reform (i.e. policy instability) in emerging market economies (though there is potentially a case to be made that the market prefers policy change to policy stability in countries undergoing economic liberalisation), and therefore makes no assumptions about the status quo except that movement from it in democracies with high contestation will generate a reaction. It is therefore more generalisable than alternative explanations about the impact of institutions on political risk, volatility and debt premiums.

While the reaction of the financial markets to changes in the policy status quo is therefore indeterminate, the opposite can be said about regime instability. Regime instability, as outlined in the definitions reviewed in section 2.2a above, is a central

component of political risk. Regime collapse is a period of extreme uncertainty and instability, and it is hard to imagine a situation in which it would be greeted positively by financial markets. This point is corroborated to some degree by the work cited in section 2.2b above by Bernhard and Leblang, but is more broadly justified by the political economic literature on the impact of regime instability on economic outcomes.

This section has so far intentionally focused upon the number and divergence of veto players, and has not mentioned Tsebelis's third hypothesis that cohesion of multiple veto players increases policy instability. This is because, in the context of political risk, the impact of cohesion is likely to run counter to this hypothesis. Fractionalisation of multiple veto players generates an additional source of uncertainty, and the ability to predict outcomes decreases. Imagine a parliament with a number of poorly disciplined parties considering an important bill about economic reform. To predict the probability of the bill's passage, it is necessary first to analyse the majorities likely in favour and second, to understand the likelihood that party members will maintain the party line on the issue. Additionally, internal debates about the utility of the bill will generate political news in the run-up to the vote, further enhancing perceptions of uncertainty. Parties that fracture more easily are also unstable, exacerbating political risk as parties collapse and undergo leadership changes.

Therefore, it is possible to hypothesise that an emerging market democracy with numerous, divergent and fractionalised veto players is likely to suffer from higher levels of political risk than other emerging market democracies for two reasons. First, the more veto players there are, the higher the level of contestation in the economy,

and therefore the greater the uncertainty about the passage of any piece of legislation (whether this bill is desirable or not from the standpoint of the markets – generating either positive or negative volatility). Second, countries with numerous, divergent veto players are more likely to suffer frequent regime collapse – another significant source of political risk. Fractionalisation of parties or other collective veto players further exacerbates the likelihood of political risk. The configuration of a country's veto players will therefore have an impact both on financial market volatility and debt premiums.

Within the remainder of this thesis, and particularly in the econometric work and the case studies on Brazil and Mexico, I observe the configuration of veto players across two dimensions: horizontal and vertical. While much of the political economy literature focuses on the impact of institutions across federal government (e.g. relations between executive and legislative powers), it is less frequently tied to the extensive theory about the political economy of federalism and decentralisation. In both Brazil and Mexico, and as demonstrated through the regressions in other emerging markets, contestation between layers of government is equally prone to lead to political risk, volatility and debt premiums as is contestation among branches of government. Przeworski notes that federalism adds another level of 'organised uncertainty' to the democratic process (Przeworski 1991). Vertical diffusion of power can be in both the political and economic realm. Some countries have democratic systems that delegate high levels of political authority downwards, further increasing the instability of policy preferences, as such players are highly responsive to their own constituents, whose policy preferences may diverge significantly from those of the national government.

Additionally, while fiscal federalism has been argued to align spending more closely with voter interests and needs (see discussion in World Bank 1997), it also increases the instability and uncertainty of economic outcomes and policy, thereby decreasing the credibility of the state as a whole on its financial targets. Mismatched tax and spend authority can lead to a high spending bias, increased deficits, and in turn leading to higher credit costs (Prud'homme 1995; Ter-Minassian 1999; de Mello 2000). Thus, federalism, or the vertical distribution of power, is also a likely source of democratic political risk.

To summarise, then, political risk can be defined as follows: the uncertainty and instability arising from the turnover of administrations (elections and other types of regime collapse such as dissolution of governments) and from the extent to which political power is diffused along horizontal and vertical dimensions. Political risk is more likely to occur in systems with multiple veto players (on both horizontal and vertical axes), where policy preferences are highly divergent (polarisation) and where cohesion of collective players is low. Distinct from theories of political economy which have analysed institutions to determine economic outcomes, here institutions are important because they directly contribute to uncertainty and instability in the eyes of investors and business participants. This is an important distinction, as section 2.4 below proposes a new role for political institutions as generators of relevant political information.

2.4 THE CREATION AND IMPACT OF POLITICAL NEWS

Implicit in the argument above is a relatively direct relationship between the existence of multiple veto players (institutions) and the generation of political risk through the process of policy contestation. This relationship can be outlined as follows: polities in which power is highly dispersed have higher levels of policy contestation. In turn, policy contestation produces political news which is interpreted by financial market participants as political risk. Many institutional theories of political economy postulate a less direct relationship between institutions and political risk. This relationship can be understood as a multiple step process. First, political institutions condition the types of policies that are adopted. Second, those policies lead to economic outcomes. Finally, the market reacts to the economic outcomes. For example, in countries where budgetary institutions give legislators power to change budgets significantly after their initial proposal, fiscal deficits are hypothesised to be more likely. The announcement of high budget deficits in turn would cause markets to charge a debt premium. Similarly, in countries with independent central banks, policy makers are more likely to have a conservative bias, and thus inflation is likely to be lower. Markets will tend to reward such countries by decreasing market premiums. Thus, institutions lead to foreseeable policies, which in turn lead to certain economic outcomes, and condition how the market is likely to perceive a country.

In contrast, my hypothesis is that domestic politics, as filtered through veto players, has a direct, rather than secondary, impact on financial market performance by generating political news which exacerbates political uncertainty and instability. Thus, the relevance of veto players (or political institutions more broadly) is not their eventual propensity to generate certain economic outcomes, but rather, their role as news

producing entities. The news produced by the process of politics is not a benign externality; it is a major source of both risk premiums and market volatility. The difference between these two processes is demonstrated in figure 2.2 below.

Figure 2.2: The impact of institutions on financial market performance
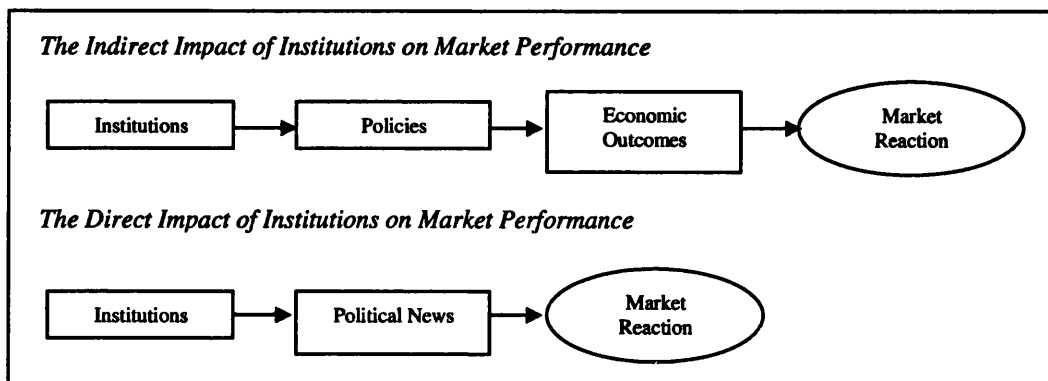
These two causal mechanisms should not be thought of as mutually exclusive, as they are likely to reinforce one another in an important way. The relationship described in the top half of figure 2.2 is likely to lead to long term debt premiums, as ongoing macroeconomic imbalances, in particular high fiscal deficits and propensity to borrow, lead over time to higher sovereign debt spreads. Many of these same institutions are likely to lead to a higher incidence of political news – thereby increasing what could be called 'short-term' debt premiums, or financial market volatility.

If one accepts the relationship between multiple veto players and the generation of political news suggested in section 2.3 above, a further question remains: once political news is generated, how strong an impact will it have on financial markets? In this section, I suggest that relevant political news is likely to lead to greater volatility than

relevant macroeconomic news, given three unique characteristics of political news: the timing and manner in which it is disseminated, the fact that it is unquantifiable, and the fact that it is more prone to uncertainty than economic news. Before detailing the relevance of these characteristics, I provide more background on two competing theories of market behaviour and the role of information in each.

As briefly mentioned in section 2.1 above, the Efficient Markets Hypothesis (EMH) predicts that all relevant publicly available information is incorporated into asset prices at any given time – and that any new information affecting asset prices will be incorporated into the pricing 'quickly' and 'efficiently' as it becomes available. Therefore the only information that should affect asset prices is information that is 'unexpected' (Fama 1970), as anticipated news should already be 'priced in.' This is a matter of no small commercial importance, and a commensurate amount of research has been devoted to it. If any consensus can be drawn from these studies, it is that the EMH is generally correct: markets do tend to register the impact of unexpected macroeconomic news in the first minutes after announcement (Pearce and Roley 1983; Pearce and Roley 1985; Hardouvelis 1988; McQueen and Roley 1993; Jones, Lamont et al. 1998). In fact, a variety of types of macroeconomic news have an impact on markets, most notably unemployment figures, inflation data, job creation data and consumer confidence. However, most studies have found that the lasting impact of macroeconomic news on equilibrium prices tends to be small.

The assumption that market participants are able to rationally evaluate market relevant news underpins the EMH, and this assumption has been highly contested by a strain of financial market theory called behavioural finance. The premise behind behavioural finance is that markets tend to exhibit volatility over time, which is inconsistent with efficient financial markets (Shiller 2002). Behavioural finance theorists attribute the persistence of volatility to the inconsistencies in human behaviour (or non-rational behaviour), and seek to understand financial market behaviour by utilising insights from fields such as psychology, sociology and anthropology. In a review of the large behavioural finance literature, Shiller identifies several strains of the literature including prospect theory, regret and cognitive dissonance, anchoring, mental compartments, and overconfidence, over- and under-reaction and the representativeness heuristic (Shiller 1998). The most relevant for explaining the reaction of financial market participants to political news is the final theory, and in particular, the theory of over and under reaction. The theory suggests that traders are overconfident in their ability to determine the impact of news on underlying asset prices, and given this certainty, they tend to over (or under) react to such news. There are two problems with this theory. First, as Shiller states, it does not provide a sense of in which direction people are likely to make mistakes:

> People simply cannot overreact to everything: if they are overconfident they will make errors, but not in any specified direction in all circumstances. The concepts of overreaction and underreaction, while they may be useful in certain contexts, are not likely to be good psychological foundations on which to organize a general theory of economic behaviour (Shiller 1998: 15).

The second problem is that this tendency to observe occasional under-reaction and occasional over-reaction provides evidence that such results are simply a product of chance, and are therefore unsystematic (Fama 1997).

Fortunately, it is not necessary to reject the rationality assumption of the EMH to hypothesise that political news has a stronger impact on financial market volatility than macroeconomic news. It does however require adjusting expectations about how much volatility a given piece of news should produce. Many economists have sought to understand how the varying characteristics of information change its consequences – not all information has a positive welfare impact on financial market performance (Grossman and Stiglitz 1980; Morris and Shin 2002). Literature that focuses on the impact of different types of information on market behaviour is critical to understanding the likely impact of political news on financial market behaviour, and thus, several pieces will be reviewed here.

Almeida, Goodhart et al demonstrate that the impact of information on financial market performance varies if the information is released in a scheduled manner (Almeida, Goodhart et al. 1998). While US economic data has traditionally been announced on a pre-determined schedule that is known to all market participants (common knowledge), Germany's macroeconomic data in the 1990s was distributed in an ad hoc fashion. As a result, the market's reaction to German macroeconomic data was greater and more prolonged. Gai and Shin's short piece for the Bank of England takes this point and expands upon it (Gai and Shin 2003). The authors draw a

distinction between what they call 'ex ante' communication and 'discretionary' communication in the context of central bank releases. Ex ante communication is institutionalised: it arrives on a certain pre-determined date in a certain pre-determined fashion. Their examples include things like regularly published reports such as the Bank of England's *Inflation Report*. Discretionary information on the other hand arrives in an ad hoc way at times and from sources unexpected by the market. This can create problems of lack of common knowledge, and therefore coordination problems amongst market participants. Gai and Shin also stress that public information must be as accurate as possible to help mitigate excessive risk. They summarise:

> Although transparency is a powerful tool for limiting the moral hazards
> of investors and governments alike, it can be a two-edged sword. The
> efficacy of communication depends on the institutional framework, the
> decision horizon and expectations of the key players, and the constraints
> that these can place on policy-market flexibility (Gai and Shin 2003: 97-
> 98)

What lessons can be drawn from this work to understand the market's response to political news? There are three characteristics of political news that may suggest that political risk plays a disproportionately large role in explaining emerging market volatility: the ad hoc and non-standardised way in which political information comes into the press and is disseminated (its unexpectedness); the difficulty of incorporating qualitative, subjective, political news into pricing models (its unquantifiable nature); and the natural level of uncertainty that surrounds most political and policy news, exacerbated by the difficulty in creating credible commitments (its uncertainty). These three characteristics are discussed in detail in sub-sections 2.4a, b and c immediately below.

2.4a Unexpectedness

First, the unexpectedness of news makes it important to investors. If the EMH is current, anticipated results should already be 'priced in'. This is especially important for understanding why political risk may have such a large explanatory power when looking at emerging bond market volatility – most political news comes in an ad hoc manner and is not pre-announced or anticipated.[25] Recall that the fact that the US macroeconomic data was always released on a standard day in a standard manner reduced market volatility in comparison to the non-standardised German announcements, regardless of the content of the news (Almeida, Goodhart et al. 1998) Like the releases of German macroeconomic data, the distribution of political news is not standardised. It can be provided in a speech, through a news leak or in a written statement. It can be announced by the head of state, a disillusioned minister, a state governor, or various other players in the domestic political arena. It is, to use Gai and Shin's term, highly *discretionary* (Gai and Shin 2003: 91).

Exacerbating the above, political news also tends to be unexpected. While some political events, like elections, are anticipated and therefore their impact on asset value can be priced in prior to the event, [26] most are not. Think for example about a government announcement of a new policy, or the news of a ministerial resignation. While some rumours may exist prior to the announcement of such news, it is more

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[25] Thus political news suffers from two types of uncertainty: timing and content.

[26] Critically, elections are also quantifiable as a probability event based on poll data, and therefore can be more easily incorporated into asset pricing models.

likely to be unexpected than the release of GDP growth figures. Thus, both the

discretionary manner of political news dissemination and its unexpectedness make it

more likely to lead to financial market volatility than macroeconomic news.

2.4b Quantification

Second, recall that the EMH relies upon the ability of the market participants to

quickly and efficiently (accurately) incorporate news into asset prices. The objectivity

of the information presented will have a strong impact on the efficiency of news

incorporation. Macroeconomic news tends to be more objective because it is

quantifiable. While there could be some debate about the importance of a decline in

US consumer confidence on GDP growth projections, it is clear that a two point

decline in consumer confidence is more severe than a 0.1% decline. Political

information is much more open to nuance, and, critically, is harder to quantify and

incorporate into pricing models quickly.[27] For example, it is hard to determine

whether a riot in the streets of Ankara deserves more or less of a political risk premium

than the collapse of the power base of the Filipino president. Similarly, a new policy

initiative's impact on macroeconomic indicators may be mixed or indeterminate.

Thus, when political information is disseminated to the financial markets, its general

effect on markets may be relatively easy to determine – good or bad for economic and

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[27] One analyst interviewed in the ad hoc interviews described in Chapter III section 3.4 mentioned that quantifying political information is not only difficult, it is also politically costly for analysts who want to maintain good relationships with governments, who are also clients. Thus, he admitted that while the economics teams have devised basic models that attempt to quantify some political variables, these scores are not made public (JPMorgan 2005).

political stability[28] – but determining the precise degree to which the markets should penalise / reward the asset price is very difficult.

Thus, quantifying politics is a major stumbling block towards assigning an appropriate political risk premium. This is especially true because the risk models built by market participants to calculate probabilities of default tend to be calibrated for slight changes in underlying economic conditions, such as the global interest rate – not for changes in the coalition structure of the party in power.[29]   Thus, the reaction of each trader or firm in the marketplace is likely to be based on their own best estimates of the seriousness of the news or on following the reaction of other traders (generating a tendency towards behaviour such as herding). As one analyst interviewed noted:

> People don't pay that much attention to the macroeconomic numbers because there is generally an equilibrium where numbers are moving. If there is a drop in GDP, it is probably a one-off event, and the markets understand where it comes from. Whereas if you have a political crisis as you do now in the Philippines, no one knows how to think about it. No one knows how it's going to turn out 6 months down the road. There is a lot more nervousness, a lot more concern because there is no unified framework to think about the impact of a political event on the long-term price of the market (JPMorgan 2005).

2.4c Time inconsistency, credibility and uncertainty

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[28] A large majority of such information tends to be negative, as shown by the content analysis in section 3.3, Chapter III.

[29] In fact, the survey data in section 3.4, Chapter III demonstrates that only 22% of respondents said that their firms had a model that attempts to quantify the impact of political variables on creditworthiness. Additionally, it should be noted that those that are quantifying politics may be doing so without taking into account complex political analysis. One survey participant said that the quantifiable variables usually included in such models include scores from organisations like Transparency International, not complex institutional variables, despite his acknowledgment that: "One of the things that we look at is political fallout... and the underlying institutional characteristics that affect policy and economic decision-making." (ABNAmro 2005)

Political news suffers from a further two problems: it is uncertain and of varying credibility. First, the uncertainty of political news is partially a result of the ad hoc and multi-faceted manner in which it is disseminated. Additionally, when macroeconomic data is released, there is almost no chance that it will change tomorrow, three months from now, or in a year's time, a very different situation from political news.[30] As Hays, Freeman et al discuss in their study of the impact of elections on currency markets:

> [The complexity of political information] implies that confirming (or denying) the validity of political rumors will be problematic and costly, even in countries with established democratic institutions where political information is readily available. These problems will be magnified in new democracies and particularly acute in countries with non-democratic political institutions and opaque political processes (Hays, Freeman et al. 2001: 210).

Second, politicians often have an incentive to announce policies which they cannot or do not intend to pursue. The problem of time inconsistency is central to an understanding of why traders' perceptions on the impact of political news may vary greatly: different market participants may have different expectations of the credibility of a given policy announcement. Much political news consists of declarations made by politicians themselves, there is always the possibility of reneging on prior announcements, commitments and promises. This is of course particularly a problem during electoral periods – and is highlighted in the political economy literature as time inconsistency (see Drazen 2000 for a comprehensive discussion). Bernhard and Leblang highlight this in their study of forward exchange rate premiums and political risk:

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[30] A caveat: data reporting and collection in some developing countries is still highly problematic, which means that macroeconomic data can be 're-released' with corrections at a later date. This is increasingly rare in large emerging market countries due to initiatives like the IMF's standards and codes on macroeconomic data collection and release.

> ...Economic agents must infer the government's commitment to the
> exchange rate by processing information about the policy priorities
> of different parties, potential election results, and likely cabinets.
> The possibility of opportunistic policy behaviour and the contingent
> nature of democratic politics complicate the inference problem
> (Bernhard and Leblang 2002: 317).

The impact of these two features of political information is that traders and analysts may not only have different views on the importance of political news as highlighted in the quantification discussion above, but different views about the permanence of such political news. This can further exacerbate volatility.

In sum, political news has several characteristics that justify a hypothesis that its release is more likely to lead to financial market volatility than equally significant economic news. This assertion is particularly important given the trends discussed in Chapter III section 3.3 below – that financial market participants are increasingly interested in utilising political information to judge the credibility of sovereign bonds. Volatility in financial markets may be increasingly attributable to political risk.

2.5 CONCLUSIONS

In this chapter, I have sought to lay the theoretical groundwork for the remaining chapters of this thesis. I have reviewed three strains of literature on political risk and its impact on financial market behaviour: articles that seek to define political risk, articles that seek to quantify the impact of political events (and less frequently, institutions) on market performance during non-crisis periods, and studies that seek to relate political risk to the propensity of economies to experience crisis. Building on these studies and the definition of political risk given by most authors, I argue that the

distribution of power and authority within a democracy, as determined by its political institutions, is significant for determining the propensity of the market to be affected by political risk. In democracies with multiple, diverse veto players, contestation is higher, and the market in turn perceives politics as both more uncertain and unstable. Crucially, my use of veto player theory makes no assumptions about the market's interest in the direction of deviance from the status quo, instead arguing that contestation over any change will produce market reaction. Additionally, I reverse Tsebelis's expectation about the impact of cohesion – in countries where multiple veto players are fractionalised, political risk will be greater as an added layer of contestation is generated during the political process. Finally, I argued that characteristics of a polity's veto players should be considered both across political branches (horizontally) and among layers of political power (vertically) given strong evidence that countries with highly decentralised power structures have additional layers of political bargaining and therefore, potentially, sources of political risk.

Building on this definition of political risk, I argued that the process of contestation produces political news, which has a direct impact on market volatility. This is in contrast to many theories of institutional political economy which would see an indirect relationship between the financial market's reaction and institutions. Utilising theories of financial behaviour, I also argued that political news is likely to have a strong impact on the production of volatility for three reasons: it occurs at unexpected times and is disseminated in non standardised ways, it is unquantifiable and it is uncertain due to the potential for time inconsistency. This argument did not require

rejecting the rationality assumption of the EMH – in fact it drew on research which has stemmed from this theory.

The remaining chapters of this thesis are more empirical than this one. Chapter III, however, begins with an important discussion that helps to nuance the theory presented here: how the role of political risk varies across regime types. In democracies, I argue that political risk is more likely to generate small but significant market volatility on an ongoing basis. In autocracies, however, the lower level of contestation means that market volatility will be limited on a daily basis, but that political events when they occur will have a stronger impact on market performance, potentially even pushing the market into crisis equilibrium. I therefore make reference to several of the studies that were reviewed in this chapter. Additionally, I seek to quickly discuss why political risk is likely to be more significant in emerging market countries than in industrialised countries through reference to concepts such as debt intolerance and 'original sin.' While this thesis does not test the relevance of political risk in industrialised countries empirically (nor does it test the impact of political risk in autocracies except tangentially through the case study on Mexico in the early 1990s), this explanation helps to provide more justification for the exclusive focus on emerging market countries briefly outlined in section 1.4 of Chapter I above.

The bulk of Chapter III, however, presents two pieces of empirical evidence: content analysis of a number of investment bank research reports and a survey of analysts about the importance they attach to political risk when valuing emerging market assets. Both provide strong support for the hypotheses that the importance of political risk has

increased for pricing decisions and that investors are interested in the level of

contestation and therefore complex institutional attributes of political systems. The

studies also support some of the underlying assumptions in this chapter, such as the

importance of the unquantifiable and uncertain nature of political news to its ultimate

impact on markets.

CHAPTER III

THE PERCEPTION OF POLITICS

3.1 INTRODUCTION

Following the construction of a theory of political risk and financial market behaviour

in Chapter II, this chapter serves two primary purposes. First, in order to nuance the

theory, I analyse the impact of political risk in different types of regimes (democracies

and autocracies) and seek to provide more explanation of why political risk has a

stronger impact in emerging market states than in industrialised countries. I argue that

whereas in democratic states the impact of political events is to create low level,

consistent volatility and risk, in autocratic states, the daily impact of politics is

relatively modest, but the potential impact of political events to generate crisis is

accentuated. The minimal impact of politics in autocracies has to do both with the low

levels of contestation in such regimes (few veto players) and lack of media freedoms,

which reduce the extent to which political events are covered in the news.

With regards to the impact of political risk in democratic vs. autocratic emerging

market states, I argue that it is difficult if not impossible for developing countries to

'escape' from considerations of political risk, even when their democratic institutions

are stable and macroeconomic fundamentals are strong. Literature on sovereign debt

provides two explanations for this trend. First, the concept of 'original sin' suggests

that developing countries are always likely to pay a political premium on their debt due

to the risk inherent in borrowing in foreign currency. Second, theories of debt intolerance emphasise that creditworthiness is determined over the course of a long period of borrowing history.

The second part of this chapter provides initial empirical support for the definition of political risk in advanced in Chapter II, section 2.3. I utilise two sources of data: 1) in-depth content analysis of almost 1,000 investment bank research reports from JPMorgan from 1998-2004 and 2) a survey of more than 40 investment bank research analysts. The content analysis provides several interesting findings: that analysts' interest in political variables in pricing sovereign debt has been increasing over time, that politics are overwhelmingly mentioned as a constraint on asset value, that the distribution of power amongst veto players is the most important political variable in such reports, that the political situation in countries with fewer veto players is analysed less often, but that political analysis is utilised for all emerging market countries, regardless of creditworthiness and economic strength. The survey corroborates these findings, and shows that an overwhelming majority of investment bank analysts consider political variables to be central to their decisions about asset value. The survey also provides support for the argument in section 2.4b of the previous chapter that a major constraint to accurately pricing political news is the inability to quantify the impact of such variables. The concluding section of this chapter outlines three testable hypotheses, and the methodologies used to investigate them, providing a basis for Chapters IV, V and VI.

3.2 POLITICAL RISK ACROSS REGIME TYPE AND ECONOMIC CONDITIONS

This section adds to the theory of political risk presented in Chapter II by investigating how political risk varies across types of regimes and economic conditions. I am interested in identifying the sources of political risk in autocracies, and whether its market impact is likely to be different than in democratic states (section 3.2a).[31] This section also includes a discussion of whether countries can 'graduate' from political risk – i.e. issue debt as investment grade debtors, where political risk is less likely to impact borrowing costs (section 3.2b). Investigating these two themes is a important preparation for the comparative work undertaken in Chapters V and VI on Brazil and Mexico. Because Mexico's democratic transition happened in the mid to late 1990s, a significant part of the dataset for Mexico (1991-2002) occurred under conditions of autocracy rather than democracy. Thus, understanding the sources and impact of political risk under these conditions is critical.

3.2a Political risk in democracies vs. autocracies

The definitions and studies of political risk reviewed in section 2.2a-2.2c of Chapter II were strongly focused on non-democratic risks such as coups, violence and civil war. I argued that a more complete definition of political risk would also incorporate the uncertainty and instability arising through the democratic process of contestation over

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[31] Extra-constitutional risks are also still highly significant for non-democratised emerging market states (e.g. in the Middle East, parts of East Asia and parts of sub-Saharan Africa where democracy is, at best, fragile) and in some tentative democracies in other regions (e.g. Andean states).

policy, power and resources. Therefore, political risk is not limited exclusively to non-democratic regimes. Additionally, there is reason to believe that amongst democracies the perception of political risk will differ. In democracies with a large number of veto players with diverse preferences and little internal cohesion, the political process may appear more chaotic, enhancing perceptions of political risk by investors. This is not to argue that political risk is strictly *greater* in such democracies than in autocracies, but rather that it is different. It is not eliminated when countries transition from autocracy to democracy, but rather changes in content as well as severity and frequency. There may be a 'u-shaped' relationship between the number of veto players and the perception of creditworthiness – low when there are few veto players (i.e. in autocracies) and low when there are many veto players (in highly dispersed and fractured democracies) and high when there are a moderate number of veto players. This hypothesis is further tested in the econometric work in section 4.4 of Chapter 4.

In order to understand the difference in the manner in which political news is likely to impact financial market behaviour in autocracies and democracies, the concept of financial market 'regimes', central to the formal models of currency crises discussed in section 2.2b and 2.2c above (Sachs, Tornell et al. 1996; Hays, Freeman et al. 2001), is useful. In these models, financial markets exist in one of two states: a normal or rational equilibrium in which volatility is moderate and the market's reaction to news is tempered, and a crisis equilibrium in which market behaviour includes capital flight, extreme levels of volatility and 'irrational' reactions to market news (herding, contagion, etc). As was highlighted in the literature review, the propensity for a market to switch to a crisis equilibrium is accentuated by political risk. Note,

however, that the two studies cited above focus on low-probability, high impact political risk events such as civil war, assassinations and, to a lesser extent, elections. Thus, both extra-constitutional risk and, in some cases, elections, can serve as triggers for financial crises by facilitating a transition to a crisis equilibrium.[32] Daily democratic political news is more likely to lead to volatility, and is less likely to lead to financial crisis. A schematic conceptualisation of this is presented below in figure 3.1.

Figure 3.1: Conceptualising the impact of political risk in democracies vs. autocracies
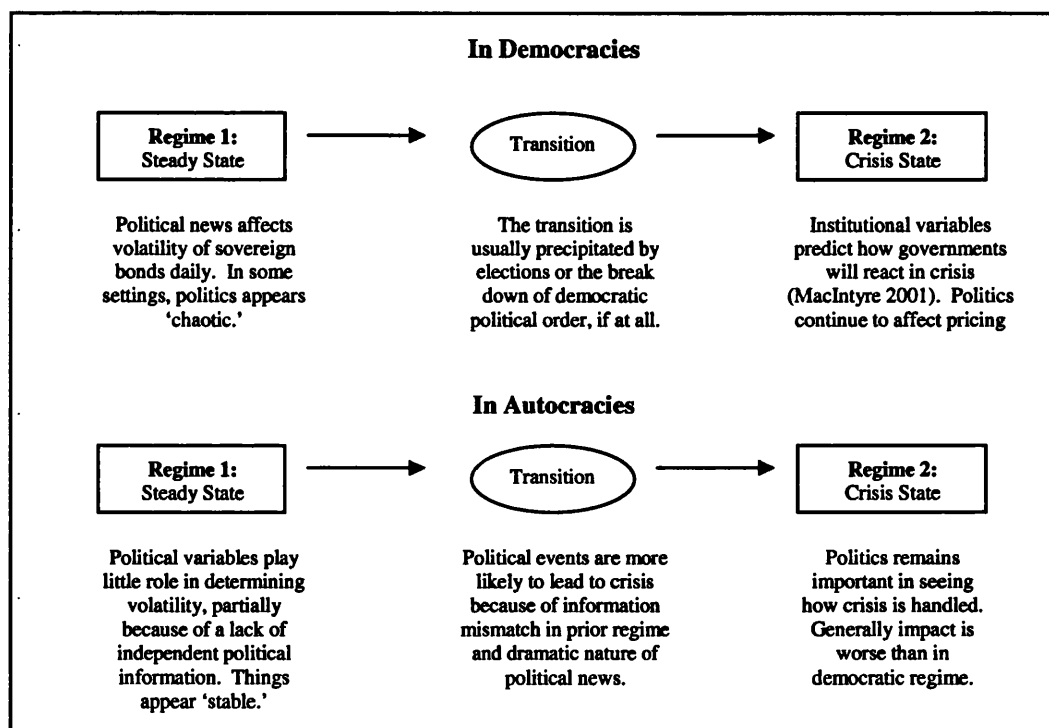
An informed view of political risk would suggest that while political risk in autocracies is less during normal periods, the potential for political risk events that shift financial markets into a crisis equilibrium are higher in such regimes.

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[32] This propensity for crisis during electoral periods helps to explain why previous scholars have concentrated on it above other political variables. Elections serve as 'sunspots'; focus points for traders and analysts whose attention to political events often needs a centre, given the high amount of information constantly available.

3.2b Original sin, debt intolerance and political risk

The second 'rider' to the theory presented in Chapter II relates to the fact that advanced

industrialised countries seem to face little to no political risk premium (Mosley

2003).[33] Are there emerging market economies in which political risk is no longer of

interest to financial market participants? If so, does this have to do with the level of

macroeconomic stability they have attained, or a reduction in political uncertainty and

instability? I argue that neither the reduction of macroeconomic risk nor the reduction

of political uncertainty and instability alone is sufficient to eliminate the market's

consideration of political variables in the short or medium term. In fact, the main

reduction in risk premiums is likely to accrue only when governments can eliminate

what has been called 'original sin' and borrow in their own currencies on the

international capital markets (Eichengreen and Hausmann 1999; Eichengreen,

Hausmann et al. 2003).[34] The inability to borrow in domestic currency creates

problems of currency mismatches and exacerbates financial market fragility (through

pro-cyclicality), regardless of underlying macroeconomic or political conditions. This

may help to explain why 'advanced' emerging market countries with stable

macroeconomic indicators and relatively stable political situations (South Korea, Chile,

several new members of the EU and to a lesser extent Mexico) are still classified as

emerging market states despite either upgrades to investment grade creditor status and /

or membership in the Organization for Economic Cooperation and Development

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[33] This section serves as an expansion of the brief review of this question in section 1.4 of Chapter 1.

[34] In some papers, Eichengreen and Hausmann use the term to describe both the inability to borrow internationally in local currency and the inability to borrow on a long-term basis, even in the domestic markets.

(OECD) or EU. It is also partially a reason for what Reinhart, Rogoff and Savastano have called 'debt intolerance:' the inability of emerging markets to manage levels of external debt that are manageable for advanced countries (Reinhart, Rogoff et al. 2003). Under this hypothesis, new EU members will 'graduate' from political risk premiums when their membership in the eurozone guarantees they can borrow in the euro. This is consistent with the reduction in debt premiums in less creditworthy European states after the introduction of the euro (Bronk 2002).

The problem of original sin is exacerbated by the fact that the generation of creditworthiness is a long process, and most emerging market countries have recently experienced periods of default or liquidity shortfall. The importance of historical patterns of default and debt management in determining current creditworthiness is central to the debt intolerance hypothesis (Reinhart, Rogoff et al. 2003) and is clearly articulated by Tomz in a paper that focuses on the role of 'learning' in the establishment of creditworthiness (Tomz 2001). His argument is that the bond markets, both historically and at present, go through a process of Bayesian updating, where new borrowers are always assumed to be 'lemons,' and are thus charged a higher debt premium until there is new information which causes creditors to change their mind about a particular country. In particular, he focuses on the way that countries can change their perceived creditworthiness particularly by surprising bond markets: if they are perceived to be lemons or 'fair-weathers' (borrowers that tend to repay until global conditions deteriorate), they can improve their improved creditworthiness by not defaulting in periods of difficult financial, economic or global strain.

If they are perceived to be 'stalwarts,' countries that always repay their debts regardless of prevailing conditions, their creditworthiness can only be dampened by an unexpected default. Using the above vocabulary then, most emerging markets would either fall into the categorisation of lemon (arguably Argentina at present) or fair-weathers (Brazil, Mexico, Russia, countries affected by the Asian Financial crisis etc) Few emerging market states could be considered stalwarts based on their historical performance (or debt intolerance), an ongoing problem given their inability to borrow in domestic currency. Thus, political risk remains relevant and financial market participants will continue to demand information about political processes in emerging market nations, despite improvements in either macroeconomic conditions or political certainty and stability.

The clarifications provided in this section help to complete the theory of political risk that was articulated in Chapter II. The remainder of this chapter provides initial empirical support for a definition of political risk that includes institutional variables.

3.3 THE PERCEPTION OF POLITICS IN INVESTMENT RESEARCH

This section and section 3.4 attempt to demonstrate three things: first, that political risk is significant to emerging market investors. Second, that interest in political risk has increased in the time period of study (the 1990s and first years of the 21st century). Third, that uncertainty and instability as redefined in the previous chapter include institutional aspects such as horizontal and vertical dispersion of power, and that these

are the primary characteristics that analysts (and therefore traders) focus on when monitoring and evaluating political risk. Therefore, the evidence provides support for the definition of political risk advanced in the previous chapter. Two sets of evidence are presented: the results from extensive content analysis of investment bank research reports and the findings of a survey administered to emerging market analysts across the financial industry. Providing support for these three hypotheses is critical to more in-depth analysis in Chapter IV, V and VI.

As noted by many scholars, the availability of political information to financial market participants, and the impact of that information (i.e. whether it is interpreted as efficiently as economic information) is under-researched. Most authors reviewed in this thesis either assume that the information that they are interested in is available to traders or provide scant evidence that it exists or is a new phenomenon. Martínez and Santiso, whose piece on the Brazilian quasi-crisis of 2002 pays more attention to the provision of information than other studies of the type, provide only anecdotal evidence of the market's interest in political information – they cite the creation of a joint venture between a major investment house and a political risk company as well as the creation by some companies of event-specific political risk models (Martinez and Santiso 2003). Other authors have noted this lack of research as a major failing of the burgeoning literature on the reaction of financial markets to political variables (Freeman, Hays et al. 1998; Mosley 2003). Thus, the purpose of this section is to demonstrate that the level of political news provision for investors in dedicated publications has increased in the past several years and includes complex democratic political analysis.

In order to determine whether or not political risk is indeed a primary focus of analysts of emerging markets, I undertook an in-depth content analysis of monthly investment bank research reports dedicated to emerging market assets from the period 1998 to 2003. Investment bank research reports, in general, are excellent sources of data for analysing the importance of political news to financial markets because they are likely to reflect, in a highly condensed manner, all significant news with an impact on asset value. The analyst's job is precisely to comb every possible information source – including international financial press, local press, government releases, personal contacts in country, traders, other analyst reports / analysts, Bloomberg, monthly publications such as The Economist, etc, and digest that information so that it is pared down to the most fundamental points affecting market prices. Thus, whatever economic or political information is contained in those reports is likely to be the most significant information for pricing market risk.

Several clear trends emerge when one looks at the relative contribution of economic and political news in investment banking research reports from the late 1990s to the present, confirming the hypothesis of an increased role of politics in investment decisions. First, since 1998, the percentage of buy / sell recommendations based on politics has increased dramatically. In the later years of the dataset, politics is often the primary criterion used to evaluate the attractiveness of sovereign bonds. Second, the research shows that political variables are usually mentioned in a negative light – that is to say, as factors dragging down value of sovereign bonds, rather than increasing it – across the dataset. Finally, institutional characteristics receive a high proportion of

coverage across the dataset vis-à-vis more traditional political risk such as violence, unrest and geo-strategic considerations.

