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Speak Clearly and Carry a Big Stock of Dollar Reserves

Sovereign Risk, Ideology, and Presidential Elections in Argentina, Brazil, Mexico, and Venezuela

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Partisan theories of political economy expect that bondholders will panic with the election of a left-wing presidential candidate. The latter seems to be what happened in Brazil in the 2002 presidential elections. However, quantitative analysis of perceptions of sovereign credit risk in Argentine, Brazilian, Mexican, and Venezuelan presidential elections from 1994 until 2007 shows no real evidence of a link between partisanship and perceptions of risk, even if the left-right divide is further broken down into left, center-left, center-right, right. Instead, international and domestic economic fundamentals have a stronger influence on risk evaluations. Qualitative analysis of the individual presidential elections shows the importance of policy uncertainty in explaining why certain electoral periods seemed more critical than others and how bondholders select between multiple equilibria. This research helps shift political analysis away from partisanship and more in the direction of policies and articulation.

Keywords: *partisan theories; political economy; political uncertainty; sovereign risk; Latin America*

Bondholders panicked when Lula da Silva was likely to win the Brazilian presidency in 2002 but had no such concern during his

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re-election bid in 2006. Nor did the victories of left-leaning Cristina Fernández in Argentina or even the re-election of Hugo Chávez in Venezuela have much of an effect. The most recent literature argues that it is not the left per se but a shift to the left that leads to concern among bondholders (Vaaler, Schrage, & Block, 2006). This would explain the reactions to the aforementioned elections but not the lack of response to Andrés Manual López Obrador almost winning the presidency in Mexico in 2006. An alternative answer might be that risk was minimal because international economic conditions were highly favorable to commodity producers and international reserves were considerable (Singh, 2005). But does this explanation hold up over time, particularly during episodes of depressed global liquidity and demand for commodities?

This article finds that, contrary to much of the political economy literature on the subject, party ideology is not an important determinant in movements in sovereign risk during presidential elections in emerging markets, whereas external vulnerability, global appetite for risk, and predictability of policies are. Based on financial data during national elections in Argentina, Brazil, Mexico, and Venezuela between 1994 and 2007, the article uses a multimethod approach of qualitative, historical analysis of electoral campaigns combined with quantitative, statistical analysis of bond spread movements, partisan ideology, party system institutionalization, reserves, and other factors.

The article begins with brief reviews of partisan and structural approaches and the role of uncertainty in explaining election-related outcomes. It then explains the data and classification of elections used. The subsequent section presents quantitative and qualitative analyses, with the intention of testing theories emerging from perspectives that emphasize partisan identity, global conditions, and policy uncertainty. Most specifically, it quantitatively tests the following hypotheses based on the partisan approach, which bondholders perceive: a victory of the left as negative; a shift from right to left as negative; left to right as positive; and left to left as neutral; a distinction between left, center-left, center-right, and right; and so on. An additional variable measuring party system institutionalization is included to see if this conditions partisan response. Statistical analyses also test assumptions of the importance of global conditions and domestic vulnerability by including in the model international reserve holdings, market volatility, and commodity prices. Historical analysis of each electoral episode complements and advances the statistical tests by indicating that interactions between policy uncertainty and external vulnerability, not partisanship, explain variance in perception of sovereign risk during elections. The inclusion of qualitative analysis is important in contextualizing political phenomena to explain why outcomes differ when international market conditions appear to be similar.

Elections and the Economy: Theoretical Models

No single theory can explain the complex relationship between political moments, such as elections, on financial and economic variables. The central claim in this article is that a combination of global economic conditions, local foreign currency reserves, and domestic policy uncertainty, rather than partisanship and ideology, provides the most complete understanding of the relationship between elections and the economy in a globalized world.

Partisan Models

Although classical partisan models of political economy emphasize how the partisan identity of a government affects economic indicators in developed countries (Alesina, Roubini, & Cohen, 1997; Hibbs, 1977), recent contributions analyze developing countries and give more attention to the way that electoral periods affect financial markets as opposed to macroeconomic indicators. Using financial market data from 1975-1998 for 78 developing countries, David Leblang (2002) found that speculative attacks are most likely to occur during a left-wing government and after an election. Block and Vaaler (2004) and Vaaler et al. (2006), using data from 20 developing countries, find that financial markets are most concerned about a shift to the left during elections but not the re-election of a candidate of the left. These studies seem to confirm the basic premises of partisan theories: (a) that market actors distinguish politicians of the left and the right; (b) once in office, politicians justify such distinctions; and (c) market actors make investment decisions during electoral periods based on the ideology of the likely victor.

Although these studies are very interesting as large-N studies, they are limited by the need to maintain comparability of data (George & Bennett, 2005). For example, they face a problem of what Herron (2000) calls "magnitude of partisanship," or how far the distance is between left and right (p. 327). Investors are unlikely to consider the partisan effect of a Michael Foot or a Tony Blair identical, though statistical analysis labels them both as left. Similarly, if Castañeda is correct, there should be markedly different responses to Latin America's moderate, institutionalist left; and its radical, populist, and anti-institutionalist left (Castañeda & Navia, 2007). Moreover, even if the left-right divide can be assumed to be equivalent in large-N studies, the analyst must also understand the meaning in terms of the institutionalization of the party system (Mainwaring, 1999).

This article adopts a two-pronged strategy to evaluate the effect of partisanship and the electoral cycle on risk perceptions. First, it includes a specific variable for party system institutionalization, which conditions the clarity of party's ideology and brand names (Vaaler et al., 2006). Second, it investigates in detail the role of partisan explanations vis-à-vis other theories through an in-depth discussion of each country.

Global Constraints

New partisan research recognizes the importance of contextual variation—specifically that "in small, open economies, domestic policy makers may retain less autonomy over some policies . . . than in larger, less-exposed economies" (Franzese, 2002, p. 371). External constraints on domestic policy making have long been a concern in Latin America, and much of the international political economy literature seems to argue that globalization weakens the role of domestic politics, making autonomous policy making impossible (Cardoso & Faletto, 1979; Garrett, 1998; Wallerstein, 2004).

