THE RISK OF DEMOCRACY

THEORETICAL AND EMPIRICAL CONSIDERATIONS ON THE EFFECTS OF ELECTORAL UNCERTAINTY ON LATIN AMERICAN EMERGING MARKETS

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ABSTRACT

I derive two basic models from political-business cycle (PBC) theory and the original obsolescing bargain model to assess the level of political and economic risk associated with Latin American elections. The first model posits that the economic risks associated with the victory of a given candidate are a function of both ideology and the macroeconomic outlook of the country. The second model builds on these assumptions to analyze the specific case of the risk of expropriation or measures tantamount to expropriation, as well as of other disruptive policies such as sudden tax hikes. It posits that this particular risk is a function of the ideological preferences of the government, as in the first case, but also of the economic cost associated with the policy.

I contend that the models help explain past and recent instances of macroeconomic instability and expropriation events. I also argue that the PBC model explains why the lead of left-wing candidates in Mexico and Brazil has not resulted in an increased perception of risk for these countries as measured by sovereign spreads—in spite of the notion that these types of candidates are invariable associated with investor malaise. I also argue, however, that the models and the theories from which they are derived are best understood as frameworks for the analysis and that it is difficult to generalize the conclusions derived from any given case.

I. RISK, UNCERTAINTY AND THE PBC APPROACH

Following Frank Knight's (1921, p. 233) classical insight, risk can be defined as the probabilistic distribution of a group of outcomes that is known beforehand, be it through a priori calculations or from statistics of past experience. Uncertainty, in contrast, occurs when there are two or more possible outcomes and their probabilities are not known—typically because the event is deemed to be relatively unique. (Certainty would be thus defined as the situation in which there is a single known outcome.) Therefore, from a theoretical standpoint, risk would only exist when all the possible outcomes are known beforehand and we are able to attach probabilities to each of them. Conversely, uncertainty occurs when we are not able to determine a defined set of outcomes—which is the case in most human endeavors—or to assign probabilities to them.

In order to illustrate this distinction, let's consider the case of a gambler that has to make a decision about whether to place a bet or not. If he is playing a game that he is familiar with—say, for example, Texas Hold'em—he can calculate his chances of winning by calculating the probability of having the best hand given the cards he has already seen and those he hasn't, because there is a finite amount of cards and a finite number of known possible combinations—as well as finite number of outcomes: winning, losing or dividing the pot. Thus, in placing a bet he is taking a known, defined, risk. Now, let's consider the same gambler pondering whether to propose to a woman he just met. To be sure, there may be a finite amount of possible outcomes: his proposal can be rejected, accepted or put aside for further consideration. However, unless he has proposed to a relatively large number of strangers in the past, there is no way he can mathematically determine the probabilities associated with each outcome. Furthermore, since he has virtually no information about the woman, he cannot even guess these

probabilities and it might still be possible for there to be other outcomes that he hasn't even considered—she could be already married, for example, and a jealous husband will kill him on the spot if he proposes to her.

Investors in the real world tend to find themselves somewhere between these two extremes. As Schackle (1969) has noted, uncertainty is bounded. That is, decision makers may be able to determine the most important outcomes—although, alas, not necessarily all possible ones—and estimate their probability with varying degrees of accuracy, and it is only when they can't do so that they are effectively "powerless" and complete uncertainty occurs. Therefore, in real life one can think of a continuum between certainty and uncertainty with particular decision-making conditions falling in between. Kobrin's (1979) distinction between certainty and what he dubs "objective" and "subjective" uncertainties is particularly useful.

According to Kobrin, certainty occurs when investors are able to estimate that one outcome is so likely to occur, that it is so dominant, that it renders all other possible outcomes practically irrelevant—a condition akin to Knight's definition of the term, or at least as close as one is bound to come given the complexities of the real world. In turn, "objective uncertainty" characterizes those cases in which there is no dominant outcome, but information is readily available and all the feasible outcomes are known and the vast majority of observers agree upon their probabilities—the functional equivalent of the definition of risk I outlined at the beginning of this section, and therefore I will continue to use the term "risk" to refer to it. Finally, "subjective uncertainty" (henceforth, simply "uncertainty") exists when the assumptions about the outcomes and their probability stem from "perceptions that are a function of the available information, previous experience, and individual cognitive processes which synthesize

both into an imagined future" (p. 70). This would be the case when the information is scarce or contradictory, and the outcomes and probabilities are not a function of an objective, broad consensus, but personal biases. (And are thus not quantifiable in any meaningful measure, they are personal opinions or guesses that cannot be corroborated.)

The distinction between risk and uncertainty may appear to be trivial at first glance, a mere issue of semantics, but it is crucial to the understanding of electoral risk. As a first approach, one could argue that in the context of an electoral process, certainty would exist when the possible actions taken by the government in the campaign period are predictable and so are the future policies that may be enacted by the winning candidate, regardless of who she might be. This would be the case of an election in the United States, for example. Regardless of who wins the election, investors may reasonably expect that the government will not declare martial law on the eve of the elections. And said investors may also be safe in assuming that the winning candidate will not engage in a broad effort to expropriate their property, in spite of her partisan affiliation, or that the government will implement regulation forbidding them from transferring their capital abroad before or after the elections.

Following the same reasoning, these investors would face an objective uncertainty, i.e. they bear risk, when both the incumbent and the winning candidate may implement one or several of a broad range of policies that affect their investment, but the information about the general orientation of these policies is widely available and it is very unlikely that either one will deviate significantly from it. While defining the exact probabilities that any given policy will be implemented may be difficult—at this stage of development of the political risk models, it may be more precise to say "impossible"—

investors may rely on a wealth of other indicators and data to assess their particular risk given the defined set of possible outcomes, to the point at which alluding to "electoral risks" may be moot. This would be the case of the elections in the United Kingdom for example. While one could speculate about a potential inclination of the Labour Party to increase spending either as an incumbent or after winning the elections, the fact is that the vast majority of analysts would concur that any expansionary policy would remain firmly constrained by macroeconomic considerations—which would effectively bar the possibility of a radical change in fiscal policy.

Finally, uncertainty may arise when there is not enough information about the incumbent or the winning candidate—or, as in the case of Brazil in 2002, about the leading candidate—and investors are then forced to rely on assumptions about their possible behavior that are rooted in previous experiences that may not be relevant or at least comparable to the case at hand. Let's consider, for example, the case of Hugo Chavez in Venezuela in 1999. At that point, little was known about Chavez's political platform and policy preferences, and even less about his ability to carry them out. At any given point, investors would have been justified in believing that there was a high probability that Chavez would engage in a broad effort to expropriate foreign investments in the oil sector, as they would have been in assuming that a civil war was looming in the horizon. Furthermore, since no other radical former military officer—and former coup leader—had ever come that close to winning the Presidency in relatively free and competitive elections in Latin America—let alone actually doing so—there was no other case to compare it with. Thus, investors were forced to rely on estimates that were educated guesses at best.

This is a rather simplistic analysis to be sure, and I will introduce significant caveats and elaborations to it throughout this section, but it is nevertheless useful in establishing the framework for the discussion of the issue at hand, because it suggests a number of considerations. First, it should be clear that what is commonly referred as risk is in fact a combination of risks and uncertainties, and that in some cases the latter will carry a greater weight in the assessment of the risk associated with electoral cycles. Second, since risk and uncertainty are a function of the specific exposure of the investor to the electoral cycle, it follows that they are better understood in the context of the investment strategies that created the exposure in the first place and those that could be undertaken to mitigate it. Finally and perhaps more importantly, it also suggests that there is no necessary correlation between democracy and risk. To be sure, democratic processes entail an "institutionalized uncertainty" that prevents us from determining the outcome beforehand (Przeworski, 2001)[1]. However, this uncertainty need not be absolute or even particularly relevant. As I have already argued, democratic elections in developed economies tend to be characterized by relative greater levels of certainty than of risk—and virtually non-existent levels of uncertainty. And given the fact that this is clearly not the case of the recent history of Latin American emerging markets, we should be skeptical of any attempt at establishing any direct and unqualified link between democratization and risk levels, and specially so when the basic institutional framework of democratic governance is already in place. One would be hard pressed to argue, for example, that Brazil has not been a democracy by any meaningful measure

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[1] Elections in authoritarian regimes, in as much as they cannot be characterized as "democratic" entail a different set of uncertainties, because even though the outcome tends to be known beforehand, there are precious few constraints on the new leadership.

since the promulgation of the 1988 Constitution, and yet its risk levels have been comparably volatile to those of non-democratic emerging markets. Or consider the case of Argentina, in which the same democratic system has been associated with the broadest and deepest economic liberalization process in the region and, less than a decade later, with the largest international sovereign default to date and what may well be the broadest assault on property rights in the history of the region (Corrales, 2002; Murillo, 2002).

Therefore, in building a definition of electoral risk one should be careful to distinguish between the uncertainty about the outcome that characterizes any democratic electoral process and the specific characteristics of emerging market democracies that might have an effect on the levels of risk and uncertainty borne by investors that are exposed to these countries and are not present in developed markets. And the best way to introduce this distinction is by looking at the theories that underpin most of the analysis undertaken with regards to emerging market risk, in both academia and the financial sector: the political-business cycle (PBC) theory and the obsolescing bargain model. Taken together, both theories provide the most comprehensive and powerful explanation of why emerging markets are perceived to be more risky and under which circumstances this may be a sound assessment.

A political-business cycle model

At its core, PBC theory posits that politicians will manipulate fiscal and monetary policies in order to control inflation or promote employment in order to get elected or reelected. Further elaborations of this theory, distinguish between this "opportunistic" PBC and another ideologically-motivated or "partisan" PBC, which assumes that politicians will

engage in said manipulation not because of short-term electoral concerns, but rather because their ideological preferences favor either growth and employment or price stability (Hibbs, 1977)[2]. Both versions of the theory have been applied with relative success across a wide sample of countries and electoral periods (Alesina et al, 1997) and particularly in developing countries (Martinez, 2005; Schuchnecht, 1996) and they underpin, either explicitly or implicitly, most of the analysis of emerging market risk and particularly in Latin America. Consider, for example, the following quotes from the *Financial Times* and *The Wall Street Journal,* which exemplify a typical partisan PBC kind of analysis:

> […] And in Brazil, leftwing president Luiz Inácio Lula da Silva is maintaining his commitment to conservative fiscal and monetary policy - although that is starting to look more threadbare following the resignation last week of the fiscally orthodox Antonio Palocci as finance minister amid the latest of a series of corruption scandals. With Mr. Lula da Silva facing an election this year, the appeal of easing spending controls could increase, especially since his economy has grown at only around 2 per cent a year since his election in 2002." (Richard Lapper 2006. Why Investors are Deaf to the Latin American March of the Populists. *Financial Times*, April 5th.)