The research reports analysed all come from one firm, JPMorgan, though research was written by more than 100 analysts. This bank was chosen because of its uniquely broad coverage of countries and regions, and because I utilise JPMorgan's Emerging Market Bond Index (EMBI) as the primary dependent variable throughout chapters IV, V and VI. This choice therefore provided some consistency to results. Additionally, JPMorgan is often cited as one of the top ranked banks for analysis of emerging market economics, and the existence of the EMBI makes its research more valuable to investors than other banks' research. [35] JPMorgan is also consistently a lead underwriter for emerging market sovereign bonds, and holds a large proportion of sovereign market debt.[36]

I analysed 44 monthly editions of *Emerging Markets Outlook* from 1998 to 2004, which yielded 993 individual reports on sovereign bond asset value.[37,38] For each report, I measured the importance of political risk by coding whether the analysts mentioned political issues as a key driver of asset value and risk. The layout of these reports tended to be similar. For each country, a first section included the analyst's outlook for the country and between three and four 'headline' news items, generally in

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[35] See annual rankings of emerging market economics research houses such as those completed by *Institutional Investor* (II 2004).

[36] JPMorgan was, for example, the top underwriter of Argentine bonds during the 1990s.

[37] In the earlier years of the reports, analysis on fewer countries was included (in 1998, between twenty and twenty five countries were included, depending on the month). By 2002 and 2003, 41 or more countries were reported on every month.

[38] Unfortunately JPMorgan has not preserved paper or electronic archives of research prior to 1998. Thus, it was impossible to test whether there was indeed a sort of 'structural break' which occurred due to the East Asian financial crisis.

bullet-point format. When necessary, I read further into the text of the report to obtain a more accurate coding of the relative importance of political and economic variables.

A two-step coding process was then undertaken. The headline news, with necessary clarification from the text, was determined to be either economic or political. This initial classification was generally a rather straightforward exercise. The second step was coding political information into one of several categories: elections, horizontal checks and balances, vertical checks and balances or political violence of any sort. Three further variables consistently reccurred in the analysis, and thus were added during the course of the coding: governments 'tying their hands' through agreements with international institutions or other countries, the ideology of the ruling party or executive (e.g. pro-market or not) and the strength and popularity of the government. I also sought to determine whether the analysis of political events was considered to have a negative or positive impact on bond value. A definition of each of these variables follows:

> **Elections:** Any news about national, state, provincial or local elections was coded as 'elections.' All election news was considered to be negative by default given the connection between elections and perceived instability demonstrated in literature reviewed in section 2.2b, unless the analyst specifically mentioned the election in a positive light (e.g. that a pro-business candidate was ahead in the polls, causing a bond rally).

> **Checks and Balances (horizontal):** News about horizontal checks and balances had three elements. First, it included information about the relationship between the legislature and the executive. If the relationship or progress on desirable legislation was positive, this variable was coded as positive, if not, it was negative. This included differences in policy preferences between the two branches of government. Second, it included analysis of relations between the judiciary and the government. The negative and positive coding was the same as above. Third, it included information about the internal cohesion of two veto players: the legislature and the executive. Any news about lack of internal cohesion (such as weaknesses in ruling party coalitions or legislative coalition) was coded as negative, improvements in such cohesion was coded as positive.

Checks and Balances (vertical): News about political or economic conflicts / agreement between the central government and state, provincial or local governments was coded as vertical checks and balances. This included reports about the effects of fiscal federalism on macroeconomic results. If the news was about cooperation between vertical layers of government, it was considered to have a positive impact, if not, and particularly when layers of government were in conflict, it was negative.

Political Violence: Any news about internal civil disorder, violent protest, civil war, rebellions, separatism or international war was coded as political violence. This variable was always negative by definition, except when there was news about peace agreements.

Institutional Hand-Tying: Any news about a country's efforts to surrender policy flexibility by making promises to a third party was considered institutional hand-tying. The most common examples were participation in bilateral, regional or the World Trade Organization (WTO) trading arrangements, membership of the European Union, or policy commitments made to international lenders such as the IMF or World Bank. If there was positive progress on hand-tying, this variable was coded as positive. If negotiations were stalling or membership was being reconsidered, the coding was negative.

Ideological orientation of the leadership: On occasion, news was provided about the general policy orientation of the leader or party in leadership. When governments were perceived as 'leftist' the coding was negative. When they were perceived as pro-market, the coding was positive.

Strength of the executive: The final political variable that was considered was mentions of the popularity or strength of the executive or leadership of a party. This on occasion was coded as checks and balances (when the news had to do with the strength of governing coalitions), but more generally was about popularity rankings in polls, and thus was considered to be a separate variable. It was coded as positive when the leader was strong or popular, and negative otherwise.

Coded in this manner, the tallies for each type of news: economic or political, with corresponding sub-categories, could thus be assembled, which made it possible to determine what percentage of news was political and what percentage was economic. A country could have more than one sub-category of news per entry. An example of a coding is provided below.

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Example: Country X[39]

- Government vows to keep fiscal discipline
- September's growth surprised on the upside
- But election cycle will likely delay the recovery

From the above, it is clear that there is at least one piece of news about economics (GDP growth) and one piece of news about politics (the election cycle's impact on recovery). The coding of the first bullet point required further reading to determine whether it was primarily a political or economic analysis. In fact, the news item referred to the government's promise to the IMF that it would reduce the fiscal deficit, though it did not mention any complications given domestic checks and balances. It was therefore coded:

Table 3.1 Example coding of country 'x'

	Economics	Politics	Elections	Hand Tying
Country X (Month, Year)	1	1	1	1

The results of this research, which appear to be robust given the high number of reports analysed, suggest strongly that the number of political variables discussed in investment bank research reports is increasing. This provides support for the argument that the total amount of political information available to investors, or the importance that they attach to it, has increased dramatically since the East Asian financial crisis – with a lag, or period of 'learning.' This trend is easy to see in the graphs below (figures 3.2 and 3.3), which show the percentage of JPMorgan buy/sell recommendations that were based on political factors from 1998 to 2003. In 1998,

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[39] The example is taken at random from one research report; country and date of the analysis are not provided in order to maintain confidentiality of the company's analysis.

almost 70% of recommendations were based on economic factors, while by 2000, research on political and economic factors converged to around 50% each, with political variables on occasion receiving the majority of coverage across countries in some months.

Figure 3.2. Contribution of politics in *Emerging Markets Outlook,* by month
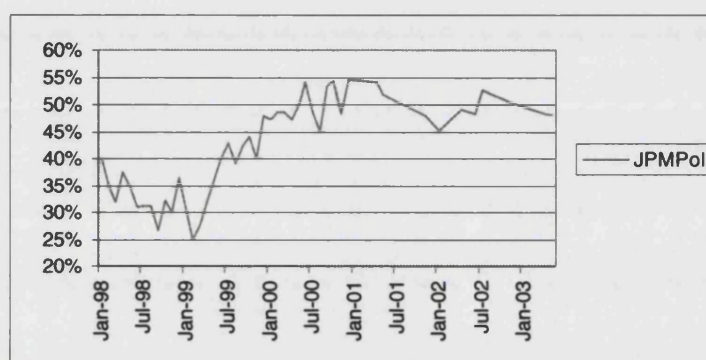
In several extraordinary cases, an entire page of research was dedicated to political rather than economic variables. This was most often the case around an election, or when other major political changes were occurring, such as major shifts in government coalitions. For example, an entire page of analysis of Turkey in one month of 1999 focused exclusively on possible government coalitions that could emerge as a result of the parliamentary election. The analyst asked the following questions to order his / her analysis: "1) Which is the largest party in Parliament? 2) Combined, do any two secular parties constitute a majority in Parliament? 3) How many parties are in Parliament – i.e., how many of the smaller parties have been eliminated? 4) What is the order of the parties in the Parliament?"[40] In this example, there was not a single

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[40] JPMorgan Emerging Markets Outlook (Abdel-Motaal 1999).

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mention of the likely economic policy of these parties, or of economic fundamentals, trends or forecasts. Instead the exclusive focus was on distribution of veto players.

Elections, however, were not the only source of extensive political analysis. When political crises emerged, as was the case consistently in some Latin American countries in the dataset (Ecuador in particular, Peru with frequency and Argentina around the time of the 2001 default), analysis also tended to focus exclusively on politics. Nonetheless, it was day-to-day politicking, such as difficulties in passing reforms through fractionalised legislatures, that received the highest degree of attention (see table 3.2 for a distribution of political variables). The following example of the importance of 'mundane' politics is typical: in October 2000, of the five European / Eurasian countries covered (Bulgaria, Croatia, Poland, Russia and the Ukraine), each had a significant section of analysis on the political situation with headline subtitles such as "Political changes remain paramount," "Politics remain an obstacle to fiscal tightening," "Noisy budget debate to produce no major easing" and "The government is still a bit at odds with itself."[41]   None of these countries, at the time, were undergoing major economic or political crisis, yet political analysis was considered paramount to the country's outlook.

In fact, every country, without exception, had some political analysis included in its outlook forecasts at some point in the dataset. The political situations of very stable economies, like Chile for example, were not immune from analysis on political variables, despite the fact that, as stated by one analyst "...the range of policy debate in

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[41] JPMorgan Emerging Markets Outlook (Das 2000)

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Chile is quite narrow."[42] Political candidates for the Chilean Presidential elections of 2000 were discussed at great length, with their policy preferences and likely economics teams receiving a high degree of attention over the course of the months prior to the election.

This is not to imply, however, that political coverage was equal: countries with less contestation and fewer veto players consistently received less coverage. Several Asian economies were a good example of this (e.g. Singapore, Taiwan and China), as was South Africa, whose government enjoyed a sizeable parliamentary majority throughout the period and consistently followed pro-market policies. All four received scant political coverage. The distribution of political vs. economic analysis by region, shown in table 3.2 below, provides some insights to the distribution of political analysis.

Table 3.2 Political analysis in *Emerging Markets Outlook*, by region

	Average Political Coverage
Latin America[43]	49%
Emerging Europe[44]	46%
Africa[45]	42%
Emerging Asia[46]	37%

As hinted at in the selected quotations above, throughout the dataset political variables were more often mentioned in a negative than positive light, that is to say, as increasing spreads rather than decreasing them. Politics were most often seen as an

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[42] JPMorgan Emerging Markets Outlook (Sekiguchi 2000).
[43] Includes: Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela.
[44] Includes: Bulgaria, Croatia, Poland, Russia and Turkey.
[45] Includes: Morocco, Nigeria and South Africa.
[46] Includes: China, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.

impediment to reform, or as a source of potential policy instability. More rare positive mentions of politics generally had to due with 'favourable,' i.e. pro-market, election results, government statements encouraging pro-market policies, or commitments by states to hand-tying mechanisms, such as IMF accords or free trade agreements. There was little variation in this data over time or across countries, though a slight increase in the amount of positive political reporting occurred in the final two years of the dataset.

Figure 3.3. Political variables impact in *Emerging Markets Outlook,* by year
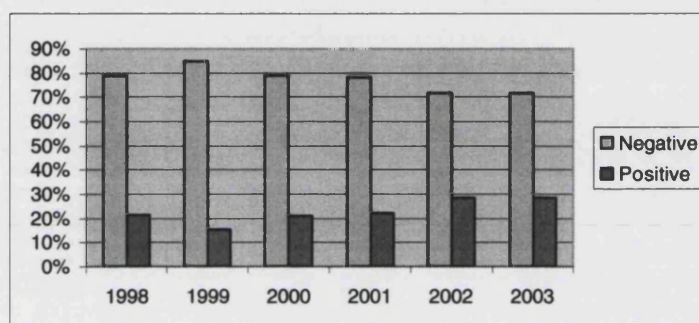
Finally, it is possible to see that the impact of both horizontal and vertical distribution of veto players receives a large percentage of coverage vis-à-vis extra-constitutional risks or elections. The most important variable, as aforementioned, was horizontal checks and balances, accounting for more than one third of all political reporting. Political violence, by contrast, was only 14% of political reporting. Elections and institutional commitments were slightly more important than political violence. However, it is interesting to note that the importance of political violence in the coverage of political variables increased over the years as a number of non-consolidated democracies and autocracies entered the dataset (e.g. North African states as well as Sub-Saharan states such as Côte d'Ivoire), and in the aftermath of September

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11, when more attention was placed on a country's security policies, anti-terrorism stance and relationship to the US (particularly in Turkey and Pakistan in the months proceeding the US-led invasion of Iraq). This trend does not seem to invalidate the idea that the importance of democratic political variables has increased over time.

Table 3.3 Political variables analysed in JPMorgan's *Emerging Markets Outlook*

	Average Coverage (1998-2003)
Horizontal checks and balances	34%
Elections	15%
Institutional hand-tying	15%
Political violence	14%
Ideological orientation of party or leader	10%
Strength or popularity of a govt or leader	10%
Vertical checks and balances	2%

Thus, the evidence from the content analysis demonstrates clearly that the importance of political variables has been increasing, that political risk is important in all emerging market countries, regardless of the underlying strength of the macroeconomic variables, that political variables are generally negative contributors to asset value and that the distribution of veto players is of primary importance to analysts of emerging market assets.

3.4 SURVEY EVIDENCE OF THE IMPORTANCE OF POLITICS

Another method of determining the relative importance of political risk to analysts and traders of emerging market debt and other assets is to ask them directly about the importance that they place on information of a political nature, the variables that they consider part of economic risk, and how they incorporate political analysis into pricing decisions. To this end, I created a brief online questionnaire, designed for completion

by investment bank research analysts and traders of emerging market debt and currencies. The questionnaire contained 15 questions which aimed at determining the relative weight traders and analysts assign to politics when valuing emerging market assets; several questions were also aimed at discovering what political variables their analysis was likely to include and some opinions on whether the importance of political risk had been rising over the previous decade. While an overview of the survey questions and results is provided in the paragraphs below, additional information from the questionnaire is used sporadically throughout the chapters (as in Chapter II) when it supports hypothesis and findings. [47]

I sent the questionnaire to 215 emerging market research analysts from major investment banks.[48] In all, ten major banks were sampled: ABN Amro, Citigroup, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, JPMorgan, Merrill Lynch, Morgan Stanley, Santander and UBS Warburg.[49] An equal distribution across emerging market regions was sought, and analysts working on pure economics or quantitative teams were also polled. The overall response rate was 19% (41 respondents), and while the number of analysts sent the questionnaire varied from bank to bank due both to the size of their research teams and access to email addresses (as demonstrated in the table below), there was a relatively equal distribution in responses so that no single bank could bias the results. There is complete list of participants in

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[47] The questionnaire is available at http://personal.lse.ac.uk/PHILLIPL and is included in Appendix I.
[48] I obtained researchers' names and email addresses through online searches and contacts with employees at several of the banks.
[49] Researchers from several other banks were included on an *ad hoc* basis after being recommended by a survey participant. These banks included American Express, BBVA, Lloyds TSB and Royal Bank of Scotland, which had one participant each.

Appendix II, but the table below demonstrates the distribution of sample size amongst participants contacted.

Table 3.4 Research analysts surveyed from top investment banks

	Total sent	Responses	Response Rate
ABN Amro	13	3	23.%
Citigroup	27	6	22%
Credit Suisse First Boston	8	3	38%
Deutsche Bank	24	1	4%
Goldman Sachs	19	2	11%
JPMorgan	49	5	10%
Merrill Lynch	8	0	0%
Morgan Stanley	33	4	12%
Santander	16	2	13%
UBS Warburg	13	5	39%
Other[50]	4	4	100%
Anonymous Respondents	NA	6	NA
Total	215	41	19.1%

While no single bank was able to bias the results, there is some level of inherent bias in the results due to the fact that the analysts most predisposed to respond to a political scientist's survey are those that are likely to find politics the most important.[51] Unfortunately, there is no easy way to control for this bias. However, the consistent use of JPMorgan's research in the section 3.3 demonstrates the importance of political variables is consistent across the analysts within the bank.

In general, the survey provided support for initial hypotheses about the centrality of political analysis to emerging market asset pricing, and of the broad nature of political variables considered in such analysis. The overwhelming majority of respondents (83%) said that the political situation was 'highly' important when analysing a country; the remaining 17% said that politics were 'moderately' important to such analysis. No

[50] Includes representatives from additional banks (American Express, BBVA, Lloyds TSB and the Royal Bank of Scotland), who were directly recommended by other participants in the survey.
[51] This bias helps to explain why most analysts surveyed did not think that the importance of politics had increased over time – they are predisposed to think that politics have always been important.

one said that politics were 'not important' to their analysis. Additionally, the majority of respondents (85%) indicated that political variables were important to country analysis, regardless of the macroeconomic condition of the country. 59% of respondents thought that political risk was 'as important' as economic risk; a surprisingly high 20% said that political risk was actually 'more important' than economic risk in their analysis. 63% considered political risk to be separate from policy risk. Very few said that their firms quantified political variables (22%), providing support for the argument articulated in section 2.4b of Chapter II that a central characteristic of political news is its lack of quantification.[52] However, a majority (56%) said that they or someone in their research team had university level training in political science, public policy or international relations — perhaps explaining the institutional complexity of the variables that arose in the content analysis in section 3.3.[53]

Additionally, the variables that respondents said were central to their political analysis ranged across the institutional framework to include the relationship between the executive and the legislature, dynamics within governing coalitions, ministerial politics and regional or federal politics. Elections were thought to be nearly universally important (emerging as a variable of consideration for almost every respondent), and many people cited 'political violence or unrest' as an important area of analysis. Contrary to the findings of the content analysis in section 3.3, there was little support for the hypothesis that the importance of political risk had been rising over time:

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[52] This question was left unanswered by more respondents (15%) than any other question, which could imply that more seek to quantify political variables, but that they were unwilling to answer due to concerns about the proprietary nature of their companies' asset models.

[53] Again, this result may be conditioned by the inherent bias in the selection, as explained on page 94.

relatively few respondents felt that the importance of political risk had been rising since the Tequila crisis or the East Asian financial crisis (17% and 8%, respectively); this, however, contradicts not only the content analysis, but also the more informal comments provided at the end of the survey by various participants. Finally, the most frequently used source of information about political risk is news – further justifying both the theory in section 2.4 of Chapter II and the methodologies used in Chapters V and VI. Table 3.5 below provides a full summation of the questions included in and results of the survey.

Table 3.5 Responses to the online questionnaire, by topic

Weighting of political variables (% of respondents)	Highly important	Moderately Important	Not important	No answer
When analysing an emerging market country or asset, how important do you consider its political situation to be when making assessments of asset value or economic outlook?	83%	17%	0%	0%
	More important than economic risk	As important as economic risk	Less important than economic risk	No answer
Which best describes the weighting you give to political risk vis-à-vis economic risk when analysing an emerging market country or asset?	20%	59%	20%	2%
	Political variables always matter	Only matter when fundamentals are bad	Political variables never matter	No answer
How does the macroeconomic condition of a country impact the emphasis that you place on political variables?	85%	10%	0%	5%

Understanding political variables (% of respondents)	Yes	No	No Answer
Do you consider political risk to be something separate from policy risk? A) Yes B) No	63%	32%	5%
	Yes	No	No answer
If you consider political variables in your analysis, does your firm have a model that quantifies their impact on asset value or economic outlook?	22%	63%	15%

	Increasing	Decreasing	No change
Rate the importance of political risk in emerging market research today, in comparison to 10 years ago.	17%	46%	29%[54]
	Increasing	Decreasing	No change
Rate the importance of political risk in emerging market research today, in comparison to years prior to the Asian Financial Crisis.	8%	43%	43%[55]
	Greater than average	Average	Less than average
The importance of political risk to my analysis in comparison to the industry average is:	30%	50%	5%[56]
	Yes	No	No answer
Do you, or others in your immediate research team, have formal university training in political science, public policy or international relations?	56%	37%	7%

Which political variables and where? (number of respondents)	Elections	Violence	Legislate Politics	Minister Politics	Coalition Politics	Regional Politics
Which political variables are you interested in when analysing a country, if at all? You can choose more than one.	35	29	25	13	20	12
	Latin America	Emergin g Asia	Africa	Middle East	Eastern Europe	None
In which regions are you especially concerned about political risk? You can choose more than one.	27	14	18	27	11	0
	No Answer	News	Govt Officials	Others in Country	Pol Risk Analysts	Other
If you include political variables in your analysis, what are your primary information sources? You can choose more than one.	1	30	24	21	25	3

Ranking political risk (% of respondents)	Of high importance	Of moderate importance	Of little importance	No answer
The impact of Brazil's political situation on its economy or asset value is:	59%	32%	2%	7%
	Of high importance	Of moderate importance	Of little importance	No answer
The impact of Mexico's political situation on its economy or asset value is:	20%	59%	20%	2%

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[54] 7% did not answer this question.

[55] 8% did not answer this question.

[56] 15% did not answer this question.

	Of high importance	Of moderate importance	Of little importance	No answer
The impact of Russia's political situation on its economy or asset value is:	68%	23%	5%	5%

Additionally, at the end of each survey, respondents had the opportunity to add comments, and to select whether they would be willing to participate in telephone interviews with the researcher to share further thoughts on the identifying of political risk, the market's response to political risk, or political risk in particular countries of interest (e.g. Brazil and Mexico). An inconsequential number of respondents added comments and a small number were willing to take part in telephone interviews. Because of the low number of respondents willing to take part in such interviews, the results are not presented systematically in the body of the text, as they are not thought to be sufficiently representative of the market as a whole. Nonetheless, for anecdotal evidence and where they add appropriate colour, several references to interviews were made in Chapter II above and additional comments are made in later chapters.

3.5 CONCLUSIONS AND TESTABLE HYPOTHESES

In this chapter I sought to clarify the role of political variables in generating political risk and financial market volatility in autocratic regimes, and briefly examined the persistence of political risk in emerging market economies in which political and economic conditions have stabilised. This discussion was meant to provide further nuance to the hypotheses of institutional political risk and political news provided in

Chapter II. Additionally, I provided empirical support for the hypotheses that the importance of political risk has been rising over time and that market participants are interested in complex democratic political variables.

Combining this work with the background, rationale and initial evidence of the role of political risk in the modern political economy in Chapter II, a full set of testable hypotheses now emerges. The remaining content based chapters of this thesis (Chapters IV, V and VI) set out to test three hypothesis, first through formal econometric modelling, and second, through in-depth case studies of two large, comparable emerging market economies: Brazil and Mexico. These three hypotheses are explicitly laid out below, and initial methods of how they will be tested are suggested.

1. Sovereign risk rates on emerging market bonds have a significant political component due to the intrinsically political nature of sovereign debt.

- The institutional distribution of horizontal and vertical power in a given democracy, as well as event variables such as elections, will be significant determinants of sovereign bond spreads.

- If institutional variables are indeed significant and are not serially correlated to the macro-prudential conditions, initial support is provided for the more direct link suggested in figure 2.2 (page 60) between institutions and the production of political news (i.e. not through interim economic outcomes).

Methodology: The importance of political variables in determining sovereign risk rates is tested through an econometric model of seventeen emerging market democracies in Chapter IV, with additional tests conducted on a dataset of mixed autocratic and

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democratic regimes to test whether the relationship between the number of veto players and perceived credibility forms a 'U-Curve'. Confirmation of the second part of this hypothesis is obtained through the same models.

2. Political news creates volatility in the sovereign bond markets of emerging market countries.

- The dispersion of power and divergence of ideas across horizontal and vertical layers of government in a given democracy will determine how much market significant political news is generated by its political process.

- The impact of political news on sovereign bond market volatility is expected to be greater than that of macroeconomic news, given the unique characteristics of political information.

Methodology: This hypothesis is tested in the in-depth case studies of Brazil and Mexico through an analysis of the sources of volatility in these markets. The behaviour of each country's sovereign bond spread is observed over the course of twelve years (1991-2002) to determine what the aggregate impact of political news is on the market volatility.

3. Political risk is not constant over time or across countries, but it is difficult for emerging market countries to 'graduate' from political risk.

- Democracies that have multiple veto players with highly divergent policy preferences and low internal cohesion are expected to suffer from greater politically induced volatility than countries with the opposite characteristics.

- Autocracies are likely to experience politically derived volatility with less frequency, though those events are likely to have a strong impact when they

occur. Democracies are more likely to experience lower intensity day-to-day political volatility caused by institutional outcomes.

- Even in emerging market economies with strong macroeconomic performance (like Mexico) and stable democratic institutions (like Brazil), political risk is likely to play an important role in determining the reasons for financial market volatility.

Methodology: A comparison of the institutional characteristics of Brazil and Mexico is undertaken, with particular emphasis on how Mexico's transition to democracy in the 1990s affected its propensity for bond market volatility. The difficulty of 'graduating' from political risk is tested by the later years in the Mexican dataset (e.g. 2000-02), in which Mexico's debt was rated as investment grade by major rating agencies and the country was a member of the OECD. Political risk should continue to play a major role in explaining financial market volatility during these years.

Thus, the remainder of this thesis seeks to demonstrate that political institutions play a strong role in explaining both steady state sovereign risk (debt premiums) and dynamic risk (volatility) through a mixture of large n econometric work, analysis of the source of volatility and comparative case studies of two large Latin American economies. It also provides insights into the varying role of political risk in autocratic and democratic regimes, and shows that it is difficult for emerging market states to graduate from political risk, as outlined in sections 3.2a and 3.2b of this chapter.

CHAPTER IV

TESTING THE IMPACT OF POLITICS ON SOVEREIGN DEBT PREMIUMS

4.1 INTRODUCTION

Thus far, this thesis has provided the theoretical background for the three hypotheses that were summarised at the end of the previous chapter: sovereign risk rates on emerging market bonds have a significant political component due to the intrinsically political nature of sovereign debt; political news creates volatility in the sovereign bond markets of emerging market countries; and the perception of political risk is not constant over time or across countries. This chapter will provide econometric evidence for the first two of these hypotheses by testing the political determinants of sovereign bond spreads for seventeen emerging market countries from 1998 to 2002. The models in this chapter demonstrate that the political variables and, more importantly, institutional variables that create political news do have a significant effect on democratic emerging market sovereign debt spreads. In some cases, such variables have a *stronger* impact on spreads than do economic variables, providing initial support for the third hypothesis above, which is further tested in the case studies of Brazil and Mexico in Chapters V and VI below. Additionally, these tests demonstrate that the importance of political variables to market performance does not lie in their eventual economic outcomes as institutional theories of political economy have tended to argue, but instead in a more immediate relationship, as there is no significant

correlation between the economic and political variables used to model the sovereign spreads.

As was stipulated in Chapter I, the price of a given sovereign bond will be determined both by the international interest rate and the perceived risk of that country's debt. The perceived risk has to do with both the ability and willingness of a given country to repay its debt, making credit risk an inherently political concept. Additionally, Chapter II provided an updated definition for political risk, which sensitised the traditional components of political risk, uncertainty and instability, to two broad institutionally determined features of modern emerging democracies: the distribution of power across horizontal branches and vertical layers of government. Here, those political features will be instrumentalised and tested, along with a standard set of macro-prudential indicators which have been shown in previous econometric tests of the determinants of bond spreads to be significant.

Thus, constructing an econometric model to test the importance of political variables in determining the pricing of sovereign bonds requires a review of earlier models of bond pricing, and significant explanation of the variable selection, sources of data and results. The lay-out of this chapter follows this logic: first, economic models of spread determinants are outlined (section 4.2), followed by a brief review of papers which have explicitly tested the impact of political variables (some of which were mentioned in previous chapters), with a more explicit focus on their methodologies (section 4.3). Second, a model is proposed which contains a hybrid of economic and political variables (section 4.4). The dataset used to test these hypotheses is then detailed for

each model and the economic and political variables utilised are explained (4.4a and 4.4b, respectively). Section 4.5 provides the results of the model and compares it to previous models. The last section of the chapter concludes, and discusses how the findings of these econometric tests will be further refined and enhanced in the case studies in Chapters V and VI below.

4.2 REVIEW OF PREVIOUS EMPIRICAL BOND-PRICING MODELS

This section reviews work that has largely arisen from the field of international economics on the empirical determinants of bond spreads; the papers reviewed here are technical, econometric pieces which attempt to uncover the economic variables which affect the price of developing countries sovereign debt (measured by the spread of any country's bond over a 'risk-free' US treasury with similar maturity characteristics). Sebastian Edwards created the first widely cited sovereign bond-pricing model (Edwards 1984; Edwards 1986). Despite the fact that Edwards was writing before the advent of the deep emerging market bond markets that were to arise in the post-debt-crisis era of the 1990s via Brady Bonds, his model has been used as the predominant paradigm for later studies into the determinants of bond spreads. Thus, given the centrality of his work, we begin with a review of his model.

Edwards's work is informed by and later served as an influence for the theoretical literature on sovereign debt default risk that was outlined in Chapter I (e.g. Eaton and Gersovitz 1981; Bulow and Rogoff 1989). Following from these earlier works, Edwards assumes that the spread of a particular bond over the LIBOR reflects the

probability of default for the country in question. The country is assumed to be a small, open economy that cannot affect world interest rates, and therefore LIBOR is exogenous to the equation. From this assumption, a simple equation that maps the relationship of the spread to the probability of default (which is captured as a function of a series of macroeconomic inputs) is formulated. Edwards then designs the following testable empirical model:

$$\log s_{it} = \alpha + \sum_{j=1}^{j} \beta_{jit} x_{jit} + \varepsilon_{it}$$

where s_{it} is the yield spread of a country i at time t, α is an intercept coefficient, the β_{jit} are slope coefficients for a set of x_{jit} macroeconomic fundamentals and the ε_{it} are a set of independently and identically distributed (i.i.d). error terms. Edwards chooses a list of possible determinants of the spread (s) compiled from the 'classic' sovereign debt literature reviewed in section 1.2, which total to 14 individual inputs. They are the debt-output ratio, the ratio of debt service to exports, the ratio of international reserves to gross national product (GNP), loan duration, loan volume, propensity to invest, ratio of the current account to GDP, average propensity to import, growth of per capita GDP, GNP per capita, inflation rates, variability of international reserves, devaluation and government expenditure over GNP. His dataset includes 19 emerging market countries during five years (1976-80), which compose a pooled cross-sectional time series and he uses a random effects model to model the equation intercepts. Using this framework, Edwards finds that some of the macroeconomic conditions mentioned above are significant, namely: the debt-output ratio, the debt-service ratio and the reserve ratio. Other variables are not significant in any of his estimations at the 5% or 10% level.

Renewed interest in the empirical determinants of bond spreads came about in the 1990s as the emerging market bond asset class had grown dramatically in size and importance in terms of international financing. This review presents a sampling of the empirical articles that are thought to be most significant. Later authors have largely used Edwards's model and methodology as the basis of their investigation, adjusting some of the economic variables but essentially replicating the econometric estimation technique. In a working paper from the World Bank, Min investigates the empirical determinants of bond spreads to see whether macroeconomic fundamentals matter, essentially reproducing Edwards's earlier study with several new economic variables and a longer and more complete dataset (Min 1998). Like Edwards, he assumes that the country in question is a small open economy that cannot affect the world interest rate and that the relationship between the spread and the probability of default is a function of a series of macro-prudential variables. These 18 variables are grouped into five separate categories (liquidity / solvency, macroeconomic fundamentals, external shocks, specific bond related variables and dummy variables), and he finds that liquidity and macro fundamentals are significant in determining spreads. Like Edwards, Min pools his data (11 countries from 1991 to 1995) – though because of the low number of observations, Min uses a dummy variable model that is estimated using ordinary least squares (OLS). Of the postulated variables, all of the liquidity variables are found to be significant (debt to GDP, international reserves to GDP, growth rate of exports and growth rate of imports, debt service ratio and net foreign assets). The macroeconomic variables (inflation, terms of trade and the real exchange rate) are also found to be significant. Both of the external variables (the treasury bill rate and the

price of oil) are insignificant, but several regional dummy variables appear to be significant.

The most recent piece of work on the determinants of bond spreads is a Bank of England working paper by Ferrucci, whose theoretical selection of the proposed economic variables is determined by constraining the inputs by a utility maximization function which looks for a country's ideal borrowing point by smoothing its debt consumption path over time, i.e. making reference to the long-term sustainable primary fiscal surplus / deficit (Ferrucci 2003). Thus, the spread is dependent on two separate conditions: first, the ability of the country to generate sufficient foreign exchange to meet its debt payments, and second, the ability of the country to generate sufficient domestic resources to purchase that foreign exchange. The econometric methodology employed is slightly more nuanced than those described above, in that Ferrucci uses a pooled mean group technique attributable to Pearson, Shin and Smith to estimate the panel dataset (Pearson, Shin et al. 1999). The pooled mean group technique is a dynamic error correction model where the equation coefficients are assumed to be fixed (homogenous) in the short-run and random (heterogeneous) in the long run. The dataset comprises bonds that are found in two emerging market bond indexes, JPMorgan's EMBI and the EMBIG. Given data availability in the indices, the panel includes monthly observations for 5 countries from 1992 to 1995, 11 countries from 1996 to 1997 and 23 countries from 1998 onwards; in total, 2005 observations.[57] Ferrucci tested 23 independent variables: 16 macroeconomic fundamentals, five

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[57] When monthly data is not available, as is the case for most macroeconomic variables that are only available on a yearly, or on occasion, quarterly basis, Ferucci estimates monthly data via linear interpolation.

external indicators and two dummy variables. All of the macroeconomic variables and external variables tested are significant with the exception of the current account to GDP ratio and an external variable composed of the yield on US corporate spreads. While the model employed in this study is substantially more complex than that used by Edwards and Min, a potential shortcoming is that Ferrucci uses a process of linear interpolation to derive monthly values for economic variables that are normally available on an annual basis. This is a potential problem as few economic variables trend linearly over the course of a year.

Additionally, there is at least one example of a model emanating from the private sector to model the empirical determinants of sovereign bonds. Goldman Sachs introduced a new model for assessing the fair value of emerging market sovereign debt in a 'Global Economics Paper' (Goldman Sachs 2000). The model is called the Goldman Sachs Equilibrium Sovereign Spread (GS-ESS) and the model closely resembles those described above as the theoretical assumptions are the same. The dataset is composed of spreads and economic variables for 15 emerging market countries from 1996 to 2000, with one bond with a 10-20 year maturity selected for each country.[58] Broadly, the methodology and conclusions are the same; Goldman Sachs use its model to estimate whether certain bonds are under or overvalued and find that of 15 bonds, 12 were undervalued, leading to the conclusion that there could be other variables which would provide more insight into the levels at which bonds trade.

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[58] Selecting a single issue bond creates a potential bias, as each individual bonds maturity and value is likely to change the discount or premium at which it is traded, in relation to other bonds from the same country. A 'safer' method is to choose a bond index, as done by Ferrucci and in this chapter.

Among the previous work on the empirical determinants of bond spreads, several authors have found that a standard set of 'macro-prudential' variables cannot do all the explaining on the variation in spreads. Ferrucci, whose Bank of England working paper is one of the most recent and econometrically sophisticated, finds that non-fundamental factors play an "important role" in predicting emerging market bond spreads. Specifically, he finds that the error terms for individual countries in the dataset follow a non-random (systemic) pattern, which suggests that market perceptions of sovereign creditworthiness "may be more broad based than that provided by the model" (Ferrucci 2003: 27). Thus there is a possibility that a consideration of political variables could illuminate these systemic errors, helping to forecast bond pricing more accurately, as bond risk can be considered to have a strong non-economic, political aspect.

4.3 EMPIRICAL MODELS OF BOND PRICING WITH POLITICAL VARIABLES

As was stated in section 1.2 of Chapter I, sovereign debt repayment and repudiation is an intrinsically political decision (relying on the 'willingness to pay') and thus some empirical work has been done to determine what impact political variables have on the pricing of sovereign debt. As was discussed in section 2.2b, a number of studies have sought to correlate creditworthiness and debt pricing to regime change, elections or political violence, all of which have found a statistically significant relationship between these political variables and metrics of creditworthiness (Citron and Nickelsburg 1987; Brewer and Rivoli 1990; Balkan 1992). As was discussed in the same section, an additional link between sovereign debt spreads and the timing of

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elections has been investigated by Block and Vaaler, who suggest, following the political economy theory of PBC that spreads may rise in anticipation of elections (Block and Vaaler 2004). Their model is worth briefly detailing, as the methods vary from those described in the papers above.

The authors use two econometric models to test their hypothesis that elections lead to higher spreads and lower credit ratings because of the political business cycle, one for each dependent variable. As the credit ratings regression is not of immediate concern here, only the methodology employed to test spreads will be detailed. The authors collected daily spreads data for 11 developing countries between 1987 and 1999; over the course of the period 14 elections occurred. Their model uses relative spreads as the dependent variable, where relative spreads are defined as the difference between the yield on a given emerging market bond vs. that of a US treasury. These relative spreads are tested against an election dummy coded to represent the 60 days before and after an election. Additionally, two dummy variables are included: a country specific dummy and a dummy representing the year. Macroeconomic variables are not controlled for, which creates a risk of omitted variable bias, though they do control for a vector of 7 macroeconomic variables in their credit ratings model. The estimation methodology employed is a generalised estimating equation approach, which allows for auto-regressive modifications. Their results confirm the hypothesis that elections, and therefore perhaps the perception of a likely political business cycle, affects bond spreads and creditworthiness: elections were on average responsible for a decline in creditworthiness ratings equivalent to one grade (on a 17 point scale) and a 21%

increase in debt spreads in the period just subsequent to an election in comparison to a non-electoral period.

4.4 A POLITICAL BOND PRICING MODEL

Having reviewed in section 4.2 above a model that seeks to explain bond spreads purely in terms of economic variables, and in section 4.3 a model that, while it introduces political explanatory variables limits them to elections, this thesis now proposes an alternative model, incorporating a much more comprehensive set of political variables, which will be used to test my central hypothesis about the impact of institutions on sovereign debt premiums. My choice of political variables is based on the discussions in sections 2.3 of Chapter II. This chapter will discuss in detail how these variables will be used in the construction of the model.

