International Economic Organization
and Sovereign Risk in Emerging Markets
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Introduction: The Company You Keep

Emerging markets the world over struggle for political as well as economic legitimacy on the international stage. Risk perceptions are an important component of their image, since access to credit on international markets can provide cash-strapped governments with much-needed financing. What can developing countries do to make themselves look attractive to private international creditors? How — in the absence of enforcement by third parties or truly binding contracts — can a country assure markets that it is a trustworthy investment, that it is both willing and able to service the loans they incur? Emerging markets have a long history of shirking their foreign debt obligations; nearly half of the defaults in the last century occurred in developing countries. How can these countries convince investors of their intentions to make good on their debt obligations?

This book argues that regional economic organizations (REOs) can help solve cooperation problems in international credit markets. But perhaps counterintuitively, the rules and enforcement within those organizations tend to be not so important to investors. Rather, investors pay particular attention to the other member states in those organizations — that is, the company a country keeps. If emerging markets announce formal ties with other countries, investors look to whether those associated countries have low political risk, which gives clues as to their willingness to service their debt. International organization with responsible countries makes emerging markets look less risky — and by the same token, organizing with ill-behaved countries will make a new member look like more of a risky investment. Specifically, sovereign spreads — the risk premium that portfolio investors demand for holding a country’s debt — fluctuate as a function of the other members of groups a country joins on the international stage. When uncertainty is high, investors use the company a country keeps as a way of making inferences about other investors’ perceptions of a country’s trajectory.

Examples of this phenomenon abound in world politics. After the 1993 split of Czechoslovakia — four years after the fall of the Berlin Wall — Slovakia seemed ready to sink. It featured crumbling, Soviet-era industries as its economic base, and isolated from the international community by the authoritarian Vladimir Mečiar. Despite many market-friendly reforms — liberalizing trade and prices, and privatizing formerly state-owned industries — the country was largely ignored by short- and long-term investors alike. All that changed in 1999, after voters dumped Mečiar and the European Union formally opened negotiations for entry with Slovakia. Within hours of the initial announcement of EU talks, the extra premium that investors demanded to hold Slovak debt — essentially, insurance against the possibility of default — plummeted. “Once we were validated by the talks with the EU, investor perception shifted radically, and this changed everything for our country,” says one official in the Slovak central bank.¹ Slovakia was not alone. For those postcommunist countries that managed to open talks with the European Union in the 1990s, the cost of borrowing abroad dropped 33 percent

¹Interview, L’udovít Ódor, National Bank of Slovakia, 23 July 2006.
— giving those once-closed economies unprecedented access to capital on international financial markets.

But as the 2007 financial crisis has demonstrated, portfolio investors can take flight as quickly as they rush in, and punish as severely as they reward. In the mid-2000s, Venezuela was flush with oil money and should have been a welcome member of any economic organization. During that period, Venezuelan President Hugo Chávez positioned himself for regional influence by signing onto South America’s biggest regional organization, the Common Market for the South (Mercosur), as well as proposing a new regional economic alternative of his own, the Bolivarian Alternative for the Americas (ALBA). But as Chávez’s acts at home became more and more erratic — nationalizing several industries, firing the well-regarded head of the central bank — investors began to look less kindly not only on Venezuela, but also the countries that were preparing to link themselves to it. Investment risk for the other members of Mercosur spiked in concert with Chávez’s anti-market behavior — even though those members traded relatively less with Venezuela than did many of that country’s neighbors.

What do these two stories tell us about perceptions of risk and their consequences? For one thing, they show the power of cognitive shortcuts in information processing. Developing countries across the globe strive to convince markets of their creditworthiness. If they fail, they remain marginalized, aid-dependent, and poor, with their only options being loans from international financial institutions — and those loans typically come with many strings attached. The prize, however, is investment capital that can further economic growth. Countries gain legitimacy through gestures great and small, both domestically and abroad. They might vote in forward-looking leaders who adopt bold policy reforms or fly in decorated international consultants. But economic development is full of false starts, incomplete reforms, political falls from grace, and policy reversals. If emerging markets have a history of uncertainty, how do investors know what to believe? More specifically, what acts do investors most closely monitor? The 2007 financial crisis has demonstrated amply that investors in financial markets are not shy about taking inferential shortcuts, and international agreements — specifically, the nature of the other members in those agreements — can serve as a powerful signal to investors about a country’s intentions, even about its perceived identity (Anderson, 1991).