> "Even in Mexico -- once a sure bet to go broke every six years, but now a model of stability -- the leader in the polls for July's presidential election is leftist Andrés Manuel López Obrador. […] Some analysts fear his policies could prompt a rise in inflation, a decline in the peso and a run on the nation's bonds, although it is unclear how he would govern." (John Lyons 2006. Latin America's Political Uncertainty Stirs Volatility Adored by Bond Traders. *The Wall Street Journal*, February 17, Page C1.)

This kind of analyses is typical of what many authors have referred to as the "confidence game" of emerging markets politics (Krugman, 2002; Martinez and Santiso, 2003), which refers to the purported tendency of analysts and investors to focus on the personal and professional background of Latin American presidents and their economic

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[2] The theory assumes, following basic monetary theory, that the government can either promote growth or control inflation, but not both at the same time.

and finance ministers, for the purposes of identifying their partisan orientation—and thus, the implications of their ascendance to power for the region's economies. The authors suggest that, given the pervasive nature of the confidence game, a candidate or a government can play investor expectations by appointing—or signaling his willingness to do so—an economic team with the right "credentials": typically, a remarkable career in the financial sector or an international financial institution (IFI) and academic degrees granted by prestigious foreign universities. And while one could make the case that such crass manipulation would only have a major effect on the least sophisticated of investors[3], it is nevertheless clear that it has some effect on the mainstream analysis of emerging markets risk. This would support the notion that, to the extent that a candidate is concerned about investors' expectations, this kind of signaling might be an expedient communication strategy—although it is more common for "leftist" candidates to leave the signaling to their economic advisors, so as not to lose face with their more radical constituents.

The reach of the PBC theory tenets goes beyond the "confidence game" types of analysis, though. Consider the following press release by Moody's Investor Services, a leading bond-rating agency explaining its decision to downgrade Brazilian bonds in the eve of the 2002 general elections:

> Moody's noted that despite the success of the current administration in facing a number of adverse external economic and financial shocks, the next government

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[3] The articles I quoted, like most of the news coverage on the topic, are also careful to mention that many fund-managers regard this partisan concerns as inconsequential, or more precisely, as sources of arbitrage opportunities. As one analyst put it: "Everyone understands that whatever government comes in, things have to change. […] When policies change companies can make a lot of money" (Liu-Er Chen, as quoted by Conrad de Aenlle 2005. Investing: Enjoying a Latin idyll. International Herald Tribune, October 21). I will discuss the rationality of these arbitrage strategies in further detail later.

will face a number of challenges. In order to maintain a stable public-sector debt dynamic, the next administration will need to maintain high primary surpluses on a sustained basis. At the same time, political pressure is building for the next administration to reactivate the economy. Achieving these two goals simultaneously under the best of circumstances may prove difficult." (Moody's, 2002).

These quotes illustrate both the enduring appeal of the basic PBC insights and the complexity of emerging market risk analysis. On the one hand, mainstream analyses tend to assume that some level of manipulation of fiscal and monetary policies is likely to take place during electoral periods in Latin America, and while this assumption is supported by past experiences, it might not necessarily be valid today. On the other hand, candidate-specific uncertainty plays some role in the analysis, but it need not be the most important consideration or even a particularly relevant one, since there are a number of international and domestic macroeconomic variables at play, as well as domestic politics-related ones. It follows then that PBC theory is a useful starting point for the modeling of electoral risks in Latin America in spite of its known limitations[4]; and that a "confidence-game" type of analysis focused on investor bias while intuitively—one might say ideologically—appealing, may also be too reductionist to be of any value. To be sure, there is ample anecdotal and statistical evidence to show that investors have tended to shy away from the "Byzantine politics" of emerging markets in the past. I would argue, however, that as investors in these markets grow more sophisticated and the amount of available information increases, the idea of investors fleeing *en masse* as a result of uncertain democratic elections does not adequately reflect reality. In order to prove this assertion, in the following pages I will derive a basic model of electoral risks

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[4] The model makes a number of strong and rather questionable assumptions about the structure of the economy and the preferences and the information available to policymakers, voters and the general public (Zarnowitz, 1996, p. 52).

as per the fundamental tenets of PBC theory, which shows that the uncertainty about the outcome of a given democratic election is but one of many variables that determine the relative levels of risk and uncertainty.

Let's consider the following simplified[5] version of the basic model implied by the opportunistic PBC theory, in which the probability (p) of economic problems is a function of the of the relative cost of the government enacting expansionary fiscal and monetary policies (E, 0 for non-existent to 1 for the highest possible ones), measured in terms of capital and current account imbalances, and the proximity of the elections (ß, which can take a value between 0 right after the elections and 1 right before). We should also introduce a time variable (t), to account for the fact that we are assuming that the immediate effect of the policies will be positive and that its negative effects can be deferred until after the new government—or the incumbent, if reelected—is installed (t+1) and it has had the opportunity to undertake contractionary policies (t+2). That is, incumbents are confident that their short-term policies will boost their popularity and that they will still have time to correct them if need be after the elections, i.e. expansionary policies can be followed by contractionary policies with relatively low cost to the government and the economy as a whole:

$$p_{t+2} = ß_t E_t - ß_{t+1} E_{t+1}.$$

As per the general provisions of the opportunistic PBC theory, the model suggests that the actual probability of economic instability in time t+2 would rise as a consequence of opportunistic incumbent behavior but that it may be partially mitigated

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[5] I will not delve into the specific equations of the macroeconomic models that have been developed for the theory because they are not of particular interest for the discussion of the issue at hand. I am confident that my simplified version is compatible with them and for those so inclined, Nordhaus (1975) develops the set of economic equations on which all the subsequent elaborations, including mine, are based.

by the actions undertaken in time t+1. This is due to the fact that we assume that E_{t+1} is greater than E_t, i.e. that the relative cost of implementing expansionary policies after the elections is increased as a result of the imbalances created or exacerbated during the campaigns and that, in as much as the new government is aware of this, it is less likely to implement them—provided that the next elections will take place in a relatively distant future[6].

We can further strengthen the model through the addition of partisan PBC considerations by introducing an "ideology" variable (I, with values between 0, or strong ideological preference for price stability, and 1, or strong ideological preference for inflationary policies) so that $p=ßE+I$ and $0 > p_t+p_{t+1} >1$—i.e. the combination can only produce certainty (0) or absolute risk (1), and we should therefore ascribe values to ß, E

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[6] The model would not work, for example, when the new government is forced to maintain expansionary policies or is prevented from implementing corrective ones as a result of a non-electoral pressures that surface or become significant *after* the election—such as a generalized discontent about the likely imposition of corrective policies that erupts *after* the new government is installed. Strictly speaking, such cases are beyond the purported scope of the model, because one cannot analyze the likelihood of a government being deposed through non-constitutional means shortly after the elections through PBC theory—nor, for that matter, with any of the current political risk models (see Lind and Santiso, 2002). However, I would suggest that the equation could be modified as follows to account for these cases: $p_{t+2}= ß_tE_t + \partial ß_{t+1}$, where $\partial > 1$, $0 < ß_tE_t + \partial ß_{t+1} < 1$, and $0 < B_{t+1} < 0.5$, since governments would tend to assume that opposition groups will resort to non-constitutional strategies more often when the next scheduled elections, either general or legislative, lay farther away in time and are thus more likely to take their chances regardless of the cost. This assumption would appear to be justified by the recent history of government changes brought about by non-electoral procedures in Latin America: of the 14 Presidents that were deposed as a result of widespread political instability since 1993, 2 were deposed in the year immediately following the general elections and none the year before the next legislative or general elections were scheduled to take place. Explaining why this might be the case or if the modified equation would hold across a wider variety of cases is, regrettably, beyond the scope of this paper, although it does pose an interesting question for democracy theorists.

and I that reflect both their different weights and their relative importance for the case at hand. Substituting for p, we end up with the following equation:

$$p_{t+2} = (\beta_t E_t + I_t) + (\beta_{t+1} E_{t+1} + I_{t+1})$$

Simply put, the greatest probability of economic instability at time t+2 occurs when both the incumbent and the winner—if they are not the same—are ideologically inclined to promote economic growth, regardless of its potential cost to the economy. This worst-case scenario is plausible because, in spite of the original assumptions of the opportunistic PBC model—i.e. perfect knowledge on the part of the government of the macroeconomic effects of its policies and a necessary application of contractionary policies in time t+1—the partisan version allows for miscalculation—if not blatant disregard—of the economic costs of any given policy due to ideological bias.

The advantages of this formulation are twofold. On the one hand, it is compatible with the findings of the ground-breaking study by Vaaler, Burkhart and Block (2006), which found that secondary bond markets perceive a higher probability of default of sovereign bonds—a rough proxy for economic instability, measured in terms of sovereign interest rate spreads over US Treasuries—in those cases in which the incumbent is trailing an opposition candidate in the opinion polls leading to the elections, and particularly so when the incumbent, the leading candidate or both are perceived to be "left-wing"—in terms of the model, when I_{t+1}, I_t or both are perceived to be > 0.5. (See Table 1.) It is also compatible with the findings of a number of empirical studies and papers that apply the PBC theory to Brazil, Venezuela and Argentina throughout the 1970's and 1980's (Spanakos, 2002) and others that find that the variables incorporated in the model are significant in determining forward exchange rate variations (Freeman,

Hays and Stix, 2000; Bernhard and Leblang, 2000) and the volatility of the Brazilian stock market (Jensen and Schmith, 2005).

TABLE 1: PBC AND SOVEREIGN RISK		
	"Right-wing" incumbent	**"Left-wing" incumbent**
"Right-wing" candidate leads	Lower spreads	Higher spreads
"Left-wing" candidate leads the opinion polls	Higher spreads	Higher spreads
Source: Adapted from Vaaler, Burkhart and Block (2006).		

On the other hand, the model also recoups one of the most fundamental insights of PBC theory, which is, alas, often overlooked: the effects of the PBC, measured in terms of the likelihood of economic instability, increased deficits or pressures on the foreign exchange rate, may indeed be low or non-existent, even in the context of blatant opportunistic and partisan manipulation of fiscal and monetary variables, provided that the relative cost of these policies is very low. After all, under the right conditions—sustained periods of net capital inflows for example—a government may be able to manipulate fiscal and monetary policy to promote growth at will with relatively insignificant costs. This might explain in part why, as many authors have noted, the evidence of the actual existence of the purported effects of PBCs is far from conclusive (Alt and Chrystal, 1983; Bender and Drazen, 2003).