4.4a Economic Variables

The economic determinants of bond pricing are relatively uncontroversial, as a standard set of probable determinants has arisen through econometric investigations such as those outlined in section 4.2 above. Breaking these variables down into liquidity and solvency metrics, a total of six economic variables are tested in the proposed model. For purposes of determining liquidity, investors are likely interested in the current account balance[59]

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[59] Here, the current account balance takes the place of other trade (i.e. import and export) variables that have been used in previous studies such as the growth of imports and exports and the propensity to trade. Growth of imports and exports were tested in earlier versions of the model presented, and proved to be consistently insignificant.

and the level of foreign exchange reserves measured as a percentage of GDP.[60] With regards to solvency metrics, four additional variables are proposed: the aggregate public debt / GDP ratio, which gives a sense of the ongoing debt burden the country faces versus its productive capacity; the fiscal balance, which gives a sense of ongoing funding needs; the GDP growth rate,[61] and the inflation rate (or consumer price index in this case), which gives a sense of the stability of monetary policy and the conditions for consumers in the economy. As the dependent variables in question are spreads rather than yields, controlling for the US treasury bill rate, as has been done in previous studies of yields and credit ratings, is not considered to be significant. Additionally, year dummies should capture any particular functions of the world economy of that given year (e.g. major financial crisis in 1998). Descriptions, data sources and coding (in parentheses) for each of these variables is given below:

1. **Current Account Balance (CABAL):** Measured as the current account balance to GDP, both measured in current US dollars. The current account balance demonstrates a country's capital account and trade account position, both of which are important proxies for liquidity in an emerging market country, and therefore, the likelihood of continued capacity to repay debt. Source: IMF International Financial Statistics (IFS) Database.[62]

2. **Foreign Exchange Reserves (FXGDP):** Liquidity metric that measures the amount of foreign currency available in the Central Bank to service debt and defend the currency, if necessary, at any given time. This variable is measured as the level of total reserves in USD (less gold) divided by GDP.[63] Source: Derived from World Bank Global Development Indicators (GDI).[64]

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[60] The foreign reserve ratio also provides some sense of movements in the real exchange rate. A more explicit metric of exchange rate metrics was tested in this model and proved to be insignificant. It is therefore not presented. An alternative measure for foreign exchange reserves, frequently used by economic and financial analysts, is the number of months of imports foreign exchange reserves can 'cover'. In footnote 64, I explain why I have used foreign exchange reserves to GDP instead of this alternative metric.

[61] Though it is standard in many types of regressions to lag GDP to give a sense of resources going forwards, because the dependent variable being modelled in this equation is a market variable which should react to current announcements of solvency, the current year's GDP rate is used.

[62] Available online at http://www.esds.ac.uk.

[63] The amount of foreign exchange reserves measured in months of import cover was also tested. The variable, however, had an unexpected coefficient, suggesting that spreads increased as months of import

3. **Debt / GDP (DEBTGDP):** Total public debt in US dollars divided by real GDP in US dollars. This metric gives a sense of how heavy the debt burden is to the overall economy, and is the most frequently cited metric of debt sustainability and capacity. Initially, including a debt service indicator (the amount of interest and amortisation owed each year) was considered. However, there was an exceptionally high level of pair-wise correlation between debt to GDP and debt service. Debt service was therefore dropped. Source: World Bank GDI.

4. **Fiscal Deficit / Surplus (FISCBAL):** Measured as the end year fiscal balance to GDP, when not available, measured as budgeting fiscal surplus or deficit. Provides a sense of the ongoing debt issuance needs of the country based on ongoing fiscal overspend: a solvency variable. Source – IMF IFS Database, or when unavailable, country data assembled by the Economist Intelligence Unit (generally derived from Central Bank data or government sponsored statistical agencies).

5. **GDP Growth (GDP):** Year on year GDP growth. A solvency variable that suggests the available resources going forward to meet debt service needs. Source: World Bank GDI.

6. **Consumer Price Index (CPI):** The CPI, which is an approximation for inflation, gives an indicator of the general growth and interest rate prospects of the country in question. Source: IMF IFS Database.

4.4b Political Variables

In a era characterised by democratised emerging market states, financial markets will respond to complex political variables – both because they are determinants for economic outcomes and because political news generated by the practice of politics under certain institutional configurations increases the appearance of instability and uncertainty. Based on the institutional comparative political economy literature and the theory of veto players in particular, it was hypothesised that the greater the number and dispersion of checks and balances along horizontal and vertical dimensions of

cover increased, and was therefore not used. Additionally, the ratio of reserves to GDP is preferred by the IMF and World Bank.

[64] Available online at http://www.esds.ac.uk.

government, the greater is the likelihood of that democracy suffering from high levels of perceived political risk, and therefore debt premiums and volatility. These variables were suggested in addition to elections, a variable to which political sovereign debt premiums are more commonly attributed. Thus, for this analysis, it was necessary to operationalise checks and balances as well as ideological polarisation and internal fractionalisation by selecting variables which measure such diffusion. The below details how these variables were selected and what they measure.

1. Checks and Balances (CB): The most desirable metric of checks and balances (or the number of veto players) would identify both the number of actors who have a say in the policy process and the diversity of their preferences. However, there are few available metrics which do both of these, and thus, the number of checks and balances in this empirical study is a separate variable from the differences in veto players' preferences. Several sources for checks and balances are available. First, Henisz's checks and balances variable distinguishes the number of constitutional veto points, conditioned on the parties that control such veto points and their majority (Henisz 2000). While his variable does cover the countries of interest for this study, the last period in the dataset is 1990 to 1994, making it unsuitable. A variable included in the World Bank's Database of Political Institutions, or DPI (Beck and al 2001), measures checks and balances in a similar way: first counting the number of veto players in the system and then adjusting this number by the level of independence of each player based on party affiliation and the level of electoral competitiveness. This variable was available for all countries until 2000; an updated and as yet unpublished version of the database with observations up to 2002 was obtained from the World Bank researchers involved in the project. Thus, observations for 2001 and 2002 come from this new (and as yet not public) database. Since the theory outlined in section 2.3 argues that the impact of checks and balances will be strongest when there are many, a log version of this variable (*logcb*) is generated and tested.

2. Polarisation (Polar): As mentioned above, the drawback of the checks and balances variable is that it does not capture the difference between the 'ideal' policy points of different players. However, a variable included in the DPI, political polarisation, is a proxy for the difference in policy preferences (Beck and al 2001). Polarisation measures the greatest distance in stated economic policy preferences (categorised as left, right and centre) between up to four political parties in the country and the president. As the variable is likely to have some interaction with checks and balances, tests were run to see the pair-wise

correlation between the two variables, which yielded a correlation of 0.37.[65] The variable is added to the equation separately to make sure that the two do not have a significant interaction – both are significant when regressed independently and the coefficient does not change sign.

3. Legislative Fractionalisation (LegFrac): Checks and balances and polarisation capture the first two of Tsebelis's characterisation of veto points: the number of veto players and the differences in their policy preferences (Tsebelis 2002). The third important metric is the level of internal cohesion of each veto player. Within the DPI (Beck and al 2001), there are two fractionalisation metrics available – that of the government and the legislature. However, the correlation of these two variables is high at 0.50, and thus legislative fractionalisation is selected. The level of legislative cohesion is a good proxy given the centrality of the legislature to the veto points analysis and the higher probability that there is legislative fractionalisation than government fractionalisation. Legislative fractionalisation, as available in the DPI, measures the probability that any two representatives chosen in a random draw would be of different parties. As above, there is a chance that there is interaction between the checks variable and the fractionalisation variable, and therefore, the pair-wise correlation was tested. At 0.39 it is judged to be relatively acceptable for inclusion – tests were later run on regressions which included both variables to ensure that tests for multi-collinearity were within acceptable limits. As above, the variable is added to the equation separately to test for interaction. Both are significant when introduced independently and the coefficient does not change sign between regressions in which the variables are added separately and jointly.

4. Fiscal Decentralisation (Fed): Finally, it is necessary to proxy for the degree of vertical power distribution in the system. It is exceptionally difficult to find a time series, cross section variable which measures the extent to which political power is divested to the sub-national level (given that political power held at this level is often held through informal rather than institutional means). It is also difficult to find reliable and consistent statistics for the level of sub-national revenue, expenditure or debt to central government levels. While such numbers are available for larger emerging market countries in the World Bank's Fiscal Decentralisation Database and the IMF's IFS database, many countries do not consistently report such data, making comparison hard. Thus, a binary variable included in the DPI is used which is coded 1 if a country has significant tax and spend authority delegated to the subnational level and 0 if not (Beck and al 2001). While this is a rather blunt tool by which to measure vertical balance of power, it is the best available metric for the diverse set of countries included in this dataset.

5. Elections (Elec): Given the importance of elections in previous works, a binary variable coded 1 in a year with an election and 0 in a non-election year was also included. This variable was obtained from the DPI and checked against

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[65] The pair-wise correlation between checks and balances (non-logarithmic) and polarisation is 0.36.

the Institute For Electoral Study's (IFES) Election Guide (Beck and al 2001).[66] In presidential systems, if legislative elections were held separately, they were not included in the variable.

4.4c Dummy Variables

Year and regional dummies (Latin America, Asia and Eastern Europe) were used to create a model which is similar to a fixed effect panel model; country dummies were not used as including seventeen dummy variables would have significantly reduced the model's degrees of freedom. Turkey was included in the European dummy categorisation. Additionally, when using a panel corrected standard error model (as was necessary given heteroskedasticity in the model), it is impossible to use a standard fixed effects model, so one had to be approximated.

4.4d The Dataset, Dependent Variable and Model

To conduct a robust test of the relationship between bond pricing and politics, a large n study is undertaken using econometric methodology. Bond spreads for 17 emerging market democracies were collected over a series of five years (1998 - 2002).[67] The size of the dataset is relatively consistent with previous models outlined in sections 4.2 and 4.3. It is impossible to assemble a longer time series and still have a balanced pool due to data constraints: complete bond pricing information is available for only a limited set

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[66] The Election Guide is available at www.electionguide.org.

[67] The countries included are: Argentina, Brazil, Bulgaria, Colombia, Croatia, Ecuador, Mexico, Panama, Peru, Philippines, Poland, Russia, South Africa, South Korea, Thailand, Turkey and Venezuela. While data is available for four other countries for the entire time span of the dataset (China, Malaysia, Morocco and Nigeria) they are thought to be insufficiently democratic throughout the entire time period in question to be included in this analysis.

of countries prior to 1998,[68] and political data is not available in a cross-national time series set after 2002. Thus, the dataset includes 85 observations in a balanced time series panel (17 x 5). It should be noted that while the majority of the empirical investigations of market behaviour focus on high frequency data – daily, or in the case of some models, even minute by minute asset values (e.g. Bernhard and Leblang 2002 use 5 minute data), here spreads are collected only on an annual basis.[69] While high frequency data is critical to test the immediate impact of news on market performance (volatility), it is not essential for testing the political or institutional determinants of bond spreads: in fact, it creates a number of problems.

High frequency financial market data is usually best captured by time series models that use only a lagged dependent variable to explain variation, and attempting to model emerging market bond spreads at high frequency with traditional econometric models is highly problematic, requiring researchers to use methods such as regime switching models (Hays, Freeman et al. 2001). Masson et al detail the numerous problems with modelling high frequency EMBI data including auto-regression and autocorrelation (Masson, Chakravarty et al. 2003). Additional problems in such methodology are introduced when institutional variables are added to the equation, which by definition change very infrequently (see discussion in Kittel and Winner 2005)[70]. Modelling with

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[68] The precursor to the EMBIG index, the EMBI, is available for only five countries between 1991 and 1994: Argentina, Brazil, Mexico, Nigeria and Venezuela. An additional six countries were added to the index between 1994 and 1997 at staggered intervals: Bulgaria, Ecuador, Panama, Peru, the Philippines and Poland. Results are less robust with the limited five country dataset; additionally, economic variable reporting to the IMF / World Bank from several of those countries was spotty or absent during the period 1991-1995.

[69] The bond spread for the year is given as the average of daily spreads from January to December.

[70] In particular, Kittel and Winner discuss the fact that the non-variability of institutional variables in panel data models may create the impression that such variables are highly significant. They suggest controlling for across country and over time affects (fixed effect models across two dimensions) and

monthly and daily data is particularly problematic for emerging market countries where economic data is generally available only on an annual basis. In the case of high frequency market data, interim economic values have to be estimated via linear interpolation (as seen in Ferrucci 2003), which is likely to be unrepresentative of actual economic performance which often moves cyclically (or even erratically) rather than linearly, and creates further problems with trending and non-stationarity.

The decision to use as the dependent variable an index of secondary market spreads, rather than individual bond prices in the primary market, also requires justification. First, as noted in Ferruci in section 4.2 above, spreads on primary issuance have an intrinsic selection bias, as countries, like companies, tend to bring bonds to market only when conditions are favourable (Ferrucci 2003: 13). Secondary spreads are also preferable because the potential dataset when using primary issuances is likely to be smaller, as many countries do not bring a major bond to market every year. This is particularly true of smaller emerging market borrowers such as Ecuador. A bond index is used, rather than selecting individual bonds from each country from each year, first because an index eliminates the chance that errors are made by the researcher in identifying comparable US treasury bonds against which to measure spreads and second because an index, which typically includes two or more bonds, reduces the chance that the spreads used reflect some sort of bias on one particular piece of debt, whose price may be moved by endogenous (e.g. maturity) or exogenous (e.g. disproportionate levels of holding by a given investor) factors.

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testing whether the coefficients of such variables still have the hypothesised sign and appear to be significant.

Specifically the EMBIG is used as the dependent variable. [71] The EMBIG is compiled by JPMorgan, and data is aggregated into an overall index as well as broken down on a country-by-country basis. Each country's daily spread represents the weighted average of the spreads on several bonds: JPMorgan stipulates that all bonds included in the aggregate pricing measure must have a face value of $500 million or greater and a duration of at least two and a half years. Additionally, the bonds included are almost always Brady Bonds or Eurobonds. As such, each spread is a blended representation of overall country risk.

Consistent with the theory of sovereign debt creditworthiness, emerging market borrowers are conceptualised as small, open economies unable to affect global interest rates. Unlike the purely economic models outlined in section 4.2, sovereign lenders analyse the risk of debt default based on two constraints: the country's economic ability to pay its foreign debt obligations, and the perceived political willingness to pay those same obligations, which in turn is dependent upon the political institutions in a democracy. The model, which looks to see the significance of political institutional variables against sovereign bond spreads, follows the standard used since Edwards, expressing the relationship between the spreads and the relevant variables logarithmically (Edwards 1986). Thus:

$$\log(s_{it}) = \alpha_i + \beta_y P_i + \gamma_y E_i + \varepsilon_{iy}$$

where P_i is a vector of country i political variables and E_i is a vector of country i's macro-prudential variables. α_i, β_y, and γ_y are vectors of coefficients and ε_{iy} is a

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[71] This is the same bond pricing index used by Ferrucci 2003 (see section 4.2 above).

stochastic disturbance term. Spreads and political and economic variables were collected into a balanced panel, and pool regression techniques were employed. As discussed briefly above, given the yearly nature of the data, it is not necessary to employ modelling techniques which are perhaps more suited to high frequency financial market data, such as ARCH models or regime switching models. Thus, a simple linear regression model was employed. However, the initial model demonstrated significant group-wise heteroskedasticy when a Wald test was conducted. Thus, throughout the models presented in the next section, a panel corrected standard error model will be used. Again, the size of the dataset and the type of model used preclude using either a standard fixed effects model or country dummies, but fixed effects can be simulated to some extent by the inclusion of regional and year dummies. In terms of other measures of robustness, none of the models detailed in the coming section exhibited multi-collinearity: the variance inflation factor and condition index for all models were well within the standard benchmark limits, which also helps to further alleviate concerns about the relationship between the logarithmic checks variable and the other two institutional variables, polarisation and fractionalisation. Finally, a Fisher Test for Unit Roots in panel data was run which proved that the models below were consistently stationary, a result which is not surprising given the short duration of the dataset and that institutional variables are not generally repeated values.

4.5 RESULTS AND EXPLANATORY POWER OF THE MODEL

4.5a Results

The regressions were run in a step by step manner, to first determine the explanatory power of the economic variables alone, then adding political variables one by one. This was done to facilitate comparison with the econometric papers reviewed in sections 4.2 and 4.3 above (the comparison is found in the subsection 4.5b below). Variables deemed to be insignificant were dropped from subsequent analysis – an important decision given the relatively small number of observations in the dataset. The results provide strong support for the hypothesis that the distribution of checks and balances across horizontal and vertical layers of government has an influence on sovereign bond spreads: checks and balances, polarisation and legislative fractionalisation were all significant at the 1% level for all models tested. While polarisation, legislative fractionalisation and fiscal federalism had the expected impact on spreads (i.e. spreads increased as polarisation, fractionalisation and federalism increased), checks and balances had the opposite effect, contrary to expectations.. The number of checks and balances was negatively correlated with spreads, suggesting that more gatekeepers on the policy process increases credibility.

One explanation for this finding is that amongst the democracies in the dataset, there was an insufficient variation in the number of checks and balances among countries, and therefore the direction of the relationship was compromised. In order to test whether this was the case, a squared version of the checks and balances term (CBSQ) was

introduced and tested alongside the original checks and balances term (non-logged) to determine whether the an increase in checks and balances increased spreads at higher values. This test also helps to determine whether there is a parabolic (u-shaped) function. These results are presented in Table 4.5 below.

The inclusion of both the checks and balances term and the squared checks and balances term confirms that this is indeed the case: while spreads decrese when checks and balances increase somewhat, at higher levels of checks and balances spreads increase. This suggests that the relationship between perceived credibility and checks and balances is parabolic. However, due to the interaction between the squared term and the original checks and balances term significance was compromised, which means that findings are not completely robust. Thus, an additional test, utilising a different database of mixed autocracies and democracies was constructed. This test and the results are explained in section 4.5b.

An additional finding was that none of the institutional variables was serially correlated to the macroeconomic variables, suggesting initial support for the causal mechanism suggested in figure 2.2: that institutions produce political news which has a direct impact on the perception of political risk, rather than being channelled through macroeconomic outcomes. Rather surprisingly, given the findings of previous authors, elections were not a significant determinant of spreads. There are at least two potential reasons for this. First, as the data in this analysis is compiled on an annual rather than monthly or weekly basis, there is a significant probability that elections have little effect over such long periods of time. Only in exceptional cases would the average annual spread be

impacted by the presence of an election in that year (e.g. Brazil 2002); in most cases, and consistent with the assumptions of prior researchers, elections are thought to have an impact in the months immediately surrounding the election (3 months is the standard used). Second, it is possible that the strong effect of elections (a binary variable) in previous analysis was acting as a proxy for an array of other non-accounted for variables – both political and exogenous to the models used by previous researchers.

Moving on to the impact of the economic variables on the analysis, of the six macroeconomic variables, only three were significant: the inflation rate, the debt to GDP ratio and the level of foreign exchange reserves. The current account balance, fiscal balance and rate of GDP growth had no statistically significant relationship to the annual level of spreads. While these results are perhaps surprising, they are relatively consistent with the findings of other recent pieces (see 45.b below which compares the results from this model to prior pieces of research). And while the three significant macroeconomic variables went some way towards explaining the variation in spreads across time and across countries, adding the political variables to the regression equation increased the explanatory power (R^2) of the model significantly. Additionally, adding a simulation of fixed effects via the inclusion of regional and year dummies also increased the R^2. Tables 4.1 to 4.5 below present the results of this analysis in numerical format. The first two tables show the results of the regression with economic variables alone: first all six variables are included, then a more parsimonious equation is suggested. Note that while the second model is more parsimonious, its explanatory power is slightly lower, suggesting that there could in fact be omitted variable bias.

Table 4.1 Emerging market spreads against macroeconomic variables
Linear Regression using Panel Corrected Standard Errors Model
Dependent Variable = Log (EMBIG)
Number of Observations: 85
Number of Groups: 17
$R^2 = 0.61$

	Coefficient	Standard Error	Z	P > z
CABal	0.15	1.01	0.15	0.88
CPI	0.85	0.17	4.99	0.00
DebtGDP	1.31	0.27	4.89	0.00
FXGDP	-0.48	0.08	-6.23	0.00
Fiscbal	0.16	0.93	0.17	0.86
GDPG	-2.48	1.87	-1.32	0.19
Constant	6.20	0.15	40.06	0.00

In table 4.1, the current account balance, the fiscal balance and the rate of GDP growth are insignificant. The three remaining variables have strong significance and have coefficients in the predicted direction. Thus, in the following equation, the three non-significant economic variables are dropped.

Table 4.2 Emerging market spreads against selected macroeconomic variables
Linear Regression using Panel Corrected Standard Errors Model
Dependent Variable = Log (EMBIG)
Number of Observations: 85
Number of Groups: 17
$R^2 = 0.59$

	Coefficient	Standard Error	z	P > z
CPI	0.78	0.12	6.26	0.00
DebtGDP	1.51	0.22	6.92	0.00
FXGDP	-0.49	0.09	-5.63	0.00
Constant	6.04	0.10	60.06	0.00

As seen above, the R^2 for the parsimonious economic model is a relatively high 0.59 (though slightly less than the previous model). Adding the selected political variables to the model increases the explanatory power significantly, to 0.65. In table 4.3 below, the election variable is included, though given its statistical insignificance, it is dropped completely from further models, including that in table 4.4, the preferred model for this chapter.

Table 4.3 Emerging market spreads against macroeconomic and political variables

Linear Regression using Panel Corrected Standard Errors Model
Dependent Variable = Log (EMBIG)
Number of Observations: 85
Number of Groups: 17
$R^2 = 0.65$

	Coefficient	Standard Error	z	P > z
CPI	0.80	0.16	4.96	0.00
DebtGDP	1.46	0.24	5.95	0.00
FXGDP	-0.21	0.10	-2.02	0.04
Logcb	-0.38	0.11	-3.33	0.00
Polar	0.11	0.02	5.41	0.00
Legfrac	0.85	0.40	2.13	0.03
Fed	0.45	0.06	8.21	0.00
Elec	0.14	0.15	0.10	0.92
Constant	5.35	0.26	20.96	0.00

Table 4.4 Emerging market spreads – Preferred model

Linear Regression using Panel Corrected Standard Errors Model
Dependent Variable = Log (EMBIG)
Number of Observations: 85
Number of Groups: 17
$R^2 = 0.65$

	Coefficient	Standard Error	z	P > z
CPI	0.80	0.16	4.96	0.00
DebtGDP	1.46	0.24	5.95	0.00
FXGDP	-0.21	0.10	-2.02	0.04
Logcb	-0.38	0.11	-3.33	0.00
Polar	0.11	0.02	5.41	0.00
Legfrac	0.85	0.40	2.13	0.03
Fed	0.45	0.06	8.21	0.00
Constant	5.35	0.26	20.96	0.00

Table 4.5 Emerging market spreads – With additional squared checks and balances term

Linear Regression using Panel Corrected Standard Errors Model
Dependent Variable = Log (EMBIG)
Number of Observations: 85
Number of Groups: 17
$R^2 = 0.66$

	Coefficient	Standard Error	z	P > z
CPI	0.81	0.18	4.41	0.00
DebtGDP	1.47	0.21	6.90	0.00
FXGDP	-0.22	0.09	-2.35	0.02
CB	-0.25	0.16	-1.54	0.12
CBSQ	0.02	0.03	0.72	0.47
Polar	0.11	0.04	2.65	0.00
Legfrac	0.81	0.31	2.64	0.00
Fed	0.45	0.06	7.41	0.00
Constant	5.55	0.26	21.11	0.00

As a further test of significance and model appropriateness, the marginal effects of each variable on the spreads was tested. The two variables with the most significant impact on spreads are foreign exchange and checks and balances: a one unit increase in foreign exchange decreases the log of spreads by 1.22 units and a one unit increase in log checks and balances decreases the log of spreads by 1.18 units. A more intuitive metric is to look at the impact of a one unit change in checks and balances on spreads (rather than the log version of these two variables) which demonstrates that the impact is by far the greatest in the dataset at 3.3. Thus, an increase of one check and balance within a political system *increases* spreads by 3.3 units as the relationship is positive rather than negative in the non-logarithmic form. The impact of polarisation and legislative fractionalisation are less at 0.71 and 0.67, respectively. Both, however, have a stronger impact on spreads than do either changes to the consumer price index or debt to GDP level.[72]

Finally, regional and year dummies were added to the preferred model (table 4.4). The impact of simulated 'fixed effects' on the model is dramatic, increasing the R^2 to 0.82 while making two of the variables (foreign exchange levels and legislative fractionalisation) insignificant. While the Latin American regional dummy is significant (and serves to increase spreads), the Asian and Eastern European dummies are not significant. All of the year dummies are significant, and the importance of year 1 and year 2 demonstrates that the Asian financial crisis had a strong overall impact on bond spreads.

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[72] It is not meaningful to discuss the impact of a one unit change of either the election or federalism variables as both are dummies.

Table 4.6 Preferred model with region and time variables

Simulated 'Fixed Effects' Model with Regional and Time Dummies
Linear Regression using Panel Corrected Standard Errors Model
Dependent Variable = Log (EMBIG)
Number of Observations: 85
Number of Groups: 17
$R^2 = 0.82$

	Coefficient	Standard Error	z	P > z
CPI	0.91	0.21	4.28	0.00
DebtGDP	1.57	0.20	7.85	0.00
FXGDP	-0.08	0.11	-0.70	0.48
Log checks &balances	-0.56	0.09	-5.97	0.00
Polarisation	0.11	0.32	3.34	0.00
Leg. Fractionalisation	0.28	0.50	0.56	0.58
Federalism	0.23	0.13	1.82	0.07
Latam Dummy	0.89	0.17	5.18	0.00
Asia Dummy	0.21	0.25	0.85	0.40
E Europe Dummy	0.29	0.24	1.22	0.22
Year 1 Dummy	0.21	0.03	6.63	0.00
Year 2 Dummy	0.25	0.03	7.32	0.00
Year 3 Dummy	0.09	0.05	1.82	0.07
Year 4 Dummy	0.10	0.04	2.19	0.03
Constant	5.12	0.38	13.41	0.00

The importance of the simulated fixed effect model indicates that there are peculiarities to the bond markets that have to do with global pricing conditions and regional specific attributes. The Wald test conducted demonstrates that their importance is critical to the model. This is not surprising: a graph of bond spreads or volatility across the dataset clearly demonstrates that there are across market effects causing bond spreads in countries to rise and fall together, as shown in graphic 4.1 below. High spreads tend to be driven by financial crises (see, for example, the period during the East Asian crisis in graphic 4.1 below, and to a lesser extent, during the Brazilian quasi-crisis of 2002), and low spreads tend to occur when there is high exogenously driven demand for emerging market bonds (e.g. low interest rates and returns available on more traditional assets in the developed world), as appears to be the case from 1999 to 2000. Nonetheless, it is instructive to see the explanatory power of the model when these time and regional dummies are excluded; this is particularly important since one of the

institutional variables is a dummy (federalism), which means that its explanatory power may have been affected by the inclusion of simulated fixed effects.

Figure 4.1 EMBIG spreads for selected Latin American countries: 1998 –2002
Source: JPMorgan EMBIG
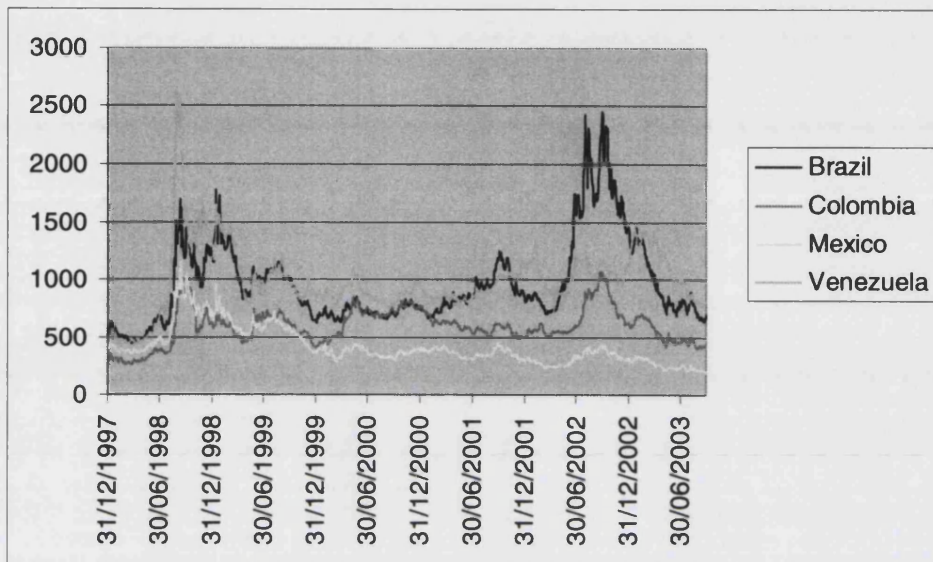
It is also instructive to compare the results in tables 4.1 - 4.5 above with recent econometric models which account for sovereign bond spreads using macroeconomic variables alone. Ferrucci finds similar results in terms of the significance of chosen economic variables: neither the current account balance nor the fiscal balance are significant / with the anticipated coefficients in his models. Additionally, the R^2 of his three group mean models are significantly lower than the models here employed: the three models have an R^2 of 0.40, 0.40 and 0.27 (Ferrucci 2003). Min's adjusted R^2 has just slightly less explanatory power than does the random effects model suggested here – all three of his models all have R^2 of approximately 0.65, the same as the model in table 4.4 above (Min 1998). Thus, a sovereign bond spread model which includes

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political variables seems to have significant benefits over more standard economic models.

4.5b Additional mixed autocratic / democratic dataset

In order to further investigate the unexpected coefficient of the checks and balances term and to test further the indication that the relationship between veto players and credibility is positive as suggested (though not confirmed due to significance problems) by the regression presented in Table 4.5 which utilised a squared term, an additional set of estimations was conducted utilising a dataset which included non-democratic regimes. The purpose of including autocracies is to increase the variance in the checks and balances variable through a different means than that used in the regression in Table 4.5.

The dataset includes 31 countries over a shorter period of time (2001-2002), given data constraints. All of the original 17 democracies are included in addition to the following countries: Algeria, Chile (which only joined the index in 1999 and therefore was not included in the previous dataset), China, Cote d'Ivoire, the Dominican Republic (which only joined the dataset in 2001), Egypt, Hungary (which joined the dataset in 1999), Lebanon, Malaysia, Morocco, Nigeria, Pakistan and the Ukraine. The variables were identical: the EMBIG was used a dependent variable and is measured annually and the sources for the independent variables were identical, including the DPI for political variables.

The findings support the initial hypothesis that an elevated number of checks and balances are not good for creditworthiness. The mixed dataset suggests that as the number of checks and balances increases, spreads increase (the two variables are positively correlated). Results are presented in Table 4.7 below. Interestingly, this dataset also suggests that autocracy is not 'good' for creditworthiness since a dummy variable coded 1 if a regime is an autocracy and 0 if not is also significant and positively correlated to increased spreads. This provides further support for the parabolic relationship suggested elsewhere – that neither high levels nor low levels of veto players are good for credibility. Finally, polarisation changes its relationship with creditworthiness: increased polarisation decreases spreads, perhaps because polarisation in the context of a number of non-democratic regimes suggests that there is democratic opposition to regime in place.

Table 4.7 Emerging market spreads – Mixed autocratic & democratic dataset
Linear Regression using Panel Corrected Standard Errors Model
Dependent Variable = Log (EMBIG)
Number of Observations: 62
Number of Groups: 31
$R^2 = 0.40$

	Coefficient	Standard Error	z	P > z
CPI	2.79	0.31	9.09	0.00
DebtGDP	1.17	0.08	14.74	0.00
FXGDP	-1.26	0.04	-28.47	0.00
CB	0.18	0.04	4.81	0.00
Polar	-0.30	0.07	-4.61	0.00
Legfrac	0.79	0.17	4.51	0.00
Fed	0.62	0.06	11.06	0.00
Autocrat	0.47	0.04	11.94	0.00
Constant	4.82	0.10	46.51	0.00

4.6 CONCLUSIONS

This chapter has shown that political variables, and in particular, institutional political variables, have a strong effect on steady state sovereign risk rates. The spreads of sovereign bonds for a diverse array of emerging market countries – both democratic and non-democratic - are proven to be highly sensitive not only to macroeconomic variables, but also to the number of checks and balances in the political system, the diversity of policy perspectives as encapsulated by policy polarisation, the level of cohesiveness of the legislature (a key veto player) and the degree to which the country in question delegates fiscal power downwards to sub-national governments. All of the above political variables were significant at the 1% level. Additionally, an econometric model which includes political variables is demonstrated to be more sensitive than a purely economic model – a conclusion borne out not only by comparison across models in this paper, but also by comparing the significance of the models detailed here with those of previous authors. Finally, initial support for the causal mechanism suggested in figure 2.2, whereby political institutions are important in and of themselves as sources of political news rather than for their role in generating given economic outcomes is supported by the fact that there was not a high level of correlation between any of the institutional variables and economic variables such as the fiscal balance or inflation rate.

Despite these strong conclusions, which go some way towards establishing the role of politics in determining the perception of risk, several caveats are in order. First, as was shown, the spread of sovereign bonds in emerging market countries is strongly

impacted by exogenous factors such as financial crises (as demonstrated through the impact of year dummies) and regional biases (as demonstrated by the impact of at least one regional dummy). Additionally, the impact of checks and balances on sovereign risk rates in the original model was not in the direction predicted by the work in section 2.3, though two later tests which attempted to increase the variance in the number of checks and balances – the introduction of a squared term and a model which analysed a greater variety of democratic and non-democratic regimes, confirmed the hypothesis that a proliferation of veto players negatively impacts credibility. Both additional tests also provided more support for the idea that the impact of veto players may be strongest in the extremes – neither too few nor too many veto players is good for establishing creditworthiness with financial market participants – the first through indicating a parabolic relationship and the second from the relationship between spreads and a dummy variable testing for autocracy. Thus, the hypothesis that an increase in the number of checks and balances is important for the creation of political news and therefore political volatility is maintained, and will be tested in the coming chapters.

There are three tasks for Chapters V and VI, the in-depth case studies of Brazil and Mexico. First, further support is needed for the theory postulated in section 2.3 and 2.4 that political news has an important impact on the performance of financial markets, and additionally, that this impact is more dramatic than the impact of economic news given characteristics of the way that political information is disseminated to markets. If Brazilian and Mexican financial markets respond more strongly to political information than to the announcement of macroeconomic outcomes, this will also

provide further support for the causal mechanism suggested figure 2.2. Second, the next two chapters will also provide more support for the initial hypothesis postulated about the relationship between checks and balances (e.g. horizontal distribution of power) and financial market volatility. Finally, the following two chapters should show conclusively what the sources of Brazilian and Mexican political risk have been since 1991, and allow for comparison of their experiences with political risk.

CHAPTER V

MAPPING POLITICAL RISK AND VOLATILITY:
BRAZIL 1991-2002

5.1 INTRODUCTION

Brazilian politics and economics have changed significantly since the early 1990s.

While at the beginning of the period Brazilian democracy under the 1988 constitution

was still in its infancy and the economy was still largely driven by the state, by 2002

democracy was both consolidated and vibrant and the government had committed the

country to a plan of significant economic liberalisation. Despite these changes, politics

played a central role in the performance of bond markets across the period, affecting

volatility in each of the years in which data was surveyed. The impeachment of

President Collor de Melo, various scandals during the two Cardoso administrations and

the election of Lula in 2002 all were major drivers of bond spreads. Additionally, the

politics of policy-making, or day-to-day democratic politicking, also played a strong

role in the volatility of bond prices, often pushing spreads to a new equilibrium point.

Overwhelmingly, this political risk was a direct result of several significant features of

Brazilian political institutions: most notably, the relationship between the legislative

branch and the executive, the fragility of governing coalitions and the interplay

between central government and state governments, especially governors.

Politics were not the only driver of bond market volatility in Brazil – there were two other strong drivers. The first, and undoubtedly the strongest driver of spread volatility, was contagion from other emerging market crises, such as the Mexican devaluation, the East Asian financial crisis and the Russian and Argentine defaults. On occasion, events in non-emerging markets also had an impact on Brazilian spreads; for example, the collapse of the US equity market in 2000 and the attacks of September 11th both had a strong impact. Second, volatility in Brazilian bond spreads was driven by major changes to economic policy (though not by more routine economic announcements) – in particular the introduction of the *real* in 1994 and the decision to allow the currency to float in January of 1999.

This chapter is organised so as to give a comprehensive picture of how political risk has affected the Brazilian government's ability to raise and sustain capital during the 1990s and early years of this decade by looking at bond spread volatility. Thus, it is broadly broken into two sections. The first provides an institutional overview of the Brazilian political system, analysing the impact of the many horizontal and vertical checks on power within the Brazilian polity on policy preferences and governance. The Brazilian party system is used as a lens through which to understand the difficulty of executive / legislature relations in Brazil, giving a sense of how dispersed horizontal power is under Brazilian formal and informal political institutions. Second, the Brazilian federation is examined, with equal attention paid to the importance of state and local leaders in political and economic power. What emerges is a picture in which political power is exceptionally dispersed, exacerbating the tendency towards feet-dragging on market-significant economic reforms, and allowing political players other

than designated economic policy makers to 'spook' markets with what is often

perceived to be unorthodox comments. Nor is this an 'accidental' outcome. As the

editorial board of the *Financial Times* noted in 1993: "Tough decisions are hard in

Brazil's diffuse political system. The 1988 constitution, fashioned as a reaction to 21

years of military rule, so surrounds the government with checks and balances that only

in unusual circumstances can it rule effectively."[73]

Once a sufficient institutional overview of Brazilian politics has been detailed, the

second half of the chapter focuses on the direct, daily impact of political events on

Brazil's sovereign bond spreads, as recorded in day-on-day changes in EMBI and

EMBIG spreads. Yearly searches in the *Financial Times* for articles with the words

'Brazil' and 'Brazilian' in the headline (in addition to the names of the relevant

president or leading presidential candidate, to capture additional news pieces) yielded a

total of 4,056 news articles, all of which were scanned for market significant news.