Susan Strange (as cited in Garrett, 1998) warned that although "states were once the masters of markets, now it is markets which, on many crucial issues, are the masters over the governments of states" (p. 787). In his study of capital mobility and development in Latin America, Mahon (1996) finds support for the idea of a virtual senate of asset holders because of constraints they impose on domestic policy; a similar argument is made by Mosley (2003), who argues that investors have a powerful voice in emerging market countries' political arenas.

Without a doubt, world commodity prices and risk tolerance on global capital markets play a fundamental role in providing constraints and opportunities for emerging markets. Similarly, capital flows into and out of one emerging market are often very influenced by events in another emerging market or in the region as a whole. But contagion is often exaggerated and bondholders do distinguish on the basis of policy choices and investment climates particular to an emerging market.

Uncertainty

A third hypothesis is that bondholders pay careful attention to domestic policies and give considerable attention to electoral campaigns, shifting financial assets not on the basis of politician ideology but on the presence or absence of clear and credible policy. Spanakos and Renno (2006) make this claim in their study of economic and financial responses to electoral periods in Brazil (2006). Similarly, Starr (1999) argues that Argentine economy adjusted better than that of Mexico in 1994-1995, because the former "operated in a relatively certain electoral environment," whereas the coalition supporting the latter was diverse and unable to find consensus (p. 204).

The current article contributes to improving the persuasiveness of the uncertainty hypotheses through increasing the number of observations of the within-case studies found in Spanakos and Renno (2006) and Starr (1999) from 3 and 2 observations, respectively, to 14 distinct electoral episodes spread over four countries within the same region. It is clear that this hypothesis cannot be easily quantified and tested statistically and there are no available measures of campaign uncertainty regarding candidates' proposals. Therefore, the article uses process tracing to identify interaction effects between policy uncertainty and external vulnerability.

Data and Variables

This article analyzes sovereign bond market reaction to electoral campaigns and postelectoral periods in Argentina, Brazil, Mexico, and Venezuela between 1994 and 2007, using a monthly time-series data set for each case. These countries were selected because of the importance of their markets,[1] and they display a range of partisan and policy orientations, offering a diverse set of situations that can be analyzed. Argentina, Brazil, and Venezuela all witnessed some shift toward the left in the period studied. Although Mexico had no governments of the left, the candidate of the left came within 1 percentage point of winning the 2006 elections. The shift toward the left in the 2002 election in Brazil, in all analyzed elections in Venezuela, and to a lesser extent in 2003 in Argentina and 2006 in Mexico, constitutes "crucial cases" in evaluating partisan theories (Eckstein, 1975, p. 118). The other observations produce results unexpected by partisan accounts—namely, support for Chávez in 2004 coincided with a decrease in risk; his election in 2006 had little effect, yet the re-election of Menem (Argentina, 1995) and Cardoso (Brazil, 1998) did.

The indicator of risk, the dependent variable in both quantitative and qualitative analysis, is JP Morgan Chase's Emerging Markets Bond Index (EMBI). The EMBI is the price that investors are willing to pay for the sovereign debt of a given country at a specific moment in time. It is the spread of the yield of a sovereign bond relative to that of a U.S. Treasury bond (considered a zero-risk benchmark) of a similar maturity.[2] Increasing in the cost of government borrowing raises the cost of borrowing across the economy, slowing growth and increasing indebtedness. When debt is denominated in foreign currency, this places additional pressures on monetary policy and foreign exchange reserves.

The EMBI is not a pure measure of political risk. First, it reflects the dynamics within international capital markets, which are external to domestic political events.[3] Second, it is largely determined by the government's ability to pay its debt, which is based on the size (relative to exports), maturity (how long before it must make payments), and composition of debt (if denominated in a foreign currency or linked to some benchmark rate). Finally, the EMBI includes perceptions of willingness to pay debt. Candidates claiming that they will not pay foreign debt while locals are starving (e.g., Lula in the 1980s) or governments that prioritize redistribution of assets over protection of property rights of asset holders drive up political risk (e.g., Chávez since 1998).

Despite these limitations, the EMBI is the benchmark used by bondholders (whose behavior is being studied) and is also used in a number of political economy studies (Bernard & Leblang, 2006). Moreover, it is the best available measure of investor perception of sovereign credit risk and a baseline indicator of general credit risk.

Although risk can be quantified based on probabilistic statistical projections, uncertainty resists such methods. Given a situation where a government will loosen monetary policy to spur spending, analysts can predict the possible effect that this will have on inflation and evaluate this in terms of the present value of a debt instrument. When a new president comes into office and has given no signals whether previous monetary policies will be continued, loosened, or abandoned altogether, uncertainty exists, making it more difficult to make accurate predictions of risk. The distinction between risk and uncertainty is largely heuristic, however, as bondholders, particularly in emerging markets, tend to conflate the two. Because bondholders must make decisions about portfolio allocations regardless of the quantifiability of conditions of uncertainty, there is a tendency to overshoot estimations of uncertainty and for this to play a more significant role in analysis of emerging market bond markets.

The independent variables included in the analysis are derived from the theories discussed previously. A first central variable is the indicator of ideological change during the electoral period. A caveat must be made in identifying presidential candidates as being on the left or right, because partisan identification in Latin America is not always straightforward.[4] This article will label parties following Michael Coppedge's work on parties and party systems in Latin America (Coppedge, 1998).[5] Certain adjustments were made because Coppedge identifies parties and winning candidates but does not identify caretaker regimes (see Table 1).[6]

The impact of Coppedge's (1998) classification of elections is tested through the inclusion in the model of dummy variables for each of the distinct types of changes that occurred in the elections. So all center-right to center-left changes become a dummy variable and so forth for all the other types of elections.