This is not to say, though, that this version of the model can provide a clear-cut assessment of economic risk or that it truly captures the dynamics at play in all cases. In as much as the model relies partially on an assessment of the policy preferences of the incumbent and the leading challenger, it is bound to be somewhat skewed in favor of those governments and candidates that are able to signal their intentions more clearly and credibly; and more specifically, it would tend to be biased towards price-stability

committed political actors since only fiscally responsible governments or would-be governments tend to feel the need to signal their firm commitment to a given policy. This would seem to support the notion implied by the confidence game that signaling matters and is supported by previous observations of emerging markets investment behavior— as Krugman (2002) has noted, strong macroeconomic fundamentals are a necessary albeit not sufficient condition to assure market confidence and particularly so during periods of relative high political uncertainty, such as elections. However, it would be hard to argue that this is the case in contemporary emerging market and, as I will show, in Mexico and Brazil in particular. Moreover, the notion that price stability is an inherently preferable policy in terms of the macroeconomic outlook of the country, as the model would imply, deserves some scrutiny.

Let's consider the problem of identifying policy preferences first. It is not an accident that the vast majority of confirmed PBC-effect sightings, both partisan and opportunistic, are largely constrained to developing countries over the 1970's-1990's period. Ceteris paribus, one would expect opportunistic and partisan PBC's to be more common when the government has relatively strong hold over the policy-making process. That is, we should expect to see opportunistic PBC effects when the incumbent is not constrained in the policy choices it can undertake—and in this context, the value of signaling commitment would be the greatest. However, as these countries—and particular Latin American ones—evolve into full-fledged democracies, the incumbent's ability to manipulate fiscal and monetary policy tends to become more and more constrained due to the increase in the number of influential political actors that may or may not play the role of "veto players" Some of this may be international, taking the form of an international financial institution (IFI) forcefully imposing a set of policies—as the

critics of the IMF contend (Feldstein, 1998; Stiglitz, 2002). However, these veto processes need not to be so controversial or apparently undemocratic. Consider the simple case in which the President does not have the legislative majority required to pass the budget for the year in which the elections will take place, and she needs the support of an opposition party that is only moderately aligned with her policy preferences. In this case, the ability of the incumbent to create an opportunistic or partisan PBC will be limited at best. And if the President is no longer in control of the monetary policy—due to the existence of an independent central bank—the probability will decline even further. Thus, even if we were to argue with some certainty that a given incumbent is more inclined to pursue a set policy course, this assessment should be modified by accounting for its actual ability to do so. Following the previous formulation, in which p = ßE+I, we would have to say that p is modified by an "ability" variable (α) so that the probability of an expansionary policy is tempered by the incumbent's hold over the policy making process. However, this subtlety is better captured by the modern elaborations of the obsolescing bargain that I discuss below and is seldom incorporated in the bulk of the analyses, which tend to assume that the incumbent is not constrained in its policy-making capabilities.

The assumption that price stability is inherently preferable should also be deeply annotated. Consider the notion that the current liquidity of international capital markets, which fosters record investment levels in Latin American emerging markets, and the international commodities markets boom, which has created an extraordinary windfall for many commodity-export dependent economies, have in effect rendered PBC concerns, and particularly partisan ones, irrelevant for the purposes of analyzing the risk

associated with the current Latin American electoral processes. Awash with commodity-related hard-currency income and seemingly endless capital inflows, Latin American governments can in fact, to put in terms of the widely used allegory, "have the cake and eat it". And even though this bonanza is unlikely to last much longer and thus should be regarded with cautious optimism, it further underscores the potential pitfalls of unquestioningly assuming that price-stability is preferable across all cases and time-periods. Moreover, in this context, policy preferences would tend to be more relevant on the margin if at all. Given strong economic fundamentals, such as a relatively low exposure to interest rate shocks, a longer-term maturity debt structure, higher levels of institutional development—including an independent central bank with exclusive authority over monetary policy and relatively well-developed local capital markets—and a flexible exchange rate regime that allows for gradual adjustments in response to changes in the current account balance (Reinhart, Rogoff and Savastano, 2003), policy preferences would play a relatively minor role, largely restricted to allowing us to distinguish between countries with otherwise functionally identical macroeconomic outlooks and in periods longer than t+2—e.g. the likelihood that one country will be able to implement structural reforms over the course of the next five years, while the other will not.

The preceding analysis need not imply that we should abandon the idea of modeling electoral risks altogether or that the PBC approach is not useful as a basic framework. As I have already argued, it informs most of the discussion of risks in emerging markets and it remains a valid explanation across a wide sample of cases. And unless one is willing to argue that this or that Latin American market has in fact "emerged"—a tall order but certainly not an impossible one—it provides the strongest

basis for a first approach to the analysis of the cases at hand. However, as I will show, opportunistic PBC models may be particularly ill-suited to explain a broader array of policies—although not necessarily partisan ones—and that a more in-depth case-by-case analysis, based on the obsolescing bargain, might be in order, and not only at the country-level but also at an industry- if not company-level.

In the next section, I will explore some further considerations on emerging market risk that are derived from the preceding analysis and the experience in both emerging and developed markets in order to determine when it would be relatively more important to pay closer attention to country-specific and industry-specific variables. Specifically, I will discuss how and when risks and uncertainties that are not strictly related to monetary and fiscal policies might be particularly relevant for the analysis. I will also show that different investors, in as much as they have different exposures to government actions and political events, will face different levels of risk in the same socio-political environment, and that this exposure is not necessarily linked to a country's emerging market status. An investor operates in a specific legal and political framework, which is comprised by a defined set of relevant international, national and local laws, regulations and political interests that are not necessarily common to other foreign or domestic investors in the same country and not even within the same industry—e.g. a British port operator is not subject to the same risks as an Arab one in the American market; a Brazilian oil company is in a better position in Venezuela than its American counterparts.

Figure 1: Latin American and Argentinean Sovereign Spreads, 1997-

Latin America Sovereigns ex Argentina — Argentina

De la Rua resigns, Argentina defaults

Second and last IMF bailout

Blindaje (First IMF bailout)

De la Rua is elected

Brazilian real devaluation

Source: Derived from the MSHYci Global High-Yield Indexes

II. THE INVESTOR AND THE OBSOLESCING BARGAIN

The PBC theory assumes that electoral risks are exclusively economic in nature, i.e. the direct result of the manipulation of fiscal or monetary policies or both. However, this is not the case in most emerging markets and particularly so in Latin America. Investors are exposed to emerging market economies through their investments in: a) productive assets located in an emerging market country (direct investment) or b) securities, such as stock or bonds, whose returns are linked in way or the other to the performance of an emerging market economy or a group of emerging market economies (portfolio investments). The distinction between these two categories can be rather arbitrary, as is the one between foreign and domestic investors, but one can nevertheless establish that, ceteris paribus, portfolio investors tend to be more concerned about economic risks, and that direct investors are exposed to certain risks that we may denominate as "political" and that do not necessarily imply any significant economic risks—although they often do. Throughout this section, I will explore the different categories of investors and of the risks they bear to determine to what extent the insights of the PBC theory may apply to them. I will then discuss the obsolescing bargain model as an alternative to opportunistic PBC-based approaches, and its implications for partisan PBC ones.

Classifying investors: beyond national origin

One can classify investors according to a number of variables, but the most ubiquitous one in the literature on emerging risk—and all of the available data

sets—is what we can dub the "national origin" variable, which refers to the domestic or foreign nature of the investor[7]. This variable is usually defined in terms of either: a) the geographical location of the investor's sources of funding, revenue, technology and managerial control (see for example Moran; 1998), the "geography dimension"; or b) the applicable international and domestic law, which usually establishes that the nationality of the investor is that of the jurisdiction in which it was legally established—in the case of companies and investment funds—or the country of citizenship or residence—in the case of individual investors, the "legal dimension". The geography dimension assumes some level of segmentation in international markets; i.e. it assumes that foreign investors have access to sources of funding, revenue, technology and managerial skills that are not available to domestic ones, due to the foreigner's access to two or more national markets that are only partially integrated or not at all. Furthermore, it also assumes that one can attach a geographical location or, more commonly, a national identity to the person or legal entity that controls the investment—i.e. an investor can be identified as "British" or "American". Thus, it is most useful when one can identify an investment that is controlled by a single individual with a single nationality that is able to raise capital and invest in two markets with different returns, one of which is her country of citizenship and the other one a foreign host country. (A very simple example

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[7] In fact, most of the literature on political risk assumes that the issue is largely a foreign investor concern. This may be due to the fact that the assumption underlying most models and studies is that domestic investors are familiar or secure enough with their own country so as not to make the issue particularly relevant for them—which underscores the rationale of finding local partners. However, as I will show, this assumption does not hold in those countries that have made some progress in liberalizing their economies, such as Brazil, Argentina and Mexico.

would be a an American citizen who purchases a factory in Ghana with a loan from an American bank.) Conversely, it is least useful when the investor is a legal entity that is controlled by multiple owners or managers with multiple nationalities—some of which may be legal entities themselves, and in turn have their own owners—and derives its returns from investments across several national markets that are relatively integrated. This would be case for example, of Sony's investments in the United States. Arguably, the investments are controlled by Sony Corporation, which is headquartered in Japan, which would classify it as a "foreign" investor. However, Sony is a publicly held company whose stock is listed in 16 stock markets worldwide, including the New York Stock Exchange (NYSE) and therefore is likely to be partially owned by American investors. And while in the past one could argue that the company was controlled by Japanese nationals and thus still be meaningfully deemed to be "foreign" (Graham and Krugman, 1994), this is no longer the case. The company's CEO and Chairman is a British-American citizen, Sir Howard Stringer, and more than two thirds of the company's employees are not Japanese—including senior managers in the foreign subsidiaries, which now account for over 70% of the company's revenue.