News that created 'volatility' – defined as days in which the day-on-day change in

spreads was greater than the annual standard deviation - was the focus. For example,

in 1993, the standard deviation of the dataset was 2.08; any daily change greater than

that in a positive or negative direction was considered to be volatility. This is

consistent with the definition used in other studies (Bernhard and Leblang 2004).

While a fair number of articles in any given year were not relevant (e.g. pieces about

specific companies, commodity markets or, as was especially the case during World

Cup years 1994, 1998 and 2002, football), the large majority were considered to be

items which potentially had affected the price of bonds. Generally, news items were

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[73] "Brazil's Third Way" (Leader 1993)

attributed to market performance during the previous day, given the natural lag in newspaper reporting.

What emerges is an exceptionally rich portrait of what caused spreads to increase and decrease on a given day – and thus what drove spreads during that year and during the entire period. By matching these news articles to daily spreads, it was also possible to compare the impact of political news and economic news directly, providing support for the hypothesis that a given piece of political news can have a much stronger impact on spreads than can economic news, a method similar to that used in other studies (Martinez and Santiso 2003). The analysis is broken into three four-year periods, which generally correspond with large structural changes in the Brazilian political economy: 1991 to 1994, 1995 to 1998 and 1999 to 2002. The drivers of political risk and of market volatility more broadly change significantly in these three periods. Finally, by completing an identical exercise in the subsequent chapter for Mexico, it is possible to draw conclusions about how the nature of political risk has been similar or different across these two countries.

5.2 AN OVERVIEW OF BRAZILIAN POLITICS AND INSTITUTIONS

A notable amount of literature has been written on the institutional malaise of the Brazilian political economy as enshrined in the 1988 constitution, as well as the informal rules and practices which govern Brazilian politics. Consequently, the contents of this section serve not to present new information per se (though there is some new and additional research on the indiscipline of Brazilian parties and transient

nature of ministerial posts), but rather, to provide a sufficient overview of the institutionalised constraints on the Brazilian state which have driven the incremental rise of politically-oriented financial market volatility during the twelve year period between 1991 and 2002. It is essential to understand the constraints Brazilian politicians and economic policy makers have faced in order to understand why seemingly mundane pieces of democratic political news, such as rumours of shifts in coalition support and congressional rejection of bills, have had such a large and consistent impact on the perception of Brazilian sovereign risk. Thus, this institutional overview is a complement to the analysis of market performance in the sections 5.4 to 5.7 below.

Two features of the Brazilian political system will be discussed at some length. The first is the Brazilian party system, which has had a profound impact on the manner in which policy making and politicking in the Brazilian government takes place at the federal level, affecting the horizontal distribution of power. The large number of parties currently represented in the two houses of the Brazilian legislature (the *Câmara dos Deputados* or Chamber of Deputies and *Senado*), and the weakness of their roots in Brazilian civil society, have made legislating major changes to the Brazilian state exceptionally difficult. The second aspect to be discussed is the delegation of powers away from the central government downwards to the state and municipal level (vertical distribution of power). Brazilian governors, state legislatures and mayors are all exceptionally important in the crafting and implementation of economic policy in Brazil. The weakness of the party system and the degree to which power is delegated

in Brazil vertically were two major sources of perceived political risk in Brazil throughout the 1990s and early years of this decade.

Both of these features, while consistent with historical patterns of Brazilian political organisation, have been formalised in their current form by the 1988 constitution. The Constitution, written in response to the high levels of centralisation and erosion of minority rights which had taken place under the more than twenty years of military dictatorship, created a complex and highly decentralised set of institutions which, "enshrined the existing institutional framework, which had created a political system combining consociational and plebiscitarian elements, that was more oriented toward representation and protection of minority rights than toward the formation of stable ruling majorities" (Sousa 1999: 50-51). In a highly unusual mix of systems, an open list proportional representation (OLPR) system was put into place for elections to the national legislature; a system whose natural inefficiencies were further exacerbated by the fact that the constitution provided no incentives for a reduction in the unwieldy multi-party system,[74] marked out exceptionally large electoral districts, and divested significant powers to a three-level federation. Additionally, the constitution provided legal protection for social rights and the treatment of minorities, such as regulation on the social security and pension systems, which implied that later administrations would require constitutional amendments to make changes to the large parts of the budget that were allocated in a non-discretionary manner by constitutional demands. As Stepan notes: "Almost everything in Brazil is constitutionally embedded. In order to change the constitution, 60% of the members of both houses (both those present and those

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[74] In fact, there are no thresholds for representation in national elections.

absent) must vote in favour of an amendment *twice*" (Stepan 1999: 29, emphasis in original text). He calls Brazil one of the most "demos-constraining" political systems in the world (Stepan 1999: 23).

As Sousa points out, by opting for a two-round presidential voting system, the drafters of the constitution hoped that a strong president with a majority popular mandate would "make the whole system cohesive, counterbalancing the centrifugal forces at work elsewhere in the political system" (Sousa 1999: 51). Additional powers given to the president, to legislate by decree (through a law known as the *medida provisória* or MP), were also provided in the constitution, to avoid a deadlock in the legislative branch on matters of critical importance. Use of the MP became a central feature of the way politics 'got done' in both the Collor and Cardoso administrations.[75] The cost of such a provision, however, was to decrease the democratic legitimacy of legislation. However, given the unwieldy nature of Brazilian parties (and therefore coalitions) and the amount of fiscal authority delegated away from the centre to states as described in the following sections, the president often had very few other choices, especially when pressures from financial markets and international institutions for economic policy reform were high.

5.2a The Party System

The contours of the Brazilian party system dictate the level of fractionalisation amongst the congress and executive, generate the transient nature of governing

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[75] Sousa reports that Collor used nearly 100 MPs during the course of his truncated administration. By October 1998, Cardoso had issued 135 MPs and had reissued 2,179 older MPs.

coalitions, and therefore have tended to exacerbate the mercurial nature of economic policy decisions. The system is a major source of both uncertainty and instability in the Brazilian polity. The party system has been one of the most frequently analysed, and lamented, aspects of the Brazilian post-authoritarian state. The first noteworthy feature of Brazilian parties is their sheer number: at the time of writing, there were 15 parties in the lower house of the Brazilian legislature, amongst whom seats were widely distributed. In the 52nd Congress, for example, it took four parties to garner a majority, in turn implying that presidents must rule through generally unwieldy coalitions of potentially disparate parties (see table 5.1). In fact, Brazil has one of the highest levels of legislative fractionalisation in the world, as detailed in table 5.2.

Table 5.1. Distribution of power in the 52nd Chamber of Deputies: 2003-Present
Source: Câmara dos Deputados, Brazilian Government

Party	% Of Valid Votes	Seats
Workers Party (PT)	17.7%	91
Party of the Democratic Brazilian Movement (PMDB)	16.8%	86
Liberal Front Party (PFL)	12.1%	62
Brazilian Social Democratic Party (PSDB)	10.1%	52
Liberal Party (PL) / Social Liberal Party (PSL)	9.9%	51
Progressive Party (PP)	9.9%	51
Brazilian Labour Party (PTB)	9.4%	48
Popular Socialist Party (PPS)	3.3%	17
Brazilian Socialist Party (PSB)	3.1%	16
Democratic Labour Party (PDT)	2.7%	14
Communist Party of Brazil (PcdoB)	1.8%	9
Green Party (PV)	1.2%	6
Unaffiliated	1.2%	6
Other (PRONA and PSC)	0.8%	4

Table 5.2. Legislative fractionalisation - Brazil in comparative perspective
Source: (Beck and al 2001)

Country	1990	1995	2000	Average[76]
Belgium	0.87	0.88	0.90	0.88
Brazil	0.65	0.87	0.86	0.85
Finland	0.80	0.82	0.81	0.81
Peru	0.57	0.68	0.66	0.68
Italy	0.76	0.54	0.63	0.67

Their sheer abundance, however, is not the key feature of Brazilian political parties that creates the contours of political risk. Historically, Brazilian parties have been weak; mass constituency parties emerged only 1945, much later than in neighbouring Latin American states, and not a single party endured the military dictatorship of 1964 to the mid 1980s in its prior form, even though that there had been eighteen years of democratic governance before the coup (Mainwaring 1995). Brazilian parties have routinely been called 'weak and inchoate' by comparative political scientists (e.g. Mainwaring 1991; Mainwaring 1995; Power 2000; Ames 2001). In Mainwaring's words: "...No other democracy grants politicians so much autonomy vis-à-vis their parties" (Mainwaring 1991: 21) and further "the most distinctive features of Brazilian political parties are their fragility, their ephemeral character, their weak roots in society, and the autonomy politicians of the catch-all parties enjoy with respect to their parties" (Mainwaring 1995: 354). Parties are undermined both by electoral laws which favour the power and popularity of individual politicians over ideology, and laws governing the behaviour of deputies within the legislature itself.

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[76] Every year in series between 1990 and 2000

As mentioned in the constitutional overview above, the OLPR system gives individual representatives an incentive to engage in anti-party behaviour. In a more dramatic description, Power states that the impact of the OLPR system is party behaviour best described as "fratricidal" (Power 2000: 28). Since candidates register themselves rather than having a selection process centralised by parties (as in a closed list system), candidates, and consequently representatives, often lack a strong tie to the party for whom they are running. Voters, in turn, have an incentive to choose politicians on an individual rather than party basis, despite the fact that voting a straight party ticket is an option on the Brazilian ballot (Samuels 1999). This problem is exacerbated by the proportional allocation of seats, providing power to ideologically weak parties, and by the provision in the constitution that allocates a high number of seats to smaller states, depriving large states of their 'true' representative power.[77]

As ideology is seldom the unifying principle of a party, the electoral cost of switching between parties in turn decreases significantly, and it has become common practice (Nicolau 1996; Power 1997; Schmitt and Araujo 1997). Until the late 1990s, there were no laws preventing deputies from switching parties at will,[78] and it is not at all unusual for a single politician to switch parties several times during the course of one legislature. Desposato estimates that "about a third of deputies and a fifth of senators will switch party during any four year period" (Desposato 2004: 5). Given the low costs of party switching, deputies do so for a variety of reasons. First, in a phenomenon

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[77] Power estimates, for example, that in 2000, São Paulo was underrepresented by some 40 seats; making an individual from a small rural state like Roraima 'worth' 33 times as much as a Paulista (Power 2000: 27)

[78] A law was introduced in 1998 that prevented deputies and senators from changing parties in the three months prior to elections.

called *partidos por alugel* ('parties for rent'), candidates in legislative elections often register themselves for parties in which they have the highest chance of winning (those in which individual politicians are not well known but proportional representation is likely to be high) rather than those with which they have long standing political or ideological ties. A switch back to the candidate's 'natural' party immediately after the election is routinely witnessed.

Second, rather than vote the party line, legislators sometimes prefer to switch parties in the run-up to an important vote, thus ensuring that they maintain support from important constituents without experiencing backlash from party leaders and whips. There is no provision for party fidelity, which was abolished in the first democratic reforms of 1985.[79] This subsequently undermines governing coalitions and makes it more difficult for governments to garner legislative majorities for their proposals.[80] Party switching in the recent congresses is represented in tables 5.3 and 5.4 below. Note that in table 5.3, it seems that there is a higher incidence of party switching in the 52nd Congress than the two earlier congresses, especially given the fact that this data only includes half of the total term (data inclusive until May 2005). Data from the 51st Congress was not available online.

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[79] The Workers Party (PT) is the only Brazilian party that practices party fidelity on a voluntary basis, as noted in Keck (Keck 1992).

[80] In fact, Brazilian deputies are notoriously undisciplined in their voting habits, with the possible exception of roll call votes, as shown in Desposato (Desposato 2001). Voting the party line is the exception, rather than the rule as in most democracies, and tends only to happen in extremely important votes when party leaders utilise high levels of political capital on enforcing the will of the party / governing coalition on deputies (e.g. carrots for voting the party line on important pieces of pork vs. sticks of threatened expulsion from the party and loss of political privileges).

Table 5.3. Party switching in the 49th, 50th and 52nd Chamber of Deputies
Source: Desposato 2004 for legislatures 49 and 50 and author's research for legislature 52[81]

	Chamber of Deputies		
Legislature Number	49	50	52
Legislature Size	503	513	510
Number of Switches	262	212	223
Switching Rate	52%	41%	44%
Number of Switchers	198	169	165
Number of Repeat Switchers	64	43	31

While the above observations of a weak ideological base and little deputy loyalty are characteristic of the average Brazilian political party, there is some variation amongst parties to the extent to which this is true. Mainwaring has described three different types of Brazilian parties: disciplined and programmatic parties, generally of the left and typified most succinctly by the Workers Party (PT); moderately disciplined parties with moderate programme commitments (centrist parties like the PSDB and PSB); and loosely organised parties with weak programmatic commitments which are used by individual candidates to forward their own agenda (Mainwaring 1995).[82] Thus, there is less party switching amongst the parties of the left. This is true in particular for the PT, which has some level of commitment to the idea of grassroots party democracy. In the 52nd legislature, for example, no deputies have left the PT (see table 5.4 below for information by party). Party switching increases dramatically, however, for loosely organised parties, such as the PP which experienced a greater than 100% switching ratio in the first two years of the current legislature.

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[81] Compiled from biographies of deputies available at www2.camara.gov.br/deputados

[82] There is some disagreement about the relevance of this distinction. Samuels, for example, questions whether party discipline is related to ideology or what he calls "structural features" such as the party's alliance strategy and candidate access to funding (Samuels 1999).

Table 5.4. Party switching by party in the 52nd Chamber of Deputies 52, to date
Source: Based on congressional biographies available at www2.camara.gov.br/deputados

Party as of May 2005	Number of Deputies	Number of Switches to Date	Switching Rate	Total Switchers	Repeat Switchers
PCdoB	9	0	0.0%	0	0
PLF	2	0	0.0%	0	0
PRONA	2	0	0.0%	0	0
PT[83]	92	3	3.3%	1	1
PFL	59	7	11.9%	5	2
PSDB	51	7	13.7%	6	1
PSB	16	4	25.0%	3	1
PV	6	2	33.3%	2	0
PDT	14	6	42.9%	5	1
PPS	17	8	47.1%	7	1
PMDB	85	50	58.8%	27	11
PTB	44	27	59.1%	26	1
PL	49	37	75.5%	29	5
PP	51	55	107.8%	48	4
PSL	1	3	300.0%	1	1

It is worth briefly noting that there is a line of counter-argument in the field of Brazilian political science which argues that parties are disciplined and that presidents do in fact hold great sway over the passage of their legislative agenda, argued most notably by Figueiredo and Limongi (see for example Figueiredo and Limongi 2000). However, as critics have pointed out, by focusing their analysis on roll-call votes, the authors have essentially overlooked a crucial period of messy politicking prior to final votes in which other interests are at play (see Power 2000: 24). The bulk of political science on Brazilian institutions has emphasised the weakness of parties and the difficulty that such weakness creates for presidents.

The overarching effect of the party weakness detailed above is three-fold. First, the sheer number of Brazilian political parties ensures that fractionalisation is high, which

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[83] Note that after the 2003 election, as recorded in table 5.1, the PT had 91 deputies. One deputy, Miro Teixeira of Rio de Janeiro, switched into the PT after having switched 2 times previously. That is to say, he was elected as a member of the PDT, then switched to the PPS and PMDB before ending up in the PT. No member initially elected as PT deputy has switched parties.

in turn makes it difficult to achieve majorities and pass key legislation. As noted in the constitutional overview, since many regulations on taxation and social spending are explicitly provided for in the constitution, reforming important spending measures often requires a super-majority or approval of a constitutional amendment. Even presidents who managed to win election in the first round, e.g. Cardoso in 1994, have failed to form coalitions with majorities, much less super-majorities.[84] The weakness and ideological inconsistency of Brazilian political parties makes the solution to the first problem, namely coalitions, difficult to manage and prone to collapse.

Second, their weakness also has an impact on the ability of the president to generate 'coattails;' even parties which refrain from running against presidential candidates so as not to split the vote hardly ever work together on the state or representative level in cohesive coalitions. Thus, presidents are forced to cobble together multi-party coalitions, many of whose component parties have no strongly developed policy ideology, and therefore participate in coalitions more to gain the spoils of leadership (e.g. ministries and state favour) rather than because of a commitment to implementing a legislative platform. In turn, coalitions are more likely to collapse, given this weak basis for formation; corruption is more likely to be rife (as votes are often bought); and powerful deputies are more likely to party switch, draining parties of important members, when votes are required of them that do not suit their constituencies. The high turnover rate of Brazilian ministers, understood thus as a by-product of the party system, is shown in comparative perspective in table 5.5.

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[84] For example, Cardoso was elected in 1994 with an alliance between the PSDB, PFL and PTB, resulting in a representation in the lower house of 35%. Support in the Senate was slightly higher (44%), while gubernatorial support was low at 33%.

Table 5.5 Average length of ministerial service for selected countries: 1990-2004
Source: Compiled from Ministerial Websites of appropriate country[85]

Country	Ministries Included	Average Length of Service (Years)
Peru	Agriculture, Education, Health, Finance and Work & Employment	1.14
Brazil	Agriculture & Food Security, Defence, Development Industry & Trade, Education, Environment, Finance, Foreign Affairs, Justice, Mining & Energy, Planning Budget & Management, Social Security, and Transport[86]	1.33
Italy	Foreign Affairs, Economy and Finance (formerly Treasury), Interior	1.70
Argentina	Defence, Education and Foreign Affairs	2.00[87]
UK	Arts, Development, Foreign and Commonwealth, Home Office, Trade & Industry and HM Treasury	2.66
Mexico	Defence, Finance and Foreign Affairs	3.28
US	Agriculture, Commerce, Energy, Health & Human Services, Housing and Urban Development, Interior and Justice	3.50

Finally, the weakness of parties adds to electoral volatility, because voters are likely to follow popular politicians rather than to adhere to well established party loyalty, making electoral results more unpredictable. A standard metric of electoral volatility, the Pedersen index, calculates the net shift in voting percentages by dividing the sum of individual party gains and loses by two. The index is scaled from 0 to 100, with a score of 0 corresponding to no gains or losses in votes for parties, and a 100 indicating that every vote went to a new party (Pedersen 1983). Brazil's electoral volatility ranks very high by this metric, with a legislative volatility score of 27.7 and a presidential

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[85] All historical lists of ministers available for each country on departmental websites were utilised. Links to ministries are available at: Argentina http://www.presidencia.gov.ar/ejecutivo.htm; Brazil https://www.presidencia.gov.br/; Italy www.governo.it/governo/ministeri; Mexico www.presidencia.gob.mx/gabinete; Peru www.peru.gob.pe/gobierno/gobierno.asp; United Kingdom http://www.number-10.gov.uk/output/Page2988.asp; and United States http://www.firstgov.gov/Agencies/Federal/Executive.shtml

[86] The names and portfolios of several Brazilian ministries names and portfolios have changed significantly over this period.

[87] Excludes the periods December 2001 - January 2002 for defence, employment and foreign affairs and March – Jan 2001 for finance when there was rapid turnover of executive leadership and hence ministers. Including these periods decreases the average significantly to 1.70.

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score of 60.0, the highest in the Latin America (see table 5.6 below). Power calls the level of electoral volatility in Brazil "staggering" and attributes it directly to the party system as well (Power 2000). Additionally, it is worth noting that presumably both volatility scores for Brazil would be higher if the 2002 and 2004 elections were included given the large shift to the left that those elections represented.

Table 5.6 Average Pedersen index electoral volatility scores in Latin America: 1980-1997
Source: (Roberts and Wibbels 1999: 577) [88]

Country	Legislative Elections	Presidential Elections	Average
Peru	53.8	40.8	47.3
Brazil	27.7	60.0	43.9
Ecuador	29.6	40.8	35.2
Venezuela	20.9	23.9	22.4
Argentina	13.2	24.1	18.7
Mexico	14.8	21.3	18.1
Chile	10.0	20.5	15.3
Uruguay	11.9	12.4	12.2
Colombia	10.2	9.5	9.9

All three of these features, which make governance on the horizontal level more difficult, repeatedly surface in the investor oriented press as driving sources of financial market volatility in Brazil.

5.2b Federalism

Section 5.2a immediately above provides a portrait of the horizontal division of power between the executive and legislative branch, but the Brazilian political system is also constrained by a strong delegation of power and authority to the state and municipal

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[88] The following countries have been dropped from the original table so as to focus more specifically on larger emerging market countries: Honduras, Costa Rica, the Dominican Republic, Bolivia, Panama and Nicaragua.

level, which further undermines the ability of a president to enforce desired policy. In

particular, the maintenance of fiscal discipline has been undermined by the powerful

states. Federalism is not new in Brazil: powerful local and regional leaders have been

a feature of the Brazilian political system since independence from the Portuguese

crown, when a federal republic dominated by powerful governors in Minas Gerais and

São Paulo was created. And while the military government who ruled from 1964 to the

early 1980s attempted to centralise political and economic power, states remained

relatively strong throughout the period, and emerged strongly during the democratic

transition (see table 5.7 below on the relatively modest centralisation of economic

authority under the military regime). Thus, this section will look at the political and

economic impact of Brazilian federalism on democracy in turn.

Table 5.7 Division of the 'fiscal pie'
Source: (Kingstone and Power 2000: 83)

Year	Central	State	Municipal
1960	59.5%	34.1%	6.4%
1970	60.8%	29.2%	10.0%
1980	68.2%	23.3%	8.5%
1990	58.9%	27.6%	13.5%

Brazil has an unusually high degree of political authority delegated downwards to the

state and municipal level. Brazil's 27 states elect their own legislative and executive

branches and governors in particular are relatively autonomous from the central

government (much more so than was the case in Mexico under the PRI, as will be seen

in Chapter VI below). The political powers of Brazilian state governors are derived

from several sources and are strongly influenced by the weak and decentralised nature

of the party system.[89] First among these powers is their role in the nomination of candidates for the legislature. In the absence of strong, cross-national political parties, Brazilian governors play a crucial role in selecting state representatives. Sub-national committees formally nominate candidates, and the primacy of personalities in Brazilian elections discussed in the previous section ensures that the support of the governor for a candidacy bid is central to the selection process and ultimately, to electoral success (Garman, Haggard et al. 2001). Would-be representatives exchange political allegiance to the governor for access to financial resources and network contacts necessary to run successful campaigns (Abrucio 1998). This also implies that gubernatorial elections tend to set boundaries on electoral alliances in the legislature, and governors have been demonstrated to have greater coattails than presidential candidates (Samuels 2000). This trend is exacerbated by the fact that state and national elections are not on the same electoral cycle.

Partly as a result of the above, governors also play a strong role in shaping the policy preferences of deputies and senators from their state once in office. Samuels and Abrucio go so far as to call state governors "a set of institutional veto players who act from outside the halls of Congress, yet who exert power within the halls of Congress, and whose primary interest is in sub-national, not national politics" (Samuels and Abrucio 2000: 46). There is a high level of crossover between senators and governors in Brazil: Selcher reports that in the late 1990s, more than one third of senators were former governors, and that others were "aspiring governors" (Selcher 1998: 27). Additionally, the continued support of the governor is important for career

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[89] Riker's classic finding that the distribution of intergovernmental resources tends to be more decentralised in the case of weak (decentralised) parties holds very well for Brazil (Riker 1975).

advancement for a legislative politician as many Brazilian deputies serve only one or two terms in the Congress.

The third major source of state power is the disproportionate distribution of representation to favour smaller / poorer states in the Brazilian congress. It is worth noting that Brazil has the second most skewed distribution of any democratic state in the world (after Argentina), and pure proportional representation is skewed both in the Senate (as in the case of the US where all states have two senators despite vast differences in population) as well as the Chamber of Deputies (Selcher 1998). Poor rural states, who have disproportionately high representation, are also the states in which there is a higher incidence of traditional, patronage political cleavages – the head of which is almost always the governor (Ames 1995). This in turn means that state allegiance on policy priorities has tended to trump other potential vectors of alignment. The North East is a particularly good example of this: the largest party in the Congress, the PFL has largely been a vehicle for North Eastern interests, and North Eastern governors meet with one another and their Congressional counterparts (who hold important positions on committees dealing with tax, fiscal and infrastructure committees) more frequently than other state representatives (Selcher 1998).

Fourth and finally, in matters of national policy making and priorities, governors tend to act on behalf of municipal leaders. Given the high concentration of Brazilian population in urban centres (some 80%) and the allocation of resources to this third tier in Brazilian federalism, this becomes a substantial source of further power. State legislatures, given the power of Brazilian governors, are relatively weak and have little

role in the policy making process. As such, governors are extremely important political players. Abrucio goes so far to call them "barons of the federation" (Abrucio 1998), and securing their support for legislation and broader policy programmes is a central feature of Brazilian presidential politics.

While the political power of governors is an often overlooked source of tension in Brazil, the delegation of economic power, or fiscal federalism, in Brazil has been well studied, and access to fiscal resources strengthens the tendencies discussed above under the political power of governors. As is consistent with Riker's axiom of the relationship between political parties and the distribution of fiscal resources within federations, fiscal federalism is particularly pronounced in Brazil (Riker 1975). The country has higher levels of tax autonomy, vertical imbalances and expenditure share delegated to the states and municipalities than most other large federal states. Brazil's fiscal decentralisation in comparison to other large democracies is captured in table 5.8 below.

Table 5.8 Comparative federalism
Source: Adapted from (Afonso and de Mello 2000: 3)

	Tax Autonomy	Non-tax Autonomy	Vertical Imbalances	Government Size	Expenditure Size
Brazil	56.4%	13.0%	31.8%	12.4%	34.3%
Latin American Average	46.1%	22.1%	25.5%	2.5%	12.2%
OECD Average	40.8%	16.7%	39.1%	13.3%	31.6%
Large Federations[90]	46.6%	19.3%	33.5%	7.0%	20.9%

[90] Average values for Australia, Canada, Germany, India, Russia and the United States.

Much as in the case of political parties, it is not only the degree of fiscal

decentralisation that is of interest, but the way in which that decentralisation is

provisioned. In Brazil, unlike in Mexico, the majority of fiscal decentralisation takes

the form of revenue decentralisation, rather than transfers from the central government

(Garman, Haggard et al. 2001). Additionally, similar to the aforementioned provisions

on social spending, a large percentage of Brazilian intergovernmental transfers are

constitutionally mandated, and few are discretionary (again in contrast to Mexico, as

will be discussed in Chapter VI below). This distribution ensures that there is a greater

level of stability in the transfers from the federal government – especially given the

legislative constraints discussed in the previous section with regards to amending the

constitution. Table 5.9 below demonstrates the extent to which Brazilian transfers are

constitutionally mandated in comparison with other Latin American states. Its

percentage of unconditional, automatic, constitutionally mandated federalism is higher

even than that of Argentina.

Table 5.9 Sources of and mandates for intergovernmental transfers
Source: (Garman, Haggard et al. 2001: 220)

Distribution	Automatic Constitutional		Automatic by Law		Discretionary	
Assignment	Unconditional	Earmarked	Unconditional	Earmarked	Unconditional	Earmarked
Brazil	88.9%	5.6%	0%	0%	0%	5.5%
Argentina	75.0%	20.0%	0%	0%	5.0%	0%
Colombia	0%	85%	0%	0%	0%	15%
Venezuela	44.2%	44.2%	1.0%	5.6%	5.0%	0%
Mexico	0%	0%	49%	0%	0%	51%

Finally, the fiscal powers of Brazilian states are further enhanced by the laxity of laws

governing their borrowing practices. As Garman, Haggard et al state: "Sub-national

governments in Brazil and Argentina have both banks and government-owned firms

with 'liberal borrowing practices.' Acting as effective conduits for government borrowing, these banks and firms have given sub-national governments considerable autonomy from central authorities; they also contributed to serious sub-national debt crises in the 1990s" (Garman, Haggard et al. 2001: 222). Brazilian states can borrow both from the World Bank and private banks, with the prior approval of the Senate and the Central Bank of Brazil. As mentioned in section 5.2a, the Senate constraint is expected to be rather low, given links between these two levels of government; therefore, constraints on sub-national borrowing are set by the Central Bank. Afonso and de Mello report that as of 2000, 40% of Brazilian public sector debt was sub-national (Afonso and de Mello 2000). Table 5.10 below compares sub-national borrowing in Brazil and Mexico from 1993 to 2000.

Table 5.10 Total debt held at state and municipal level as a % of GDP
Source: Secretaría de Hacienda y Crédito Público de México (SHCP) and Brazilian National Development Bank (BNDES)

	1993	1994	1995	1996	1997	1998	1999	2000
Brazil	9.4%	10.4%	11.6%	13.0%	14.7%	16.4%	16.3%	18.5%
Mexico	1.3%	1.9%	2.2%	2.0%	1.8%	1.9%	1.7%	1.6%

To summarise, the vertical distribution of power in Brazil plays a large role in stability of governance and predictability of policy outcomes. In turn, it is expected to have an important impact on the perception of political risk, not least because the power of the governors has significantly complicated the reform of the Brazilian political economy through their control over legislative preferences and revenue.

5.3 METHODOLOGY[91]

This section provides an overview of the methodology used to analyse the impact of political news on the performance of sovereign bonds in this chapter and Chapter VI below. The exercise undertaken was a relatively simple one: over period of 12 years, I sought to determine what caused volatility in markets by reading a major financial newspaper which routinely reports on the 'causes' of the markets behaviour the previous day. As described in section 5.1, I sought to explain the behaviour of the markets on any day in which there was 'volatility' – where this term is defined as days in which the change in spreads was greater than the annual standard deviation. However, I read any relevant financial press for all days within the 12 year period, where relevance was determined by key word searches ('Brazil / Mexico,' 'Brazilian / Mexican,' and the name of the president or leading presidential candidate). There is a relatively limited risk of misattribution of market behaviour to news pieces because of the sequence in which the exercise was undertaken. First, all relevant press for a year was read and recorded by date. Second, this information was matched to daily change in spreads on the EMBI or EMBIG index.[92] Thus, much of the information gathered did not have an impact on the market that was above the defined 'threshold' (day on day change greater than the average standard deviation) and was therefore considered to be irrelevant. Additionally, there are a number of days with volatility in for which there was not an explanation reported in the press: only 60% of the days on which volatility is above the annual standard deviation for Brazil can be explained; though

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[91] Graphs of the EMBI and EMBIG index for Brazil and Mexico throughout the period 1991-2002 are available in Appendix III.

[92] EMBI data is used from 1991-97; EMBIG data is used from 1998-2002.

that number increases to 75% when considering years of crisis (i.e. where volatility is 3% or more). In the case of Mexico, as reported in section 6.3, a greater percentage of volatility was explained in the press. Thus, while it is not possible to explain all of the financial market volatility experienced in Brazil and Mexico from 1991 to 2002, it is possible to get a rather complete sample of the causes of volatility.

The newspaper that I chose for this exercise was the *Financial Times* (FT), given its extensive coverage of emerging markets and financial market behaviour as early as 1991. While there is some bias in using only the FT for this analysis, alternative financial dailies (e.g. the *Wall Street Journal*, Brazil's leading business newspaper, the *Folha de São Paulo* or the leading Mexican business daily, *El Economista*) would have likely lead to similar results, given that the sources for such news articles (traders, market analysts and in country correspondents) are generally the same. Additionally, using a Brazilian or Mexican newspaper would have had the distinct disadvantage of complicating key word searches such as the country name, as is possible when using foreign language press. Additionally, using one paper throughout the period for both countries provides consistency to the dataset and avoids a bias that would have arisen in using a different newspaper for Brazil and Mexico.

Once the information was gathered and 'matched,' I analysed its impact. First, I categorised each piece of news by content, using a method similar to the content analysis detailed in section 3.3. Information could be either of an economic or political nature, with political news broken down further into categories corresponding to the political variables utilised in the regressions of section 4.4b. The three variables

checks and balances, polarisation and legislative fractionalisation together were grouped under the category 'congressional delays, rejections or approvals of key bills.' News about federalism ('state vs. federal government') and elections was also recorded. Further political news was categorised as 'cabinet reshuffles, ministerial resignations or appointments,' 'announcements of a new government policy,' 'changes to the popularity of the president,' 'strikes or violence,' and 'fragility of the governing coalition' (as distinct from legislative fractionalisation). News about economics is called 'release of macroeconomic figures or forecasts.' I also recorded market behaviour that was attributed to financial market contagion or IMF or international lending (similar to the 'hand tying' variable in the content analysis of section 3.3). Similar to the content analysis in section 3.3, the variables included in this list are not strictly theoretical: all news which was cited as having an impact on bond spreads was included, and grouped into the above categories.

Several metrics were constructed to measure the impact of these various types of news on sovereign bond performance. The first was designed to look at the accumulated impact of the news over the whole period of investigation (e.g. the year or the whole 12 year period). This metric was constructed by summing all volatility caused by that type of news, and is recorded in the tables throughout sections 5.4-5.7 and 6.3-6.6 in Chapter VI as 'Accumulated Impact.' The frequency with which the type of news was matched to volatility was also recorded. To look at the individual impact of pieces of news, I recorded the average change in spreads that a particular type of information produced and the maximum daily volatility created by that type of news. Again, it is worth emphasising that only news which produced volatility as mathematically defined

above was included, so as to screen out news that created only an inconsequential market reaction which could be confused with general trading activity.

5.4 RESULTS SUMMARY: BRAZILIAN POLITICS AND VOLATILITY

The material contained in sections 5.4 – 5.7 of this chapter, as well as in sections 6.3 – 6.6 of Chapter VI below strongly confirms the hypothesis that political news creates volatility in sovereign bond markets, and that political news generates more volatility than economic news, as theorised in section 2.4 ('The Creation of Political News'). This material is also robust evidence that checks and balances, and in particular the relationship between the executive and the legislature, is responsible for creating market volatility. Second only to contagion, financial markets respond strongly to news about executive / legislative relations, causing day on day changes in spreads to be higher than in the case of economic information.

Before providing a detailed account of the analysis completed on the Brazilian market from 1991-2002, this section briefly describes the overall results of the content analysis and EMBIG / FT volatility analysis. Table 5.11 below is central to understanding the major forces impacting on the rate of Brazilian sovereign bond risk in the twelve-year period 1991 to 2002, and provides strong support for the hypothesis that democratic politics, as conditioned by underlying institutional settings, has an essential role in determining the rate of financial market volatility.

Table 5.11 Variables responsible for Brazilian bond market volatility: 1991-2002[93]
In order of accumulated impact (in absolute value terms)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	Accumulated impact	Frequency	Average Δ in spreads	Max daily volatility
Contagion	292.4%	35	8.4%	48.8%
Congressional delays, rejections or approvals of key bills	148.5%	40	3.7%	44.0%
Elections	107.5%	33	3.3%	15.0%
IMF or international lending	-55.5%	21	-2.6%	15.0%
Corruption or scandals	45.4%	19	2.4%	6.7%
Cabinet reshuffles, ministerial resignations or appointments	27.7%	23	1.2%	14.0%
State vs. Federal government	26.7%	13	2.1%	15.0%
Announcements of new government policy	-26.3%	82	-0.3%	-19.0%
Changes to popularity of president	17.0%	5	3.4%	7.5%
Strikes or violence	16.4%	7	2.4%	11.7%
Fragility of governing coalition	9.2%	7	1.3%	3.5%
Release of macroeconomic figures or forecasts	-3.6%	34	-0.1%	14.1%

Perhaps the most striking data to come from this analysis is the realisation that the variable which has the least aggregate impact on bond market volatility is the release of macroeconomic information, or the release of new forecasts for economic variables. This is in part strongly conditioned by the fact that the impact of macroeconomic news on the market performance, on the whole, tends to balance. While there are large swings attributable to macroeconomic news releases (as evidenced by the maximum daily volatility score of 14% - still significantly lower than the maximum volatility for checks and balances), on the whole, *macroeconomic news has no net impact*.

The behaviour of the Congress (checks and balances), on the other hand, had an exceptionally strong impact on Brazilian bond volatility – leading to an aggregate increase in spreads of 149% over the course of 12 years. In fact, the only variable with

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[93] Days on which there was no indication of what caused the volatility in FT reports are excluded from this analysis. See an explanation of the percentage of data this excludes in section 5.3.

a larger aggregate impact on the market (and larger maximum daily volatility) is contagion from other international financial crises, though it appears in the news with slightly less frequency. Aggregating the impact of the news about veto players (congressional delays, rejections or approvals of bills; cabinet reshuffles; state vs. federal government; and fragility of the governing coalition) gives an aggregate impact of an incredibly high 212%. The direction of the volatility of these variables also provides support for the predicted impact of the coefficients in section 4.5 – i.e. checks and balances increases spreads and creates volatility.[94]

It is also interesting to see how these variables compare to variables that have often been cited as sources of financial market volatility, such as elections. While both are very important in explaining market volatility, elections are actually less important in the case of Brazil than is congressional politics, and this despite the enormous impact of the 2002 election of Lula (which alone counted for an increase in spreads of some 82%, or some 76% of the total volatility directly attributable to elections, as is evident in table 5.14 in section 5.6).