Party institutionalization is measured as the average age of the top two governing parties and the main opposition parties or a subset of according to the situation in each country, as defined in the Database of Political Institutions (Beck, Clarke, Groff, Keefer, & Walsh, 2001). This variable is included in the model to control for the inchoate characteristics of certain Latin American party systems, which could weaken the influence of parties and ideology on economic turbulence. The expectation is that older party systems will decrease risk, because it increases the brand names of parties. Party system should also condition the uncertainty present in elections in which there are changes toward the left. This situation occurred in the presidential elections of the 1999 and 2003 in Argentina, 2002 in Brazil, and 1998 in Venezuela. An interaction term was added for the Brazilian elections in which a center coalition stayed in power.

Another set of political determinants of risk is associated with traditional electoral cycle variables. The first one indicates the 6 months prior to the election, with a regressive count from –6 to the –1, from the farthest away month to the closest one. As an election approaches, there should be greater risk and therefore a positive effect on the EMBI. The second electoral cycle indicator is a progressive count of the 6 months after the election, ranging from 1 to 6. The relationship here should be negative with EMBI, because as one moves away from elections, risk should decline as a victor appears and begins to choose ministers and coalition partners. This reduces uncertainty surrounding eventual government policy. Thus, the election variable, a dummy indicating the month of the election, should also have a positive effect on risk assessment.

The next set of variables examines the claim that it is vulnerability to external events that explain perceptions of country risk regardless of

Table 1
Partisan direction of Electoral Change by Election in Argentina, Brazil, Mexico, and Venezuela

Country and Election Year	Incumbent	Winner	Partisan Direction
Argentina 1994	Menem	Menem	Center Right–Center Right (re-election)
Argentina 1999	Menem	De La Rua	Center Right–Center Left
Argentina 2003	Duhalde	Kirchner	Center Left–Left
Brazil 1994	Franco	Cardoso	Center–Center (same coalition)
Brazil 1998	Cardoso	Cardoso	Center–Center (re-election)
Brazil 2002	Cardoso	Lula	Center–Left
Brazil 2006	Lula	Lula	Left–Left (re-election)
Mexico 1994	Salinas	Zedillo	Center Right–Center Right (same party)
Mexico 2000	Zedillo	Fox	Center Right–Center Right
Mexico 2006	Fox	Calderon	Center Right–Center Right (same party)
Venezuela 1998	Caldera	Chavez	Center[a]–Left
Venezuela 2000	Chavez	Chavez	Left–Left (re-election)
Venezuela 2004	Chavez	Chavez	Left–Left (confirmation)
Venezuela 2006	Chavez	Chavez	Left–Left (re-election)

a. Rafael Caldera ran as an independent in 1994. His coalition leaned toward the center-left during its first 2 years and toward the center-right during its last 2 years. Thus, he is coded as centrist.

domestic political events. The analysis used the level of foreign currency reserves as a proxy for access to foreign (hard) currency and vulnerability to financial crises more generally. This variable was obtained in the International Financial Statistics data set from the International Monetary Fund and was logged to increase comparability. Because credit risk is what is being investigated and so much Latin American debt has been historically denominated in dollars or linked to the value of the dollar, this indicator is especially important.

In addition to the vulnerability to the external environment, it is also important to take into consideration the liquidity of the global market and its appetite for risk. Two variables are included in the model. The Chicago Board Options Exchange Volatility Index, which indicates volatility over a period of 30 days in the S&P 500 is a widely used indicator of risk appetite among investors. Because investors consider global market conditions, the lower the volatility in the S&P 500, the more willing investors should be to purchase higher risk instruments, such as emerging market bonds. In addition, as the export profiles of the economies analyzed earn a significant portion of money from commodities and emerging markets are more likely to receive investment booms when commodity prices increase, a measure of global commodity prices, PALLFNFW, derived from the International Monetary Fund is used. The PALLFNFW is a combined measure of the price indices for all fuel and nonfuel commodities. This indicator is used, because it is the most holistic index of commodity prices and all of the governments analyzed here, to varying degrees, export petroleum and/or natural gas, as well as other commodities.

The model also controls for local factors including the Consumer Price Index and Central Bank independence, the latter measured by the length of tenure of each bank's president or governor (Cukierman, 1992; Cukierman, Webb, & Neyapti, 1992). The expectation is that longer tenure is perceived by investors to mean more independence and therefore should reduce the effect of elections on uncertainty.

Analysis

The pooled sample of countries is analyzed using cross-sectional time-series linear models with feasible generalized least squares correcting for AR(1) autocorrelation within panels and heteroskedasticity across panels. A model is tested with the conditional effect of party system age (Model 2) and without interaction terms (Model 1). Fixed effects by country are estimated to control for other country-specific factors that are not modeled. For each individual country, Prais-Winsten AR(1) regression is used with robust standard errors, which corrects serious autocorrelation problems found within panels and for cross-panel heteroskedasticity violation.[7] A lagged term of the dependent variable to control for possible layover effects from 1 month to the next is also included in the models.

Results are presented in Table 2. The most influential variables in explaining EMBI variation over time and space are the lagged term of the dependent variable, the natural logarithm of international reserves, and Central Bank independence. Volatility Index (VIX) is influential in the pooled sample and in Brazil, whereas commodity prices are significant for Mexico. All vary in the expected direction. That is, the size of the reserves, central bank independence, and commodity prices all have a negative correlation with the

EMBI. The same relationship exists in most cases between the VIX and the EMBI. The political variables, however, perform very poorly. None is statistically significant, which indicates that the electoral cycle, characteristic of the change in parties and levels of party institutionalization do not affect risk evaluations. This suggests that sovereign risk is relatively indifferent to the political situation. The exception here is Brazil, in which the election month, a change from center to left (Cardoso to Lula in 2002), and the interaction between party institutionalization and center to left change all influence risk.