This is not to say, however, that it is impossible to make a distinction between foreign and domestic investors—or that it is not drawn on a regular basis in every country in the world. Even if the ultimate ownership and control of an investment can be rather diffused, there is a wealth of international and domestic legal and regulatory standards that would nevertheless classify it as foreign (domestic). Let's consider, for example, Sony's investments in Mexico. Since they are usually undertaken by the American subsidiary of the corporation (Sony USA),

they are considered to be foreign and are thus subject to different fiscal and regulatory regimes than domestic investments. (And, it should be noted, they are included in the national accounting of American, not Japanese investments, which may be somewhat misleading when measuring the bilateral economic relationship between the two countries.) However, the Mexican subsidiary (Sony Mexico) created through this investment is considered to be a Mexican legal entity, and its investments—purchasing land to build a plant, for example—are thus subject to a different array of laws and regulations—such as its fiscal regime—that may not be applicable in principle to those of Sony USA or Sony Corporation. Or consider the case of a Japanese company that issues American Depository Receipts (ADRs) in the NYSE. While one may assume that the national origin of the company's owners will become more diverse as a result of the issuance, it will still be deemed to be foreign for the purposes of determining its rights and liabilities under American law—and therefore for its interaction with the American regulators and other American entities, such as creditors and shareholders, as well as for the purposes of its accounting in major statistical databases.

Defined in terms both of geography and law, the national origin variable is particularly relevant for the purposes of the analysis of electoral risk because it allows us to determine who would bear increased risk should the government or a powerful political actor find it expedient to discriminate among investors on the basis of their real or perceived nationality, as is often the case in "strategic industries" such as oil, mining or utilities and particularly so during electoral cycles. For instance, the winning candidate in the 2005 Bolivian elections, Evo Morales, built a significant portion of his campaign platform around the notion that the

"foreign control" of the country's mineral resources was undesirable; and this preference has had a clear and identifiable effect on the policies he has implemented towards the sector after he assumed the Presidency. However, I would argue that the increased importance in emerging market economies of investors who are truly global in terms of their investment and hedging strategies and consequently of their risk exposure, greatly limits the national origin variable's usefulness as a stand-alone approach across a wider variety of industries and sectors.

As emerging market governments liberalize their economies, it becomes increasingly hard for the government to distinguish between "foreigners" and "nationals" and to discriminate amongst them, even if there is a temporary reversal of the liberalization process. Consider the case of the exchange controls imposed in Argentina in the wake of the 2001 economic crisis. While the government made some efforts to discriminate amongst companies on the basis of the effects of their activities on capital flows, like relaxing the restriction on foreign transfers for exporters but making them more cumbersome for importers, the measures affected investors in these sectors in a comparable fashion regardless of their national origin, i.e. both were unable to service their import-related financial obligations. And the same can be said of the freezing of bank assets: since the government could not afford to distinguish between domestic and foreign depositors—assuming it could, which is highly unlikely— because it could be reasonably assumed that both were equally likely to make a run for the bank if they hadn't already done so,

the "corralito" regime did not make any distinction in this respect[8]. It is clear then

that national origin is not very useful for the risk assessment of but a handful of

markets and industries in which foreign investors are legally or politically

discriminated[9]. (Table 1 provides a brief overview of how some national markets in

Latin America fare in this respect.) And while this is certainly the case in a number

of sectors of the Brazilian and Mexican economies—most notably petroleum

(Mexico) and media and infrastructure (Brazil)—it is no longer so in other, key

industries, such as banking. Furthermore, as a result of the broader liberalization

and economic integration process of these countries, foreign investors have a

significant and relatively unrestricted participation in the local capital markets; as

well as large-scale investments in Mexican and Brazilian government and

corporate securities traded in American and European markets—and domestic

investors have a greater exposure to international markets either by their

investments abroad or through the effect of global events on their ability to raise

capital international. And while arguably still a relatively uncommon phenomenon in

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[8] One could make the case, of course, that the government was aware that a higher proportion of foreigners would be affected by the measure, by virtue of their having a larger participation in these sectors relative to the nationals. However, determining if this was the case would be extremely hard and very much irrelevant, since the ostensible aim of the controls was to stabilize the capital account, not to "punish" foreign investors. Moreover, the fact that the "corralito" regime—the freezing of bank assets—was implemented concomitantly should dispel any notion of preferential treatment for nationals, since they were likely to be the most affected by the measure—foreign investors could bypass the restrictions by recurring to their bank accounts abroad and, to the extent that they are more sophisticated, they were more likely to have some kind of hedging strategy in place. If anything, the government can be accused of treating foreign investors too favorably relative to domestic ones.

[9] It would be very relevant, for example, in the case of China, because the country's legal regime imposes significant restrictions on foreign investors across all sectors of the mainland economy.

Latin America as opposed to Asia, the rise of MNC's based in these two countries complicates matters even further: According to the UNCTAD (WIR, 2005) there are 7 Latin American non-financial MNC's ranked among the top 50 from developing countries in terms of their foreign assets in 2003, four based in Mexico and three in Brazil and they are all significantly diversified (figures 2 and 3). Emerging market-based investors are thus only domestic in a relatively narrow sense, since they are exposed to country-specific events, but also to regional and global ones, just like foreign investors are. In this context, it is useful to distinguish further between those investors that invest in emerging market debt and equity ("portfolio investors") in international and local capital markets, regardless of their national origin, and the specific subset of investors that invests in productive assets in a specific geographic location ("direct investors").

Table 2. Relative importance of national origin vs. investment type in selected Latin American countries

	Higher liberalization of key sectors and industries[1]: National origin is less relevant	Lower liberalization of key sectors and industries: National origin is more relevant
Higher integration of financial markets[2]: Portfolio investment is increasingly important	Mexico, Chile, Argentina (pre 2001), Colombia	Brazil
Lower integration of financial Markets: Foreign direct investment is relatively more important	Mexico (pre 1994), Guatemala	Venezuela, Bolivia, Ecuador, El Salvador

Source: the author with information provided by the State Department, the IMF and the national governments.
[1]Estimated in terms of the relative number and importance of restrictions on foreign investment in strategic industries such as banking, infrastructure and energy.
[2] Estimated in terms of the participation of foreign investors in local capital markets, and of local companies in international capital markets.

Portfolio and direct investors

The most important difference between portfolio investors and direct investors is that the latter have a direct equity stake in a defined set of physical assets—although not necessarily control over them. This stake effectively "ties" the investor to a geographical location, making it relatively more difficult to adjust her exposure to changes in local conditions without incurring significant losses. Portfolio investors, in contrast, tend to be able to enter and exit positions with relative ease—assuming, of course, that the assets in question are liquid, which might not be the case in smaller local capital markets—and adjust their risk exposures constantly. This mobile nature of portfolio investment and the relatively resiliency of direct investment and their effects on the host country has long been a hotly debated topic in development literature (Loungani and Razin, 2001), but one can make the case that it is relevance for the purposes of the assessment of electoral risk is relatively limited. Or more precisely, one can argue that both types of investors are exposed to a comparable—albeit not identical—set of risks and that direct investors, in as much as they aware of the fact that short-term adjustments would be relatively costlier for them, may hedge their exposure beforehand to the effect that the difference between the two types of investment becomes almost trivial.

This might appear to be a rather counterintuitive approach at first, to be sure. After all, there is a large body of empirical studies that demonstrate that direct investment and FDI in particular is less volatile than portfolio investment, particularly during periods of economic crisis (Lipsey, 2001). Furthermore, the investment trends in Latin America after the debt crisis of the 1980s and in Mexico

and Southeast Asia after the financial crisis of the 1990s clearly show that direct investment increased even as other capital flows such as bank loans were reversed. However, the key issue in analyzing risk exposure is not the resiliency of the investment, i.e. whether the investor reversed the investment or not, but rather why it stayed in the country or exited it. In other words, the "bolted down" nature of direct investment would only relevant for the analysis of electoral risks to the extent that direct investors perceive and hedge risks differently than portfolio investors do, and this is not always the case.

As several authors have noted (Kant, 1996; Hausmann and Fernandez Arias, 2000) the share of FDI relative to total capital inflows tends to be higher in riskier countries—measured in terms of their sovereign credit ratings—and in those with weak institutions. This does not mean that foreign direct investors perceive these countries to be less risky, but rather that foreign investors prefer to internalize transactions that would otherwise take place in the market precisely because these countries are riskier. An investor might prefer, for example, to outsource or license its products to a local company rather than invest in productive assets in the country, because it gives it greater flexibility. Outsourcing and licensing contracts allow companies to shift production and investment to adjust to changes in the demand for its products, and reduces their exposure to liabilities resulting from capital expenses and its labor relations. An outsourced labor force does not introduce pension liabilities in the company's balance sheet and the cost of liquidating it should the current number of employees become inadequate is considerably lower. Likewise, the sunk costs associated with the investment, such as land and machinery, are offloaded to the local company; and

the local contractor is left to deal with local non-market risk factors, such as regulation, taxes and the like. However, if transaction costs in the local market are too high, the investor might be better off exercising direct control over the investment, to prevent the local companies from taking undue advantage of the relationship. A computer manufacturer, for example, might be reluctant to transfer sensitive technology to a local company for fear that it will steal it; and therefore would prefer to produce directly on its own. Or it might find that local suppliers are so unreliable that it has to produce its own supplies internally, although it is more common for major technology companies to encourage their international suppliers to establish their own direct investment in the country where the plant is located or where there are cost advantages to be realized as a result of lower skilled-labor costs and trade agreements[10].

More importantly, the distinction between portfolio and FDI capital flows obscures the true nature of the relationship between the investor and the actual investment. To be sure, direct investment has specific qualities in terms of its effects on the economic development of the host country, and particularly so in the case of foreign direct investment: it might promote technology transfers, increase competition in the local market, promote the development of human capital and increase tax revenues (Moran, 1998a; Feldstein, 2001). However, investors do not undertake direct investments to promote the development of the host country but to

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[10] This is the case in Mexico, where a significant portion of basic components manufacturing is actually undertaken by foreign direct investors supplying other foreign direct investors, in what amounts to a transplantation of the global supplier-buyer relationship—e.g. Solectron's establishment of a factory near Guadalajara to facilitate the supply of components for the local Hewlett Packard plant. (Dussel, 2000)

derive returns from it, just like any other investor. Thus, while it is tempting to think of direct investment as a "bolted down" investment from which the investor cannot easily walk away from, the fact is that there is a number of financial transactions that allow investors to reverse their investments without having to divest their assets, and that direct investors do not hesitate to recur to them.