Finally, it is interesting to note the large impact that corruption scandals and other types of political scandals have on the perception of Brazilian risk. As Fleischer and many other Brazilianists have noted, "The practice of political corruption in Brazil has a long history since the colonial period" and can generally be broken into two categories: the manipulation of politics for individual material gain and the illegal

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[94] Note also that the direction of the volatility caused by such variables further reinforces hypotheses articulated in section 4.4 about the predicted impact of such variables on market performance. While congressional politics did have occasionally positive impact on spreads (i.e. decreasing them), the aggregate impact was both negative and large.

reallocation of public funds into political campaigns (Fleischer 1997: 297). However, the negative market reaction to news of corruption or related political scandals was not attributed in the press to the negative impact such misappropriation of public funds could have on public finance, but rather, its implications on Congressional and coalition politics. The 1988 Constitution gave additional powers to both the Brazilian Senate and the Chamber of Deputies to conduct special inquiries called the *Commisões Parlemantares de Inquérito* (CPIs), which they use strategically to delay key votes or to pressure the governing coalition. CPIs gives the Congress powers "equivalent to those of the judicial authorities" (Figueiredo 2000: 11) and can lead to criminal and civil sanctions if approved by government ministries. Such inquiries are often used for partisan purposes – to stop key pieces of legislation, to send a message to the government coalition, or to extract benefits from the government.

Figueiredo notes that they can often be used as tools in a political exchange, and Pereira and Mueller note that in 2001, the Congress used CPIs to accelerate the government's disbursement of money left over (*restos a pagar*) from the 2000 budget (Figueiredo 2000; Pereira and Mueller 2003).[95] Thus, CPIs are one method by which minorities within the governing coalition "...delayed legislative action, pressed the government for concessions in exchange for their votes, or blocked controversial items" instead of confronting the President directly on legislation (Sousa 1999: 55). Volatility attributable to scandals and corruption in this dataset, therefore, can be

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[95] While outside of the formal time period of this analysis, in 2005, the Lula government was plagued by a major CPI, which was investigating corruption amongst key members of the PT, including Lula's chief of staff, initially spooking markets and dramatically reducing the effectiveness of his governing coalition.

understood as yet another by-product of the difficult relationship between the legislative and executive branches of government.

There are three general conclusions that can be drawn from analysis of the yearly data (which is detailed in sections 5.5-5.7 below). First, volatility tends to be concentrated in certain years in the dataset – in these years, the levels of volatility in the political and economic variables tend to be higher, suggesting that such volatility occurs in tandem, consistent with the hypothesis in section 3.2 and survey data in section 3.4. Both political and economic news have a higher impact when market conditions are adverse. Second, the importance of key political variables related to Brazil's institutional setting is highly influenced by key events that are relatively well known from previous studies of these crises, though more daily politics has an impact as well. Finally, looking at the number of mentions of a certain type of news is not sufficient to understand its market impact. For example, while far fewer newspaper articles attributed movements in financial markets to the East Asian crisis than the Argentine crisis, the impact of the Asian and Russian crises on the Brazilian market was much larger, when aggregated, than that of Argentina's. More nuanced observations about the changing nature of perceived political risk are illustrated in the following three sections, which break the analysis into three four-year periods: 1991-1994, 1995-1998 and 1999-2002. Doing this also allows the provision of more background on why certain variables emerge at the times that they do, and provides more interesting examples of the impact of political and economic risks on the performance of Brazilian bonds.

5.5 ATTEMPTS AT REFORM UNDER NEW BRAZILIAN DEMOCRACY: 1991-94

The period 1991-1994 was marked by two overarching trajectories: on the economic

side, the government's attempts to regulate large macroeconomic imbalances (the most

important of which was to find a lasting solution to rampant hyperinflation), which

included a series of unsuccessful 'shock' economic programmes, followed by the

eventual adoption of the more orthodox, and relatively successful, *Real* Plan. On the

political side, the primary impetus was to consolidate constitutional democracy, which

looked on several occasions as if it was destined to collapse – most notably during the

impeachment of Brazil's first elected president since the military coup in 1964,

President Fernando Collor de Melo (Collor), at which time there was a risk, if small, of

renewed military intervention.[96] High levels of politically derived financial market

volatility marked the period, especially because the swings in policy positions between

administrations and ministers of economics were greater than in subsequent periods.

It was during this period that Brazil returned to the fold of the international investment

community through a series of negotiated restructurings with its private creditors, with

whom the government had been in default and arrears since the mid 1980s. The

resumption of credit flows to Brazil coincided with the rise of new types of political

risk. There were two large risk events in this period: first, the impeachment of Collor,

and the subsequent decisions by the interim Franco administration in 1992; and second,

the 1994 elections in which Cardoso's early prospects of victory looked weak due to

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[96] Several other episodes highlight the relative fragility of Brazilian democracy during this period, for example, the referendum on the future of Brazilian politics, which proposed a return to monarchy, among other structures, as potential alternatives to the 1988 constitution.

the popularity of Lula.   Table 5.12 provides information on the accumulated impact of

each type of news and the frequency with which each type of news was attributable to

volatility.

Table 5.12 Variables responsible for Brazilian bond market volatility: 1991-94
Accumulated impact (Frequency)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1991	1992	1993	1994
Coalition politics	-2.0% (1)	---	6.4% (2)	-4.1% (1)
Congressional politics	---	44.0% (1)	3.7% (1)	16.2% (3)
Contagion	---	---	---	---
Corruption	---	---	6.7% (3)	7.1% (3)
Elections	---	---	-2.9% (1)	16.8% (8)
IMF lending	---	---	4.7% (2)	10.2% (1)
Macroeconomics	---	---	-5.7% (2)	-4.7% (2)
Ministerial politics	---	8.7% (1)	-0.4% (2)	0.5% (2)
Policy	-8.4% (10)	9.0% (3)	-21.3% (11)	37.5% (7)
Popularity of president	---	---	---	---
State vs. Federal govt	-3.6% (2)	---	-2.0% (1)	---
Strikes or violence	---	---	2.2% (1)	11.7% (1)

1992 was marked by exceptionally high volatility, almost all of which had to do with

the inconsistent and anti-market policy announcements of Franco.   From when Collor

was first implicated in a high level government corruption scandal in May until his

impeachment, spreads increased to a total of 116bp, which is relatively moderate given

the gravity of the political crisis (see figure 5.1 below).

Figure 5.1 Annotated Brazilian bond spreads, 1992 (in basis points)
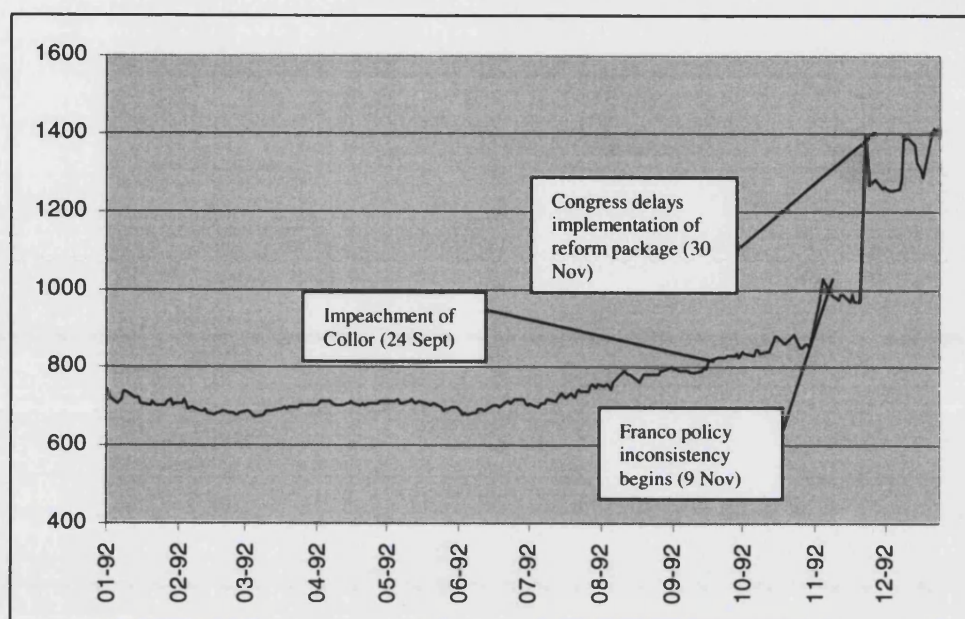
It was the period after the impeachment, in which Franco became interim president, in which spreads increase massively (see figure 5.1 above). Disagreements between Franco, who preferred heterodox economic policies, and the many orthodox economic ministers who served him and were fired in turn, led to series of dramatic daily spread increases. For example, spreads increased 44.0% on 30 November when the President cancelled an important privatisation by sending a fax to international media, issued a memo putting him in charge of all price increases and threatened broader heterodox policy – all without consulting his economics team.[97] This news, which came on the back of a Congressional rejection of a set of reform measures, led to the resignation of the finance minister (Kraus), driving spreads up another 8.7%. Overall, the inconsistency of Franco's policy during the late Brazilian spring (November and

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[97] The largest annual decrease in spreads came the following day, when spreads were reduced by 9.0%, implying that the previous day's increase was at least partially exaggerated.

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December) of 1992 resulted in a cumulative 60% increase in spreads. This process of volatility generated by Franco's ill-conceived economic policies and the resignations of a string of economic policy makers, drove spreads throughout early 1993 as well.

Risk in 1994 was resolutely led by the election, and by the fears that Cardoso's resignation from the Finance Ministry to pursue the presidency would lead to the failure of the *Real* Plan and the new currency, the *real*. The introduction of the new currency in and of itself was a major source of risk – it was unclear at the outset whether the *real* was another gimmick to end inflation. To provide some examples of the impact of these two coinciding events (the election and introduction of the new currency), speculation about the hopes for the government's economic policy plan in light of Cardoso's resignation coupled with the rising popularity of Lula in the polls led spreads to increase from 453bp on 23 February to over 1000bp by the beginning of April. A direct comparison of the impact of major shifts in economic policy and pure politics yields similar conclusions: the announcement of a new currency index resulted in a two-day increase of spreads of 28.5%; Cardoso's resignation from the post of finance minister provoked a larger increase of 29.6%.

Figure 5.2 Annotated Brazilian bond spreads, 1994 (in basis points)
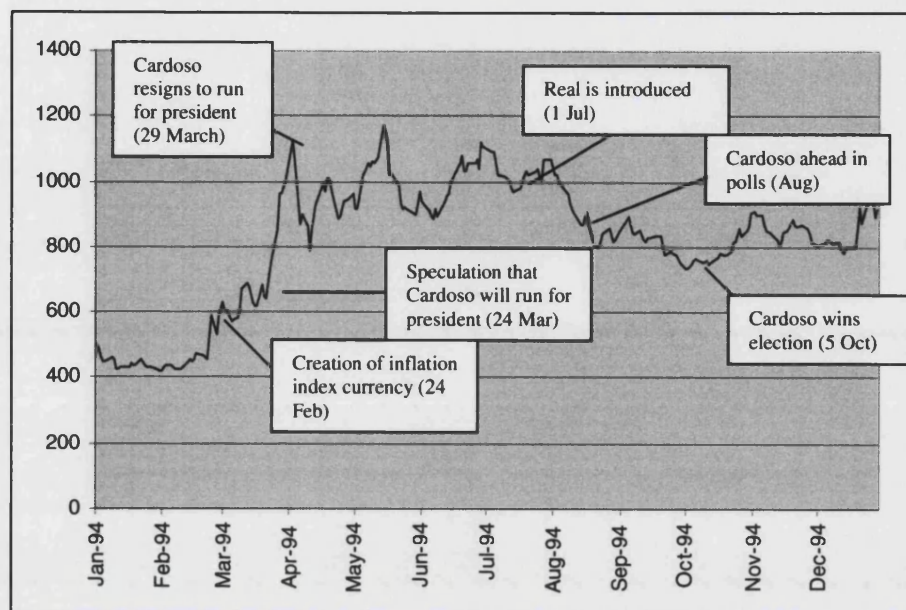
As if a preview to 2002, nervousness in the markets surrounding the election only began to abate when Cardoso pulled ahead in the polls for the first time on 8 August – leading to a 3.1% decrease in spreads. Similarly, when poll data shows Cardoso's lead over Lula was consolidated at the end of the same month, spreads dropped a further 5.1%. Nonetheless, perhaps demonstrating the fickleness of financial markets, the market's reaction to Cardoso's strong win the first round of the election was tempered by speculation that the government was planning on introducing exchange controls, resulting in a relatively large loss of value in the equity markets, and an increase, rather than decrease, in spreads.

Aside from these two large political risk events, two political variables in particular are important in determining spreads during these years. The first is the relationship between the government and the judicial system. Indeed, the largest daily increase in

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spreads in 1991 had to do with the Supreme Court's ruling that the government's decision to freeze all short-term financial assets for 18 months in an attempt to control the money supply during the previous year had been illegal (3.42% on 25 April). The second was pressure emanating from vertical power sharing, seen by the role of the states in pushing spreads up through a lack of fiscal discipline, as was required by the centre. As an example, in 1991, a price freeze mandated by the central government as part of a new shock economic programme in February was undermined by the governors of Rio de Janeiro and São Paulo, who increased bus tariffs by 40% despite price freezes, resulting in a 2.1% increase in spreads. Horizontal power sharing, while of course central in the process of Collor's impeachment and to some volatility around during the Franco period, was less important in this period than later.

5.6 CONSOLIDATION OF ECONOMIC REFORMS AND CENTRIST POLICIES: 1995-98

The wild swings in policy preferences that were witnessed between 1991 and 1993 had largely subsided by 1995. Cardoso was inaugurated President for what would become the first of his two terms in January 1995, putting in place a solidly pro-market economics team which, in sharp contrast to the preceeding two administrations, was remarkably stable for the majority of his eight-year presidency. Macroeconomic trends were quite positive at least for the first years of the period – in later years, Brazil's twin deficits (external and fiscal) became a problem that led to the eventual devaluation of the *real* and the decision shortly thereafter to let the currency float. Nonetheless, even prior to the currency crisis, this period was not characterised by calm markets. High levels of contagion from global and regional financial crises and the battle between of

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executive and legislative policy preferences created large swings in bond prices. It was in these years that the unwieldy nature of the Brazilian party system and the strong protections of the constitution with their subsequent impacts on executive effectiveness became central to investor's understanding of Brazilian political economy. Cardoso's attempts at fiscal reform met multiple impasses in the Congress as well as the courts and state governments. The analysis for this period, therefore, contrasts the impact of contagion from global financial crises to that of the risk attributed to Congressional politics, to get a sense of their respective importance and linkages.

Table 5.13 Variables responsible for Brazilian bond market volatility: 1995-98
Accumulated impact (frequency)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1995	1996	1997	1998
Coalition politics	---	---	3.2% (1)	---
Congressional politics	5.4% (4)	-6.8% (5)	-15.3% (2)	72.6% (14)
Contagion	54.7% (5)	---	98.7% (6)	88.8% (5)
Corruption	0.3% (2)	16.9% (4)	15.1% (3)	---
Elections	---	3.3% (1)	6.1% (1)	-5.9% (5)
IMF lending	---	---	---	-31.4% (4)
Macroeconomics	-11.9% (4)	-1.9% (1)	21.7% (4)	27.0% (5)
Ministerial politics	-13.9% (4)	-2.2% (1)	---	11.7% (2)
Policy	3.0% (7)	-20.0% (8)	-12.2% (4)	7.3% (9)
Popularity of president	---	-3.2% (1)	---	7.4% (1)
State vs. Federal govt	---	---	4.7% (3)	---
Strikes or violence	---	-0.1% (2)	---	---

The Mexican, Asian and Russian financial crises, all of which occurred during the 1995-1998 period, had a strong and consistent negative impact on the perception of Brazilian risk. The reaction of investors to this risk was characterised by substantial outflows of capital, placing a long-term strain on the ability of the government to defend the *real* currency peg. While contagion was a strong driver of Brazilian bond prices into new, higher equilibrium rates during this period, the sharp increases in spreads are usually directly attributable to global events for a relatively small number

of days.[98] Instead, the real impact of contagion is to focus investors' attention on a given market, and make its political and economic performance much more subject to volatility. This is inconsistent with the two predominant hypotheses about the sources of contagion – first, that contagion is passed through countries with trade or financial linkages, whether those be in terms of investor profile or lender profile (on trade see for example Glick and Rose 1998; on finance see for example Kaminsky and Reinhart 2000; Kodres and Pritsker 2002). It is also inconsistent with the 'rational herd' or 'animal spirits' hypothesis because it demonstrates that investors do indeed spend time looking at countries suffering from contagion in great depth, analysing both their underlying economic and political situations and reacting over time, rather than relying on rumours (Calvo and Mendoza 1998).[99] It is however, broadly consistent with an alternative explanation: that contagion can be caused by investors' perception of similarity of economic and political conditions, causing them to focus increased attention on such markets (Eichengreen, Rose et al. 1996).[100]

The impact of the Mexican Tequila crisis of 1994-95 on the Brazilian bond markets, in comparison to the impact of later crises, was relatively tempered. Volatility in the Brazilian sovereign bond market attributed by the financial press to contagion from Mexico occurred in the first two months of 1995, January in particular. During the second week of January, for example, spreads increased a massive 35% in two days (17% a day), sending spreads well over 1000bp, starting a progress towards higher

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[98] In fact, the average number of days in which a crisis in another country was directly mentioned in the financial press as the cause of financial market falls was four.

[99] This does not imply that reactions to political and economic news in such markets are necessarily appropriate (i.e. without volatility), simply that such variables do move markets, and it is not the threat of contagion alone which creates spikes in bond spreads during periods of financial crises.

[100] Eichengreen, Rose et al also focus on the importance of trade linkages in this article, being one of its two possible explanatory variables for contagion (Eichengreen, Rose et al. 1996).

bond spreads that did not fade until May of that year. At their peak, bond spreads reached more than 1600bp, though these increases were related to Brazilian political and economic trends, not the fear of actual trade or financial spill-over from Mexico, as described above. The Asian financial crisis of 1997 and 1998 had a stronger impact on Brazilian bond spreads: the largest single increase to bond spreads in 1997 occurred on 27 October, when spreads rose 49% in response to the failure of the Hong Kong stock markets and broader Asian events. From late October to mid November, spreads more than doubled: from 339bp on 22 October to 748 on 13 November. Problems in South Korea in December also had a strong impact on Brazilian spreads, causing them to rise some 10.2% on a single day. The impact of the Russian default in August of the following year was also strong: spreads increased 34% in two days (20 and 21 August) in response to Russia, followed by even larger increases during the next week.

As argued above, it is difficult to attribute the steady rise of spreads that tended to occur after all of these crises directly to contagion; rather, several days of strong contagion from international financial crises seemed to increase investor sensitivity to news of a domestic nature, be it economic or political. On the political side, despite the strong support that Cardoso formally enjoyed via a four party coalition, the reform agenda advocated by the administration, key to market confidence and IMF support, was repeatedly stymied by Congress, where even parties of the coalition could not be counted on for passage of key bills. Passage of Cardoso's fiscal reform amendments were perceived as key by investors to rectifying Brazil's dangerous level of fiscal deficits. In 1998, the aggregate impact on spreads of announcements about congressional delays on approval of legislation was a massive increase of 73%. Fears

that key votes would be delayed in the Congress due to the elections of 1998 lead to an increase in spreads of some 22%, and the rejection of bills that were central to the Brazilian accord with the IMF in late 1998 led markets to rise a further 15%. In some cases, the fear of Congressional laxity was related to contagion (e.g. in August 1998 from Russia), in other cases it was related to pending IMF accords. The impact of Congressional delays was also strong during other years of this period, most notably 1999, when lack of Congressional support was a focus of market volatility just after the devaluation of the *real* and later in the year (e.g. May), when concerns arose over the Congress's actual commitment to bills approved in the wake of the IMF accords and devaluation in January.

Figure 5.3 Annotated Brazilian bond spreads, 1998 (in basis points)
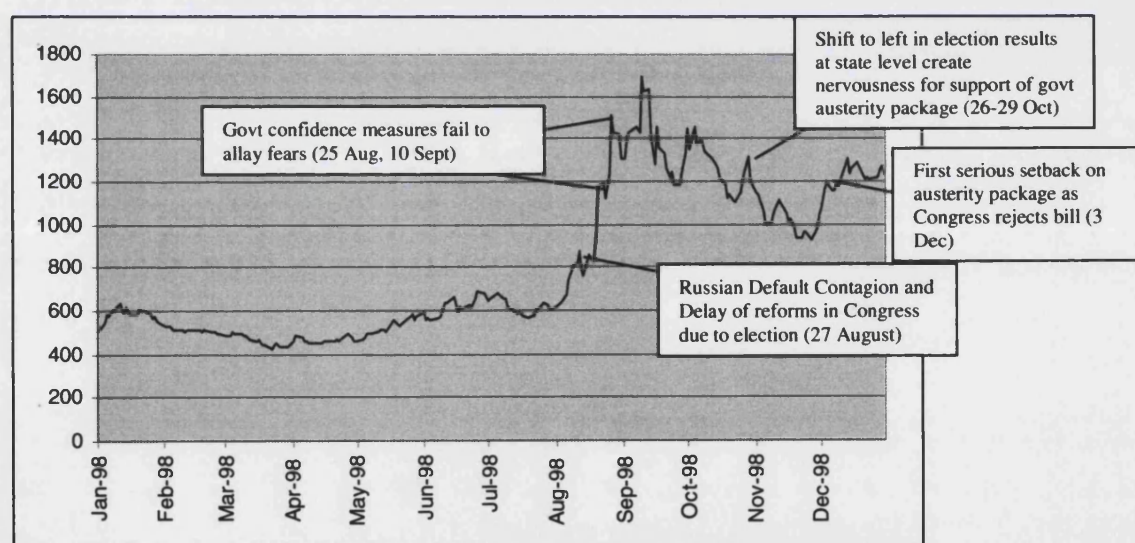
The impact of Congressional politics in earlier years of the dataset was significant, if smaller in its aggregate importance. Notably, in 1995, early Congressional support for Cardoso's economic reform programme provided great hope to politicians and

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investors alike that his reform measures would easily rectify the looming imbalances created by the articles in the constitution establishing spending obligations, driving spreads down. This trend reversed as the government suffered the first of a string of defeats for its legislative agenda in 1996. The knock-on effects of this lack of Congressional support were apparent as well: jitters around the strength of this alliance arose in 1997 and a major reshuffle in 1998 confirmed a lack of support amongst parties. There was some volatility attributed to ministerial allocations and alliances in 1995 as well.

Figure 5.4 Annotated Brazilian bond spreads, 1996 (in basis points)
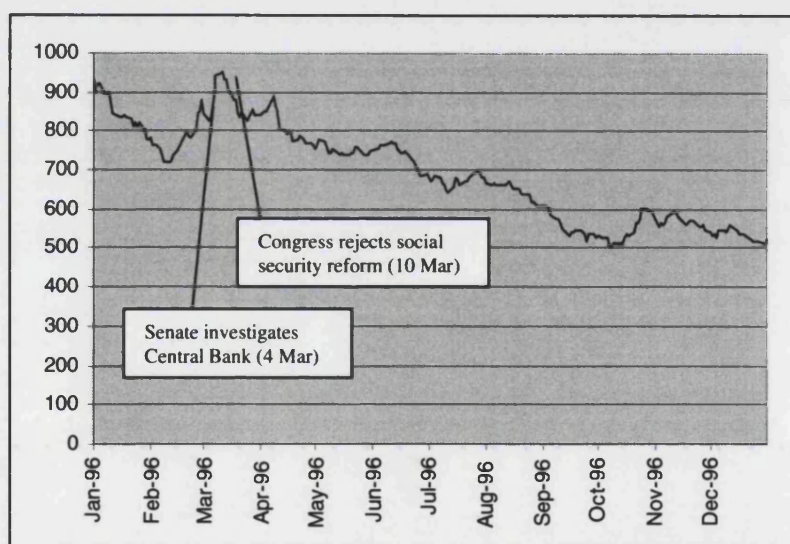
Finally, the 1998 elections had a moderate impact on spreads (as visible in figure 5.3 above). There was an initial fear in the markets that the delicate position of the economy would allow Lula steal electoral victory from Cardoso – sending spreads upwards some 12% during the Brazilian winter (June – August). However, Cardoso's lead solidified early, and spreads later fell on poll data that showed Cardoso with a

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strong lead. Nonetheless, the market had an exceptionally muted reaction to his strong first-round victory, in which the government coalition was rewarded with a renewed majority in Congress and the re-election of alliance governors. Instead, the markets were plagued once again by the fear that Congress would impinge upon the government's ability to bring about the fiscal reforms necessary to fulfil Cardoso's post-election announcement of budget cuts of 20%. This fear was linked to the ability of the government to deliver on conditions set out in a later accord with the G7 and IMF, in which Brazil was to receive a significant liquidity injection. The rise in bond prices over 26 - 29 October were some 17.4%, completely reversing any gains made from the election or the IMF pledge, all of which the FT attributed to fears over Congressional compliance.

5.7 TRANSITIONS IN POLITICAL POWER AND POLICY REGIMES: 1999-2002

The period 1999 to 2002 witnessed two important changes in the Brazilian political economy. First, in January 1999, Brazil was forced to abandon the peg that tied the *real* to the US dollar, moving it towards even deeper integration into the world economy via the trading of its currency. This decision was tightly linked to the trends described in the previous section, such as the impact of contagion from the Asian and Russian financial crises and the subsequent steady decline in Brazilian currency reserves. But the currency crisis was also connected to the continued lack of support for the president's reform bills in the Congress and a well-known example of the risks of fiscal federalism: the announcement by Itamar Franco that the state of Minas Gerais would default on its debt. The second major change during 1999-2002 had to do with

the 2002 elections, which saw the first transition of the Brazilian presidency to a politician of the 'opposition', providing another well known example of political risk. The election of Lula is perhaps the quintessential example of the speculative nature political risk can take during electoral periods.

Table 5.14 Variables responsible for Brazilian bond market volatility: 1999-2002
Accumulated impact (frequency)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1999	2000	2001	2002
Coalition politics	3.2% (1)	---	2.7% (1)	---
Congressional politics	22.5% (5)	6.4% (2)	-0.2% (3)	---
Contagion	---	13.9% (4)	18.4% (13)	17.9% (2)
Corruption	---	---	-0.7% (2)	---
Elections	---	2.8% (1)	4.0% (1)	82.0% (15)
IMF lending	-12.0% (3)	---	-11.9% (4)	-15.1% (6)
Macroeconomics	-16.6% (3)	-5.2% (4)	5.7% (5)	-12.2% (3)
Ministerial politics	10.7% (3)	1.9% (1)	-3.0% (2)	13.8% (4)
Policy	-30.2% (9)	3.5% (6)	0.4% (5)	5.1% (3)
Popularity of president	10.4% (2)	---	2.4% (1)	---
State vs. Federal govt	40.6% (5)	-6.9% (1)	---	-6.2% (1)
Strikes or violence	---	3.0% (1)	-0.3% (2)	---

The causes and impact of the Brazilian currency crisis require significant discussion, and some mention of the events of late 1998. Brazilian finances were precarious by the end of 1998, despite the $41 billion loan released by the IMF in late December which was intended to inspire confidence in the markets, stem capital flight and thereby protect both the *real* peg and the possibility of a Brazilian debt default. While the markets did respond positively to the announcement on the day of the loan's release (21 December, a drop in spreads of 5.0%), rumours of impending currency devaluation and Cardoso's battles with an unruly congress moved spreads up again before the year ended. There had been a momentary drop in spreads due to the Congressional approval of several key bills in November of 1998 (the approval of tax and pension reform moved spreads down by nearly 11%). But the rejection by the Congress on 3

December of a cornerstone of the IMF / Cardoso fiscal adjustment package, a tax on

civil servant salaries, sent spreads up 9% in one day, reversing the trajectory. At the

beginning of the New Year, Congressional unruliness for once took a back seat to the

shocking announcement by Franco that Minas Gerais would default on its debt owed to

the Central government. Markets entered a tailspin – spreads moved upwards 26% to

levels higher than those seen during the height of Russian contagion, leading to the

decision on 13 January to devalue the *real* by 8%.[101] In fact, the Congress, in a move

of good will towards the embattled government, passed a tax reform measure the next

day that had been introduced as a *medida provisoria*. Nonetheless, the government

was forced to allow the *real* to float the next day, 15 January. The markets expressed

relief, with spreads decreasing some 19%.

Figure 5.5 Annotated Brazilian bond spreads, 1999 (in basis points)

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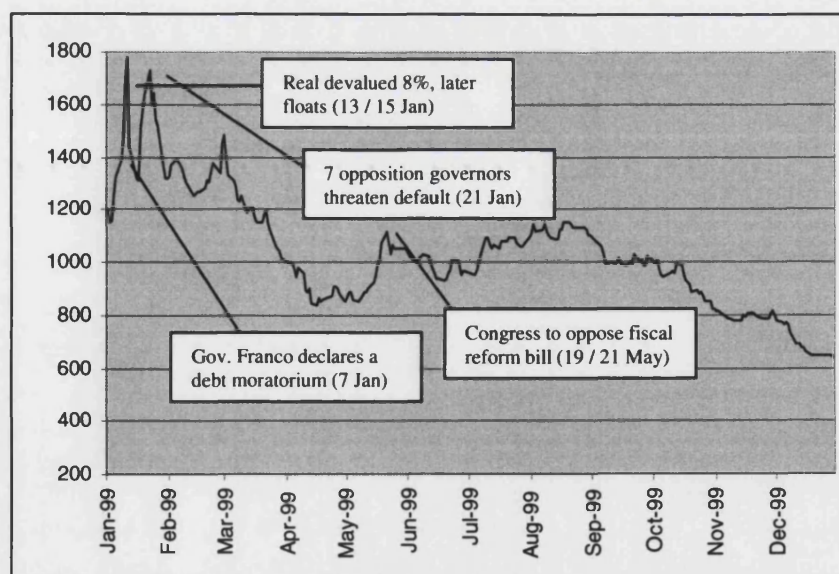
[101] The impact of Franco's announcement is larger than the drop in the markets registered on the day of the devaluation, on which spreads increased 14%.

The impact of political risk in 1999 was far from over, however. Spreads went up a further 15% on the 21 January when seven opposition governors announced that they intended to default on their state debts, and gave the government a 3 week period in which to organise a restructuring. Fear of lack of Congressional compliance with fiscal reform bills in May sent spreads up another 12% (19 and 21 May). Cardoso's exceptionally low popularity rates in June forced him to undertake a cabinet reshuffle and threatened to undermine the governing coalition, sending spreads up a further 6.6%. And finally, huge anti-government protests in Brasilia in August raised spreads 3.8%, reducing further the market's expectation of significant Congressional compliance with legislation on reform. The sole bright spot for the government during this year from the standpoint of political variables appears to be the appointment of a former Soros fund investment manager, Arminio Fraga, as head of the Central Bank just after the devaluation. While Brazil's politicians were incensed, calling speculators like Fraga "jackals" and "criminals",[102] Brazilian spreads fell by more than 10% in a day. And despite the economy's amazing resistance to inflation and recession, beating all economic forecasts, economic variables had a comparatively weak effect on bond prices in 1999. The announcement that the recovery from the devaluation was strong in May decreased spreads by a mere 3.9% (bearing in mind that the volatility threshold for 1999 was 3.3%) and was one of only two macroeconomic announcements which moved markets over this threshold during the year.[103] Thus, the causes of Brazilian spread movement in 1999 surrounding the currency crisis are almost resolutely political in nature, with the impact of political events having a greater impact on the

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[102] "A fox among chickens: Geoff Dyer profiles Arminio Fraga, the new head of Brazil's central bank" (Dyer 1999)
[103] An announcement by the government in February that it expected GDP to contract 3-4% in 1999 sent spreads up 3.8%.

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market than even the decision to devalue and float the currency itself. Certainly the relationship between the executive branch and the Congress and state governors is central to an understanding of political risk during the Brazilian currency crisis.

The second major event of the 1999-2002 period is of course the 2002 elections, a market phenomenon which has spawned a mini-literature in its own right, as reviewed in Chapter II. The election caused a massive amount of speculation, driving spreads to their highest point in the entire twelve-year dataset, reaching more than 2400bp in September. News about the election corresponded to an 82% increase in spreads in 2002, with extreme volatility (in excess of 15% increases per day) starting as early as June, when poll figures showed Lula strongly in the lead. The market's negative reaction to Lula and the election had to with two related elements. The first factor was the policy stance of the PT, which was still significantly radical and stressed the importance of national economic autonomy rather than global financial integration. Combined with the extremely tight liquidity position the government found itself in due to soaring spreads, a rapidly depreciating *real* and high interest rates, there was a fear that the government would not be able to roll over its large short term debts, and would be forced into default, a probability made greater by the perceived lack of political will from a future Lula administration to pay international creditors. Thus the markets reacted strongly to poll data that showed Lula or other leftist candidates (Ciro Gomes in particular) in the lead, as well as to announcements by the PT or Lula himself about the proposed direction of policy if elected. Nonetheless, Lula's attempts to demonstrate good will to the international creditor community by moderating the party's policy platform or by later agreeing with Cardoso to sign a pledge to the IMF of

fiscal discipline, had a very moderate impact (spreads decreased 4.8% on 19 August

when the candidates signed an IMF deal). While the announcement by the IMF that it

would provide $30 billion of support to the government ten days earlier had brought

spreads down by some 9.4%, spreads rose nearly 15% two days later when new poll

data showed Lula remaining solidly in the lead.

Figure 5.6 Annotated Brazilian bond spreads, 2002 (in basis points)
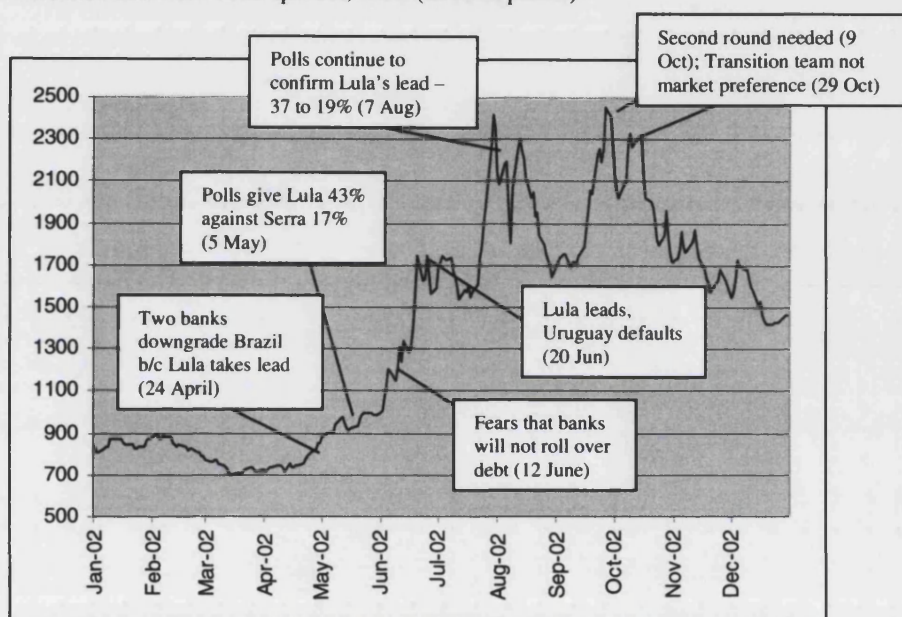
An interesting point to note was that Lula was not an outsider or radical / populist

candidate; the São Paulo business community went so far as to publicly declare their

support for Lula in the *Folha de São Paulo* in September, a move which had no impact

on the perception of international investors in Brazilian bonds of the credibility of the

candidate (spreads rose 9.2% as their declaration came on the same day as further poll

data confirming a strong Lula lead). The desperation of both Brazilian businessmen,

policy makers and international economists and investors to tame the markets came to

nought: in a series of what were supposed to be high profile articles to bring down spreads and relax pressure on the currency, Central Banker Arminio Fraga, finance minister Pedro Malan and even George Soros wrote articles in the FT urging a considered look at the strengths of the Lula candidacy and the Brazilian economy. As Soros argued: "Brazil's problems cannot be blamed on anything Brazil has done; the responsibility falls squarely on the international financial authorities. Admittedly, Brazil is going to elect a president who the financial markets do not like; but if the international financial markets take precedent over the democratic process, there is something wrong with the system."[104]   The 2002 election did in fact resemble something akin to the situation modelled in a paper by Ellman and Wantchekon, where the power international investors generates an 'election under threat' (Ellman and Wantchekon 2000). Reduction in spreads did not begin until well after the election, which had two rounds – the announcement that the election would move into a second round caused markets to soar another 8.9%. Even after this second round, in which Lula gained a huge victory over former health minister Jose Serra, reductions in perceived risk linked to appointments of pro-market members of the economics team and policy announcement had but a moderate impact.[105]

Highlighting 1999 and 2002 does not imply that 2000 and 2001 were years in which political risk played little role in determining market volatility. Brazilian bonds reacted strongly in both years to the possibility of Argentine contagion, and to Turkish

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[104] 'Don't Blame Brazil: The market's reaction to the IMF's $30 billion rescue package shows that a new approach is needed, argues George Soros' (Soros 2002)
[105] The appointment of Luis Fernando Furlan, a key São Paulo businessman, as trade minister reduced spreads 4.1%. The appointment of Antonio Palocci to the post of economic minister only resulted in a reduction of some 2.8%.

contagion in 2000. Congressional politics again played a role in Brazilian risk in 2000: a compromise agreement between the government and the legislature on spending reform was viewed by the markets negatively as it included a number of populist spending measures. The decision by the Supreme Court to uphold the governments' pension reform scheme, previously approved by the Congress, reduced spreads more than 2% in March. Likewise, 2001 was a year of significant political volatility: Cardoso's coalition came under major threat in the early part of the year, forcing a cabinet reshuffle. Additionally, his support in the Congress was significantly undermined by the demise of speaker of the Senate and head of the huge PFL party, Antônio Carlos Magahlães, one of Brazil's most important politicians and long-standing senator of the northeast state of Bahia. After losing a leadership contest, Magahlães, who had been a lynchpin to Cardoso's political authority, accused the government of high-level corruption, initiated a CPI, and withdrew the support of his party from the coalition. Despite this political turmoil, the most important determinant of spreads during 2001 had to do with the impact of Argentine contagion (which led to a $15 billion rescue package from the IMF, $5 billion of which was earmarked for intervention in the currency markets) and jitters surrounding the September 11th attacks in the United States.