The election month always has a soothing effect on risk, and during the actual month of the election, risk normally decreases. The change from Cardoso to Lula did affect risk, but it appears to be an isolated effect when compared to the other Latin American countries analyzed here. The effect of the change from center to left was also conditional on the level of party institutionalization in Brazil. For a 1-unit change in year of party system, there was a significant reduction in the negative impact of the center to left change that occurred in 2002. Therefore, in Brazil, party system institutionalization has the expected theoretical effect. But the absence of a party system effect suggests that the effect in Brazil in 2002 may have been caused not by the youth of the Workers' Party per se but the uncertainty generated by the potential of its leading a government coalition. The possibility that regression analysis in this and the other elections analyzed might be missing part of the story or important interactive effects leads to the next section, which qualitatively analyzes the 14 cases.

A Historical Analysis of Uncertainty and Elections

The elections that most significantly increased the perception of sovereign risk were those of 1995 in Argentina, 1998 and 2002 in Brazil, and 1998 in Venezuela. The partisan effect here is ambiguous at best. Even the policy uncertainty hypothesis is not completely straightforward, as there may have been more policy uncertainty in other elections. However, the interaction between policy uncertainty and external economic conditions and domestic reserves explain why these four episodes generated the greatest risk. The next section relies on process-tracing through within-case analysis to identify when and how policy uncertainty and external vulnerability produced sensations of risk (George & Bennett, 2005, ch. 10). The analysis highlights results unexpected by partisan theories such as the increase in the EMBI during the 1995 elections in Argentina, the 1998 elections in Brazil, the lack of change in the 2006 elections in Mexico, and the decrease during the

Table 2
Regressions for Emerging Markets Bond Index (EMBI) in Argentina, Brazil, Mexico, and Venezuela: 1993 to 2007

	Model 1: EMBI	*SE*	Model 2: EMBI	*SE*	Model 3: Argentina	*SE*	Model 4: Brazil	*SE*	Model 5: Mexico	*SE*	Model 6: Venezuela	*SE*
Lagged EMBI	0.94	0.01***	0.94	0.01***	0.86	0.11***	0.71	0.08***	0.65	0.09***	0.78	0.08***
Pre-election	–10.15	14.14	–11.50	14.59	–50.52	32.44	10.92	13.67	–8.96	6.85	–10.18	11.61
Post-election	–4.62	14.63	–4.04	15.07	41.75	42.14	–17.06	15.92	–0.11	8.47	–5.45	8.73
Election	–143.79	95.44	–144.15	95.80	–162.06	350.08	–213.75	126.36*	–7.35	20.74	–84.37	80.65
Center-right to center-left	–66.90	103.04	30.45	413.42	–442.37	405.87						
Center-right to center-right	25.65	67.52	23.30	68.39	–136.44	176.29			–24.40	33.77		
Center-left to left	149.15	109.80	–1,826.54	3,887.00	–4,437.47	5,152.34						
Left to left	32.72	70.62	29.64	71.49			6.95	52.96	24.23	33.95		
Center to center	50.07	82.67	221.74	484.31			223.74	266.08				
Center to left	15.92	82.46	–53.58	141.17			45,730.72	14,778.19***			–20.85	158.81
Age of party system	0.60	1.67	0.55	1.74	–13.13	9.79	22.85	16.72	2.56	2.63	0.48	1.74
Party × Center to Left			2.16	3.86			–2,473.53	800.30***		4.01	4.74	
Party × Center-Left to Left			104.84	206.35	216.13	274.83						
Party × Center-Right to Center-Left			–4.15	16.40	11.52	14.66						
Party × Center to Center		–12.99	35.21			–5.25	19.92					

(continued)

Table 2 (continued)

	Model 1: EMBI	*SE*	Model 2: EMBI	*SE*	Model 3: Argentina	*SE*	Model 4: Brazil	*SE*	Model 5: Mexico	*SE*	Model 6: Venezuela	*SE*
International reserves (Natural log)	–93.84	46.84**	–96.13	47.17**	–550.58	474.02	–137.63	54.15**	–181.65	83.97**	–223.19	94.87**
Change in the Consumer Price Index	0.04	0.37	0.07	0.38	9.07	5.89	–2.25	1.65	–0.82	1.80	0.06	0.31
Index of Fuel and Non Fuel Commodities	0.82	0.95	0.81	0.96	–11.17	5.64**	2.80	1.08**	2.14	0.82**	0.44	0.88
Volatility Index	7.24	2.47***	7.45	2.55***	7.28	10.52	9.33	3.59**	4.29	2.64	3.57	5.68
Central Bank independence	–0.50	0.48	–0.50	0.48	–3.15	2.01	–3.52	1.20***	–1.00	0.58*	–1.72	0.78**
Constant	777.64	429.11*	791.61	431.99*	5,880.45	4,610.81	1,151.02	638.51*	1,812.81	822.28**	2,190.46	950.39**
Observations	639		639		162		158		162		161	
Number of panels	4		4		1		1		1		1	
R-squared					.94		.91		.89		.90	
Durbin-Watson transformed					1.99		1.96		2.08		2.04	

Source: International Financial Statistics and Database of Political Institutions: Electoral cycle variables, Central Bank Independence and election characteristics, coded by authors.

**p* significant at 10%. ***p* significant at 5%. ****p* significant at 1%.

revocatory referendum in 2004 in Venezuela. Examining these examples of deviance provides alternative explanations for the increase in perception of risk in Argentina in 2003, Brazil in 2002, and Venezuela in 1998—cases that are crucial for partisan theories.

Argentina

The three presidential elections studied here show the re-election in 1995 of Carlos Menem, the center-right president; the 1999 election of Gustavo de la Rua, leading a center-left coalition; and the 2003 victory of Nestor Kirchner, a leftist peronist.[8] Risk peaked 2 to 3 months prior to all elections, but the most troubling were the elections of 1995 and 2003, not 1999 and 2003, as partisan theories predict (see Table 3). The question is, what explains why the re-election of Menem coincided with an increase in perception of risk? And does that explanation hold for the slight increase in 1999 and significant increase in 2003?