In a recent survey (IMF, 2003), the IMF Capital Markets Consultative Group found that foreign direct investors use a broad range of intra-company financial transactions to reduce their exposure to a local market. This may take the form of extraordinary dividends paid by the subsidiary to the parent, accelerated repatriation of earnings or forcing the subsidiary to increase its leverage by borrowing from local sources external to the firm and repaying the parent company for its initial equity investment. Provided that the company can anticipate an increased level of, say, exchange controls risk, it might be able to repatriate the bulk of its earnings before these controls are actually implemented by requiring the subsidiary to transfer its profits to the parent either directly, through a special dividend perhaps, or indirectly, e.g. by requiring the anticipated payment of an intra-firm loan and forcing the subsidiary to borrow in the local market to do so—which may have the further advantage that, in the event of a devaluation, the weight of the subsidiary's debt on the parent's balance sheet would be greatly reduced. (Transfer pricing mechanisms, which refer to the practice of overcharging the subsidiary for intra-firm produced supplies to reduce its profits, would not be particularly useful for short-term adjustment, but they may also be implemented if the particular risk is present over a longer period of time, as would be the case of the likelihood of changes in the subsidiary's fiscal regime.) Moreover, in the case of

particularly risky investments such as infrastructure projects, the investor may try to frontload the bulk of the expected returns, by imposing a higher amount of fees payments in the first years of the project or transferring the risk of the subsequent stages to other investors. This can be achieved by tailoring build-operate-transfer (BOT) or build-own-operate-transfer (BOOT) agreements so as to increase the burden on the host government once construction is completed and operational—arguably, the single riskiest stage of the project, since it is the time in which the investor's proprietary resources are relative less important. Or alternatively, the original investor may include other investors with higher leverage power over the host government—such as international donor agencies or powerful domestic banking interests—in the financing structure of the different stages of the project through debt or equity stakes as well as purchasing insurance policies.

This implies that the differences between portfolio and direct investors may not be as significant as a simple flow-to-flow comparison would lead us to believe. If we assume that a foreign direct investor can reduce its exposure with relatively low costs through changes in the financing structure of its subsidiaries or through insurance, and that it will prefer direct investments in riskier countries, then its risk assessment and hedging strategies are not essentially different from those of a portfolio investor who is exposed to the same markets. Both will try to adjust their position as a result of a change in the relative risk of the investment and will do so trying to minimize the cost of the adjustment, either by building in protections in a direct investment or by trading securities and options. Moreover, it also implies that it is possible that a portion of the capital outflows leaving the country over the course of capital flight or a net capital outflow period may in fact come from the

original FDI stock. That is, we should not assume that only portfolio investors are behind periods of net capital outflows, for it is possible that some foreign direct investors are reversing their investments through financial channels instead of through the outright liquidation of their assets.

This is not to say, of course, that all foreign direct investments and portfolio investments can be equally or at least comparably hedged. The usual caveats apply: the specific circumstances of a given investment matter, to the effect that some foreign direct investors are more constrained than others in their ability to adjust their exposure, just like some portfolio investors are more able to trade extensively and continuously than others. However, this analysis does imply that it is possible to think of foreign direct investment risk in comparable terms to portfolio risks, and particularly in light of the assumption that investors require higher returns in exchange for undertaking riskier investments relative to other opportunities, i.e. through portfolio theory.

The fundamental insight of modern portfolio theory is that investors measure risk and return in terms of the overall portfolio of their assets, rather than by looking at each one in isolation. This implies that the effect of changes in the risk of a particular investment—such as the heightened threat of expropriation of an oil field—are measured in terms of their effect on the risk and return of the other assets. The corollary of the theory is that as an investor diversifies its holdings, its overall risk decreases—that is, the risk is diversified away. An investor that has access to a broad variety of capital markets and asset classes—such as American stocks, European bonds and emerging markets direct and portfolio investments— may have a relatively lower exposure to political events in a given country than

another investor whose returns depend exclusively on the performance of the local stock market. It follows then that a well-diversified investor would react differently, if at all, to a temporary downturn of say, Brazilian stocks in the eve of the Presidential elections, then would an investor who invested her life savings exclusively in these stocks. The former might want to adjust her exposure but not necessarily liquidate it, while the latter would try to exit the position as soon as she can. This can be explained by the fact that the performance of the Brazilian stock market is lowly correlated to the performance of global markets and exhibits higher returns on average, to the effect that as the value of the position drops its effects on the overall portfolio may not justify liquidating it—assuming, again, that the drop is temporary. Furthermore, some investors may not try to diversify away the risk in their portfolios, but rather to exploit arbitrage opportunities in the markets. These investors typically believe that they are able to estimate the future performance of an asset class better than the market does at any given point in time. Armed with these estimates, they try to find assets that are, in their view, undervalued (overvalued) and buy (sell) them. For example, the drop in Brazilian stock prices may actually entice a hedge fund manager to increase her exposure to this particular market, sensing a bargain. Or a state-owned Chinese petroleum MNC might find that its government's leverage makes it more attractive to invest in Venezuela, relative to a United States-based company.

It also follows that one would expect investors to increase their exposure to riskier assets with higher returns, when the returns on relatively less risky or "risk-free" assets—such as cash and US Treasury bonds—are low, because doing so improves the risk-return profile of their portfolio, that is, it allows them to increase

their returns with only a moderate increase in the risk they bear. (Or when riskier assets are the only ones available: Chinese petroleum companies, for example, tend to find that investment opportunities in upstream assets are constrained to riskier countries, because their international competitors already have a stronghold on the vast majority of "risk-less" oil and gas fields[11]. Conversely, we should also expect an increase in the returns of "risk-free" or less risky assets, such as the one resulting from an increase in US interest rates, to reduce the appetite for riskier asset classes. This is the case, for example, of emerging market bonds. As Uribe and Yue (2005) demonstrate, an increase in US interest rates leads to a delayed but significant overshooting in emerging market sovereign spreads—the difference between the interest rate of an emerging market bond issued by the government and that of US Treasuries. That is, for each percentage point change in the return—the interest rate—an investor would get by investing her money in relatively risk-free bonds, she demands more than a one percent increase in the return of the riskier ones—the result of a decrease in demand for riskier bonds while the total amount offered remains constant. More interestingly, the authors also find that an increase in US interest rates and the subsequent increase in sovereign spreads has a more significant effect on the total output of a given emerging market economy than would a sovereign spread increase alone. That is, that the impact of US interest rate changes on the business-cycle of an emerging

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[11] And it is not a coincidence that the Chinese government is actively seeking to improve its standing with second-tier, politically unstable oil producing countries. In as much as its access to western-controlled companies is limited, as was evidenced by the controversy over the purchase of Unocal by a Chinese SOE, there is limited room for growth and an active diplomatic effort is a sound risk reduction strategy as I discuss later.)

market economy, measured in terms of output, is greater than the effect of a change in sovereign spreads driven solely by domestic or general emerging market factors—such as the political-business cycle (PBC), changes in domestic macroeconomic variables resulting from domestic monetary policies, "contagion" effects and the like. This difference can be explained in part by the fact that interest rate shocks do not only affect sovereign borrowing—which in turn affects the ability of domestic corporations to raise money in international capital markets—but also other variables that may be associated with the country's business cycle, such as the levels of foreign direct investment (FDI) and its terms of trade (Kose et al, 2003; Calderon et al, 2003).

Uribe and Yue's model would then seem to suggest that the performance of an investment in an emerging market economy does not depend solely on country-specific or emerging-market specific factors, but also on international ones, such as the aforementioned interest rate shocks—a finding that is a corroborated by a number of empirical studies and models (see for example Aioli et al, 2006). This is compatible with the basic tenets of the portfolio theory, because it implies that an investor might adjust her exposure to a given emerging market's assets regardless or at least not exclusively as a result of changes in the country's economic or political conditions, because it needs to rebalance its portfolio due to changes in the risk and return of some of her holdings. It would also support the notion that, ceteris paribus, countries with relatively low vulnerability to external shocks will fare better, i.e. will be perceived as less risky during high-uncertainty periods than those that are more vulnerable, in terms of all kinds of capital inflows and not only FDI—although one would expect FDI to decrease relative to other capital inflows.

The use of portfolio theory is thus particularly useful because it allows us to explain changes in investment trends in the context of general market forces that are only partially subject to emerging market-related uncertainty. That is, in explaining the behavior of a given investor or, more commonly, of a group of investors—say, pension fund managers—with regards to an emerging market, we can isolate a number of variables that are properly defined as risk—such as the probability of changes in the interest rate—and those that are more properly characterized as country-specific uncertainty—such as the perceived likelihood of a relatively unknown candidate affecting investor interests. Furthermore, we can distinguish those risks that are largely a result of external events and approximate the relative weight of domestic variables. Taylor and Sarno (1997) found, for example, that for the 1988-1992 period, global and country-specific variables had an equal weight in determining long-term equity investments in Asia and Latin America, and that global variables—and most notably US interest rate levels—had a greater impact on bond market dynamics over the short- and the long-run.

Risks by type of investment

A good way to understand this taxonomy and how it may be applied to the problem at hand would be to imagine an investor who owns US Treasury and fixed-rate dollar-denominated sovereign bonds from an emerging market we may refer to as Z; as well as two candle factories, one in Massachusetts and another one in Z. In theory, the investor's bonds have some probability of default—i.e. that the issuing governments will be unwilling or unable to make the coupon (interest) payments or repay the principal. However, in the case of the American bonds, the likelihood of

this event is so minimal that they are considered, in fact, to be risk-free. That is, the investor can be said to be certain that she will not lose her investment because there is a single outcome—full repayment—that is completely dominant.

This is not the case of the Z bonds, though. Z's government has access to a limited amount of dollars—from its reserves or capital inflows—to make periodic payments and repay the principal should it be necessary. (Governments may rollover the existing debt with a new issuance.) And under certain macroeconomic conditions—sustained current account deficits, for example—this amount may dwindle to the point in which there is a high probability that it will not be able to meet its obligations—i.e. it is unable to pay. Furthermore, a new government may come along that decides that the cost of servicing the debt acquired by its predecessor is too high and thus default on its debt even though it still has the ability to pay—i.e. it is unwilling to do so. This was the case of the Argentinean default of 2001 and the subsequent restructuring process. While President Kirchner would have been able to obtain more resources from the International Monetary Fund (IMF) to continue servicing its debt in spite of the country's economic crisis, doing so would have entailed political and fiscal costs that his government considered unacceptable—at some point he declared that he would not continue to service the debt "with the blood and sweat of the Argentineans".

In addition, our hypothetical investor may bear the risk that interest rates will increase, which would make the bond less valuable—and vice versa. Of course this would only be the case if she does not hold on to it until maturity, in which case the changes in interest rates are irrelevant. However, sovereign bonds tend to be traded extensively in secondary markets, so we may assume that our hypothetical

investor will do so too. Her investment has therefore three possible outcomes (default, increase in value, decrease in value) and each outcome's probability can be estimated using a wealth of widely available information from the financial markets and credit rating agencies, as I explain in the next section.