Investors use the company a country keeps as an important heuristic, or speculative formulation, through one central mechanism. Portfolio investors coordinate on public pronouncements that are easily generalizable across situations. Investors may not know about the details of an organization’s structure, the degree to which rules are enforced, or the speed at which attendant policies are implemented (if, in fact, they are implemented at all). But bond traders make inferences based on the already visible attributes of the better-known members of the organization, and the announcement of economic ties is a visible and public way for emerging markets to link to those countries. In an environment of high uncertainty, the peer effect of international economic organization is a commonly relatable and publicly observable way for markets to arrive at similar assessments — even if those assessments subsequently turn out to be flawed, and even if, as is often to case, the proposed economic ties never materialize. Indeed, herd behavior may drive markets

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2Behavioral finance (Thaler, 1993, 1994) and prospect theory (Kahneman and Tversky, 1979) have long argued that investors evaluate assets using interesting shortcuts; Zuckerman (2004) shows that although investors rely on classifications, these classifications are imperfect.
to over-rely on international organization as a heuristics in shaping their views on the risk associated with a given country. But in the short term, the company a country keeps can have a big impact on a government’s ability to borrow on international capital markets.

Individual bond traders can arrive at a whole host of different assessments, of course, based on their own judgments or from the differing weight they might put on various indicators. In the last fifty years, with the improvement not only of computer processing power but of available data to crunch, algorithms can digest scores of variables and spit out a proposed price. But bond traders also act on their own personal judgment, which stems from experience, sentiment, or their own appetites for risk. Bond traders are in environments where there is a glut of information about countries that they themselves have likely never visited; thus, they must sort through a variety of second-hand information to make their assessments about the level of risk. They must make what in decision theory is called a decision under uncertainty — a case when each possible alternative is associated with a probability distribution, but those distributions are unknown (Ben-Haim, 1998).

Investors’ assessments can be particularly subjective in high-uncertainty environments such as emerging markets. Eichengreen and Mody 1998 demonstrated empirically that particularly in emerging markets, bond spreads are more a function of market sentiment than of economic fundamentals. In fact, bond traders who deal particularly with emerging markets have been accused of having “too much money and too little local knowledge or power.” This is in part a function of the unreliability of statistics in emerging markets, and their vulnerability to political or economic shocks. In such high-uncertainty circumstances, investors are particularly sensitive to overall market sentiment on particular assets, and how other investors are interpreting the actions of emerging markets. International organizations, I argue, can be a powerful driver of market sentiment in high uncertainty environments — and markets use the known members of those organizations as effective shorthands in their estimations of less-known members.

The argument advanced in this book make a distinct contribution to the debate on international cooperation. International relations scholars have long advanced the importance of international institutions as a means of promoting stability and coordination among nations. This book tests that claim using a measure of uncertainty in countries from financial markets: the risk associated with sovereign bonds, a measure that is of substantive as well as theoretical interest to social scientists. The argument offers a new mechanism — the company a government keeps — through which institutions matter. In contrast to previous research, I find that the effect of the company a country keeps has little to do with the legalistic design of the organization (Koremenos, 2001, 2005; Rosendorff, 2005; McCall Smith, 2000) or the policy reform that countries undertake in order to enter (Schimmelfennig and Sedelmeier, 2005), or the unobserved factors that might drive countries both to enter certain types of organizations and to have certain kinds of risk profiles (Vreeland, 2001; VonStein, 2005), or rule enforcement in the organization. Nor is the effect simply a function of being in the same neighborhood (Simmons and Elkins, 2004; Gleditsch and Ward, 2006). The argument advanced here is a new and independent mechanism through which international institutions can matter. Because

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3This phenomenon has been widely noted in many types of investment; see Kindleberger (2005); Benartzi and Thaler (2001, 2007).
4“A nasty spillage,” The Economist, 10 June 2006.
These effects are independent of policy change, the inferences about a new member’s quality may be undeserved — witness the severe market corrections of risk assessments in Greece, Spain, and Portugal. But these changes in risk perception are an empirical reality.