Menem eliminated hyperinflation, and his victory over Frepaso's José Octávio Bordón was by 20 points.[9] The margin of victory and the re-election of a market-preferred center-right candidate should not have contributed to an increase in risk. At one point, Bordón's Frepaso coalition did threaten the Menem candidacy, but as *The Economist* ("Argentina shades," 1994) reported, "no serious candidate today . . . proposes even to reverse the free-market reforms" (p. 38); nor was there any challenge to the convertibility plan (which constitutionally established the peso as equal to 1 dollar). What was concerning was how Argentina would adjust to the fallout from the devaluation of the Mexican peso, which had affected perception of credit-worthiness in the region as a whole. These concerns slowed support for Bordón as "Argentines think . . . who better to find solutions, ask Peronists, than the slayers of hyperinflation?" ("Argentina fighting," 1995, p. 43). To bond holders, a vote for Menem meant the continuation of a relatively predictable and credible set of policies and policy makers. Nevertheless, the increased electoral strength of Frepaso and the increased independence of Peronist politicians meant that the next government would face more constraints on its ability to make potentially unpopular reforms. This can be seen by the increase in the EMBI following the elections, which suggests that there were indeed governability concerns. These concerns were exacerbated by the shift toward risk aversion that followed the Mexican devaluation. As investors became more risk averse, the premium on reserves and policy uncertainty increased. Thus, the best explanation for the unexpected rise in the EMBI in 1995 is due to an interaction of political

Table 3
Emerging Markets Bond Index at the End of 6 Months, Prior to and After Elections

Time	Argentina			Brazil				Mexico			Venezuela			
Months Prior and After Election	11/94 to 11/95	04/99 to 04/00	10/02 to 10/03	04/94 to 4/95	4/98 to 4/99	4/02 to 4/03	4/06 to 4/07	01/94 to 01/95	1/00 to 1/01	1/06 to 1/07	06/98 to 06/99	01/00 to 01/01	06/06 to 06/07	Recall 02/04 to 02/05
$t-6$	826	595	6,064	1,127	463	847	215	402	433	132	669	913	226	720
$t-5$	1,074	784	6,155	1,087	570	982	270	484	353	122	833	813	199	647
$t-4$	1,279	756	6,342	1,186	660	1,560	252	547	345	140	2,526	895	207	684
$t-3$	1,638	846	5,985	1,094	607	2,360	222	424	381	135	1,573	946	233	659
$t-2$	1,488	773	6,615	810	1,419	1,643	222	532	434	157	1,399	980	225	643
$t-1$	1,283	663	6,096	737	1,332	2,412	232	505	378	154	1,623	892	234	584
t	1,029	635	5,059	845	1,200	1,759	222	430	349	135	1,309	839	182	550
$t+1$	1,206	650	5,164	815	983	1,622	221	435	314	130	1,472	785	211	490
$t+2$	1,221	533	4,485	919	1,239	1,460	190	456	313	141	1,399	802	224	459
$t+3$	1,205	594	5,021	1,054	1,516	1,331	189	445	362	132	1,140	863	206	400
$t+4$	1,178	548	4,916	1,211	1,378	1,189	194	863	383	140	813	903	222	403
$t+5$	1,293	564	5,355	1,441	1,044	1,050	167	1,023	391	115	1,020	958	259	452
$t+6$	1,073	566	5,509	1,213	875	819	156	1,384	362	124	926	842	341	427

uncertainty—related to Menem's ability to maintain governability and discipline over his coalition—and the change in investor sentiment following Mexico's devaluation. That said, Menem's popular support and credibility served as a break on the increased perception of credit risk. It is clear that the role of party ideology of the victorious party was irrelevant.

The 1999 election had a much less significant effect, although the two-term president was replaced by a shift toward the left. Both Eduardo Duhalde, two-term Peronist governor of Buenos Aires province, and centrist Fernando de la Rua, a former mayor of Buenos Aires representing the center-left Frepaso coalition, critiqued Menem, but neither offered a break with fundamental macroeconomic policies. Even still, the size of a debt essentially denominated in dollars had become worrisome and "[i]nvestors have started to worry that Argentina's exchange rate, even though its parity with the dollar is written into law, could yet go the way of its much less rigidly pegged counterpart in Brazil" ("Leaders," 1999, p. 15). To this end, both candidates insisted on their maintenance of the currency board, thus giving clear signals of policy continuity. However, unlike the 1995 elections, global conditions were more favorable. Thus, with little uncertainty about broad fundamental issues, there was no reason to expect a short-term spark that would deepen concern, though worries remained about the long-term policy mix.

In 2003, Menem challenged a progressive coalition of Peronists behind Nestor Kirchner. *The Economist* ("The Americas," 2003) writes: "[i]n policy terms, the run-off is a battle between Mr. Menem's glitzy conservatism and Mr. Kirchner's nebulous social democracy" (p. 57). The ambiguity of Kirchner's proposals as well as his status as an unknown governor of Patagonia forced Kirchner to engage credibility-building exercises such as securing support from caretaker president Eduardo Duhalde who, despite having defaulted and devalued, regained credibility among bondholders. Kirchner's post-Washington consensus left-wing appeal was bolstered by linking himself to Lula rather than Chávez.[10] Finally, his trump card was publicly declaring that he would maintain Roberto Lavagna as finance minister, a definitive commitment to maintain policies that were considered credible and predictable ("The Americas," 2003, p. 57). In addition, the 2003 election occurred as global growth and particularly commodity prices were rapidly rising. The increase in the EMBI, however, despite improving commodity prices, global liquidity, and a return of investment to Argentina, suggests that the international environment was not enough. Kirchner's attempts to reduce policy uncertainty clearly helped but were insufficient as both his vision of post-Washington Consensus, and the possible governability issues that he might face were never persuasively settled during the campaign. The postelection increase in the EMBI supports this latter point.