The investor's equity investments, on the other hand, are subject to a different, albeit somewhat related, set of risks. Ceteris paribus, both her factories are comparably exposed to what is usually referred as "commercial risks" or "industry risks". This would include, for example, the likelihood of going bankrupt or becoming less profitable if a competitor starts selling cheaper candles of comparable quality; or if people stop buying candles because they find an alternative. Likewise, they are also comparably exposed to "Acts of god", destructive natural phenomena over which humans have no control, such as earthquakes, floods, lightning strikes and the like. Both types of risk are hard to estimate—as Donald Sull (2006) has noted, business managers face nothing but uncertainty in planning for the future—but it is possible to do so and, more importantly, to hedge against it. After a while, business managers should become able to estimate market trends in both countries, using the same methodologies, and adjust accordingly; they may also buy insurance against the most likely natural disasters or accidents, which is widely available in both markets, and garner an estimation of their actual risk from the premiums they pay. Hence, the fact that one factory is in Z is not particularly relevant in terms of our investor evaluation of both industry and acts of God risks. In as much as both markets entail risks that accrue to the industry in a comparable fashion regardless of its geographical location, such as demand and competition, the factory in Z could just as well be in Wyoming

or in Japan. The peculiarities and challenges of operating successfully in this or that market are not specific to the fact that one of them is an emerging market, even though they may feel that way for the inexperienced investor.

Clearly, this is not the case when analyzing other risks, such as those stemming from the socio-political and jurisdictional environment of each factory. Whereas one could argue that both factories are equally vulnerable to, say, white-collar crimes, it should be clear—and investors seldom forget this—that the efficiency of the police forces and the transparency of the judiciary system of Z are not up to par with that of the United States, and that the crime rates in both countries are radically different, and so is their potential effect on the factory's operations. Our hypothetical investor may still approximate this risk, however, by factoring in the cost of hiring additional private security and specialty insurance policies, such as kidnapping insurance—as well as more common theft and fraud insurances. Furthermore, since the factory managers and their insurers may have access to extensive data sets, both public and private, about the likelihood of criminal events occurring, their estimations would be accurate enough to say that there are defined outcomes and that they can assign probabilities to them. Likewise, after a while, the business managers and their lawyers should be able to determine the costs associated with the enforcement of contracts given Z's judiciary system—although, as was the case of some of the pioneer foreign investors in China, this learning process may prove to be all too costly.

We may now turn our attention to the risks associated with the socio-political environment of each factory, their "political risk", which is usually defined as the likelihood of realizing losses or less than expected returns on a given investment a

result of political events or government actions (Holton, 2004; Moran, 1998; Fitzpatrick, 1983). One should be mindful that this definition entails three significant problems. First, it implies that political risk always has a negative effect on an investor's return and this is not necessarily the case—one can think of political events that may actually have a positive effect on an investment return such as a liberalization of the foreign exchange markets. Second, it fails to take into account the difference between risks as measurable sets of probabilities, which can be hedged, and subjective uncertainty—not a trivial distinction, since one could argue that many political events tend to be rather unique or at least not common enough to warrant any meaningful statistical analysis. Third, it does not provide a clear indication as to how and when a risk may be classified as political, as opposed to non-political or commercial risks that are related to political events but not directly derived from them—such as a devaluation that is brought about in part by botched policies. However, since these issues are not particularly relevant for the model—which is based on government manipulation, rather than direct action or inaction—we may use this concept of "pure" political risks without further ado.

"Pure" political risks

In order to analyze the political risks our investor may bear, we can start by using the same source of information we used in the other categories: insurance policies and risk models. Our hypothetical investor might be able to obtain political risk insurance to protect her investment in Z from government and multilateral agencies, such as the Overseas Private Investment Corporation (OPIC) of the United States government, the Multilateral Investment Guarantee Agency (MIGA)

of the World Bank Group and from private insurers. These policies usually protect the holder against the following risks: expropriation, currency inconvertibility or transfer restrictions, political violence and, in the case of private insurance policies and MIGA's, breach of contract[12]. The definition of each risk varies slightly across insurers and in the scholarly literature, but there are enough common elements to define them and more importantly, to identify how they have evolved over time and how relevant they might be in contemporary emerging markets.

Take expropriation, for example. Traditionally, it could be defined, as Truitt (1970, pp. 25) does, as "an official taking by a sovereign state of the tangible property of alien corporate ownership with a view toward the continued exploitation or that property for the public utility of the expropriating state in lieu of continued ownership and control by private foreign enterprise". The expropriating authority may be a *de jure* or *de facto* government, and the expropriation itself may not be accompanied by a formal legislative act but it must appear to be permanent; and it might be applied to a single company or to a whole industry—as would be the case of a nationalization. (Forced divestments would be included as well.) However, thusly defined, expropriation is a dwindling source of political risk. The number of actual expropriations and nationalizations has actually decreased significantly since it peaked in the early 1970's: While in 1975 there were 83 cases of expropriation and nationalization, there were only about 11 from 1982 to 1992 (Minor, 1993). Minor also found evidence that supports Kobrin's (1984, p. 338) four hypotheses as to why this might be the case:

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[12] To be sure, this is not a complete listing of the potential political risks and I will not provide a much more thorough one in this section, since Simon (1984) already compiled what is arguably the most exhaustive and complete list to date.

1. The nationalization of industries in which ownership was deemed essential, such as mining and petroleum ventures was almost complete by 1976. In most cases, private participation was transformed from equity-based concession agreements to contractual arrangements.

2. As time since political independence passes, the symbolic content of the country-foreign investor relationship decreased in many countries, while the instrumental or functional content increases. This reduces the incentives for politicians or social leaders to attack foreign investment on ideological grounds, because foreign investment becomes a less-sensitive political issue.

3. The administrative, managerial and technical capabilities of host countries increased. This improved their bargaining power and allowed them to use regulation, instead of expropriation, as a tool to ensure that investor behavior remained in compliance with their policy objectives.

4. International economic conditions in the late 1970's—which created balance of payments problems in many developing countries—increased the demand for capital inflows and, particularly, export-oriented FDI.

The upshot of this argument is that the risk of outright expropriation may still be significant in those countries that have ample access to hard-currency through means other than loans and FDI, as is the case of petroleum exporting countries during the present boom, like Venezuela. This would also be the case of countries in which foreigners still have equity stakes in profitable mining or petroleum industries and in which this participation is a matter of significant popular discontent, as is the case of Peru and Bolivia. In fact, the advantage of the former army office Ollanta Humala in the opinion polls leading to the Peruvian general

elections in 2006 sparked significant concerns amongst the investors who were exposed to the country's mining industry—the third producer of copper in the world and the fifth most important gold miner—in spite of the assurances from the candidate's economic advisory team that there were no plans for expropriation, but just for a higher tax rate[13]. The same occurred in Bolivia after President Morales imposed a 50% tax on gas companies and in Venezuela, after President Chavez touted the notion of changing the terms of the contracts governing foreign participation in the petroleum industry. Furthermore, the increased preference for regulation that Kobrin identified may have, ironically, increased the risk of what is called "creeping expropriations" or "regulatory takings"[14], which can be broadly defined as an act of government that deprives the investor from her ownership or control rights over an enterprise, without necessarily resorting to outright expropriation. This would be the case when a government changes the regulatory framework of an investment to the point in which it wholly reduces its value or renders it useless for the investor, without taking it away from her.

In order to better understand this concept, let's return, once again, to the case of our hypothetical investor. Both her factories are subject to a number of regulations, including zoning laws, local and federal environmental laws, health laws and the like. (We may assume that she was in full compliance when she built

[13] To be sure, Humala had also hinted that he might be inclined to promote the "nationalization of strategic industries", although he later seemed to recant these statements ("Peru poll tax threat to mining companies", Financial Times, March 23rd 2006).

[14] The Organization for Economic Cooperation and Development (OECD) prefers the term "indirect expropriation" (OECD, 2004) and many treaties contain language about "measures tantamount to expropriation". For the purposes of this essay, we shall assume that they are all equivalent.

and started operating the factories.) Now let's imagine that the government of Y, a province of Z, starts receiving complaints about the candle factory from local environmental groups, to the effect that candle production is dangerous for the environment and the health of the local population[15]. Conceivably, the government of Z could enact national legislation banning the production of candles altogether, on grounds of these concerns. However, let's assume it doesn't do so because it continues to believe that candle production under the current standards is acceptable and our investor's factory has not violated the law. In light of this inaction—and under the unrelenting pressure of its local constituents—the government of Y decides to shut down the factory on its own, citing health concerns, but using a local zoning law because health laws are subject to the jurisdiction of the national government, which effectively prevents the local government from enacting new local health laws or enforcing the federal ones.

In doing so, the government of Y has effectively deprived the owner from the control rights associated with the factory, since even though our investor still owns the company and its physical assets—the building, the land on which it is built—it can no longer operate it for its original purpose. And if the equipment can only be used to produce candles, i.e. if our investor cannot start producing other products with it, as is usually the case, she has effectively lost any chance at making any profits on her original investment. Moreover, the government of Y may also decide that the land on which the factory was built has an environmental value, and is thus not appropriate for any sort of commercial exploitation. Our investor would be then

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[15] This example is directly derived from the arbitration award in the case of "Metalclad Corporation v. United Mexican States" (ICSID, 2000).

the proud owner of a useless piece of land, with a useless factory sitting on it. Hence even though her property has not been expropriated, for all practical purposes her fundamental rights as an owner have been taken away—i.e. it has been subjected to a measure tantamount to expropriation. (We may ignore for the time being the question of whether she would be entitled to compensation for the taking or how she would go about obtaining it, which I will discus in more detail later.) A similar situation would arise when the government, acting as a party to a contract—typically, a BOOT agreement—decides to change the law to the effect that the project is no longer economically viable—which in the terms defined above, would be characterized as a "breach of contract".

The risk of a regulatory taking is not typical of Z's status as an emerging market, though. In fact, a good portion of the claims for arbitration filed under the investment protections of Chapter 11 of the North American Free Trade Agreement (NAFTA) for alleged uncompensated measures tantamount to expropriation have been brought against the governments of Canada and the United States, and not only or even primarily against Mexico as it was assumed would be the case when the agreement was negotiated (Public Citizen, 2001). And while one might argue that the merits of these claims are mostly inexistent, it should be clear that a number of investors in *developed* countries are increasingly finding themselves in a position in which their investments are rendered less valuable by regulatory acts, regardless of whether this acts are valid in light of the applicable international and domestic law.