This argument comes at a time when international agreements are on the rise, particularly regional trade agreements (Mansfield and Milner, 1997; Pevehouse, 2002; Donno, 2010; Goertz and Powers, 2012). The number of international and regional organizations has grown steadily in the past decades, but their effects are far from understood. With multilateral trade talks in crisis, and with purchasing power in Asia on the rise, the accession of Russia, Vietnam, and Ukraine to the WTO may be less formative than the possible creation of a deep trade agreement that would include Australia, India, Southeast Asia, and China, or the Trans-Pacific Partnership — a regional trade agreement that includes the United States, Australia, Malaysia, Singapore and Vietnam. In November 2011, Vladimir Putin announced the formation of a new Eurasian Union; commentators noted that Russia would use this regional organization as a way of projecting its power in the east. Realizing the assumptions that markets make about members enables a better understanding of these organizations’ effects.

This book offers two important contributions to the literature on international cooperation. The first is theoretical: I argue that portfolio investors pay attention primarily to the reputation of other members of an organization in determining a country’s willingness, not its ability, to uphold its debt. Taking insights from management theory and sociology as well as political science, I posit that investors’ private expectations about particular countries coordinate around those countries’ public affiliations within international organizations. When an emerging market announces close ties with a given group of nations, investors take the reputation of those member countries into account, as indicators of a new member’s willingness to cooperate in international bond markets. This focus on peer effects stands in contrast to much of the research that places particular emphasis on institutional design in international organizations (Koremenos, Lipson and Snidal, 2001; McCall Smith, 2000). It also stands apart from claims on how regime type and domestic institutions influence investor perceptions (Schultz and Weingast, 2003; Li and Resnick, 2003; Saiegh, 2005). This book suggests that a focus on domestic factors alone is incomplete; investors’ uncertainty coordinates on the company a country keeps in addition to what its domestic institutions look like.

The second is empirical: through data analysis as well as qualitative field research and case illustrations, I show that institutions matter to markets and also address the questions of “when” and “how” they do so. Firsthand interviews with portfolio investors, finance ministers, central bankers, and trade officials, from Brussels to Istanbul to Lima to Johannesburg, supplement the empirical findings. This on-the-ground research gives support to the theory at all levels.

This book focuses on the credibility that REO membership can give to emerging markets in particular, but the basics of the argument can also extend to the developed world. They have resonance in any situation where information is poor and where investors take

6 “At APEC, President Obama welcomes Asian trade agreement, warns Iran,” Politico, 12 November 2011.
7 “Russia’s Putin dreams of sweeping Eurasian Union,” Associated Press, 3 January 2012.
mental shortcuts to arrive at their assessments. “The company you keep” tends to op-
operate as a heuristic device that is independent of actual changes that occur in a country as a
result of international organization — that is, that the reaction is often disproportionate
to the reality. Given the recent crisis of asset-backed securities throughout the world, this
argument should have particular relevance.

The findings presented here are also of importance to the research on international
development. The terms on which countries borrow can make or break emerging markets
hoping to attract international capital. Countries in that category account for 80 percent
of the world’s population, all but a quarter of its land mass, 66 percent of its foreign-
exchange reserves, and 50 percent of its purchasing-power-parity adjusted GDP. Over 40
percent of developing-country debt is investment grade — up from just 3 percent in 1997.
As governments in developing countries issue their debt on international markets, the
interest rates associated with their sovereign debt will have big impacts on their ability
to raise revenue. And sovereign debt — government-issued debt securities, also known as
government bonds — is a fast-growing category of asset; by the end of 2011, there were
$31 trillion worth of government bonds in issue, up from $11 trillion in 2001. Thus, the
arguments and results in this book are of concern for countries hoping to raise money on
international capital markets.

Is paying attention to the company a country keeps a rational response on the part
of investors? That is, does joining an organization with good members really promote
better behavior on the part of the new member? Conversely, do countries of ill repute
infect their international partners? The answer is nuanced. Deep trade ties do leave
countries exposed to economic or political shocks in their neighbors; repeated interactions
may bring countries’ preferences closer together; and adoption of group rules may bring
members’ policies more in line with one another. I give evidence that the extent of
investor reaction is usually not justified by the observable changes in countries, not least
because the actual level of integration often falls short of the level of proposed integration.
Members of all sorts of organizations break supposedly strict rules; bailouts are extended
to countries regardless of their formal international ties; and countries do not necessarily
mimic the behavior, good or bad, of their international partners. However, since investors
traffic not only in countries’ actual performance, but in other investors’ perceptions of
that performance, the changes in risk levels may still be rational. That is, investors can
benefit in the short-term from acting on these heuristics, even if the herd’s perceptions
do not match the fundamentals on the ground, since investors have an incentive to act
in tandem with market sentiment. Of course, what is rational for one investor can create
systemic risk when compounded; investor positions become serially correlated, and a
given fixed-income instrument can become systematically over- or under-valued — but it
can still make sense for investors to follow the herd in the short run.