Thus, the period 1999-2002 was likewise ruled by political risk: the relationship of the executive with the legislature as well as state governors proved crucial, as did the transition to opposition rule and the election of Lula. The following section attempts to draw some conclusions about the changing nature of Brazilian political risk and what the future of political risk could look like in Brazil.

5.8 THE FUTURE OF POLITICAL RISK IN BRAZIL

What conclusions can be drawn from the above analysis and what is the future of political risk in Brazil? First, it is clear that politics in Brazil is an active source of perceived risk, and that traders as well as analysts have a clear understanding of complex variables related to the current Brazilian political system, such as the relationship between the multi-party Congress, the President and the governing coalition. Additionally, it is possible to see that while the earliest years in the dataset were dominated by power struggles between the courts and the president, as well as by risk generated by the unconsolidated nature of economic reforms, the middle years of the dataset were squarely impacted by power struggles among horizontal layers of government. These were highly related to the susceptibility of Brazil to contagion from international financial crises. The final years under analysis were notable for the relationship between the federal government and state governments, as well as the impact of the transition to opposition power in the form of the 2002 election. The legislature impacted bond performance through delaying the passage of reform measures and by initiating a series of investigations against the executive branch of government.

All of the above analysis provides strong support for the hypothesis articulated in Chapter II section 2.4 that the impact of political news on financial market performance is likely to be stronger than that of economic news, given the attributes of political news such as its unexpectedness, unquantifiable nature and uncertainty. Throughout the dataset, Brazilian politics impacted the occurrence of volatility to a

much higher degree than did announcements about economic policy, leading to the conclusion that a high degree of Brazilian bond market volatility in the twelve years in question was attributable to political events.

What does the analysis in this chapter suggest is the likely future for Brazilian political risk? It is clear that the multi-party and coalition system in Brazil will continue to be a source of risk, though Brazilian presidents have effectively used their executive powers (e.g. the MP) to push through crucial legislation, reducing some level of uncertainty and instability in legislative/executive relations. Additionally, the dialogue about institutional reform of the 1988 constitution to reduce the powers of individual politicians or the number of parties have active in the early 1990s has all but fallen off the radar – adding to regime stability. Another point of hope in the reduction of political risk volatility comes from the fact that Brazil's most disciplined party, the PT, is now governing the country. This provides some advantage in terms of internal cohesion of veto players and in theory should help with policy preference convergence, though the coalition built in the wake of the 2002 elections contained many members who were significantly more leftist than the centrist leaders of the PT at the *Plano Alto*. This has caused friction within even this historically strong party. Finally, some analysts have suggested that the successful transition to opposition rule, which did not result in a massive shift to the left as expected in terms of economic policy, rules out the possibility of another electoral scare such as that witnessed in 2002 (or to a lesser extent in 1994). Nonetheless, a word of caution is in order. As one survey participant, a São Paulo based analyst for a major investment bank, pointed out: the PT is emerging

from its governing experience as a much smaller, and potentially much more radical party (ABNAmro 2005).

The implications of the findings in this chapter for policy are discussed at greater length in Chapter VII – first, however, these findings are compared to a similar study undertaken on Mexico in Chapter VI.

CHAPTER VI

MAPPING POLITICAL RISK AND VOLATILITY:
MEXICO 1991-2002

6.1 INTRODUCTION

The trajectory of political and economic change in Mexico has been very different

from that described in the previous chapter on Brazil, with economic reforms

preceding genuine democratisation by some 10 to 15 years. But like Brazil, Mexico's

political and economic development has been subjected to the varying perceptions of

creditworthiness reflected in a volatile bond market. Many observers of Mexico today

have the impression that the country's current impregnable commitment to pro-market

economic policy, reinforced by institutional mechanisms like NAFTA, makes it

immune to political risk.[106] This chapter aims to show a different trend. While

Mexican politics may have had a lesser role in determining the overarching trajectory

of Mexican risk (which has declined relatively steadily since 1996), perceptions of

Mexican political risk have had a strong and consistent impact on the performance of

the bond market. The sources of political risk in Mexico can be divided into two

distinct phases. From 1991 to 1995 volatility that was politically derived had to do

primarily with the authoritarian nature of the Mexican state, as well as with its external

relations. News about electoral fraud, corruption and progress on democratic reform

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[106] In fact, 75% of the respondents to the questionnaire presented in Chapter III section 3.4 said that
political risk in Mexico was of 'moderate' or 'little' importance, in comparison to 36% for Brazil. 22%
of that total said that Mexican politics were of 'little' importance compared to just 3% for Brazil.

within the ruling Party of the Institutional Revolution (PRI) caused a great deal of market volatility, which exceeded that produced by macroeconomic events on aggregate. From 1996 to 2002, Mexican political risk was driven by the day-to-day workings of democratic politics as enshrined in its particular set of institutions. This makes the sources of political risk in Mexico very similar to the those in Brazil: battles between Congressional priorities and those of the president, the constraint of an increasingly independent court system and the inevitable conflicts over access to resources between vertical layers of government as decentralisation has become a pronounced feature of Mexican governance.

During these two periods, several distinct turning points can be identified. 1994 stands out in this analysis as it saw a culmination of pressures on the state to democratise political participation, and market volatility in this year was determined to an enormous extent by the political violence that plagued the Mexico throughout the year. It was at the end of this tumultuous year that the recently inaugurated President Ernesto Zedillo decided to devalue the peso, starting what was to become known as the tequila crisis. The period immediately after was characterised not only by a renewed commitment to liberal economics (which then extended to the free-floating exchange rate), but to the first genuine attempts to democratise Mexican politics at the expense of the preservation of the PRI and therefore presidential power. Zedillo's administration successfully accomplished what many long-time observers of Mexican politics thought impossible: a peaceful transition to a multi-party democracy without altering the 1917 constitution (see for example discussions in Cornelius, Gentleman et al. 1989). This transition ushered in a second period of Mexican political risk, one

based on more democratic and institutional risks, most notably on the renewal of constitutionally mandated checks and balances. The transformation of the Mexican Congress from a rubber-stamp body to a body with an active political agenda not always in line with that of the President has served as a large determinant of Mexican political risk post 1997, which served as a turning point similar to as 1994 in terms of the types of risks that became significant.

This chapter is laid out in a format very similar to that of the Chapter V above. First, in order to better understand where investors have perceived political risk in Mexico, an institutional overview is completed which focuses on two points. The first is the distribution of power horizontally among the presidency, the Congress and the courts. The presidency, which until recently was the central institution in Mexican politics, is used as a lens through which to understand the interaction of these three branches before and after the democratisation that took place under the Zedillo administration. The second institutional feature that is discussed is similar to the case of Brazil, namely, the relationship between vertical layers of government. The recent Mexican administrations have decentralised fiscal responsibility to a significant degree downwards to state and municipal governments. Likewise, in the period prior to 1997, the interaction between state governments and Mexico City was largely determined by the relationship between the President and PRI governors. As this relationship came under significant strain in the 1990s, and was consequently a significant source of risk, traditional relationships between these vertical layers of government are also considered.

The next sections of the chapter detail the findings of the volatility analysis that was completed from the *Financial Times* on the performance of Mexican bonds in the EMBI and EMBIG indices from 1991 to 2002. The methodology employed for this analysis is identical to that used in the Brazilian chapter, as described in detail in section 5.3. In total, 4,313 pieces of news were scanned which contained the words Mexico, Mexican or the name of the president in the headline. First, an overview of the results is presented. Then, Mexican political risk is considered in three phases: 1991 to 1993 at which time the administration of Carlos Salinas de Gortari was attempting to consolidate and strengthen commitment to neo-liberal economic reforms; 1994-1997 which was a period of significant political reform paving the way for the election of a Congress dominated by the opposition in July 1997; and 1998-2002 in which time the executive (both Ernesto Zedillo and Vincente Fox) was forced to confront new challenges from vertical and horizontal layers of government. The final section concludes and provides an overview of the contents of the final chapter of this thesis.

6.2 AN OVERVIEW OF MEXICAN POLITICS AND INSTITUTIONS

This overview, like that in Chapter V, serves to provide sufficient background to understand the democratic political risk drivers in Mexico, rather than to present any original research, per se. Consistent with the theory of veto players established section 2.3, it is broken into two sections: on the distribution of horizontal and distribution of vertical power in the Mexican state. The horizontal distribution of power in the Mexican system is best understood by analysing the institution of the Mexican

presidency, which during the country's post-revolutionary history served as the state's 'primary' institution, controlling the effectiveness of all other constitutional checks and balances. Through discussions of the powers of the Mexican presidency, it is possible in turn to evaluate the powers of the Congress (Chamber of Deputies and Senate), political parties and the court system. It serves as a point of focus for the analysis much as the party system was the point of focus for the Brazilian institutional overview. While the presidency also provides a good starting point for understanding the vertical distribution of power in the Mexican polity, further discussion is necessary about the role of governors, mayors and state legislatures in Mexico, both in the pre-reform and post-reform eras. This necessarily includes a discussion of fiscal federalism, as distribution of spending authority has been increasing divested downwards in Mexico since the early 1990s. This section proceeds by discussing these two divisions of power – horizontal and vertical – in turn.

6.2a An omnipotent presidency

The Mexican political system has been called 'hyper-presidential,' an 'authoritarian presidency,' and an 'absolute sexennial monarchy.'[107] Peruvian novelist Mario Vargas Llosa went so far as to call the system of rotating power amongst one party the 'perfect dictatorship.' What all of these descriptions attempt to capture is the fact that since the presidency of Lázaro Cárdenas in the 1930s, Mexican presidents have enjoyed what George Philip has called 'meta-constitutional' powers and what Luis Carlos Ugalde terms non-constitutional partisan powers (Philip 1992; Ugalde 2000). Various

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[107] Casar 1996, Johnson 1977 and Cosío Vilegas 1977 as cited in (Philip 1992).

scholars have noted that according to the constitution, the Mexican presidency is actually a relatively weak institution in comparison with other systems (Shugart and Carey 1992). Nonetheless, the Mexican presidency acquired a series of non-formal partisan powers that effectively made it the only significant player in the Mexican political system from 1930 until at least the 1970s. There is broad agreement amongst scholars of Mexico that since that time, the powers of the presidency have been slowly eroded, with an acceleration of this divestiture of power under the presidency of Miguel de la Madrid (1982-1988) and under Ernesto Zedillo (1994-2000), in particular (Cornelius, Gentleman et al. 1989; Philip 1992). The current powers of the presidency closely approximate the *de jure* constitutionally derived powers (Philip 2002). Before discussing the decline in these powers however, more will be said about the 'meta-constitutional' powers of the Mexican presidency.

The primary means by which the Mexican president asserted his power over the political system was through a corporatist structure closely linked with the PRI, of which he also acted as a *de facto* head. Cárdenas (1934-40) enshrined this role by declaring himself the *jefe máximo* of the 'revolutionary family.' Civil society in Mexico was organised under three encompassing sectors: workers, peasants and the military. Almost all citizens of the state, therefore, were members of the PRI through their participation in trade unions, agricultural organisations or the military – there were few non-PRI civil society organisations (Levy and Bruhn 2001). Thus, the PRI became the primary means through which to achieve power and resources, at local, state and federal government level. Additionally, the direct and indirect manipulation of electoral outcomes ensured that the PRI was able to garner Soviet-style electoral

majorities, controlling not only municipal leadership, state governorships and state legislatures, but also federal deputies, senators and of course, the presidency.

The President also played a role in selecting gubernatorial candidates and filling important Congressional posts (such as speaker). As Mexico operates a closed-list electoral system, this essentially provided him with the powers of head of the party. Additionally, through a process known as the *dedazo* ('hand selection')[108] the president chose the PRI loyalist who was to become the future president. The candidate was revealed in a process called the *destape* (unveiling), and PRI officials and elected politicians would fall in line behind this selection (Philip 1992). Thus, a system arose in which the president, as head of the PRI and head of the electoral system, effectively controlled all routes to power and therefore resources.

As a result, the role of the Congress in such a system was almost negligible for most of post-revolutionary Mexican history. The PRI consistently enjoyed a super-majority in the Congress, and as deputies were reliant on presidential favour for their continued careers, there were high levels of party loyalty. This permitted the president to pass almost any legislation introduced into the Chamber of Deputies. Further solidifying the centrality of the president for career advancement, members of the Senate and Chamber of Deputies are prohibited by the constitution from seeking consecutive re-election, effectively releasing them from the constraint of meeting constituents' demands (Weldon 1997). Ugalde has called this situation in which accountability is shifted from below (the constituents) to above (the presidency) "reverse

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[108] This is my non-literal translation. The term actually means 'big finger,' because the candidate was 'pointed out' by the president.

accountability" (Ugalde 2000: 131), and notes that the lack of re-election has also damaged the quality and professionalism of Mexican legislators. Formal powers of the Congress, such as Senate approval of Presidential appointments, budgetary drafting and oversight by the Chamber of Deputies and the right for minorities in either house to start investigations on federal agencies and state-owned enterprises (*comissiones de investigación*) were almost never used, exacerbating a lack of accountability and therefore widespread corruption.

Despite the fact that they had little access to power, parties of the opposition have been active throughout the post-revolutionary period. Today, there are two primary opposition parties, the National Action Party (PAN) and the Party of the Democratic Revolution (PRD), and several smaller parties, most notably the Mexican Green Party (PVEM), which formed an electoral coalition with the PAN during the 2000 elections. The PAN has existed since 1939, and was originally an alliance between the Roman Catholic Church and economic conservatives in the *Cristero* war.[109] While the party was able to gain a very limited number of elected positions before the 1980s, the debt crisis of 1982 gave the party new sources of support. As its economic programme has traditionally been oriented towards business and orthodox economics, the PAN won the support of important sectors of Mexican business (especially small and medium sized businesses) in the wake of the debt default (Levy and Bruhn 2001: 95). The PRD, on the other hand, arose out of displeasure within the PRI at the neo-liberal orientation of the de la Madrid government, calling for a more nationalistic economic strategy, in keeping with the original principles of revolution. Key members of the

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[109] Between 1926 and 1929, the Catholic Church waged a war against the Mexican state due to the anti-clerical provisions in the new Constitution.

PRI, most notably Cuauhtémoc Cardenas, broke away from the party and formed an electoral alliance, which included Mexico's more traditional leftist parties. The success of Cardenas and the what was to become PRD in the 1988 presidential elections, which were widely thought to have suffered from massive electoral irregularities, became a major motivation for the political reform of the Mexican system.[110] Table 6.1 below demonstrates the rising power of the opposition in the Mexican Chamber of Deputies.

Table 6.1 Representation in the Mexican House of Deputies: 1970-2003
Source: Adapted from (Ugalde 2000: 146)

Legislature	PRI	PAN	PRD or Left[111]	Other[112]
1970-73	83.5%	9.3%	7.0%	0.0%
1973-76	81.8%	10.8%	7.3%	0.0%
1976-79	81.7%	8.5%	9.7%	0.0%
1979-82	74.5%	10.7%	12.2%	2.5%
1982-85	74.7%	12.6%	9.5%	3.0%
1985-88	72.0%	10.2%	14.7%	3.0%
1988-91	52.2%	20.2%	27.6%	0.0%
1991-94	65.4%	17.6%	7.2%	0.0%
1994-97	60.2%	23.6%	14.0%	0.0%
1997-00	47.6%	24.2%	26.6%	1.2%
2000-03	42.2%	41.2%	10.0%	6.6%

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[110] It is unclear whether Cuauhtémoc Cárdenas or Salinas won the election. However significant irregularities were reported which constituted electoral fraud, in turn influencing the narrow margins by which Salinas was thought to have won. For example: the 50% abstention rate reported by the government was significantly higher than previous years and inconsistent with evidence of increased voter registration; the government failed to release results from nearly one half of voter precincts despite the fact that results were available in those precincts for Congressional votes; in more than 1,700 precincts Salinas was reported to have 100% of the vote; and the announcement of even preliminary election results was delayed by six days, the delay blamed on computer malfunctions and "atmospheric conditions." In the end, Salinas was declared the winner with some 50.7% of the vote (Cornelius, Gentleman et al. 1989: 20-21).

[111] Prior to the PRD, includes a number of left-wing parties pre-dating the PRD, most of which no longer exist.

[112] Prior to 1997, this includes the labour party. In 1997-2000 it includes only the PVEM. In 2000-03, includes the PVEM, Labour Party, Democratic Convergence Party, National Society Party and Social Action Party.

As is noted in the table 6.1 above, there were two watershed elections. The 1988 elections saw the PRI majority dropping significantly, largely as a result of Mexicans' dissatisfaction with the economic situation of the country. Both the PRD and the PAN benefited greatly in this election, though their gains were reversed in the following Congress, in which the PRI's share of the vote increased. Additionally, the 1997 election was a landmark in that the PRI lost its Congressional majority for the first time since the revolution. This trend was solidified in the 2000 elections, ushering in a period of divided government under an opposition president. Since 1997, first Zedillo and then Fox have had to struggle with a new reality in Mexican politics: the Congress as a check to Presidential power. Without a congressional majority, modern Mexican presidents have been forced to negotiate with opposition parties for support of their legislative priorities.

6.2b Reform of the presidency

What caused this shift and how were opposition groups able to take power given the description of the electoral system above? While many reforms started as early as the 1970s (the PAN was allowed a few very small victories in local government during this decade), the process of democratic reform accelerated under Zedillo. His rationale for this reform has two likely sources. First, the 1988 election had sent a strong message to PRI leaders that blatant manipulation of the electoral process was no longer an acceptable means of maintaining power. Thus, by most counts, the 1994 election was relatively free and fair. Second and probably more importantly given the stalling on democratic reform in the six years between 1988 and the Zedillo presidency, were the

circumstances under which Zedillo took power. The weakness of the Mexican polity was exposed in a number of violent events in 1994 – starting with the invasion of several towns in the southern state of Chiapas by a rebel army calling themselves the Zapatistas, in honour of the Mexican revolutionary hero, on 1 January to coincide with the starting date of NAFTA. The Zapatistas (or EZLN) took up Zapata's call for land and liberty, fighting for democracy and democratic reform, despite their non-democratic means (Levy and Bruhn 2001). Additionally, Salinas's original presidential candidate for the 1994 elections and a friend of Zedillo's, Luis Donaldo Colosio, was assassinated while giving a campaign speech, resulting in Zedillo's selection as candidate. With his presidential beginnings so inauspicious, it is unsurprising that Zedillo recognised the necessity of some level of democratic reform in his time as president.

In fact, Zedillo saw democratic reform as his historical legacy. In an interview with the *Financial Times* in January of 1996, Zedillo said that reducing the power of the Mexican presidency to its constitutional limits was his: "contribution to building the new democracy that Mexico needs. If we want to have a more powerful Congress, we somehow need to have a more moderation in the power of the presidency...".[113] He pursued what he called a three-pronged approach to democratic reform: changing the relationship between the presidency, Congress and judicial branch; reforming the electoral code in partnership with opposition parties to ensure free and fair elections; and decentralising power and resources to state and municipal governments. The first

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[113] "Zedillo seeks to reduce political power at the top: The president of Mexico tells Stephen Fidler of his desire for political change without causing administrative weakness," (Fidler 1996).

two will be discussed in turn, while the third forms the bulk of section 6.2c below on the distribution of vertical power in the Mexican polity.

With regard to changes in the relationship between the president, the Congress and the judiciary, changes to the Congress have mostly been the result of the changing contours of opposition representation. The increasing numbers of opposition deputies, who as demonstrated above captured a majority in 1997, have changed the way in which the president has related to the Congress, making it a much more active partner in the policy and budgetary process, one of Congress's key powers. The PRI has also loosened control over key Congressional committees, such as budgetary oversight (Ugalde 2000). However, there is still a significant constraint on active Congressional participation in the drafting of the budget due to the timing of the budgetary process. While the executive branch begins budget planning in June and has until 15 November before the budget is required to be submitted to the Congress, the Chamber of Deputies has only until 15 December to analyse and vote on the budget. This is an increasingly complicated task, making substantive change on the budget nearly impossible, and creating pressure on the Congress to pass the budget before the 15 December deadline.[114] Finally, it is worth noting that the Senate has no powers over the budget (in the Constitution, the budget is the exclusive responsibility of the Chamber of Deputies) due largely to clauses inserted in the constitution when the Senate was abolished in the late 19th century in favour of a unicameral system.

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[114] The Congressional session ends on 15 December, but can be extended to 31 December in the case of an emergency. It is not clear what should happen in the case that the budget is not approved by the 1 January deadline. Article 75 of the constitution stipulates only that payment to federal employees must continue. A leading legal scholar, José Luis Soberanes, quoted in Ugalde, says that the likely outcome would be the initiation of a 'constitutional controversy suit' in front of the Supreme Court (Ugalde 2000: 32).

Despite these constraints in budgetary power, Congressional powers of investigation have been increasingly used to check federal power, with the presidency becoming an increasing subject of investigation. Several campaign-financing scandals have been revealed under both the late Zedillo and Fox administrations. The most notable use of these powers has been in the scandal related to the bailout of Mexican banks in the wake of the Tequila crisis, the so-called Fobaproa (the *Fondo Bancario de Protección al Ahorro* or Fund for the Protection of Banks and Savings) scandal. More about this scandal is said in the section 6.6 below. Finally, Zedillo allowed much more criticism of the presidency both from within the government (e.g. ministers) and from outside, such as from the press and opposition parties (Levy and Bruhn 2001: 115). The 'dethroning' of the president and normalisation of press/presidency relations was initiated by Zedillo's decision to investigate Salinas's brother Raul in connection with the murder of the head of the PRI in late 1994.

Zedillo's legacy also extended to a transformation of the judicial branch, which had traditionally been viewed as a tool of the president and other high-ranking PRI officials. As Camp documents, Zedillo removed all sitting justices of the Supreme Court, gave the Senate greater power in approval of justices, and gave the Court the policy making power to review legislation for its constitutionality (Camp 1996: 4). The last of these reforms strengthened both the Congress and Court, as legislation could be submitted for judicial review by a relatively small number of members.

On the topic of electoral reform, Zedillo sought to forge an agreement with the PAN

and PRD as well as smaller opposition parties on the reform of electoral laws. Both

campaign financing laws as well as the structure and independence of the electoral

council were to be changed to make them more transparent. These reforms were also

meant to consolidate progress on making Mexican elections more competitive and fair

under previous administrations, allowing an increasing number of opposition

politicians access to power at both the federal, state and municipal levels. As elections

became fairer, the PAN was particularly adept at capturing votes in urban centres and

in the north of Mexico, places in which the PRI's traditional means of vote buying and

coercion were less effective. The party gradually consolidated power in these regions:

in 1989, the PAN controlled 18 of 2,400 local governments (less than 1% of Mexico's

population) and no governorships; by 1999 six states had PAN governors and 223

mayors were from the PAN, controlling a third of the Mexican population (Shirk

2000). The PRD was more successful in some southern states and in Mexico City after

Zedillo opened the post of Mayor of Mexico City to direct election (rather than

presidential appointment, as stated in the Constitution). The PRD has captured the

mayorship in both elections for the post (1997-2000 under Cárdenas, and 2000-05

under Andres Manuel Lóprez de Obrado or AMLO), giving it governance over some

20 million Mexicans and a large percentage of Mexican GDP.

Zedillo also sought to reduce meta-constitutional powers through electoral reform

within the PRI. As he took a more hands-off role in the appointment of important

politicians, an ad hoc primary system arose within the party for major posts, which was

later extended to the presidency when Zedillo failed to *destapar* (hand pick) a

candidate for the 2000 elections (Ugalde 2000: 128). The PRI has adapted relatively well to this new situation; the PRI presidential primaries of 2000 pitted two well-known Mexican politicians against one another and the voting was perceived to be competitive and democratic.

The preceding paragraphs provide a great deal of insight into the probable causes of political volatility in both the pre and post Zedillo period. Political risk prior to the Zedillo presidency, and in 1994 in particular, should be characterised more by extra-constitutional and external risk, such as episodes of violence, revelations of high-level corruption or Mexico's external relations. In contrast, as the political system became increasingly democratic with a higher level of contestation between the presidency and other branches of government, politically induced volatility should increasingly be provoked by democratic politics, such as coalition building, congressional politics and ministerial turnover. The next section takes a brief look at the arrangement of vertical power consolidation under the traditional PRI, and the ways in which presidents since the 1980s have sought to decentralise power and resources to state and municipal levels.

6.2c Federalism

Consistent with the description above, political and economic power in Mexico was traditionally highly concentrated in Mexico City under the leadership of the president. While governors have been described as the 'viceroys of their states,'[115] their service

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[115] As quoted in (Rodriguez 1997)

was resolutely at the discretion of the president, and all governors were from the PRI until the PAN's landmark victory in the 1989 election in Baja California. Not only were governors nominated for candidacy by the president, they could be replaced or forced to resign at will by the president. De la Madrid dismissed the governors of Chihuahua and Guanjuato for political reasons (i.e. letting the PAN win too many local elections), while a record sixteen governors were asked to stand down under Salinas due to a mix of electoral fraud, lack of loyalty to the president and party, and in some cases, promotion to higher federal level positions (Ward and Rodriguez 1999 b: 676). Zedillo, as part of his larger anti meta-constitutional powers drive, did not seek to actively replace any governors; though as detailed in section 6.6 of this chapter, three governors were forced through popular (but not presidential) pressure to step down during his administration. As the centre released its control on electoral results, more gubernatorial posts were won by the PAN and PRD: today, 15 of Mexico's 31 states are controlled by these two parties (some in coalition with smaller parties), an amazing change considering that the first opposition governor was elected only in 1989.

Governors' primary powers prior to the reforms and electoral shift of the mid 1990s were twofold. They had the ability to appoint heads of municipalities, making them a crucial link in a chain of owed favours for political power to Mexico City. Additionally, they lobbied the president for discretionary funds to be spent within their states. According to Ward and Rodriguez, some 80% of all state expenditure awarded by Mexico City was discretionary, and governors who were considered to be the most 'successful' were those that were the most adept at securing discretionary funds from the treasury (Ward and Rodriguez 1999). A reproduction of table 5.9 in section 5.2b

of Chapter V demonstrates that some 51% of fiscal funds in Mexico were discretionary.

Table 6.2 Sources of and mandates for intergovernmental transfers
Source: (Garman, Haggard et al. 2001: 220)

Distribution	Automatic Constitutional		Automatic by Law		Discretionary	
Assignment	Unconditional	Earmarked	Unconditional	Earmarked	Unconditional	Earmarked
Mexico	0%	0%	49%	0%	0%	51%
Brazil	88.9%	5.6%	0%	0%	0%	5.5%
Argentina	75.0%	20.0%	0%	0%	5.0%	0%
Colombia	0%	85%	0%	0%	0%	15%
Venezuela	44.2%	44.2%	1.0%	5.6%	5.0%	0%

A central element to the changes implemented under first Salinas and later Zedillo was the decentralisation of fiscal authority to state and municipal governments. The reform was intended to further enhance the process of democratisation by divesting power to more local levels. In practice, however, this process has been characterised by a serious imbalance in that while spending on education, security, health and other key social services has been decentralised to a large extent, the requisite decentralisation of tax responsibility has been almost completely lacking. Some 95% of all Mexican tax revenue is centrally collected (though that figure decreases to 75% when revenue sharing systems are included); in contrast, 50% of expenditure has been decentralised, primarily via transfers (Diaz-Cayeros 2005). Given the dependency on this transfer system, governors and mayors have become increasingly vocal during the budgetary process, under which they are most able to secure resources required for funding needs. The mismatch between access to funding and absence of taxation responsibility has led to a problem of accountability. Additionally, transfers to state governments under

Fox's government has caused controversy as non PAN governors have accused the executive of unfairly tipping resources in the direction of PAN controlled states.

Despite these imbalances, in comparison to Brazil, Mexican state level debt is significantly lower (refer to table 5.10 in section 5.2b of Chapter V). This tendency will continue to be reinforced by Mexican laws on state level borrowing, which include the use of a 'master fund' to manage and guarantee state debt and recently introduced state level credit ratings by reputed private agencies (Martin 2004). This metric provides some indication of the ability of and need for state governments to raise their own debt in each country.

6.3 RESULTS SUMMARY: MEXICAN POLITICS AND VOLATILITY

Similar to the previous chapter, before providing a detailed account of the behaviour of the Mexican market from 1991-2002, this section describes the overall results of the content analysis and EMBIG matching exercise. 4,313 pieces of news were analysed for this analysis spanning the years 1991 to 2002. A much higher percent of volatility in the Mexican market was directly discussed in the *Financial Times* - some 69% of total days with volatility could be explained by news coverage. In fact, an exceptionally high 74% of volatility which resulted in an increase in spreads was accounted for. Similar to the Brazilian data, during years of crisis, the degree to which volatility was accounted for in the financial press was much higher: while in 1991 only 25% of negative volatility and 17% of positive volatility was accounted for, in 1994 and 1995, 100% of negative and positive volatility was explained, respectively.

The first thing to note from the data is that the standard deviation of daily changes in the spreads of Mexican bonds are highest in 1994 and 1995, due to the political events in that year and the subsequent devaluation of the peso, and in the years in which the Asian financial crisis had a strong effect (see table 3 below). However, it is also worth nothing that the volatility in all of the later democratic non crisis years of the dataset (1999-2002) are higher than the first three years of the dataset in which Mexico was an autocracy (1991-1993). Additionally, the number of days with volatility is higher in the democratic period than in the autocratic period. While this does not say anything about the extent to which volatility in those years was driven by political events, it is an interesting piece of descriptive statistics that provides some insight into the debate about the impact of democracy on financial market volatility, particularly in light of the unexpected direction of the veto player coefficient in the econometric work in Chapter IV. In contrast to scholars who have argued that democracy increases financial market stability, in the case of Mexico, it seems that while the overall level of spreads has declined slightly when one excludes periods of crises (see a graph of Mexican bond spreads from 1991 to 2002 in Appendix III), volatility has actually increased.

Table 6.3 Volatility in the Mexican Bond Market: 1991-2002
Source: EMBI (1991-97) and EMBIG (1998-2002)

	Standard Deviation of Daily Δ in Spreads	Max Daily Increase in Spreads	Max Daily Decrease in Spreads	Number of Days with volatility
1991	1.85%	6.43%	-10.15%	59
1992	1.86%	12.50%	-9.39%	40
1993	2.29%	10.05%	-15.31%	50
1994	5.18%	13.67%	-14.37%	30
1995	5.88%	39.32%	-37.35%	38
1996	2.60%	8.35%	-7.75%	71
1997	4.89%	50.12%	-25.24%	30
1998	4.17%	22.70%	-11.90%	48
1999	3.10%	20.49%	-12.63%	57
2000	2.86%	9.70%	-12.86%	63
2001	2.37%	11.05%	-6.94%	69
2002	2.72%	10.41%	-6.99%	69

Two additional striking results emerge from the aggregated data presented in this section. First, as mentioned in section 6.1 above, there was a notable transformation of Mexican political risk during the course of the 1990s. While in the earlier years of the dataset political volatility was driven primarily by corruption, extra-constitutional violence and US / Mexican relations (the passage of NAFTA in particular during 1993), the later years in the dataset were characterised by a high level of volatility stemming from disputes between the Congress and the Executive on legislative priorities and other issues of power sharing such as court rulings, fiscal federalism and inter-coalition politicking. This strongly conforms with the hypothesis outlined in section 3.2a of an evolution of political risk to match the process of democratisation in emerging market countries. The second extraordinary observation coming from this analysis, which is particularly surprising given the perception by analysts that Mexico trades closely on fundamentals, is that the aggregate impact of volatility stemming from macroeconomic announcements and changes to forecasts of indicators was 0%. The average volatility was also 0%, suggesting that while particular pieces of macroeconomic news may move markets strongly, their aggregate impact over the medium term in Mexico has been nil.

As in Brazil, contagion was the largest driver of volatility throughout the dataset. Perhaps also surprising given investor perceptions of Mexico's immunity to non-US contagion, the aggregate impact of contagion on the Mexican market was much stronger than in Brazil – 400% vs. 292%. Brazilian crises affected the Mexican market on two occasions (1999 and 2002) and contagion from events in the US such as the

collapse of the Nasdaq, the Worldcom and Enron scandals and September 11th had a stronger impact on Mexico than on Brazil given the dependence of the Mexican economy on US economic health. Nonetheless, as is clear from table 6.3 below, political variables, and Congressional politics in particular, had a strong impact on spreads, resulting in an aggregate increase of 127%, nearly as much as in Brazil (149%), despite the fact that relations between the Mexican congress and the president did not become an important metric for political risk until the PRI lost its congressional majority in the 1997 mid-term elections. Likewise, the impact of violence and strikes on the Mexican market was strong – resulting in an aggregate increase of 91% - most of which (41 out of 91%) was incurred during the tumultuous year of 1994. Table 6.3 below presents the data accumulated from the twelve years of analysis in a more succinct format.

Table 6.4 Variables responsible for Mexican bond market volatility: 1991- 2002[116]
In order of accumulated impact (in absolute value terms)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	Accumulated impact	Frequency	Average Δ in spreads	Max daily volatility
Contagion	400.4%	43	8.9%	50.1%
Congressional delays, rejections or approvals of key bills	126.9%	48	2.6%	22.7%
Strikes or violence	90.8%	40	2.3%	19.4%
Elections	56.7%	33	1.7%	12.3%
Corruption	59.7%	14	4.3%	8.7%
State vs. Federal government	42.4%	8	4.7%	7.0%
Announcements of a new government policy	-31.7%	72	-0.4%	39.3%
Cabinet reshuffles, ministerial resignations or appointments	27.7%	15	1.8%	13.7%
IMF or international lending	-25.6%	8	-3.2%	-14.4%
Changes to popularity of president	18.6%	6	3.1%	9.1%
Democratic Reform	18.4%	13	1.4%	12.5%
Fragility of governing or opposition coalitions	16.6%	8	2.1%	5.8%
US Politics or bilateral relations	11.2%	51	0.2%	-37.3%
Release of macroeconomic figures or forecasts	0.0%	48	0.0%	43.1%

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[116] Days in which there was no indication of what caused the volatility in FT reports are excluded from this analysis. See the explanation of the impact of this in section 5.3.

As is shown in the table 6.3 above, the variables of analysis used in the Mexican content analysis varied slightly from that of Brazil. Two variables were added. The first measured the impact of policy announcements about 'democratic reform,' which consisted mostly of changes to electoral rules or had to do with internal PRI reform under the Salinas and Zedillo administrations. The second looked at the relationship between Mexico and the US, since the political relations between the two often had a strong influence on Mexican risk rates. This was particularly true during the negotiations between the Salinas government and the Clinton administration on NAFTA (this variable brought down spreads by more than 23% in 1993), and in the days following the peso devaluation of 1995, when the Clinton administration made unusual credit lines available to the Mexican government in addition to IMF financing (-21.6%). These issues will be discussed in more detail in section 6.4 – 6.6.

Another variable changed meaning over the course of the period: state vs. federal government. Unlike in Brazil where this variable almost always focused on fiscal relations between the state and central governments, in Mexico, this variable was more often about the replacement or forced resignation of corrupt or inept PRI state governors by the president. In the later years of the dataset, there were examples of the impact of fiscal federalism on the perception of Mexican risk: both when a governor called a moratorium on debt repayments and when a number of opposition governors protested against the Fox government's perceived bias in distributing fiscal resources to states with PAN leadership. This led to more broad calls for distribution of funds away from the centre and towards municipal and state governments in the 2002 budget.

The progression of this variable is therefore consistent with the institutional analysis in section 6.2b.

The analysis that follows is broken into three distinct phases, though not as equally spaced as in the previous chapter. Instead, the analysis is broken into the period 1991 to 1993, 1994 to 1997 in which there was major economic and democratic reform, and the period after 1997 categorised by victories of the opposition and the return to constitutionally mandated checks and balances.

6.4 SALINAS'S PRI AND CONSOLIDATION OF ORTHODOX ECONOMICS: 1991-93

The overarching themes of the years 1991 to 1993 had to do with the advancement of Salinas's vision of a modern, neo-liberal Mexican economy, and in accordance with that vision, the creation of a regional trade agreement with the United States and later Canada. The political reform agenda under Salinas stalled to a large degree despite the suspect conditions under which he was elected in 1988, and thus the political volatility between 1991 and 1993 had more to do with extra-constitutional risks given that 'democracy' was still subservient to the power of the PRI. It is worth noting that many of the political variables that later became important had no impact in the first years of the dataset including coalition politics, congressional politics, and the popularity of the president, consistent with the regime model proposed at the outset of Chapter III. Incidences of strikes and violence and substantive political reform were also relatively low. Instead, two political variables in particular mark this period: first,

the deliberations over the approval of NAFTA by the US Congress led to a massive

amount of speculation in 1993, with small volatility in previous years as well. Second,

the forced resignation of governors as part of a drive towards moderate democratic

reform impacted markets in both 1991 and 1992. The following paragraphs look at the

major trends of this period and the relationship of these variables to Mexico as a whole

during these years.