This is also the case, and perhaps more interestingly, of the risk of adverse regulation that, while not amounting to expropriation, may have a negative effect

on the company's profitability. Suffice it to remember the case of the Windfall Tax imposed by the United States in the 1970's—and the modern version that was discussed in 2005. After the global oil supply shocks caused the American oil companies' profits to increase several times over and the voters started paying hefty prices at the pump, the two chambers of Congress decided to investigate the matter. As a result of the hearings, the oil industry suffered a public relations nightmare as well as a newly minted 70% tax on "extraordinary" profits. The continuing political expedience of this measure—although not, alas, of its economic wisdom—is attested by the fact that, when the international oil majors announced record profits in the 2004-2005 fiscal year, lawmakers and interest groups in the United States, Norway and Great Britain started touting the possibility of imposing some version of the tax.

While much attention is devoted to the risk of emerging markets due to the fact that their institutions and political systems are perceived—with justification in most cases—as relatively more unstable and unpredictable than the ones of the more developed countries, all investors face some form of regulation-related risk, regardless of the location of their investment. In principle, developed countries may be as inclined to raise taxes, impose tariffs, or change environmental standards as their emerging markets counterparts, if not more so. The United States Congress, for example, leads the charge in seeking to curtail US-China bilateral trade; and a group of congressmen and senators have gone as far as introducing legislation that would increase tariffs on Chinese products and rescind China's "permanent normal trading" status if the Chinese government does not devalue its currency and terminate other commercial practices that are deemed "unfair" and "harmful"

for the American economy. The economic rationale for these measures is tenuous at best—they affect Chinese interests as well as American ones—a fact that has led many independent observers to argue that they are motivated primarily if not exclusively by electoral considerations ("Portman's Complaint", *The Economist*, March 16th 2006). Furthermore, a relatively stable and democratic political system is not a safeguard against political risks stemming from social pressures or political considerations, but may in fact be even more risky, as the cases of Mittal Steel and DP World show.

Mittal Steel is a London- and Rotterdam-based steel multinational company (MNC) with operations in 14 countries that launched a hostile-bid in early 2006 for Arcelor, a Luxembourg-based steel consortium with operations in 60 countries and, most notably, extensive operations in France, Belgium, Spain and Luxembourg. Immediately after the bid was announced, the Luxembourg and French governments, as well as a host of associated parties, declared that they were opposed to it and vowed to support Arcelor's board in its effort to reject the takeover, citing corporate governance concerns and, more importantly, the need to protect nearly 30,000 jobs in France that could have been downsized after the merger. This opposition is not essentially different from the one a foreign investor would face when entering a relatively protectionist environment dominated by powerful local business interests, who lobby the host government to avoid losing their market-share—a typical emerging market scenario. In both cases, the government is intervening to prevent an investment—or at least to make it costly enough so as to make it unviable—in order to protect the economic interests of a small but influential subset of its constituents. In this sense, one could make the

case that it is akin to the Indian government's delay in liberalizing its retail market to accept foreign investment due to the pressure of domestic business groups seeking to obtain a first-mover advantage and, if possible, to avoid foreign participation in the industry completely. (Or the case of Japan's non-tariff barriers in the same industry, which include restrictions on the ability of investors to own and operate large retail stores.)

One could make the argument, of course, that the European Union's regulatory and legal framework affords Mittal Steel more protections against the French government's efforts than the Indian system would to a foreign investor in a similar situation. However, this is largely irrelevant for the analysis of the issue at hand, since Mittal Steel is a European company—granted, with an Indian owner— and therefore can be hardly considered as a foreign investor as far as the European Union is concerned. If anything, the problem is that Mittal is not a French or Luxembourg investor whose interests are aligned with those of these governments' labor and governance concerns. And as such, this preference for a domestic investor is not essentially different from the Indian government's, who has a policy of encouraging the development of local companies and would thus prefer an investor who is compatible with it. Furthermore, given the uncertainty associated with judiciary adjudications in any country or common market, including the EU, these protections do not eliminate the risk even if they may reduce it in the eyes of some investors—what would amount to a case of subjective uncertainty, rather than risk.

The case of DP World, a Dubai state-owned enterprise that operates port concessions illustrates a related set of political risks. Through its acquisition of

P&O in 2005, a British port operator, DP World obtained the right to operate a number of ports in the United States. The White House and the regulatory authorities green-lighted the deal in principle, but it then met huge opposition from a group of very influential members of Congress, who claimed that an Arab port operator would increase the risk of terrorist attacks. In order to finesse over the fact that the United Arab Emirates are an ally of the United States—as President Bush remarked at several times during the debate—the opposing groups then advanced the argument that ports were a strategic industry that would be best managed by an American company and that DP World should sell the concession to a domestic operator, as the company eventually did. (Which amounts, one could argue, to a forced divestment even if there was no direct government action.)

One would be hard-pressed to argue that the American political system is as unstable as that of an emerging market. However, the case of DP World clearly shows that even the most stable systems can become extremely unpredictable quite suddenly—to the point in which the President's own staff may not realize the controversy that an investment may cause. Furthermore, it also evidences that the institutional safeguards that would normally reduce political risk—such as an independent legislature—may in fact become a source of political risk themselves; and that the nationality of the investor and the public profile of the investment may be as relevant in a developed market as in a developing country—just as in the case of Mittal, or the instances of US-bashing campaigns that swept Latin America in the 1970's and persist to this day in the Andean region.

The DP World case is also a nice illustration of the dual nature of terrorism risk in contemporary developed and emerging markets: on the one hand, the

investors may suffer losses as a result of terrorist attacks that disrupt their operations or damage their physical assets, a text-book if relatively newly prominent case of political violence risk which is included in most insurance policies and risk models alongside other varieties, such as potential damages resulting from insurrection—including guerrilla kidnapping of personnel, as occurs in Colombia—and damage resulting from civilian protests, which tend to be more common—or more precisely, almost exclusive—to emerging markets. On the other hand, they may also be affected by the measures adopted to prevent terrorist attacks, such as extended and costly inspections at ports of entry—a huge issue for "just-in-time" business models—when not outright political interference based on nationality and other characteristics that may be perceived to be correlated with a higher terrorism risk, and which may not be evident at first—which in turn are more common, although not exclusive, to developed markets.

Taken together, these cases also serve to illustrate the paradox of democratic regimes and political risk exposure and its corollary for democratizing emerging markets: as popular participation increases, reducing the risks associated with authoritarian regimes over extended periods of time—most notably, that of political violence and radical change—it also empowers a broader array of actors to affect an investor's economic interests, by granting them legitimacy and influence that in the past was constrained to a handful of powerful economic and bureaucratic interests; or by making it more difficult for host governments to crack down on violent or non-violent groups that present a physical obstacle if not an outright threat, to the investor's interests (Wells, 1998). Moreover, in the context of open democracies, this uncertainty stems not only from

domestic actors in the host country but also from activist networks and other interest groups in the investor's home country and at a global level (Simon, 1984; Keck and Sikkink, 1998). The governments of Pakistan and Malaysia, to cite a widely publicized case (Klein, 1999), may be able to shield Nike from domestic criticism stemming from its use of contractors that employ children and women in less than adequate—from a Western perspective—labor conditions. And they may even be justified in doing so, on the grounds of their sovereign right to enact the labor standards and public demonstration laws they deem appropriate within their jurisdiction. But they are not able to prevent US- and Europe-based activists from calling for boycotts against the company's products in its most profitable markets or even forcing Nike to terminate its outsourcing contracts for fear of losing lucrative business from universities and other politically conscious consumers.

Thus far I have analyzed a broad range of risks that are common to both developed and emerging markets. And even though my analysis is far from exhaustive, it would appear to corroborate earlier findings about the converging pattern between developed countries' and emerging markets' risk, in which the former are becoming riskier and the latter safer (Diamonte et. al., 1996). This is not to say, of course, that all systems are equally risky. To the extent that emerging markets may be more likely to promote and protect the interests of "national champions"—both state-owned and private—or their governments may prove to be more receptive to their lobbying efforts, one may still be able to make the case that they are riskier for a wider variety of industries and investors, as opposed to very specific and perhaps exceptional cases. What's more, even though state-owned monopolies in strategic sectors such as utilities and the petroleum and mining

industries have been all but eliminated in even the most statist of developed nations—as the recent efforts to eliminate the last vestiges of government majority ownership and control in the gas monopolies of Spain and France demonstrate—this is clearly not the case in most emerging markets. The Chinese government, for instance, has retained control over the vast majority of the industries it has liberalized through majority or controlling stakes; and the government of Russia has moved to increase its grasp over the petroleum industry after the initial impetus for the liberalization of the sector—going to the extent of prosecuting the former communist leaders that had established themselves as industry titans in the years following the demise of the Soviet Union. In Latin America, the Mexican government has hinted that the State's monopoly over the upstream activities of its petroleum industry will remain tightly in place for the foreseeable future, as will do the ban on foreign participation in downstream activities—which include gasoline and diesel retail operations. And, according to its own industry regulators, it still has a long way to go in adequately enforcing its own competition laws when it comes to the interests of the former state-owned telephony monopoly and current dominant player, Telmex ("Mexico competition chief urges telecoms reform", Financial Times, March 14th 2006).

These two examples point to the crucial characteristic of emerging markets: the fact that they are, justifiably or not, perceived to be more prone to affecting investor interests in a discriminatory or arbitrary fashion. This would also be the case of exchange controls. Currency inconvertibility results when a government enacts regulations that prevent local companies and individuals from converting their holdings in local currency to their home country currency. Transfer restrictions

on the other hand occur when the government implements new regulations limiting the ability of investors to transfer money abroad. The investor would therefore be unable to convert the profits in local currency to dollars; or to receive payments—fees, debt service, dividends, payments for purchased goods—from its subsidiaries and clients. These risks are different from the risk of devaluation—although one could think of circumstances in which the two would occur closely to each other, such as times of economic crisis—in two key aspects: first, whereas a devaluation might reduce (or increase) the value of the cash flows that are affected, this is not the case of currency inconvertibility or transfer restrictions, which would eliminate the cash flow entirely—at least for the time the measure lasts. Second, and perhaps more importantly, the risk of devaluation is mainly derived from macroeconomic factors but also, albeit rather indirectly, from political ones; whereas the risk of currency inconvertibility and transfer restrictions is mostly dependent on political factors, that is on the preferences of policy-makers.

Given the definition of political risk I outlined before, i.e. political risk as a function of the potential effects of government actions and political events on investor returns, it follows that it is positively correlated with a) the government's ability to regulate, tax and otherwise interfere with economic activity; and b) the frequency and scope of disruptive political events. Also, and perhaps more importantly, it suggests that the basic principle underlying partisan PBC models, i.e. that governments will manipulate policy as a result of partisan considerations, is applicable to a wider range of cases, and not only fiscal and monetary variables, but that opportunistic considerations would not play a significant role.