Brazil

The Brazilian EMBI increased prior to the 1998 and 2002 elections, but there was little effect prior to the 2006 elections, and it decreased prior to the 1994 elections. The increase in the pre-electoral periods in 2002 and the lack of concern in 2006 is predicted by partisan theories, but that of 1998 is not (Vaaler et al., 2006). As with the 1995 elections in Argentina, an examination of the unexpected rise in risk in 1998 explains the limitations of partisan approaches. The evidence suggests that the concern in 1998 was about Cardoso's ability to respond to exchange rate pressures introduced by international crisis, not about Cardoso per se or the credibility of his particular group of policy makers. In contrast, in 2002, the concern was the inability to predict what policies Lula might pursue as president particularly amid risk aversion on global markets and moderate levels of external vulnerability. The ideology of the Workers' Party candidate did not play a significant role in increasing perception of sovereign risk.

Fernando Henrique Cardoso, the finance minister who was credited as having engineered the remarkably successful exchange-rate based stabilization *real* plan,[11] won the 1994 presidential elections against Lula da Silva of the Workers' Party. As support for Cardoso's candidacy increased, the likelihood of continuation of policies that were considered viable by bondholders increased, and the perception of default risk decreased considerably. In addition, the interest of bondholders to re-enter Latin American markets in the early 1990s contributed to a reduction in perception of risk.

The Brazilian electoral campaign of 1998 followed the Asian (1997) and Russian (1998) crises, which centered around currency mismatches and current account problems and led to several devaluations and one major default. The realities of electoral politics forced president and candidate Cardoso to defend the *real* prior to the elections, creating considerable opportunities for speculation, reducing foreign reserves, and driving up the EMBI (as debt levels were harder to sustain). One month before the elections, Cardoso increased interest rates to defend the *real*, while Lula proposed a referendum on whether capital controls should be imposed (Moffett & Fritsch, 1998). It is not surprising that despite the vulnerability of the Brazilian market to the global financial malaise, bondholders believed that Cardoso could more credibly weather the storm of contagion and constrain inflationary impulses of a possible devaluation than Lula could. Nevertheless, the appeal for Lula's discourse and the potential risks of holding together a reform coalition following a potential devaluation was a concern, as is evidenced by the postelection increase in the EMBI (when the devaluation occurred). Thus, as in the case of the Argentine elections in 1995, external factors spurred an increase the risk associated with governability, but the selection of the preferred candidate contained perceptions of risk.

In 2002, Lula, now a center-left moderate, was the forerunner among a field of candidates who ubiquitously proposed a rather ambiguous concept: change. Given Lula and the Workers' Party's historic resistance to policies that bondholders favored and the Workers' Party's lack of experience in national governments, there were questions about what Lula would do once in office. The clarity demanded by bondholders was especially important, given the debt default in Argentina in December of the previous year and the generally low risk tolerance in capital markets. Lula's "Letter to the Brazilian People" outlined a sense of fiscal responsibility and moderate principles, but before and after releasing that letter, he also spoke of renegotiating contracts and made comments about future monetary and fiscal policy that conflicted with the very content of his letter (Spanakos & Renno, 2006). The increase in the EMBI led to increased interest rates, a weakening of the exchange rate, and accelerating inflation, which contributed to exploding Brazilian debt, as some 80% of debt was based on those rates. The collapse of Argentina was troubling for investors, but commodity prices were increasing throughout the campaign. Thus, the international environment presented a situation of multiple equilibria. The ambiguous content and inability to predict policies of a future Lula government encouraged bondholders to favor the more negative equilibrium and created a space for an attack on the *real.*

Once elected, Lula decreased uncertainty through several credibility-building exercises (the choice of Antonio Palocci as finance minister and Henrique Meirelles as central bank governor, as well as increasing the fiscal surplus target set by the International Monetary Fund agreement; see Sola, 2006), which set clear guidelines for the type of policies that would characterize his government. The shift to policies endorsed by his predecessor and investors was crucial in the rapid reduction in the EMBI in 2003 and its continued decline during his term in office. His re-election in 2006 posed no threat, because his policies were both predictable and had received relatively favorable reviews from market analysts. In addition, 2006 was a year of robust global growth, considerable liquidity in international markets, and high prices for commodities, which reduced the financing pressures on nearly all emerging markets.

Mexico

Although the Mexican sample only provides victories of the center right, it contains the elections that produced the end of a one-party regime (2000) and intensely contested elections (2006). The lack of a significantly increase in the EMBI during the pre-electoral periods is because all Mexican elections took place during relatively good moments for global capital markets, the role of Central Bank autonomy, and policy convergence among *Partido Revolucionario Institucional* (PRI or Institutional Revolutionary Party) and *Partido Acción Nacional* (PAN or National Action Party) technocrats and politicians.

The beginning of the North American Free Trade Agreement in January 1994 was an event highlighted by the Chiapas Rebellion and the assassinations of PRI presidential candidate Luis Donaldo Colosio and PRI president José Francisco Ruiz Massieu. Pressures on the government were considerable, yet neither of the two preeminent candidates, the PRI's Ernesto Zedillo nor Diego Fernández de Cevallos, proposed any significant change in either monetary or fiscal policy. An increase in the U.S. federal funds rate placed pressure on the peso, which forced the government to spend foreign currency reserves and shift toward dollar-denominated short-term bonds with high interest rates. But importantly, it was not until after Zedillo took office and, as a response to the reduction of reserves, devalued the currency that the EMBI increased considerably. In addition, despite concerns about Chiapas, Mexico had been enjoying a foreign investment boom and led emerging market countries in regaining the attention of global investors. Thus, the election took place during a period of generous global credit markets and domestic policy clarity, though there was domestic tightening of credit and an increase in concern about political risk.