While 1991 is unusual in the dataset because a relatively small amount of the volatility

in that year is explained by the content analysis,[117] of the volatility that is accounted

for, almost all is political. As is shown in figure 6.1 below, the overall trend for bond

risk in Mexico in 1991 was positive, that is to say that risk was decreasing, as the

government worked to restructure its debt and fortify trade agreements with North and

Central America. Political variables of import include: expectations from the finance

minister of the imminent release of details about NAFTA, dithering on firm

announcements on the privatisation of steel companies, and Salinas's decision to block

the PRI candidate in Guanajuato from becoming governor after allegations of massive

electoral fraud. This is the first example in the dataset of the impact of the breakdown

in the traditional relationship between the president and PRI governors on bond

volatility. In August 1991, Salinas's decision to block the governor from taking office

resulted in an increase in spreads of 2.0% (the standard deviation for this year was a

very low 1.9%).

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[117] 17% of increases and 25% of the decreases in spreads are explained by the FT.

Figure 6.1 Annotated Mexican bond spreads, 1991 (in basis points)
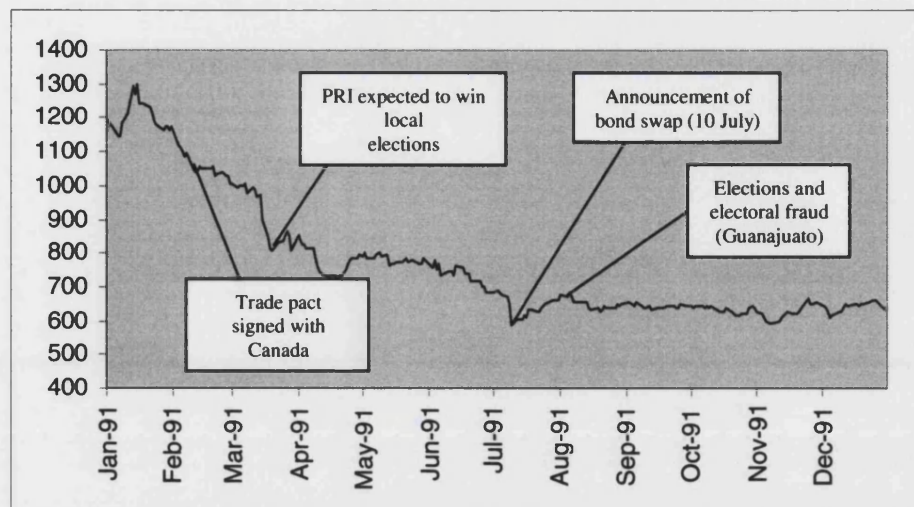
An even more pronounced reaction was registered in 1992 when the governor of Michoacán was forced to resign on allegations of fraud and under pressure from Mexico City: spreads increased 7.0%, much higher than the standard deviation for the year. Related experiences of political risk in this period have to do with the minimal attempts that were made to reform the PRI and the electoral system under the Salinas administration. In 1992, for example, concern that the PAN's reputation as a genuine opposition party was being threatened by its relationship with the PRI led to the resignation of a number of high-ranking PAN officials, and sparked a massive increase in spreads (12.5% in a single day). The threat of instability in the opposition was closely linked, the FT claimed, with perception of lack of reform on behalf of the PRI.[118]

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[118] "Mexican ruling party pushed towards reform" (First 1992).

Figure 6.2 Annotated Mexican bond spreads, 1992 (in basis points)
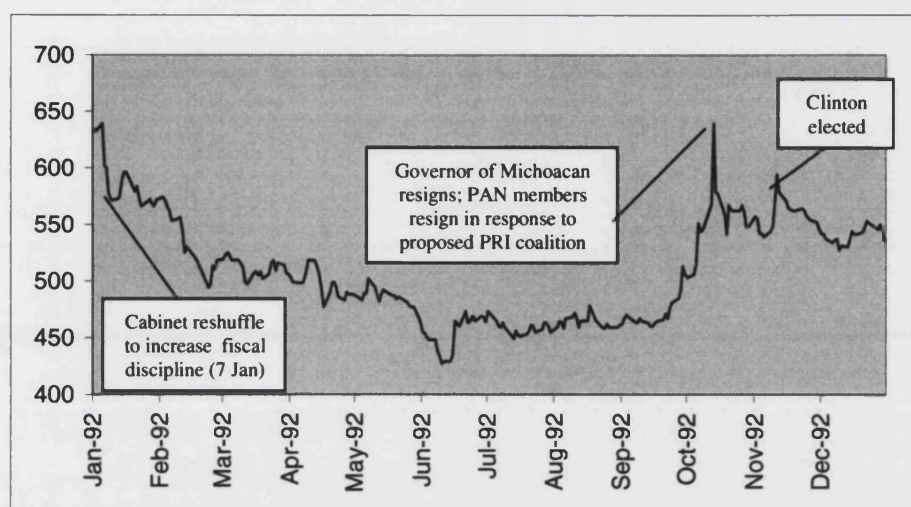
Aside from the instances mentioned above, political risk in the second half of the Salinas administration was linked to the government's ability to secure the North American Free Trade Agreement. This volatility took two forms. First, it was related to internal progress on policy reforms considered a prerequisite by the US for Mexico's admission to the agreement. As an example, announcements of economic liberalisation and privatisation programmes were regarded as positive both for the overall trajectory of the Mexican economy and as bargaining chips exchanged for US approval of NAFTA. The election of Clinton in late 1992 increased Mexican spreads substantially, due to the impression that the president-elect was against the NAFTA agreement, as can clearly be seen in figure 6.2 above.

Second, and particularly in 1993, US domestic politics directly impacted the Mexican bond market as the prospect of US Congressional rejection of the accord threatened to scupper the government's free trade programme, on which it had largely staked its

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reputation. In late October and early November, concerns over congressional rejection led spreads up 57.5%. However, on 10 November, news emerged that the bill was likely to pass, bringing spreads down by more than 15% in one day. The following days saw spreads decline by a further 20%. Both of these events are shown in figure 6.3 below. The approval of NAFTA set Mexico on a positive, bullish course which resulted in spreads falling from more than 500bp in October to 266bp by the end of the year. This optimism was firmly reversed, however, on the first trading day of 1994, after a dramatic uprising of an indigenous peasant army, the Zapatistas or EZLN, in the southern state of Chiapas on 1 January – as discussed at length in section 6.5 below.

Figure 6.3 Annotated Mexican Bond Spreads, 1993 (in basis points)
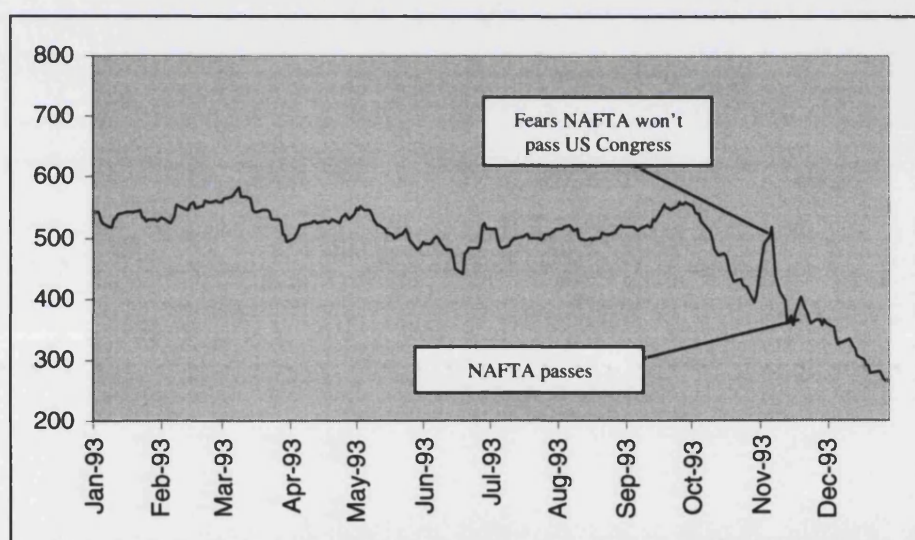
Finally, it should be noted that positive reports of Mexican economic performance also had a relatively strong impact on Mexican spreads, particularly in 1991 and 1992. Mexico became the developing world's top destination for foreign investment during these years, and its economic and political progress was covered extensively in the

Financial Times. Positive news about Mexican macroeconomic fundamentals led

spreads down by 22.0% in 1991, though a slowdown reduced these gains by 11.0% in

1992. The increases in 1992 had largely to do with the surprise announcement by the

government in October that it would increase the daily amount by which the peso was

permitted to devalue, from $0.20 to $0.40, which increased spreads by almost 5.0%.

The aggregate impact of macroeconomic news on the performance of Mexican bonds

between 1991 and 1993 was slightly positive, i.e. decreasing spreads, as seen in table

6.4 below. The main drivers of spreads were changes to policy and US politics in

NAFTA – macroeconomics played a strong role in 1991 (categories with no mentions

– including coalition and congressional politics, contagion and the popularity of the

president were deleted).

Table 6.5 Variables responsible for Mexican bond market volatility: 1991-93
Accumulated impact (frequency)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1991	1992	1993
Corruption	--	--	-2.7% (1)
Democratic Reform	--	12.5% (1)	-2.6% (1)
Elections	-7.7% (1)	--	4.5% (2)
Macroeconomics	-22.1% (5)	11.3% (4)	-2.6% (1)
Ministerial politics	--	-9.8% (2)	-4.0% (1)
Policy	5.3% (4)	-4.5% (7)	-26.2% (7)
State vs. Federal	2.0% (1)	7.0% (1)	--
Strikes or violence	--	-10.2% (2)	--
US Politics or Relations	--	10.1% (2)	-23.8% (20)

6.5 THINGS FALL APART: THE UNRAVELLING OF THE PESO AND THE PRI: 1994-97

The period between 1994 and 1997 was highly volatile. Not only was the Mexican

market strongly affected by the devaluation of the peso at the end of 1994 and the

Asian financial crisis of 1997, political risk had a strong impact both at the beginning

and the end of the period. These years are pivotal in coming to a new understanding about the contours of political risk in Mexico, with 1994 and 1997 serving as bookends in a transition from a focus on extra-constitutional, violent risk to democratic, institutional risk. While in 1994 the markets responded strongly to a series of uprisings, assassinations and kidnappings, in 1997, Congressional politics came to the fore of Mexican political risk for the first time in its post-revolutionary history. The interim years (1995 and 1996) were extremely important in so far that it was during this time that President Zedillo made significant efforts at reforming the Mexican political system by decreasing the 'meta-constitutional' powers of the president and enhancing the level of competition amongst Mexican political parties. This section will look at each of the years in this time period, focusing on how large a role political risk played in determining market behaviour.

In stark contrast to the previous period, 1994 began a period of difficulty for Mexico both in terms of political risk and economic risk. The dramatic events of 1994, almost all of which were violent, extra-constitutional political risk events, led bond spreads up sharply. The bond market opened for the year with a 14% increase in spreads on 3 January, in response to the Zapatista invasion. Several days later, spreads increased a further 19.4% (the second highest daily increase for the year) when several bombs, allegedly planted by the EZLN, exploded in Mexico City while San Cristóbal de las Casas, a large town in Chiapas, remained under heavy attack. Intensification of the fighting on 19 January, coupled by worries over PRI unity in the selection of

presidential candidate Luis Donaldo Colosio, increased spreads a further 15.0%.[119]

Later attempts by the government to come to an accommodation with the rebels had a similar impact on spreads. The market responded negatively to the government's decision to negotiate and concede significantly to Zapatista demands, resulting in a 25.0% increase in spreads during late February. Throughout the year, as negotiations between the government and the Zapatistas resulted in continued delays of a peace deal, the perception of Mexican risk continued to rise. In mid June, for example, spreads increased 9.6% when the rebels spurned the government's peace offer. The rejection of the deal resulted in the resignation of PRI heavy-weight Camacho, who blamed the failure on Zedillo's leadership. The markets rose a further 9.8%, especially as the leader of the Zapatistas, *Subcomandante* Marcos, announced that the rejection of the peace deal was linked to a lack of political reform which could ultimately lead to civil war. The total impact of these events was an astounding 107% rise – providing insight into the trend that increased Mexican spreads from 266bp on the final day of trading in December 1993 to 556bp by the end of June. The impact of these events on bond spreads is visible in figure 6.4 below.

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[119] Manuel Camacho, former foreign minister and an important PRI official, was then acting as the government's chief negotiator in Chiapas. There was speculation that he intended to launch an independent bid for the PRI presidency, contravening the long-standing tradition that the current president chooses the presidential candidate.

Figure 6.4 Annotated Mexican bond spreads, 1994 (in basis points)
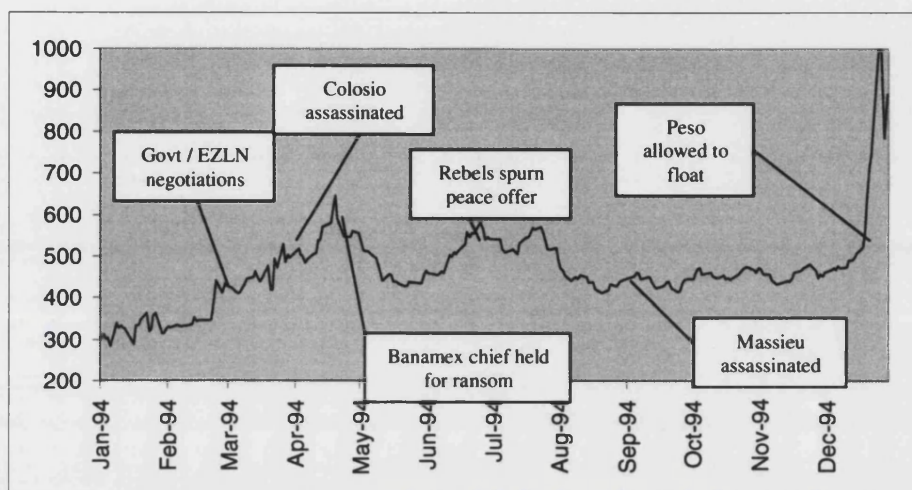
Unfortunately for Mexico, the Zapatista uprising was only the first of a series of violent political events that marred the year. As briefly mentioned in section 6.2b, on the evening of 23 March, Colosio was assassinated while giving a campaign speech, throwing Mexican politics into turmoil and leading to an 18.0% increase in spreads the following morning. Speculation that Zedillo would be named candidate by Salinas sent the markets up a further 12.0%, as did speculation that Camacho, head government negotiator in Chiapas, would again consider a presidential bid. Two further episodes of violent political risk also drove markets. The first was the kidnapping of the head of the large Mexican bank, Banamex. A threat issued by his kidnappers that he would be killed unless his business associates and family paid a ransom of $50 million sent markets up 6.0% in early April and a further 6.0% in late

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April.[120] Finally, the head of the PRI, Ruiz Massieu was assassinated in the street in Mexico City in late September. Over two days, the spread on Mexican bonds increased by a relatively moderate 6.7%. This assassination, however, was to have a prolonged impact on the perception of Mexican risk, and on the process of democratic transition. The assassination was ultimately linked to the brother of former president Salinas, Raul Salinas, revealing a vast network of corruption linked to drug money. The investigations into the Colosio and Massieu murders resulted in a number of high level resignations including two attornies general, two interior ministers (one in 1995) and at least one congressional member. The resignations of the attorney general and later the deputy attorney general were particularly bad for the perception of political risk, as they both claimed that they were unable to conduct a sufficiently robust investigation into the murders due to political pressures.

These events almost completely overshadowed the 1994 presidential election, a surprising outcome given the highly contested nature of the 1988 elections and the chaos surrounding the naming of Zedillo as a candidate. The aggregate impact of the elections on spreads was a relatively modest in comparison (a decrease of 13.8%). There was a positive reaction as the PRI pulled ahead in opinion polls in late July, and a PRI victory was largely priced in through a 18.0% decrease in spreads (from just over 500bp to 413bp on the day of the election results). Because of this previous pricing in, the actual victory of Zedillo itself had almost no impact on the markets. In comparison to the impact of prior events the effect of the 1994 election was minor.

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[120] A similar kidnapping of the vice president of a large super-market chain which occurred shortly thereafter (25 April) did not have a strong impact on markets, primarily because the government was by that time making positive progress in talks with the EZLN on a negotiated settlement.

The final and crucial event central to understanding the sources of Mexican market volatility in 1994 was the surprise decision by Zedillo to devalue the peso 15% just weeks after his inauguration. While this initial decision resulted in a decline in bond markets of only 7%, during the next two days, concerns about whether this devaluation was significant enough led spreads up a further 26.6%, and the peso, under extreme pressures, was allowed to float freely on 22 December. Concerns about the impact of the devaluation on the health of the Mexican banking sector five days later brought spreads up a huge 43.0%, rising further still (13.7%) when newly appointed finance minister Jaime Serra Puche was forced to resign under massive pressure from Wall Street. It is interesting therefore to look at the impact of various factors on the Mexican market in 1994 in isolation – to compare the impact of political and economic variables (categories with no mentions were deleted).

Table 6.5 Variables responsible for Mexican bond market volatility: 1994
Accumulated impact (frequency)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1994
Democratic Reform	10.3% (1)
Elections	1.1% (5)
IMF or international lending	-13.8% (4)
Macroeconomics	43.1% (1)
Ministerial politics	13.7% (1)
Policy	33.7% (3)
Strikes or violence	40.9%(14)

While the political events of 1995 and 1996 were not nearly as dramatic as those of 1994, political risk was still a significant component of Mexican bond market volatility during these two years. Risk in these two years was dominated by two things: first, the Tequila crisis, or the financial malaise that hit the Mexican economy in the wake of the

flotation of the peso. Second, the process of democratisation, as embedded in Zedillo's three-pronged reform programme discussed in section 6.2. The impact of the currency crisis on volatility in 1995 was enormous. Rumours of the imminent collapse of the Mexican banking system and a potential government default on short-term debt linked to US dollars (*tesobonos*) sent the market into a panic – spreads increased 23% on 4 January and a further 39% on 10 January.[121] To some extent, that volatility was tempered by the international lending packages which were made available shortly thereafter. The United States announcement that it would provide Mexico with a bailout package of up to $30 billion on 12 January led to the largest one day decrease in bond spreads during the year (37%). US President Bill Clinton's decision several weeks later to bypass Congressional approval for the bailout package and make $20 billion available directly from the Treasury (plus an additional $30 billion from the IMF and the Bank of International Settlements) brought spreads down a further 13%.[122] News related to the peso crisis dominated spread volatility throughout the first half of the year.

Domestic political risk in these years was focused on Zedillo's attempts to reform Mexican politics and on responses to these reforms from various actors including the Congress, the parties of the opposition, PRI 'dinosaurs'[123] and rebel groups with violent means including the Zapatistas. As mentioned in section 6.2, by ordering thorough investigations into the deaths of Colosio and Massieu, Zedillo began a

[121] In an unprecedented effort to save the Mexican economy, the US Federal Reserve stepped into the peso market on 9 January to stem the selling of the peso. The Mexican government also tapped Canadian credit lines on that day.

[122] It is worth noting that speculation between these two announcements that the US Congress would reject the bailout package drove spreads up 15%.

[123] A term frequently used to describe members of the PRI's conservative, anti-reform wing.

process of removing the impunity of PRI members and strengthening the independence of judicial inquiry. Thus, the announcement by the attorney general that there had been a significant cover-up in the Colosio case in February sent markets up more than 8.0%. The arrest of Raul Salinas, while boosting Zedillo's popularity amongst Mexicans, resulted in a further 6.9% increase in spreads. Likewise, in a rerun of the battles between the centre and the state governors during the Salinas administration, Zedillo's insistence that the governor of Tabasco, Roberto Madrazo, resign in the wake of alleged electoral fraud increased spreads 8.7%. A later resignation by the governor of Guerrero in March 1996 increased spreads some 3.7%. Rebel violence initiated by the EZLN and a group in Guerrero also pushed spreads up to some extent, though the overall impact was less significant than the impact of democratic political risk.[124] Likewise, Zedillo's plans for a major reform of the electoral laws, in concert with the main opposition parties the PAN and PRD, generated substantial volatility. In February, lack of agreement between the major parties drove spreads up more than 5.0% on two separate occasions; the announcement that the PRI and PRD had come to an agreement in principle (which excluded the PAN) reduced spreads by more than 4.0% in April.

The last year in this series, 1997 was monumental because for the first time in modern Mexican history parties other than the PRI dominated the Congress. Additionally, the mayor of Mexico City was freely elected for the first time; Cuauhtémoc Cárdenas of the PRD gained governance over 20% of the Mexican population living within the

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[124] On 30 August 1996, spreads increased 6.2% in response to these uprisings, which the rebels themselves claimed were linked to a lack of genuine democratic reform within Mexico.

administrative borders of the *Districto Federal.* This dramatically changed the nature of political risk in Mexico, shifting it towards issues of checks and balances between the president and competing holders of horizontal and vertical power. As noted in the table 6.3 of section 6.3, Congressional politics led to an increase in spreads in 1997 alone of nearly 17% from two incidents. First, and in what was to become a trend in subsequent years, there was a significant amount of volatility surrounding the Ministry of Finance's presentation of the annual budget to the Congress in November. The new opposition- dominated lower house grilled finance minister Ortiz significantly on the government's proposed austere budget, sending markets up by more than 7% in a day. Second, there was a major breakdown in party discipline amongst the PRI that affected the passage of a government sponsored tax reform bill in December, which lead to an increase in prices of 9.7%. Tensions between newly independent local leaders and the central government also ran high; the government's attempt to embarrass recently elected Cárdenas with a show of force against drugs in Mexico City sent spreads up 5.1%. Finally, 1997 was also marked by a high level of contagion from Asia: at the end of October and beginning of November, spreads rose a combined 99.7% on concerns of the impact of the Asian crisis.

Figure 6.5 Annotated Mexican bond spreads , 1997 (in basis points)
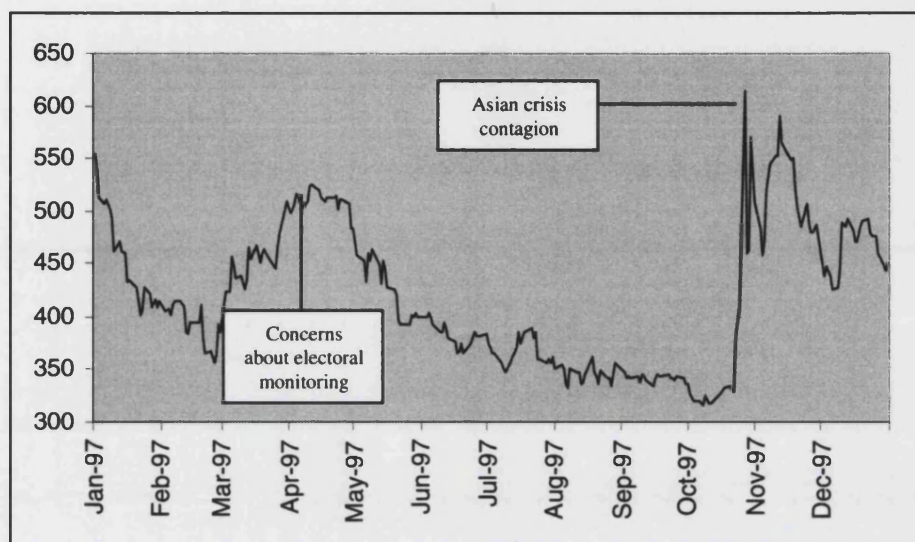
Table 6.6 below provides the relative weighting of such factors on the performance of Mexican bonds in 1995-1997; note in particular the increasing importance of democratic political risk in the table as reflected in the substantial rise of congressional political risk and democratic reform. The impact of policy announcements faded as time passed from the Tequila crisis; as seen in both the graph above and table below, contagion from the Asian crisis was a major driver of spreads and volatility in 1997.

Table 6.7 Variables responsible for Mexican bond market volatility: 1995-97
Aggregated yearly impact (Number of mentions in parentheses)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1995	1996	1997
Coalition politics	--	--	--
Congressional politics	--	1.9% (2)	16.7% (2)
Contagion	--	--	114.1% (5)
Corruption	28.0% (4)	3.3% (1)	--
Democratic Reform	--	5.0% (3)	-12.8% (2)
Elections	11.4% (1)	5.3% (1)	--
IMF or international lending	9.0% (1)	--	--
Macroeconomics	5.9% (1)	-15.5% (7)	5.1% (1)
Ministerial politics	-7.2% (1)	-3.4% (1)	--
Policy	72.4% (10)	-33.1% (10)	-10.9% (2)
Popularity of president	9.1% (1)	4.4% (1)	--
State vs. Federal	--	9.0% (1)	--
Strikes or violence	0.5% (2)	16.5% (2)	-5.5% (1)
US Politics or Relations	-21.6% (11)	6.0% (3)	23.2% (3)

6.6 OPPOSITION VICTORY AND THE RETURN OF CHECKS AND BALANCES: 1998-2002

As noted in section 6.2b, the transition towards a more competitive Mexican polity began in 1997, and was consolidated through the last period of enquiry, 1998 to 20002. The macroeconomic performance of Mexico was also strengthened significantly during this period: the US based investment rating agency Moody's upgraded Mexican debt to investment grade in March 2000, facilitating access to cheaper credit. The economy became increasingly integrated with the US, and the Mexican stock market often traded in line with the US based Dow Jones index. The bond market responded moderately to economic announcements – the Moody's decision, and later speculation that Standard & Poor's (S&P) would follow suit – was a major source of volatility in 2000 and 2002. Nonetheless, and despite initial hypotheses from analysts to the contrary, both political risk and contagion from global and regional financial crises

remained a major driver of bond market volatility. The political variables that impacted markets during these years (and in particular after the 2000 elections) were those to do with democratic institutions, their reform, and contestation over policy making and resources – precisely the variables identified in section 6.2a-6.2c.

1998 set the tone for the strong role that democratic political risk was to play in Mexico during this final period of consideration. In fact, political risk in 1998 was exceptionally high – 81% of the days with positive volatility were driven directly by political concerns. 53% of decreases in spreads were likewise explained by political events (see table 6.7 below). Attempts at democratic reform again played a role in generating volatility: Zedillo's decision to forgo the naming of the PRI presidential candidate through the *dedazo* sent spreads up 5.8%, presumably because of the lack of certainty in the process of candidate selection in absence of this process. Further weakness in the PRI's position nationally was confirmed with several state-level victories for the opposition. The PAN took the governorship of Aguascalientes in August, increasing spreads 4.4%. In November, the PRD won the governorship of Tlaxcala, and despite PRI victories in Puebla and Sinaloa at the same time, spreads rose 4.5%. The forced resignation of the governor of Morelos after a spate of kidnapping and extra-constitutional violence sent spreads up a similar amount. All of these episodes demonstrate the market's nervousness over the uncertainty of Mexico's transition from a one-party to multi-party state, despite the fact that many of these episodes indicated positive progress towards democratisation. Finally the three-year truce with the EZLN was broken in June with major military operations, leading up

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markets nearly 7.0%. This was the only extra-constitutional political risk event recorded for the year.

Table 6.8 Variables responsible for Mexican bond market volatility: 1998
Accumulated impact, (frequency)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1998
Congressional politics	47.2% (15)
Contagion	108.4% (8)
Corruption	8.7% (1)
Democratic Reform	4.8% (3)
Elections	20.6% (3)
Macroeconomics	0.9% (2)
Ministerial politics	4.7% (1)
Policy	-7.2% (1)
Popularity of president	8.3% (1)
Strikes or violence	6.3% (3)
US Politics or Relations	16.5%(5)

The increased contestation in the Congress was also a central cause of volatility. As in 1997 and years to come, the passage of the budget through the opposition-dominated Congress had a strong impact on volatility – fears as early as September that an emergency budget would be required in lieu of Congressional approval plagued the markets, increasing spreads by more than 6.0%. At the end of November, spreads increased 8.0% in a single day when Congressional discussions over the budget ended in an acrimonious shouting match between PRI and non-PRI members. In mid December, renewed fears of an emergency budget again increased spreads by nearly 5.0%. The amount of volatility surrounding the Mexican budgetary process suggests that analysts and traders have a fairly advanced amount of knowledge about the particular features that complicate an easy passage of the budget, including the short period of Congressional review.

Additionally, the scandal over the use of a public fund to bailout risky Mexican banks in the wake of the Tequila crisis, known by its Spanish acronym Fobaproa became a primary means by which the Congress demonstrated their opposition to the pro-market policies of the Zedillo government, which in turn generated a vast amount of market volatility. Arguments over Fobaproa were responsible for the largest one-day increases in spreads in 1998; similarly, the prospect of accord generated the greatest daily decreases.[125] Often, investor concerns over the impact of the ongoing acrimony over Fobaproa became a way to channel concerns over contagion from the Russian and impending Brazilian crises.

In 1999, Zedillo's reform continued to generate political risk, as did preparation for the 2000 presidential election. Weakness in Zedillo's party support, evidenced by a major cabinet reshuffle, resulted in two days of spread increases each of more than 4.0%. The formation of an eight party electoral alliance against the PRI drove markets up nearly 5.0%, despite the fact that there was little likelihood that it would remain operational until 2000.[126] In the first example of Brazilian-style problems of fiscal federalism, the announcement by the governor of Chihuahua that he would not repay debts owed to the central government increased spreads by 4.4%. The reception by the markets of PRI presidential candidates was warm: the announcement that PRI heavy-weight Roberto Madrazo would run brought spreads down more than 4.0%, and Francisco Labastida's eventual landslide victory in the first ever PRI primaries brought

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[125] The ultimate agreement between the Congress and the executive on Fobaproa reached in 1999 brought down spreads another 4.0%.

[126] In fact, the PAN and PRD split and ended their coalition in September of the same year, sending spreads up 3.8% - demonstrating that neither coalition nor lack thereof would settle markets.

markets down a further 4.5%. Interestingly, the Zedillo government, fearing the so-called 'sexenio curse,'[127] successfully obtained an $11 billion credit line from international lenders including the United States in case of election-related crisis in June of 1999, more than a year before the election. The announcement of this credit line, and Mexico's subsequent letter of intent to the IMF asking for a total of $23 billion, reduced spreads by 4.3%.[128]

Table 6.9 Variables responsible for Mexican bond market volatility: 1999
Accumulated impact, (frequency)
Source: EMBI / EMBIG index as matched to daily reporting in the *Financial Times*

	1999
Coalition politics	0.5% (4)
Congressional politics	14.9% (8)
Contagion	38.1% (7)
Corruption	8.7% (1)
Elections	-7.2% (4)
IMF or international lending	-9.1% (4)
Macroeconomics	-2.3% (8)
Ministerial politics	11/5% (2)
Policy	-19.4% (6)
State vs. Federal	4.4% (1)
Strikes or violence	18.0% (5)
US Politics or Relations	-4.9% (1)

Congressional politics had a strong role in creating volatility in 1999 as well. A showdown with the government over allegations of illegal campaign funding in the 1994 elections pushed up spreads in June, as did the lack of agreement on the 2000 budget, which almost caused a constitutional crisis. The budget was passed just four hours before midnight on 31 December, avoiding a situation where the president would

[127] The *sexenio* curse, of which much has been written, describes the phenomenon that financial and currency crises in Mexico have tended to occur every six years, in tandem with the presidential election (Heath 1999).
[128] It is interesting to speculate what the effects of this sort of pre-emptive electoral emergency credit would have been on the Brazilian elections of 2002. While it would have been harder for the government to obtain such a line of credit from the US, given that Brazil did not have as strong a strategic partnership as Mexico with the US, the IMF perhaps could have made such a line of credit available to the Cardoso government, reducing concerns over a crises of liquidity in 2002.

have potentially had to roll over the previous year's budget or send the case to the Supreme Court. The main driver of Mexican spreads in 1999, however, was the Brazilian crisis, demonstrating that Mexico was far from immune to troubles in neighbouring countries. On the day that the *real* was devalued, for example, Mexican spreads increased 20.5%. The impact of the Minas Gerias moratorium was almost as strong on the Mexican market as on the Brazilian market.

The market build-up to the historical 2000 election was much more muted than expected, perhaps as a result of the aforementioned emergency credit line Zedillo had secured more than a year before, perhaps because the country's upgrade to investment grade credit by Moody's in February assured investors of the strength of Mexico's finances.[129] Moderate volatility was recorded prior to the election, especially as favour switched between PRI candidate Labastida and PAN candidate Fox. The first opinion poll putting Fox in the lead, for example, resulted in an increase of spreads of 5.4%, and an opinion poll a month later confirming that trend resulted in another 5.6% increase. Additionally, concerns over the fairness of the election unsettled markets in June, just a month prior to the elections. Despite these concerns, Fox's victory in what was perceived by all to be a free and fair election caused currency, equity and bond markets to soar – spreads dropped more than 7.0%. There was confidence that his party's pro-market stance would mean a continuation of the policies of the PRI and further integration with the US given his relationship with corporate America.[130]

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[129] The announcement of Moody's decision brought down spreads a massive 12.9% in one day and a further 10% in the following days.

[130] Aside from previous elected political positions, Fox once served as the head of Coca-Cola Mexico.

In the days and weeks following the election, the market was less sanguine. Fox's announcement at the end of July that he would seek a 'harmony' government with the PRD drove up spreads almost 6.0%; in October, there was significant concern amongst analysts about the quality of Fox's political and economic appointments. Many of his ministers were former businessmen, with little practical experience in politics, and analysts became worried about their capability in managing the PAN's congressional minority and the historically unique position that the new PAN government found itself in. On the back of such fears, between 5 October and 13 October spreads increased 19% - from 312bp to 364bp.

The history of volatility in the Mexican financial markets in 2001 and 2002 underscores the same trends as in the previous years – the markets were concerned about Fox's inability to pass legislation through a divided Congress, the strength of his coalition and leadership over PAN ministers, relations with governors, and the implications of financial crises in Argentina, Turkey and Brazil, and buoyed by reports of further liberalisation and privatisation of the economy. To provide several examples, in 2001 infighting amongst Fox's ministers led spreads up 7.0%, the failure of Fox's tax reform legislation in the Congress increased spreads by 6.5%, and problems in the gubernatorial elections in Tabasco increased spreads by nearly 5.0%. In 2002, Fox's pleas to the Congress in his state of the union address for support of reform legislation moved spreads up more than 7.0%, allegations of PAN campaign finance irregularities during the 2000 election increased spreads 6.0% and charges by non PAN state governors that the government was favouring PAN states through opaque fiscal federalism rules increased spreads by 5.5%. Such examples provide

strong support for the hypothesis that democratic politicking under conditions of divided government in Mexico has increasingly become a source of major market volatility.

6.7 THE FUTURE OF POLITICAL RISK IN MEXICO

This chapter has sought to construct an argument that runs counter to commonly held beliefs about the stability of Mexican financial markets in the post-NAFTA, post-tequila crisis period. While the general perception is that Mexico's sound macroeconomic fundamentals, increasing integration with the US economy and democratisation should make it immune to political risk, this chapter has shown that Mexico continues to experience high levels of politically induced volatility, the sources of which are increasingly of a democratic and institutional nature. While the democratic reforms put into place since the beginning of the 1990s have changed the sources of political risk that investors of Mexican debt respond to the impact of political risk has remained relatively constant and in some cases increased in its importance vis-à-vis economic risk. Power sharing between the executive and the Congress in particular will continue to be a source of market volatility, as will the evolving relationship between leaders and their parties and between Mexico City and state and municipal governments.

Of the above, the friction between the Congress and the Presidency is likely to be the most problematic. As Lawson points out, none of Mexico's three largest parties is set to disappear in the coming years, and despite claims several years ago that the PRI was

destined for the dustbin of history (see for example Meyer 1989), the party has managed to reinvent itself and secure support without cooption to the surprise of many observers. Lawson states: "Multiparty presidential rule and the divided government that it brings are here to stay. Given permanent divided government, the quality of governance in Mexico will depend more than in most countries on the coalition-building skills of political leaders. If opposition-party elites prove obstructionist or recalcitrant, or if presidents prove unable to deal effectively with Congress, gridlock will prevail" (Lawson 2004: 149). This gridlock, in turn, will continue to impact the performance of Mexican bonds and other markets, such as currency. This tendency will be exacerbated if reforms that the market considers key, such as the privatisation of the energy sector, remain stalled. The mid-term elections of 2003, while beyond the formal scope of this analysis, augur poorly for Fox and for Mexican governance. The PAN lost 50 seats in the Chamber as well as losing one of its coalition partners, the Green Party (PVEM), to the PRI. As discussed in this chapter, Fox has been able to pass few of his major legislative priorities, and his administration has been plagued by an unusual level of infighting by Mexican standards.

Second, the relationship between Mexico City and state governments could also serve as a point of potential risk, especially if the imbalance between divested spending authority and revenue raising responsibility is not rectified. Mexico at present has no strict fiscal responsibility law, although through banking regulations, it is clear that the federal government is not obliged to bail out state debt (Webb 2004). This tendency for state-level overspend could be exacerbated by a proposal popular with politicians from all three parties: to change the no re-election clause for federal deputies and other

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politicians to increase professionalism and incentives for cross-party cooperation. An unintended consequence of this change could be that as Mexican politicians become more accountable to their constituents through the process of seeking re-election, their incentive to create a 'political business cycle' or to lobby for and secure pork-barrel projects is likely to increase, undermining fiscal discipline.