8“Oat cuisine,” The Economist, 11 February 2012.
9On the irrationality of markets generally, see (Kindleberger, 2005; Aspara, 2010). One study shows
that past experience and existing beliefs tend to guide investors, rather than logical thinking and rational
decision-making (Knauff et al., 2010).
1 International Cooperation and Uncertainty

This topic intersects with a broader research question that has shaped academic debate for years. Namely, how do institutions matter, and to whom? Political scientists have grappled with this question for decades. The initial stages of the debate were theoretical, with realists arguing that powerful states behaved as they pleased (Mearsheimer, 1994; Krasner, 1991). Liberal institutionalists, by contrast, argued that international organizations were pivotal in ensuring cooperation among states. The list of possible mechanisms behind how IOs might encourage cooperation among states was broad and inclusive. International organizations were assumed to simultaneously spread norms of behavior (Finnemore, 1996), reduce transaction costs (North, 1990), ensure punishment of bad behavior (Axelrod, 1984), provide information about other actors’ behavior (Milgrom, North and Weingast, 1990), and to provide frameworks for litigation and enforcement of rules (Goldstein et al., 2000; McCall Smith, 2000). These many distinct mechanisms, in the early stages of IO research, were rarely assumed to be mutually exclusive; indeed, many writers on this topic claimed that all these forces were in effect simultaneously (Keohane, 1984; Ikenberry, 1988; North, 1990). When researchers on international organizations turned to the empirical, then, they faced a daunting task. How would it be possible to disentangle these many different potential mechanisms?

I put forward and test the independent effects of a mechanism that is novel in this literature. This argument about “the company you keep” is relatively new to the field of international organizations, but it has a longstanding history in other areas of research. Disciplines throughout the social science have studied and theorized about so-called neighborhood effects. Researchers have observed the effects of peer groups in education and crime, of endorsements in management and finance; of labeling in sociology, of self-fulfilling prophecies in psychology, and of group ritualization in anthropology. Management theory has examined the influence of an underwriters’ reputation on the price of an asset (Carter and Manaster, 1990) and the self-fulfilling power of stereotypes (Chen and Bargh, 1997).

Those studies all point to the critical importance of actors’ relationships to a variety of outcomes. But the mechanisms of influence are often either ill-defined, contradictory, or both. If peer groups matter, is it because the individuals within those groups actually change their behavior as a function of being in that group? Or do others make unfair inferences about the propensities of individuals in those groups, even if those individuals’ nature is fundamentally unchanged? Or is the chain of causality more complex, such that individuals modify their behavior as a result of their new (deserved or undeserved) reputations — or even that the types of individuals who join certain groups are only acting on propensities that were previously unobserved?

This book will examine all those possible mechanisms from both a theoretical and an empirical perspective. My key argument is that, in assessing the risk premia on sovereign

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10 See Dreher and Voigt (2008); Gray (2009).
11 For just a few examples, one study in sociology focuses on how criminal activity and drug abuse patterns tend to be replicated within neighborhoods, as a result of “collective socialization” and “contagion” (Case and Katz, 1991). Mead (1934) gives a sociological account of how the self is socially constructed and reconstructed through an individual’s interactions with their community. Psychologists have studied how labeling can have negative impacts on the mentally ill (Scheff, 1966). Becker (1963) studies the effects of deviance from social groups on the behavior of an individual.
debt, investors are looking for two types of information. One is on a country’s ability to service its debt. This is information that can be gleaned relatively easily, by looking at macroeconomic indicators and past performance. But governments change; new policies are enacted; and reading the tea leaves for developing countries can be a difficult task, particularly when getting solid priors on the second type of information: a country’s willingness to service its debt. This is where “the company you keep” comes in. Visibly bad behavior among a developing country’s closest friends can make financial markets skittish about the reliability of that country by extension, since markets assume that countries form ties with nations they hope to emulate. Conversely, investors cut slack to emerging markets that themselves have histories of behaving badly, if they join groups of countries that have upstanding reputations. Joining different groups can potentially affect a country’s ability to service its debt, through the economic benefits where trade integration occurs — but the company it keeps fills in the blanks about its willingness to honor its debt obligations. This peer effect is distinct from the material benefits that may emerge as a result of international organization. Markets may not get this right, as the current financial crisis in the eurozone shows: simply being, for example, in the same club as Germany does not mean that every other country adopted fiscal discipline. But this heuristic was nonetheless a powerful driver of European sovereign spreads for years.