The critical political transition—the first time an opposition candidate had been allowed to win the presidency since the Mexican Revolution—made possible by the 2000 elections generated only a moderate increase in the EMBI. The victorious PAN was a probusiness party, and its candidate, Vicente Fox, a liberal, made it clear that political change was about eliminating authoritarianism and corruption, not reversing economic reforms. There were concerns about whether the PRI, as it moved to the opposition, would become more populist and less liberal, but concerns about the Mexican government's future policies and willingness to meet its debt obligations were limited. In addition, although the U.S. stock market had crashed, the real economy in the United States had not yet slowed and Mexican reserves remained strong. As such, the external environment remained relatively favorable. Thus, in the midst of relatively favorable external conditions and clarity about macroeconomic policy, political transition did not increase risk.

Felipe Calderón, a political conservative and supporter of free market enterprise, represented no threat to markets when he won the 2006 elections as the candidate of the PAN. Andrés Manuel Lopez Obrador's (known in Mexico as AMLO) program for government was remarkably similar to that of Lula and other center-left leaders, and he sent road shows to Wall Street to assure them of his commitment to fiscal responsibility and his respect for central bank independence. Although he had been critical of fiscal constraint under neoliberal governments, he demonstrated fiscal responsibility while he was governor of the Federal District. The Economist ("Leaders," 2006) rejected the idea raised by the Calderón campaign that AMLO was "a Mexican version of Hugo Chavez," though it was not clear if he was a "modern social democrat" like Lula (p. 10).

Why did electing Lula panic markets while almost electing AMLO did not? Here the perception of Central Bank autonomy in conditioning policy choices and maintaining policy continuity seems to explain why electing Lula panicked markets while almost electing AMLO did not. Although *The Economist* was concerned about contempt that AMLO had shown for institutions, such as the Central Bank, the Mexican Central Bank had been de jure and de facto independent since 1993 and was widely regarded for its competence and nonpartisan analysis. This is distinct from the election of Lula in 2002, where the Central Bank's recently achieved de facto autonomy was the result of the relationship between Cardoso and his Central Bank governors. It had not been institutionalized, and Lula had rejected legislation to make autonomy and/or independence formal. AMLO's critiques were unlikely to change Central Bank direction, although it was unclear whether Lula would follow up on statements about widening the band for inflation targets and reducing the role of the finance ministry vis-à-vis the planning ministry, either of which would have considerably reduced Central Bank autonomy. Finally, the high price of petroleum, Mexico's main export, and the general state of Mexico's debt profile also contributed to a muted sense of risk. The perception of a low-risk institutional environment continued after the election even amid AMLO's postelectoral protests and setting up of a "shadow government." As a result, the potential victory of AMLO might have introduced some policy uncertainty, but Central Bank autonomy and domestic and international fundamentals tempered this concern.

Venezuela

The Venezuelan data are especially troublesome for partisan theories. Chávez's victory in 1998 is linked to a rapid rise in the EMBI, a mild increase in the pre-electoral period of 2000, a decrease throughout the recall election of 2004, and a moderate increase following the 2006 elections. What then explains why perception of risk increased only when Chávez was first elected in 1998 and a few months after his re-election in 2006?

The 1998 elections provided clear evidence that the two-party dominance of the Punto Fijo system was over (Dietz & Myers, 2007). In 1998, Chávez, a former coup leader with no governing experience, was supported by a broad but largely uncoordinated base of voters disenchanted with systemic parties and who applauded that he was "the only candidate to attack the market economics that the Caldera government belatedly accepted two years ago" ("The Americas," 1998, p. 30). He proposed a more participatory republic based on a vague ideology of "Bolivarianism," which combined elements of socialism, neostructuralism, and radical democracy. His enormous popularity was concerning to bondholders who identified him as a maverick who was entering a political vacuum where he would be capable of making very significant and unpredictable changes. His anticapitalist and anti-imperialist rhetoric gave clear signals that he was likely to use the oil wealth available to redistribute assets as opposed to paying debt. Moreover, given the low value of petroleum, Chávez would have few policy instruments available to make the social changes that he proposed, which could lead toward fiscal irresponsibility.

In office, Chávez showed policy restraint and even endorsed some conservative macroeconomic policies, while he continued to launch philippics against oligarchs (Buxton, 2003). So in 2000, he was hardly the candidate favored by the market, but bondholders had a better idea of how to separate the rhetoric from the policies. Importantly, the considerable support for the 1999 constitution and the overwhelming victory of Chávez and the coalition of parties and movements associated with him conferred a legitimacy and predictability to the system. What was less predictable was whether Chávez would follow a developmentalist, state-led growth approach to macroeconomic policy or whether he would move toward socialism, as critics alleged (Lebowitz, 2006). The ambiguity of future policies while new rules of the game were being established occurred alongside a recovery in global petroleum prices, which improved the government's ability to continue to meet its foreign debt obligations and which were—and remained until 2007—fairly minimal, given the value of petroleum as potential collateral. Like the other countries studied here, commodity prices are inversely correlated with risk, though the considerable value of petroleum, particularly since 2004, has provided assurances for Venezuela's debt, even though it has pursued policies that are considered unwise and unsustainable by the majority of analysts of that market.

During the recall referendum of 2004, Chávez solidified his support, which was particularly essential in reducing policy uncertainty and concerns about regime stability following the April coup of 2002 and the general strike at the end of that year. Chávez was able to consolidate his regime in 2003 due to increased petroleum prices and the introduction of "social Missions." By the time the recall election occurred in 2004, the economy was growing robustly, and state-directed social development programs were a regular part of Venezuelan life. This, combined with the lack of credibility of the opposition, led to a resounding victory for the government in the recall election of 2004. The significant decrease in the EMBI during the election campaign, thus, had nothing to do with a move away from a leftist politician or the moderation of that politician. If anything, Chávez became more committed to using fiscal policy in very aggressive ways to promote social equity. Rather, the decline in risk was due to the increased value of petroleum vis-à-vis the small foreign debt stock and the increasing consolidation of new rules of the game by Chávez.