Aside from the consequence of greater horizontal and vertical power sharing, Mexican political risk in the future may also increase around elections. There are several reasons to expect that this could be the case. First, the 2000 presidential election was something of an anomaly given the pattern of economic crises surrounding elections in Mexico's recent history (Heath 1999). As was argued previously, crisis was in part avoided by Zedillo's ability to secure a contingency credit line from the US, IMF and other creditors nearly a year before the election. It is less certain whether Mexico would be able to secure such a line of credit in the future, especially as US priorities in the post September 11th world have shifted from Latin America. Second, the risk of the 2006 election being a rerun of the quasi-crisis surrounding the 2002 Brazilian election should not be dismissed out of hand. One of the front-runners for the presidency is Mexico City's former leftist mayor, Andrés Manuel López Obrador (AMLO). While AMLO's political upbringing does not resemble Lula's (he has a degree in politics and public administration and was formerly a key politician for the PRI in his home state of Tabasco until he broke with the party in 1989), the PRD's economic platform often resembles the Brazilian PT's, emphasising a nationalistic economic policy. His party's lack of experience at the presidential level, as well as the fact that its state power base is narrower than the PANs, could spark market jitters.

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And while this crisis may not impact sovereign bond spreads to the extent it did in Brazil given Mexico's substantially better public debt position, it could create substantial volatility and impact the value of the peso dramatically, in turn damaging the health of the economy.

Third, it is likely that beyond the 2006 elections, whatever the outcome, electoral volatility in Mexico will continue to increase, providing additional reason for market volatility. As Klesner has effectively argued, the dynamics of party political allegiance in Mexico have changed: whereas opposition parties used to identify with people of a certain ideology ilk, parties have now realigned themselves on a pro and anti regime axis, with the PAN vs. PRI dynamic in the north and a PRD vs PRI dynamic in the south (Klesner 2005). Mexican voters will choose whichever politician they believe most competent, with their pro or anti regime stance strongly affecting their perception of competence. Supporting this, Lawson notes that only two thirds of Mexicans claim allegiance to any given party, and only a quarter claim to be 'strong' supporters of a party (Lawson 2004: 145). Finally, the lack of coordination in the scheduling of national, state and local elections will increase the number of incidences of electoral uncertainty more than in a country with closely coordinated elections.

In sum, the above provides a picture of political risk in Mexico on a rising trajectory, in contrast with the (qualified) optimistic view of a decline in Brazilian political risk. This will largely depend on how future Mexican presidents and their political parties manage divided government and coalition building as well as their ability to undertake political reforms which will rectify above-mentioned imbalances in the system. It also

largely depends on the realism of investors about the risk of an AMLO presidential

victory in 2006; that is to say, whether the lessons of Lula's 2002 election have been

learned. As one participant in the telephone interviews commented:

> There is absolutely a possibility of AMLO winning the election, and his chances of winning are very substantial... I think that we are short-changing the political risk. That said, I suspect if the markets start to discount an AMLO win by increasing the spread, generating capital flight and just generally being obnoxious, he will come out with the pleasant 'mooing' sounds that we are used to from people like Lula. He is smart enough to know that he doesn't want to fight with the foreign bankers and the PRI at the same time (Santandar 2005).

Chapter VII

Understanding And Managing Political Risk

7.1 Introduction

This thesis began with a discussion of the globalisation of financial capital and its constraint on domestic policy in the developing world. The theory and evidence presented in this thesis shows that financial markets place an additional constraint on developing countries by penalising them for the process of democratic politics. By overlooking the role of politics in financial market performance, those who have sought to understand debt premiums, market volatility and financial market behaviour such as clustering and herding were missing a key explanatory variable. Both the price at which emerging market countries borrow on the international capital markets and the volatility in the performance of traded debt are strongly affected by political variables, including the contestation over power and policy that is a natural by-product of democratic systems of governance. This chapter attempts to review the findings of the thesis (in section 7.2) and detail the implications of these findings (in section 7.3). There are three sets of stakeholders potentially interested in the findings: policy makers in developing countries, international policy makers and investors in emerging market assets. Thus, section 7.3 describes several options for minimising political risk applicable to each group. The penultimate section of this chapter sets out an agenda for future research (7.4). Three strains of future work are suggested: further studies on emerging market and industrialised countries not covered in this thesis, expansion of

the model designed in Chapter IV to look in greater depth at the impact of volatility on market performance and further research on the theoretical claim that institutions have a direct rather than secondary impact on financial market performance. Concluding thoughts are provided briefly in section 7.5.

7.2 SUMMARY OF FINDINGS

The central hypothesis of the thesis outlined in section 1.3 had two parts: 1) that political risk is higher in democracies with numerous and diverse veto players because contestation in such polities is higher and 2) that higher levels of contestation increase the incidence of political news, which due to its unique characteristics vis-à-vis economic news, will have a strong and typically negative impact on sovereign bond spreads and sovereign bond market volatility. Theoretical justification for part one of this hypothesis was provided in sections 2.3 of Chapter II that explained political risk as a by-product of veto players. I argued that in democracies where there are numerous, diverse and internally fractionalised veto players, the process of contestation over policy and resources appears 'chaotic' to investors, characterised by high levels of uncertainty and instability.

As a corollary, and to support the second part of the hypothesis above, I argued in section 2.4 that the process of contestation generates political news, which may not be 'efficiently' processed by investors, in turn leading to financial market volatility. In contrast to the expectation of the EMH that all relevant news is accurately and quickly priced in (Fama 1970), three characteristics of political news were highlighted as

potentially problematic. First, political news is unexpected both in content and timing of release (section 2.4a). Second, it is difficult to quantify (2.4b) and third, political news suffers from problems of credibility and certainty (section 2.4c). All of these characteristics imply that the markets may respond strongly to political information. Insight from financial theorists on the disproportionate impact of ad hoc information on market behaviour, in particular, were highlighted (Almeida, Goodhart et al. 1998; Gai and Shin 2003).

Support for this central hypothesis formed the bulk of Chapters IV, V and VI, though additional support was provided in sections 3.3 and 3.4 of Chapter III via content analysis and survey data. In Chapter IV, I demonstrated that political variables related to the quality of a country's veto players (checks and balances, polarisation and fractionalisation) helped to explain the variation in sovereign bond spreads amongst a group of 17 emerging market countries. Based on traditional models of sovereign debt spreads which have focused on macroeconomic indicators (Edwards 1984; Min 1998; Ferrucci 2003), I designed a model which included both macroeconomic factors as well as variables measuring political institutions. This 'politically informed' model not only helped to better explain the variation in debt spreads amongst countries, it also showed that political institutions have a stronger impact on spreads than other variables, and provided support for the hypothesis that institutions impact financial market performance directly.

In Chapters V and VI, after introducing the characteristics and power distribution of the Brazilian and Mexican political systems in some depth, I undertook a volatility

analysis that established the determinants of Brazilian and Mexican volatility from 1991 to 2002. The analysis showed clearly that aside from contagion, contestation among veto players is the strongest determinant of financial market volatility, both in terms of its accumulated impact as well as the maximum volatility generated by political events.

Through the process described above, I answered the main research question as well as the three smaller research questions outlined in section 1.3 of Chapter I – what is political risk, what role do institutions play in generating political risk and what is the impact of political risk on financial markets? Political risk in democratic countries is the uncertainty and instability resulting from regime change as well as contestation amongst veto players. Institutions play a direct role in generating political risk because they dictate the level and type of contestation in a political system. The impact of political risk on financial markets is strong – and it has an impact on both the risk premiums that countries pay to borrow as well as the amount of volatility in financial markets.

There are three accomplishments of the thesis worth highlighting in more detail. First, the thesis provided a new definition of political risk adding to what is generally an under-theorised field. Traditional definitions of political risk have focused on uncertainty and instability arising from extra-constitutional regime change, violence and a narrow array of political variables (such as elections and cabinet dissolutions). While these political variables are undoubtedly important (as shown in empirical work in the thesis), it was suggested that uncertainty and instability in democratic polities

also arises via the process of policy and resource contestation. This definition drew on the findings of institutional political economists, and particularly on the work of Tsebelis, who has suggested that the distribution of veto players is an important determinate of policy outcome and regime stability in democratic states (Tsebelis 2002). Additionally, the distribution of power among vertical layers of government was hypothesised to be important, especially as many emerging market states have decentralised both political and fiscal powers to state and provincial governments in the past two decades.

This expanded definition of democratic political risk was then tested through two studies in Chapter III: content analysis of investment bank research report and a survey of investment bank research analysts. Both provided strong support for the hypotheses that political risk includes complex democratic variables, that political variables are equally important in determining asset value as macroeconomic variables, and that the importance of political analysis has been increasing. First, content analysis of nearly 1,000 pieces of emerging market research was completed, which showed an increase in the number of news items that were focused on political variables during the period 1998 to 2003. Whereas less than 30% of variables were of a political nature in the early years of the dataset, by the later years, political variables routinely accounted for more than 60% of such analysis. Additionally, this research demonstrated that political analysis is central to perceptions of assets across countries. Complex democratic political variables providing information about checks and balances and federalism were of high importance to such analysis, comprising some 36% of all political news reported in such reports.

Additionally, a survey of more than 40 investment bank research analysts confirmed the results of the content analysis: 83% said that they view political variables as 'highly important' to their analysis and an equally high percentage thought that political variables were important to asset value regardless of prevailing macroeconomic conditions. The survey participants also provided support for the definition of complex political risk suggested by citing a diverse array of variables as important for their analysis of emerging market assets. Insights from this survey also bolstered other hypotheses and methods of the thesis, such as the difficulty in quantifying political variables and the centrality of news to political risk, though this evidence did call to question the assumption that the importance of political information has been increasing over time.

The second accomplishment of the thesis is that it attempted to expand the relevance of institutional analyses of political economy by demonstrating that institutions have a direct rather than secondary impact financial market performance. Rather than seeing political institutions as important for their eventual impact on macroeconomic outcomes, it was suggested that the process of politicking in countries with institutions in which power is highly diffused generates political news, which impacts the performance of financial markets in the form of political risk. A direct causal mechanism between democratic politics and financial market performance was therefore suggested in section 2.3 (and illustrated in figure 2.2) which was later tested in the econometric model in Chapter IV, and in the case studies contained in Chapters V and VI. This finding reinforces and expands theories of institutional political

economy by articulating a new means through which institutions are important in the global political economy. Political institutions are best understood in this context as news producing mechanisms and therefore strongly condition the likelihood of political risk.

Third the thesis showed that one of the primary drivers of volatility in financial markets is the contestation amongst domestic political actors – something that previous research on financial market volatility has rarely focused on. In fact, it showed that over the course of 12 years, macroeconomic news has had no net impact on spreads in either Brazil or Mexico. In contrast, political information has had a strong accumulated and negative impact on spreads. The relationship between the president and the Congress is particularly important for determining political risk, though vertical distribution of power has also been a determinant of volatility throughout the period. The volatility analysis on Brazil demonstrated that political risk has been strong outside of well known incidences, such as the debt moratorium by Governor Itamar Franco in 1999 and the presidential elections of 2002. In fact, the relationship between Brazil's highly fractionalised legislature and the Brazilian president has served as a major source of political risk throughout the 1990s and early years of the 21st century. While Brazilian presidents have to some extent limited the impact of political risk by passing laws encouraging party discipline, fiscal discipline amongst sub-national governments and using their extraordinary powers to obtain support for policy initiatives, political risk in Brazil is unlikely to fade substantially in the coming years. This is especially likely to be true given the difficulty that the Lula administration has had in enforcing discipline amongst the historically cohesive PT,

and by the fact that there is a possibility that the Brazilian left will radicalise after the experience of the Lula administration.

Mexico proved an exceptionally interesting case for two reasons. First, the general perception that political risk in Mexico is no longer relevant given the country's integration with the US proved to be false: volatility in Mexico was strongly determined by its political institutions. Second, the democratic reform that took place in Mexico during the period of observation allowed for a comparison of the impact of extra-constitution political risk and democratic political risks. While the extra-constitutional, violent risk that Mexico experienced in 1994 generated a very high level of volatility and contributed in no small part to the commencement of the tequila crisis, the democratic political risk which characterised Mexico in the later half of the 1990s centring on the relationship between the Congress and the president as well as the relationship between Mexico City and state governments strongly impacted daily volatility. This provides significant support for the differentiation between types of political risk in the two archetypal regimes presented in Chapter III. The degree to which the Mexican market has responded to democratic political risks was surprising – since 1997, the aggregate impact of Congressional and vertical politicking has been almost as strong as in Brazil since the early 1990s.

The prospect for political risk driving spreads volatility in Mexico was also discussed, with little optimism for a decrease in political risk. The return to constitutionally mandated checks and balances with the democratic political reforms of the late 1990s implies that future Mexican governments will have a long period of adjustment in

learning to manage conditions of legislative minorities and divided government. Additionally, the prospect of the PRD taking power in a future presidential election could create a situation akin to that in Brazil in 2002: high volatility around the election of a leader whose credentials are not nearly as pro-market as the financial markets may like.

Thus, through several different methodologies, this thesis has provided support for the hypotheses articulated in the introductory chapter that political news has a strong impact on financial market volatility, and support for the hypothesis credibility is adversely affected by the proliferation of veto players in emerging market democracies, and on the other extreme, by the complete lack of veto players in autocratic regimes, confirming previous hypotheses of a parabolic relationship between credibility and veto players. What can be generalised from these findings? How applicable is the definition of political risk here articulated to emerging market countries outside of the Latin American region? First, the econometric study in Chapter IV demonstrates that political institutions are important determinant of sovereign debt spreads in a variety of countries, including those in Central and Eastern Europe, Northern and sub-Saharan Africa and the newly industrialised states of Asia – and that proliferation of veto players negatively impacts credibility after a certain 'turning point.' , What can be said about the connection between political risk and financial market volatility in other countries, given that the empirical testing in Chapters V and VI only focused on Brazil and Mexico? Some reassurance that similar results would be obtained by looking at other emerging market countries with highly diffused power bases is provided by the fact that Brazil and Mexico serve as counter cases. While in the case of Brazil high

levels of democratically derived political risk was expected, in Mexico, the impact of democratic politics is generally perceived as low. As the conclusions from the volatility analysis proved this to be false, it seems reasonable to assume that in other cases in which political risk is expected to be low (e.g. some Asian states) that political variables actually drive financial market volatility to a large extent. This case also suggests that the impact of democratic political risk is different than that in the autocratic period – it occurs with less frequency though individual events have a less strong impact on the whole.

It is also worth asking whether the results in this thesis are likely to hold for non-portfolio investment such as FDI. While the thesis does not investigate the sources of perceived political risk amongst foreign direct investors, it is plausible that their concerns about investing in emerging market democracies are similar to those of portolio investors, and that therefore they are interested in complex democratic politics. However, it would be surprising if individual news events in democracies had such a strong impact on fixed investment flows, given the more long-term nature of this type of investment. While investors of FDI might be interested in democratic political risks, there investment decisions are unlikely to be as strongly driven by the 'noise' created from the policy process in emerging market democracies. Confirming this hypothesis would require additional econometric work to measure the impact of institutional variance, including checks and balances, on FDI in and outflows.

7.3 POLICY IMPLICATIONS

The institutional nature of the argument presented in this thesis may seem deterministic, with few policy implications for politicians that have to take the distribution of power within their political systems as a given. However, there are a number of practicable strategies for limiting the impact of political risk on borrowing rates and market volatility. These are desirable for policy makers interested in limiting the impact of perceived political risk and for financial market participants interested in more predictable and efficient markets. Thus, there are three potential audiences for the implications from this thesis: policy makers in developing countries (whether middle income emerging market nations or lower income countries that hope to pursue a path of financial liberalisation), international policy makers in institutions like the International Monetary Fund and Bank of International Settlements and emerging market investors. Implications for each group are outlined in sections 7.3a-7.3c below.

7.3a For domestic policy makers

My analysis in this section is broken into three types of strategies for mitigating political risk: the standardisation of political news releases, domestic reforms with positive externalities for market performance and financial market innovations. As section 2.4 of Chapter II discussed in length and empirical research in Chapters IV, V and VI corroborated, the unexpected timing and presentation of political news in part explains why it has the tendency to lead to such high volatility. While the nature of political news release makes it much harder to standardise than macroeconomic news, there are two examples of 'standardisation' of political news arising from the Mexican case that could be expanded to other practices and countries. First, the President's

State of the Union address in the autumn of each year provides a predictable platform for the announcement of government strategies and policy priorities for the year. Information in Chapter VI, section 6.6 showed that analysts routinely discuss the likely contents of this address prior to the speech itself (usually with some leaks from the government), in turn helping financial markets to anticipate new policies. Brazil, in contrast, has no such highly publicised forum for executive level announcements of policy priorities, exacerbating the extent to which presidential policy announcements seem ad hoc and unpredictable.

Additionally, the Mexican budgetary process, though consistently generating high volatility since 1997, has a predictable timetable for Congressional introduction and approval, facilitating analysis. Over time, the expected impact of budgetary proceedings on Mexican financial volatility should decline as successive Mexican congresses continue to pass the budget in time to meet the 31 December deadline and avoid constitutional crises. One potential policy strategy to minimise this volatility would be to extend the period of Congressional review by several weeks to a month. In individual country cases, there are likely to be other types of political information which could be standardised: in the US, for example, discussions between the White House and the press are well structured and standardised. While this suggestion may not be appropriate for all cases and would not eliminate all unpredictability of political news, it could help to decrease political volatility in some cases.

The second strategy for mitigating political risk applicable for this group involves identifying domestic political reforms that have a positive externality of reducing

political risk. As seen in the case studies of both Brazil and Mexico, certain types of reform measures and new laws have been effective in limiting the impact of highly divergent and fractionalised veto players on political risk, while improving democratic governance. The change in Brazilian legislation preventing party switching in the run up to elections in 1998 will help to curb incentives for such behaviour in Brazil to some extent. Stricter laws on party switching or informal institutions that help to curb it (such as those that exist in the PT) may increase party disciple and therefore decrease the political risk that is currently a result of the fractionalisation of the legislature. Additionally, fiscal discipline laws for state and municipal governments in both Brazil and Mexico should make a significant contribution to reducing the likelihood of fiscal profligacy in sub-national governments, thereby decreasing potential episodes of political risk stemming from announcements by governors or municipal administrators of poor fiscal positions.

In the case of Mexico, as discussed within sections 6.2 and 6.7 of Chapter VI, the Mexican constitution does not allow re-election of Mexican deputies, which may decrease incentives for members of different parties to form and maintain coalitions. A democratic reform bill to permit re-election could enhance the possibility of cooperation between parties and individual legislators by providing them a long term view (i.e. creating a situation in which legislators of opposing parties see their interaction as a 'repeated game'), thus reducing the internal fractionalisation of coalitions and its consequent political risk. Thus, reform measures that are desirable for the enhancement of democratic practice may be beneficial for the reduction of financial market volatility. While the constitutionally mandated powers of individual

veto players cannot and should not be changed for the benefit of secure credit, reforms that make governance easier and enhance the time horizon of key players could have a positive externality of reducing both sovereign debt premiums and financial market volatility. While these benefits may not be central to discussions of such reform within the context of domestic politics, it is useful for policy makers to consider such impact when evaluating between costs and benefits of such reform.

The third category of recommendations for mitigating political risk is risk-reducing innovations in financial practice. These options are likely to be highly desirable given their direct link to the problem of financial market premiums and volatility, and because they may incur less domestic political resistance than the suggestions mentioned above. A recent major innovation in emerging market finance is international bond issuance in domestic currencies. To date, at least three countries have issued international bonds in their domestic currencies: Uruguay in 2003 and again in 2004, Colombia in 2004 and Brazil for the first time in September 2005 (Tovar 2005). While countries who have issued this type of debt have paid higher interest rates than they would to pay borrow in US dollars or euro, this type of borrowing does away with 'original sin', a major source of ongoing political risk as discussed in section 3.2b, by reducing the currency risk. This practice should be encouraged: locally denominated bonds will become more creditworthy over time and in turn the differential in borrowing costs will be reduced. An additional useful strategy for minimising political risk may be for governments to encourage the further development of a sophisticated domestic financial industry (including in country teams of traders, analysts and researchers). Financial market participants who are country

nationals and are stationed within a country may be better equipped to make rational judgements about the political risk arising from personalities or processes than teams of analysts and traders based in New York or London.[131]

7.3b For international policy makers

While section 7.3a above provided suggestions about how domestic policy makers may be able to minimise the impact of politics on sovereign debt premiums, there are also some policy implications for international policy makers arising from the research presented in this thesis. The econometric work in Chapter IV and the volatility analysis in Chapters V and VI demonstrated that politics has a strong impact on the performance of emerging market sovereign bond markets. Further innovations in research into the *political* determinants of premiums and volatility should be pursued by institutions such as the IMF, complementing the recent increase of research on governance and institutions. The IMF has financial resources and access to information that would help to design finely calibrated political models of market performance. Additionally, its research may have more gravitas in convincing financial market participants of needed changes to trading and investment behaviour. Undertaking a major programme of research into this field would require hiring more trained political scientists to complement the work being done by economists. While the World Bank has gone some way towards this by starting a programme on political economy, the IMF has as of yet resisted this trend.

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[131] This is true regardless of the 'death of distance' (Cairncross 1997) that globalisation may imply.

The IMF also has a role in determining the regulation of global financial capital which is important for this discussion. The ability of financial capital to move liberally in and out of emerging market countries is partially to blame for volatility. Additionally, the fact that certain financial players (such as hedge funds) can profit from negative volatility exacerbates the tendency for inefficient markets. Since there is little profit to be made on economic announcements (which as has been seen create limited volatility), some types of financial market participants may stand to gain from markets that continue to process political information inefficiently. Additionally, the lack of regulation for hedge funds, including the lack of transparency about holdings of assets, size and investment strategies, is highly problematic for an international capital market system in which access to information has consistently proven to be beneficial for the appropriate allocation of risk. Given the relatively high regulation of other types of financial market participants, and the role that hedge funds have played in generating major financial market crises in the emerging market world, it is worth investigating the implications of this lack of regulation on financial market performance and political risk.

7.3c For financial market participants

The most concrete implications of this thesis are for the third class of stake-holders: financial market participants. The empirical work throughout this thesis has shown that fundamental misunderstandings and mistrust of politics drives risk rates and volatility to a significant degree, and that such outcomes are exacerbated by the limited role that politics play in generating long-term quantifiable predictions of asset value.

Improving methods for processing political information, including the design of models that attempt to explicitly quantify political variables, could do much to reduce loss-making volatility, and could benefit emerging market borrowers. Given the high number of qualified political scientists working in the field of emerging market research, it is surprising that a greater effort has not been made to utilise large comparative institutional datasets (such as the DPI) to generate models which are calibrated for political 'fundamentals' as well as macroeconomic fundamentals. This is a particularly important recommendation for rating agencies like S&P and Moody's, whose credit ratings already contain a degree of political analysis (as demonstrated by the quote on page 44) and whose sovereign risk ratings are powerful, widely used benchmarks throughout the financial industry (Sinclair 2005). Some political risk insurers and political risk consultancies have began to generate models that are calibrated to include political variables; in such models, political variables generally account for nearly 50% of the total inputs.[132] In the case of banks, funds and trading houses where there is not sufficient expertise or resources to build politically calibrated proprietary financial models, the use of political risk consultancies can act as a substitute. Firms should seek to utilise information from political risk consultancies in which political information incorporated in models is driven by political theory and includes information about institutions and other complex political variables, sensitised by political scientists.[133]

A second strategy for minimising the inappropriate assignment of political risk is to increase the interface between emerging market investors and politicians and

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[132] Author's own experience with insurers and political risk consultancies.
[133] The Eurasia Group is one such example.

candidates in developing countries. While politicians may think it is an anathema to consider international capital a 'constituent', politicians routinely meet with business leaders from various industries, and the financial industry should be no exception. Clear communication between politicians and financial market participants would help to minimise the uncertainty of political information, and personal interactions wherever possible would increase the credibility of such information. Finally, mirroring the suggestion in section 7.3a for governments to promote the development of local financial industry, investment banks would benefit from utilising their regional offices as centres for emerging market research and trading, so as to enhance the quality of political information received and utilised.

In sum, there are three well defined groups for which the implications of this thesis may be of interest: policy makers in developing countries, international policy makers and investors of emerging market assets. There are ways in which all three groups can seek to minimise the extent to which political information generates risk premiums and market volatility including reforms to democratic governance with positive externalities for market performance, improvements in the ability of actors to process and utilise political information and financial market innovations such as international bonds denominated in local currency. All should be given serious consideration if the 'black box' of political risk is to be opened.

7.4 AGENDA FOR FUTURE RESEARCH

Before concluding in section 7.5, this section outlines three broad streams of future research which arise from the analysis contained in the thesis: analysis of political risk in countries not discussed in this thesis, and in particular in selected industrialised countries such as the EU, the necessity for further research on the blended political and economic model proposed in Chapter IV and further theoretical work in institutional political economy, drawing on the hypotheses of this work.

First, it is clear that more clarification is necessary about the role of political risk in advanced industrialised countries since authors have found contrasting conclusions about its impact. Most claim it has limited impact, though some have found that elections and cabinet reshuffles have a strong effect. In particular, it would be interesting to study the impact of political risk in Europe, given the unique degree to which political power in Europe is divided amongst a number of veto players: subnational, national and supra-national. The impact of individual member state political risk on joint assets, such as the Euro, would be of interest, as would the impact on European wide political risk, such as decisions reached by the European Commission of Parliament. It could be hypothesised, for example, that the euro is likely to suffer from higher political risk than the US dollar given the more complex political structure underpinning its credibility. Additionally, by applying these findings to the case of European bond markets, it may be possible to conjecture how the markets would price supra-national European bonds, should they ever be brought to market.

Within this same stream of future research, it would be interesting to apply the methods devised in this thesis directly to other emerging market states, and particularly, to those in Asia where political risk may take different forms, to test whether the hypotheses hold as strongly. A further study on the role of political risk in quasi-democracies or autocracies would be interesting, particularly as the number of new issuers in this type of state continues to increase given favourable global credit conditions. A follow up study on the impact of political risk on the Mexican and Brazilian markets in the wake of the 2006 presidential elections to be held in both countries is necessary, especially given the large number of elections occurring in Latin American during this year (12), the perceived re-emergence of the 'left' in Latin America and the leading position of AMLO in the Mexican polls.

In the second stream of future research, there is a strong need to build upon the findings of the model in Chapter IV and the volatility analysis in Chapters V and VI. First, the impact of political news on financial market volatility should be tested econometrically using high frequency financial·market data (e.g. five minute data) so that the conclusions are more comparable to previous work done on the EMH. This would provide greater insights into ways in which political information are utilised and incorporated into asset prices. Second, the model generated in Chapter IV should be used to forecast bond prices in a manner akin to the model by Goldman Sachs in the paper reviewed in section 4.3 (Goldman Sachs 2000). This exercise could be further expanded to see whether a volatility model of the type described directly above is predictive. These tests could have wide ranging impacts on the way that financial market participants analyse and price risk.

The third and final stream of proposed future research is further exploration of hypothesised direct relationship between political institutions and financial market behaviour. There are numerous ways that this research agenda could be expanded. First, the reaction of other types of markets, especially currencies, to news generated by political institutions rather than economic outcomes determined by politics should be tested. Second, a much more elaborate research agenda would focus more broadly on the implications of these findings on the market's understanding and interest in politics. The thesis has demonstrated is that the market is interested in political events, though not necessarily in the underlying structural changes in politics and policy. This reaction of markets is instinctive, rather than considered, which has implications about the depth of political understanding of traders. The depth of this understanding could be tested further through more substantial surveys and interviews of non-research market participants. Third, the thesis has not investigated whether market participants become desensitised to reoccurring political news in the same polity over time. Such a finding would suggest that the process of democratic politicking is of interest if the news about it is unexpected, closely conforming to the Efficient Markets Hypothesis. Once one can accurately anticipate that for example Mexico's budgetary process will always be hotly contested in December, the news will cease to be of interest to perceptions of creditworthiness, and will therefore cease to be priced in.

7.5 CONCLUDING THOUGHTS

Reliable and affordable access to capital is a central concern for policy makers in the developing world. Political risk premiums and financial market volatility constrain governments ability to dedicate resources to social and political goals. Thus minimising risk premiums and volatility are critical for advancing the development of emerging market countries. To address these two inter-related problems, two pre-conditions must be met. First, the sources of risk premiums and volatility must be identified and thoroughly investigated. Second, political will must be present to make changes to the structure of global finance. This thesis has taken one small step towards identifying an often overlooked source of risk premiums and financial market volatility: democratic politics. Generating political will for reform is a next step. It is crucial that reform to the international financial system, involving both public and private actors, become central to discourse on development in the coming years.

LSE

Survey on Political Risk
in Emerging Market Research

Prepared by Lauren Phillips

IMPORTANT
The following information is for the purposes of the researcher only and will not be released to third parties.

Name	
Title	
Firm	
Division	

PART A - General

1. When analysing an emerging market country or asset, **how important** do you consider its political situation to be?

   No Answer ▼

2. Which best describes the **weighting** you give to political risk vis-à-vis economic risk when analysing an emerging market country or asset?

   No Answer ▼

3. Is the importance of political variables conditional on **macroeconomic conditions?**

No Answer	▼

4. Which **political variables** are you interested in when analysing a country, if at all? You can select more than one.

Elections	▲
Political violence or unrest	
Legislative politics	
Ministerial politics	
Coalition politics	▼

5. Do you consider political risk to be something separate from **policy risk?**

No Answer	▼

6. If you include political variables in your analysis, what are your primary **information sources**? You can choose more than one.

Don't use political variables	▲
New spapers, Bloomberg, Magazines, etc...	
Discussions w ith government officials	
Discussions w ith others in country	▼

7. If you consider political variables in your analysis, does your firm have a model that **quantifies their impact** on asset value or economic outlook?

No Answer	▼

8. In which **regions** are you especially concerned about political risk? You can choose more than one.

Latin America	▲
Emerging Asia	
Africa	
Middle East	▼

PART B - Political Risk Over Time / Across Firms

9. Rate the importance of political risk in emerging market research today, in comparison to **10 years ago.**

   [No Answer ▼]

10. Rate the importance of political risk in emerging market research today, in comparison to years prior to the **Asian Financial Crisis**.

    [No Answer ▼]

11. The importance of political risk to your analysis in **comparison to the industry** is:

    [No Answer ▼]

12. Do you, or others in your immediate research team, have formal university level **training in political science**, public policy or international relations?

    [No Answer ▼]

PART C - Country Ratings

Please try and answer the following questions in a **general manner** rather than with reference to present circumstances.

13. The impact of **Brazil's** political situation on the outlook for its economy or asset value is:

    [No Answer ▼]

14. The impact of **Mexico's**

    [No Answer ▼]

political situation on the
outlook for its economy or
asset value is:

15. The impact of **Russia's**
political situation on the
outlook for its economy or
asset value is:

No Answer ▼

Additional information or Comments?

Please indicate in the space below whether you would be willing to
discuss political risk further in a telephone interview with the researcher.
If you are based in London, an in person interview could also be
arranged. Additionally, please add any comments here.

APPENDIX II

Survey Participants[134]

Adriana Dupita: Economist. Economic & Market Analysis, Citigroup.
Alberto Ramos: Senior Economist. Global Investment Research, Goldman Sachs.
Anna Gaworzewska: Senior Economist. Group Risk, Lloyds TSB Bank Plc.
Chetan Ahya: Executive Director. Economic Research, Morgan Stanley.
Chip Brown: Managing Director. Latin American Economics and Fixed Income Derivatives, Santander.
Christine Shields: Head of Country Risk and Emerging Markets. Group Economics: Royal Bank of Scotland.
Claudio Piron: Head Asia FX Strategy. Economics Research: JPMorgan.
Dave Murray: Managing Director Global Emerging Markets Research. Global Markets: Deutsche Bank.
David Fernandez: Managing Director. Economics Research: JPMorgan.
Debbie Orgill: Senior Economist. Global Markets: ABN Amro.
Don Hanna: Group Head. Economic & Market Analysis: Citigroup.
Donald McLauchlan: Director. Emerging Markets Research: UBS.
Eric Chaney: Chief Economist, Europe. Research: Morgan Stanley.
Gabriel Sod-Hoffs: Vice President. Global commodities and currencies: JPMorgan.
Gordon Smith: Group Economist. Economic & Market Analysis: Citigroup.
Hector Chavez: Chief Economist, Mexico. Research: Santander.
Jankiel Santos: Senior Economist, Brazil. Global Markets: ABN Amro.
Javier Santiso: Chief Economist. Economics Research Department: BBVA.
Joachim Klement: Economist. Wealth Management Research: UBS.
John Calverly: Chief Economist. Emerging Market Research: American Express.
Jonathan Garner: Managing Director, Head Emerging Markets Strategy. Equity Research: CSFB.
Mario Mesquita: Chief Economist, Latin America. Global Markets: ABN Amro.
Marco Ghiringheli: Unknown. CSFB.
Olgay Buyukkayli: Economist. Economic & Market Analysis (CEEMA): Citigroup.
Oliver Weeks: Unknown. Morgan Stanley.
Oussama Himani: Director. Emerging Market Research: UBS.
Rohini Malkini: Economist. Economic & Market Analysis: Citigroup.
Rory MacFarquhar: Executive Director. Economic Research: Goldman Sachs.
Sin Ben Ong: Vice President. Economic and Sovereign Research: JPMorgan.
Sophie Payot: Associate. Global Investment Strategy: UBS.
Stefan Hoffer: Emerging Market Analyst. Emerging Market Research: UBS.
Swati Sawhney: Junior Economist. Emerging Market Economic & Market Analysis: Citigroup.
Vincenzo Guzzo: Senior Economist. Economics and Equity Research: Morgan Stanley.
Walter Mitchell: Analyst. Fixed Income Research: CSFB.
Yarkin Cebeci: Vice President. Economic Research: JPMorgan

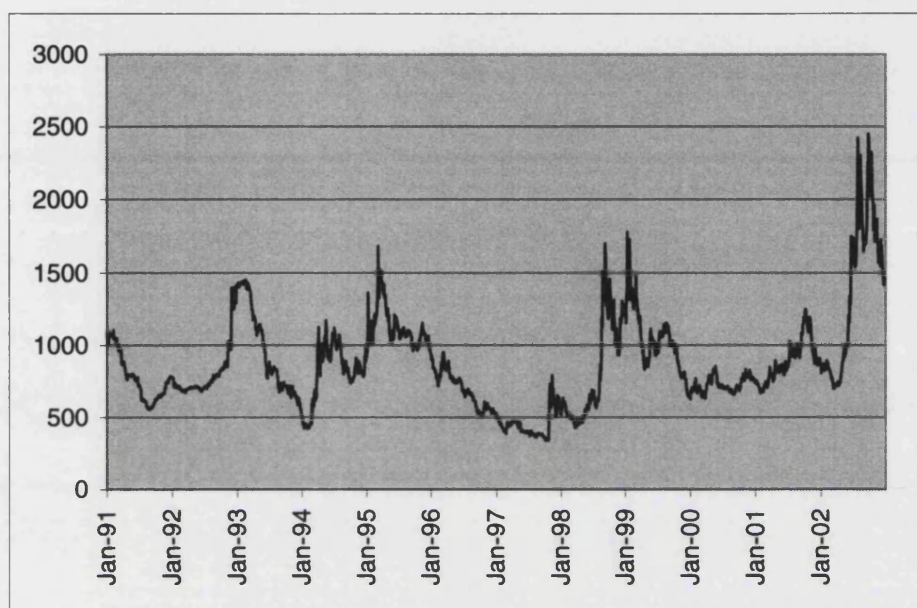[134] Six participants declined to provide their name when submitting their surveys, and thus, they are not included here.

APPENDIX III
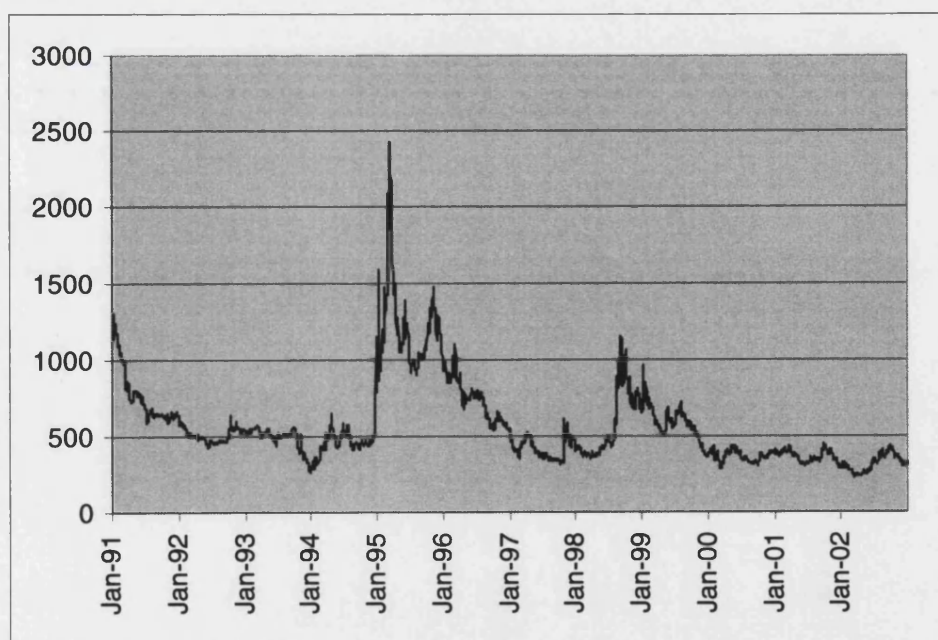## Brazilian and Mexican Sovereign Bonds: 1991-2002

Figure A.1 Brazilian bond spreads 1991-2002 (in basis points)
Source: EMBI (1991-97) and EMBIG (1998-2002)

Figure A.2 Mexican bond spreads 1991-2002 (in basis points)
Source: EMBI (1991-97) and EMBIG (1998-2002)

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