By looking at the role of international organizations on investor confidence, and by parsing out many different aspects of those organizations and their members that might influence third parties, this book makes important theoretical and empirical distinctions that enhance our understanding of what matters in institutions. I show how being in the same neighborhood is not equivalent to being in the same club — and how, to extend the metaphor, the requirements for entry, the rules of membership and the structure of the building are less important than the quality of the members in a particular club. In more technical terms, I demonstrate that the impacts of international organization on a country’s perceived creditworthiness are not a function of selection (the underlying propensity of an actor to choose like-minded groups). Nor can those impacts be explained away by the policy reform that countries undertake either before or during membership in a particular organization. The quality of members can have substantial effects — particularly when those members give their blessing to policy reform in new members, as in the case of the European Union, or when economic or political crisis hits an influential member, as in the case of Mercosur, the Andean Community, or the South African Development Community. In the context of international organization, the company you keep has an impact on a country’s standing in financial markets. The rational expectations hypothesis hinges on the assumption that all market participants have equal access to the same data, and that those actors also share one model of how the world works. Since IO membership is elective, unlike geography, it makes a strong statement about the types of countries that a country considers its peers, and thus serves as a potential expression of willingness to pay. Regions are static across time, whereas IO membership is dynamic — not only at the moment when countries themselves join, but also when the addition or exit of still other countries either dilute or reinforce the brand.
2 Why Emerging Markets? Why Sovereign Debt?

The claims about international organization and international cooperation are vast ones, and what I present here is an examination of these claims along a relatively narrow dimension. Drawn fine, this argument focuses on a somewhat limited sample (emerging markets) and a fairly specialized measure of credibility (sovereign debt), which is merely the collective evaluations of one set of private actors at a given time. Furthermore, the claims extend most powerfully to one particular type of international organization (regional trade agreements). This focus inevitably limits the scope of the claims I am able to make. Yet these are powerful test cases for many of the claims about international organizations and their welfare implications.

Taking those components in turn — why focus specifically on emerging markets, a category that excludes both the more developed countries and the very poorest? Richer countries have other indicators from which investors can make inferences about their debt; those deeper markets are better-understood and there is less need for heuristic shortcuts in assessing their creditworthiness. The poorest countries do not issue their debt on international markets, since their levels of risk are so great that an insufficient number of international creditors are willing to lend to them. By contrast, emerging markets occupy a middle ground — not so poor that they are fundamentally untrustworthy and not creditworthy, and not so rich that it is easy for investors to gather information about them. They are still at the stage where investors want to give them credit but have differing opinions about the risks of doing so.12 Particularly for countries with a patchy track record in the global marketplace, keeping good international company will give them a credibility boost in the eyes of investors. This is not an argument that applies to countries that are experiencing such low economic growth that their main sources of revenue are from aid. The countries under consideration here are not ravaged by war or suffering widespread famine or disease. Rather, they are all at stages of economic development where they might have buyers for their debt on international markets. Thus, they are at a point where their future may be uncertain, but there is an opportunity for investors to bet on that future — and possibly reap rewards from the risk. Elucidating the mechanism for why this might be the case can help us gain an understanding of how institutions work, and which aspects of them carry weight in specific settings.

In terms of the second component, spreads on sovereign debt — the gap between the risk associated with one country relative to a comparable more stable security, such as US Treasury bills — is but one way of operationalizing reputation. Unlike many of the other data used by social scientists, these measures are generated by a group that has an incentive to get those perceptions right: traders of a country’s sovereign debt. Scholars in the social sciences are increasingly turning to financial market data for empirical work on a number of topics relating to international behavior and domestic policy.13 What can this measure of government capability and willingness to repay its debt tell political scientists, and how does it differ from other economic indicators? I offer three main justifications for

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12 Many articles on diffusion and persuasion use this logic; where new countries or new issue areas are those most likely to be influenced by external forces. See Johnston (2001); Finnemore and Sikkink (1998).