The increased familiarity with Chávez, stockpiling of foreign currency reserves, and the boom in global markets explain the relatively mild change in the EMBI prior to 2006. His declarations about moving toward a vague 21st-century socialism since 2005 did not mark a clear shift away from the general state-centered, prodomestic producer economy that he had been pursuing since at least 2003. The EMBI increased after his re-election, because he believed that he had a new mandate to change the "geometry of power," which meant substantially altering the 1999 constitution. The effort proved unsuccessful, but what is relevant is that Chávez's move to accelerate the transition to 21st-century socialism through a very vague set of 69 constitutional amendments rendered the policy environment unpredictable, driving up risk, even despite record prices for petroleum and robust dollar reserves. Thus, even when domestic and economic fundamentals are strong, policy uncertainty can drive risk.

Conclusion

There is little quantitative and qualitative support for partisan explanations of sovereign risk related to elections in Argentina, Brazil, Mexico, and Venezuela between 1994 and 2007. This is true of both simple partisan (right-left difference) and more sophisticated partisan accounts that distinguish between incumbent and challenging leftist candidates and between radical and institutional lefts. These results question how important the right-left scale is in studies of Latin America. The data also control for party system institutionalization, a variable often ignored in the analysis of how elections affect financial markets. The data show that older party systems in Latin America do not necessarily lead to increased stability and predictability of the political system, as is claimed by the literature on partisanship (Mainwaring, 1999).

The quantitative analysis is strongest in support of the role of external vulnerability and risk tolerance. This finding confirms conventional wisdom among market professionals, that risk is based on ability to pay debt, which is best represented by access to foreign currency. Foreign reserves are critical for emerging markets, particularly during downturns in global liquidity, because many emerging market borrowers issue debt in foreign currencies, creating a potentially unsustainable currency mismatch (Eichengreen & Hausmann, 2005). The obvious policy implication is that governments should try to denominate their debt in local currency and should maintain foreign currency reserves that exceed what may be considered adequate under noncrisis situations.

But how large the stock of foreign currency reserves should be to ensure confidence in a government's ability to meet its debt obligations is subject to perception. This is where the policy environment enters and the issue of uncertainty emerges. A reserve of 30 billion U.S. dollars may be sufficient in one context but not in another. More important, for emerging market countries, it may be both at the same time, as was the case in Brazil in 2002, when perceptions of policy uncertainty led to the negative interpretation of foreign reserves driving the market. If economic fundamentals allow for multiple equilibria, policy clarity can explain perceptions of risk. Moreover, as is the case in the postelectoral period in Venezuela in 2006, political uncertainty can drive sovereign risk even in the face of record reserves and commodity prices. Thus, tracing interactions between policy uncertainty, policies chosen, and vulnerability to external events best explains perceptions of sovereign movement during electoral periods.

Future research should examine these processes during ministerial shuffles and other periods of change between elections. It should also examine whether the relationship that credit markets perceive between risk and uncertainty is echoed in other arenas such as equity markets.

Notes

1. Venezuela's market is less important, but due to the foreign policy of president Chávez, the purchase of the debt of neighboring countries, and the burgeoning local currency debt market, it is becoming increasingly important.

2. This is measured in terms of basis points, in which 100 basis points is the equivalent of 1%.

3. When there is greater liquidity, interest in investing in emerging markets, or when commodity prices are high, investors will be less exacting. Perception that certain other countries or regions are "hot" can reduce market demand for the debt of a particular country and increase risk. Similarly, internal dynamics of capital markets can punish one country for the failures of another, ironically even if the former is seen as relatively successful. This was the case in 2001, when traders who lost money or could not sell Argentine debt sold Brazilian debt to cover their losses, increasing Brazil's Emerging Markets Bond Index.

4. Part of this is due to low levels of partisan ideology and/or policy clarity among many political parties (Mainwaring, 1999) and a relative convergence left and right in Latin America about economic policies in the most recent wave of democratization.

5. The more recent classifications are considered to be preliminary by Coppedge (Personal communication, July 6, 2007).

6. For example, the de la Rua Coalition was center left, but Nestor Kirchner was replaced by Eduardo Duhalde, a conservative. The Brazilian elections were also coded slightly differently. Given that there was significant continuity between the Itamar Franco and Fernando Henrique Cardoso administrations, both were coded as center.

7. The dependent and independent variables were tested for unit root problems using the Dickey-Fuller test and detected problems only in the Consumer Price Index variable. Given that it did not present consistent effects on Emerging Markets Bond Index, it does not appear to be a substantial problem. A violation of homoskedasticity was detected in the pooled sample using the Breusch-Pagan/Cook-Weisberg test for heteroskedasticity as well as a problem of first order correlation, using the Wooldridge test for autocorrelation in panel data. This was corrected by using cross-sectional time-series Feasible Generalized Least Squares regression for the pooled data and Prais-Winsten AR(1) regression for country-specific analysis.

8. As stated earlier, left to right labels are not uncontroversial. Coppedge (1998) labels the Partido Justicialista (Peronist party) as center-right, and so that distinction is maintained here. Duhalde was clearly an opponent of the Peronists who surrounded president Menem, but he stressed social concerns more than Menem did.

9. All electoral data are from Georgetown University's Political Database on the Americas: http://pdba.georgetown.edu/Elecdata/elecdata.html

10. The linkage to Chávez is very important, as Evo Morales success seems to have been boosted by Chávez's support, whereas Felipe Calderón and Alan Garcia were able to gain points by associating Andrés Manuel López Obrador and Ollanta Humala with Chávez.

11. Unlike previous efforts at controlling inflation, the *real* plan was more credible, largely because of the successful negotiation with Congress by Edmar Bacha, secretary of economic policies at that time, to anchor the new currency through fiscal restraint.

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