13 See, for example, Ferguson and Schularick (2006); Mitchener and Weidenmier (2008); Tomz (2007); Stasavage (2007); Mitchener and Weidenmier (2008).
my choice of dependent variable: one is theoretical, the second is practical, and the third is the substantive implication. Spreads on sovereign debt are superior as a measure of uncertainty to many other financial indicators; its level of detail and relative availability give it an edge over other economic indicators; and finally, a country’s cost of borrowing can have important implications for its ability to raise capital on international markets.

Countries can gain international legitimacy by running military demonstrations, winning wars, throwing summits, or hosting international sporting events. This is admittedly a very specific claim about how a particular audience (international bond traders) regards international organization. Yet sovereign debt (and market measures more generally) have gained great traction in political science as a means of measuring and operationalizing otherwise elusive concepts, such as uncertainty (Root, 2005), reputation (Tomz, 2007) and credibility (Jensen and Schmith, 2005). Many of the propositions about the power of institutions center on how they decrease uncertainty, a concept that is difficult to measure directly. Investment data are particularly useful in testing such claims, since measuring and pricing uncertainty is one of the market’s fundamental operating principles. Especially in volatile emerging markets, investors stand to gain or lose vast sums of money on the basis of their bets on the security as well as the potential return of an investment. The trick, however, lies in grappling with a lack information by changing it into measurable probabilities; in other words, translating uncertainty into risk, risk into opportunity, and opportunity into profit (Root, 2005). This is of tremendous importance to developing countries, who strive to break free from development traps and gain access to international finance.

In finance, calculating risk associated with governments is a common practice, but social scientists have only recently begun to take advantage of these data. Sovereign debt — the measure employed in this book — is increasingly in use in political science as a means of measuring third-party expectations. In the past ten years, researchers have used market data — including stock market returns and sovereign paper of various maturities — to test various hypotheses. Sovereign debt in particular, though, has served as a stand-in for state credibility on international markets. Since sovereign debt often has maturities that extend past the lifespan in office of any given leader, it is a useful indicator of the reputation that countries have irrespective of who is in office.

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14See (O’Neill, 2006) on prestige in international relations, Kurscheidt and Rahmann (2006) on the reputational benefits of hosting the FIFA world cup in Germany.

15See Mosley (2003); Jensen and Schmith (2005); Stasavage (2007); Bernhard and Leblang (2002, 2006); Mosley and Singer (2009). Tomz (2007) has effectively harnessed the rates at which countries can borrow abroad as an indicator of reputation. My focus here, however, is different. Where Tomz was concerned with leveraging data on international interest rates as a proxy for a country’s reputation, I examine how that reputation changes as a function of membership in international organizations. In technical terms, then, although this concerns the same outcome (dependent variable), the main explanatory factors (independent variables) differ. Tomz provided convincing empirical evidence that yields on countries’ sovereign debt are a strong indicator of a country’s reputation on international credit markets, and that yields are elastic to bad behavior on the part of those countries. That is, when countries give indication of defaulting on their debt, markets treat them as more risky investments. However, I show that developing countries need not behave badly themselves in order to be treated as risky investments. If they form close ties with other countries who engage in risky behavior, investors will treat them as risky, too. Thus, my argument takes a different theoretical tack: I show that countries’ reputations are a function not only of their own behavior but of the behavior of their friends. This implies that investors piece together their assessments of countries’ reputations through what are at times inefficient means.
Theoretically, sovereign debt offers a summary of how markets rate government stability as well as the future levels of development in a country. Unlike other forms of investment, such as foreign direct investment in long-term plants and projects, bondholders have little interest in the promotion of any one good, in historical ties to a country, or in current-day alliances. Bondholders seek profit — and relatively quick profit at that — and they profit from seeking relatively high rates of return in environments with varying degrees of risk. As such, the yields and spreads on bonds reflect perceptions of that economy, both in terms of other investors’ assessments as well as in future returns on investment (I will discuss in further detail below how those perceptions work). Thus, they are themselves a measure of collective uncertainty about the ability as well as the willingness of a country’s government to uphold its obligations to service its debt. Yields on sovereign debt are therefore an obvious theoretical choice in testing the claims about expectations of future behavior found in the literature on international institutions, which claims that institutions should regularize behavior and encourage cooperation.

Utilizing sovereign debt yields for research purposes also provides substantial practical advantages. Particularly in developing countries, where data are only as reliable as the governments that collect them, this type of financial market data offers significant benefits to researchers. For one thing, there is a lot of it, and at high levels of detail. Although trading of emerging-market sovereign debt only became widespread in the 1990s, the fifteen years for which data are available represent a full cycle of operations for bond investors, including the heady days of enthusiasm for emerging-market debt in the mid-1990s and the investment backlash following the Latin American and East Asian debt crises (Erb, Harvey and Viskanta, 2000). Though coverage of sovereign debt varies across region, in many cases it is available in weekly and daily increments. This is far more substantial and detailed coverage than can be had for many other economic indicators in emerging markets. The level of detail afforded by sovereign debt allows us to examine the impact of particular events as well as trends over time.

Finally, and importantly, there is a considerable substantive reason that social scientists — and indeed, governments — should be concerned with estimating the determinants of sovereign risk. The volume of money traded in sovereign debt is huge. The 2008 financial crisis and its aftermath initially dampened investors’ tolerance for risk, but portfolio investment will not rebound cyclically, and that emerging economies will have ever greater access to international capital. The Institute for International Finance estimated capital flows to emerging markets totaled $435 billion in 2009, down from $667 billion in 2008. But in 2010, emerging market debt trade reached a record high of $6.765 trillion. More and more countries are turning to sovereign bond markets as a form of financing; even Angola, one of the most risky sovereign investments, took advantage of the increasing appetite for emerging market sovereign debt by issuing a bond in January of 2011. Sovereign debt is thus an increasingly important part of international capital flows.

Therefore, risk levels in sovereign debt are rightfully making headway in political

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16 See Biglaiser and DeRouen (2007) on how FDI tends to track military alliances or colonial ties.
19 “Angolan Eurobond Yield May Be Near Nigeria’s on Oil Boost, Standard Says,” Bloomberg, 21 April 2011
science and public policy for theoretical and practical reasons, as well as for the increased importance these debt instruments play in emerging economies’ fortunes. In addition to the relative quality and availability of these indicators compared with other types of economic data in developing countries, they also serve as an independent measure of uncertainty — a concept that is extremely important in much of the literature on the consequences of membership in international institutions — and provide us with leverage in operationalizing difficult-to-measure concepts such as risk and uncertainty. They are also in of themselves an increasingly important means of financing in emerging markets. Previous research (Mosley, 2003) has shown the powerful effect that market forces can have on governments. The cost at which a country can borrow on international markets has immense impact on its ability to raise revenue. For an emerging market, prohibitively high interest rates on international capital markets effectively cuts them off from that source of financing — so it is important to determine the factors that make emerging markets seem less risky to investors.

3 Chapter Outline

This book proceeds in the following manner. Chapter 2 lays out the theoretical underpinnings of the central hypothesis: that “the company you keep” on the international stage can make an emerging market look more or less risky, depending on the nature of that company. Organizations that promote economic links among members with strong political quality seem less risky to investors; conversely, membership in organizations with countries of poor political quality will increase perceived risk. Investors make inferences about a country’s willingness (not its ability) to repay its debt based on the company it keeps. This is a function of both the public nature of economic agreements and a relative commonality of its interpretation. This chapter also examines rival explanations in the form of hypotheses to be tested in subsequent chapters. These hypotheses include the possibility that creditworthy countries “select” into good institutions; that countries undergo changes either in the run-up to entering the organization; or that investors are anticipating the enforcement of rules once countries join an organization.

The third chapter extends the argument to a global scale. I test the argument on all emerging markets that issue debt on international markets, and examine the effects of membership in a wide variety of international organizations. I demonstrate evidence for the central hypothesis — that risk decreases when emerging markets integrate closely with good-quality members — for a sample of over 100 developing countries, both on quarterly data from 1993 to the 2008 and on annual data from 1980 to 2008. This finding holds up against the three alternate hypotheses described above. Economic and political indicators as well as metrics for policy reform do not cancel out the evidence for “the company a country keeps.” The central finding is robust to the possibility of enforcement, as indicated by greater legalization and dispute-settlement in the agreement, and of economic changes in member states. The effect of proposed integration with good-quality countries is substantial; its magnitude trumps many of the variables indicating economic fundamentals on the ground.

The fourth chapter focuses on a single organization, to test the argument that the institution itself matters more than what you do to get in. I demonstrate that candidacy for the European Union leads to a decrease in perceived default risk. I find that the
drop in risk is strongest when the EU puts its “seal of approval” on candidates’ economic policy reform in the negotiation stage. I also test three alternative hypotheses for the mechanism behind the drop in risk. First, I use instrumental variables to measure the cultural factors that drive states to open negotiations with the EU, while controlling for the unobservable factors that affect market perceptions. Additionally, I test whether this effect is the result of preexisting policy reform taken either within or outside the process of EU accession. I also look at enforcement records of the EU, by examining violations of the Stability and Growth pact as well as budget crises in Hungary and bailouts of both EU and non-EU members. I find little evidence for any of the alternate mechanisms: the “seal of approval” has the strongest effect.

The fifth chapter looks at the underbelly of the company a country keeps — when joining groups with risky partners will lead to increases in perceived risk and uncertainty. I focus in particularly on membership patterns in ALBA, which was founded by Cuba and Venezuela to serve as a leftist counterpart to other integration schemes; the organization is strongly identified with Hugo Chávez and his anti-Western rhetoric. Although for some countries, the news of their accession was no surprise — Bolivia’s Evo Morales had already identified strongly with socialism when his country joined, for example — for other countries their membership gave new information to investors. I show the changes in perception that accompanied their joining. For Russia — the country most in flux at the time of the announcement of the Eurasian Union — risk perceptions increased once it proclaimed closer ties with Belarus and Kazakhstan. I also show how risk levels changed for Tanzania once it pulled out of COMESA, a poorly functioning trade agreement in Africa. Finally, I examine the impact of China’s free-trade areas in emerging markets, demonstrating that although risk for those countries has not increased systematically, the variance surrounding investor perceptions has increased.

Chapter Six looks at the effects of new entrants to organizations on core members. This chapter explicitly focuses on the effects of enlargement to existing institutions, a topic that is understudied in political science. Taking the example of Germany, I also show that the drop in risk levels emerging markets entering good organizations are echoed by slight increases in risk for the stable members at that organization’s core. I look at investor reaction to defaults in the Mercosur countries; an illustration of Uruguay’s debt restructuring following the Argentine crisis demonstrates that investors were overly skittish about Uruguay’s prospects based on the company it kept. I also show how opening Mercosur entry to Venezuela — an oil-rich country with a high level of political risk — was associated with increases in risk for core Mercosur members. But, under what conditions does the company a country keep begin to lose its sway? Finally, I show how letting in too many risky members can degrade the brand of a good organization, by looking at changes in risk as countries negotiated with a larger European Union after the 2007 enlargement. This demonstrates that risk for core members can actually increase by letting in new members — evidence that challenges the view of research in endogenous cooperation, which holds that heads of state will only form institutions where compliance is likely, and therefore do not take risks (Downs, Rocke and Barsoom, 1996).

The final chapter concludes by expanding on the implications of the central argument, that investors react decisively to membership in international institutions at two extremes: they reward membership in agreements with high-quality members, and they punish those who join agreements with poor-quality members. This is an important find-
ing for the study of international cooperation and comparative development. In addition to its contribution to the academic literature, this book has implications for public policy as well as for future studies of the merits and demerits of international economic ties and international agreements. Currently, international organizations of all variety are in flux. Debate rages in the European Union over the consequences of opening negotiations with Turkey, which likely played a part in France’s recent rejection of the constitution. While the effects of NAFTA are still a subject of controversy, the United States’s attempt to create a comprehensive trade agreement in Central America has stalled, in favor of pursuing bilateral trade agreements with developing countries. At the same time, the Doha round of negotiations in the WTO have been aborted, and the future of institutionalized multilateral trade is unclear. Crucial to these discussions is whether and how the institution can maintain its clout among international audiences, providing benefits to developed and developing members alike. By disentangling the characteristics of international institutions that matter to financial markets, this project will contribute to discussions of effective institutional design, as well as regional integration and economic cooperation. Furthermore, it sheds light on one of the most common claims of the literature on international institutions — the claim of reduced uncertainty — and provides a theoretical as well as an empirical elaboration of the conditions that contribute to that uncertainty.

References


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