The obsolescing bargain, then and now

Broadly speaking, the original obsolescing bargain model posits that the investor's bargaining power peaks in the early stages of the project, when she is still able to withdraw her investment or halt the development of the project with minimum losses. Assuming that the host government is not able to replicate the project and its associated benefits—the technology, managerial know-how and capital that the investor provides mostly, but also the marketing channels it may have access to—on its own or by enticing another foreign investor to take the place of the original one, the investor would then have a higher bargaining power. Failure to comply with the original terms of the investment—or to agree to more advantageous terms for the other side—on the part of the host government would then result in its losing the deal—i.e. in "no-entry". The power relationship changes, however, as the investor incurs increasingly larger sunk-costs—building the project's facilities, training the local workforce—that cannot be recouped in the event she decides to leave. The government is thus increasingly able to alter the terms of the original agreement to better suit its interests—or, for that matter, those of a successor regime—if not to expropriate the investment. This problem is particularly acute in those industries in which the added value of foreign participation drops precipitously after the major capital investments and technology transfers have taken place. This was the case of the petroleum industry after the supply shocks of the 1970's. After the increasing number of independent oil companies vying to provide technical services and the windfall from oil exports profits taxes reduced the need for the technical expertise and capital of the major oil companies in the 1960s, the fear of a global supply shortage all but eliminated their last competitive

advantage, their control over distribution channels (Vernon, 1981)—in fact, many state-owned oil and gas monopolies that were created after the first wave of expropriations acquired other private companies to establish their own refining and retail operations in the US and Europe such as PDVSA's Citgo in the US.

The dominance of the model in the political risk literature attests to its predictive power and insight, but some authors have introduced enhancements to it that are worth considering. Eden and Molot (2002), for example, note that the entry of a second-wave of MNC's changes the dynamics and outcomes of sequential bargains, increasing the importance of firm rivalry and the corporate governance of the industry as determinants of the likelihood that the host government will attempt to change the rules of the game throughout the life of the investment. However, two developments in particular, the incorporation of reputation factors and international investment protection agreements, merit particular attention.

Drawing on the literature on game theory, Veugelers (1993) proposes that the contemporary State-investor bargains are better understood in the context of the host country's desire to build a reputation as a safe destination for foreign investment. In a one government, one investor scenario implied by the obsolescing bargain model, an opportunistic government is clearly better off by appropriating[16] the investment—or for that matter changing its regulatory framework to better suit its interests but stopping short of appropriation—although the investor may still be able to make this option less attractive for the host government by introducing enforceable arbitration clauses, by credibly threatening retaliation by her home

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[16] For the purposes of this paper "appropriation" is used as the equivalent of both expropriation and measures amounting to expropriation.

government or by creating local interests aligned with her own—through joint-venture agreements with a powerful local monopoly that require continued transfers of technology, for example.

Reputation considerations enter the game when the host country is not dealing with a single investor in a one-shot game, but rather with a stream of future investments and its current government's horizon is long-term. (A regime that faces a high probability of being replaced or deposed might find it more expedient to behave opportunistically because it is only concerned with short-term gains and may not be around for another round of negotiations.) This would be a "reliant" type of government, which Vuegelers defines as one that: a) operates within a relatively infallible legal structure that guarantees near-perfect enforceability of contracts, even when the government is involved, i.e. the decisions of the courts are impartial and the awards are always enforced even if one of the parties to the dispute is a government body—NAFTA comes to mind—; or b) faces the prospect of significant retaliation from the international community; or c) is particularly committed to a particular type of investment; or d) is committed to protecting investments as a matter of principle.

Since the government knows whether it is opportunistic or reliant, but the investor does not, past behavior becomes crucial in defining investor expectations. If the government behaves opportunistically at one point, investors will tend to assume that it will do so in the future and may therefore ascribe a higher value to a no-entry strategy. That is, it will assume that the probability of another appropriation is so high that the potential returns on her investment are simply not worth the risk—or more precisely, that will require returns so high that they may

make the investment economically unviable. Conversely, if the government behaves reliantly for a given period of time—say, during the first wave of investments taking place after an appropriation—the expectation of opportunistic behavior would either a) be revised downwards or b) remain unchanged. Of course, if no entry occurs after the first instance of opportunistic behavior, there will be no change in investor expectations. It follows then that emerging markets, plagued by their own past appropriations and politically-motivated affectations of foreign investor interests—even if they were undertaken by previous authoritarian regimes that are not connected to the current democratic ones, as is the case in most Latin American countries—bear the burden of proof in a manner that their developed counterparts do not.

This "burden of proof" problem helps to explain the emergence of two-tier bargain process that characterizes the current environment of most emerging markets and particularly Latin American ones. The two-tier bargain process proposed by Ramamurti (2006) comprises two negotiation levels: the first takes place between States—the home country and the host—either bilaterally or in the context of multilateral negotiations, as well as between States and international financial institutions (IFI) such as the IMF; whereas the second could be characterized as the traditional State-investor bargain process. First-tier negotiations would thus include, albeit not exclusively: bilateral investment treaties (BIT) and regional and multilateral agreements that incorporate investment provisions, such as NAFTA; IMF loan packages that incorporate the requirement of structural adjustments in the borrower's economy that are relatively irreversible, such as privatization; World Bank project agreements that entail similar changes;

and WTO accession agreements. Second-tier agreements would include the specific negotiations between an investor and the host country that take place within this framework, such as tax-incentives for a particular investment, specific arbitration clauses, and other micro-level issues.

Developed countries promote these agreements because it reduces the uncertainty faced by their investors and exporters abroad, enabling them to capture the competitive advantages associated with emerging markets—lower costs, market access—with lower transaction costs. (Although, as in the case of NAFTA I discussed before, these protections might turn against them.) And a similar reasoning applies to IFI's and emerging markets: in as much as FDI is associated with development, and the availability of FDI is constricted by the conditions in the host country, it is in their best interest to promote the introduction of measures that reduce risk and uncertainty for foreign investors. Furthermore, trade agreements reduce uncertainty for all parties, not only developed ones, by establishing clear and enforceable rules for market access and thus reducing their ability to impose arbitrary restrictions to trade.

A typical modern BIT would include some if not all of the following provisions[17] (Peterson, 2004):

1. *Absolute standards of treatment.* This are usually included in a clause stating that the investments covered by the treaty—which are usually limited to those established after the treaty enters into force—should be subject to "fair and equitable treatment". In principle, this would preclude a government from

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[17] In principle, these provisions affect all industries and sectors, except for the ones that are explicitly excluded in the treaty—as would be the case of "strategic industries" such as utilities and mining.

enacting discriminatory regulations against a particular investor or acting in a way that may be construed to be "unfair" to its interests. Most treaties also apply the relevant protections to the post-investment stage—i.e. not covering the expenses undertaken during the exploration and planning phase of the project.

2. *Relative standards of treatment.* These are usually reflected in clauses mandating that foreign investors be treated at least as well as the domestic ones ("National treatment") if not better; as well as in clauses establishing that the investor should have access to the protections afforded by the treaty or by a BIT signed with a third party that affords more rights to investors (Most-favored-nation treatment, or MFN). The effect of MFN clauses is to prevent the host country from discriminating between foreign investors, favoring a preferred trading or investment partner.

3. *Protections against expropriation or nationalization.* These include protections against both outright expropriation and measures amounting to expropriation such as the one I discussed above.

4. *Dispute settlement protections.* These usually take the form of clauses establishing the right of the investor to have recourse to dispute settlement mechanisms other than the host country's judiciary system. This may include State-State mechanisms, such as WTO panels or State-Investor arbitration procedures, such as the ones carried out under the auspices of the International Centre for the Settlement of Investment Disputes (ICSID) of the World Bank. The fundamental assumption underlying these clauses is that local

courts are unreliable, which is a common concern when dealing with emerging markets.

5. *Other protections.* Many BITs include provisions to the effect of guaranteeing the investor's right to repatriate profits. Some provide for protections against political violence on the part of the host government. And finally, a small number of treaties contain provisions that prevent the host government from imposing restrictions with regards to the nationality of key employees, as well as from implementing regulation that forces the investor to fulfill certain performance requirements—say, for instance, that 50% of the total production must be exported.

These versions of the obsolescing bargain model are fully applicable to electoral processes in Latin America. However, modeling the risk of disruptive policies requires us to disregard opportunistic PBC variables, focusing instead on partisan ones. Recall that the PBC model was defined as: $p_{t+2} = (\beta_t E_t + I_t) + (\beta_{t+1} E_{t+1} + I_{t+1})$, where p_{t+2} represented the likelihood of economic instability after the elections, and it was composed by the probability of expansionary policies before the elections and right after. If we expand the range of possible policies in times t and t+1 to include expropriation and other political events that might have an effect on the returns of a direct investment[18] ("disruptive policies") and we define r_{t+2} as the future probability of their taking place in a period relevant to the investor after the elections, we should find that the basic relationship between partisan incentives and government policy suggested by the model would hold in principle—

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[18] As I already showed, PBC considerations are already accounted for in the variables that matter most to portfolio investors.
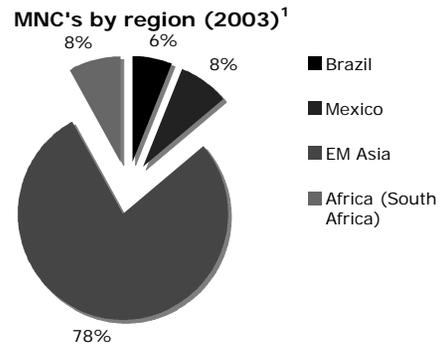
with the applicable caveats—but not the one between opportunistic electoral incentives and incumbent policies, as per Veugeler's formulation. That is, the risk of major disruptive policies is not a function of the time to the elections (ß) but rather of the specific cost of the policy, defined not in broad macroeconomic terms but case-specific ones—e.g. the cost of expropriating two otherwise identical companies might not be the same, provided that one of the investors is protected by his government and the other one is not—and of the ideological preferences of the leading candidate:

$$r_{t+2} = I_{t+1} - E_{t+1}$$

This formulation assumes that the preferences of the incumbent do not matter, i.e. that the incumbent will not implement direct and broad-scale disruptive policies such as expropriations solely as a result of the elections, but its successor might do so should it find expedient and compatible with its own preferences—and regardless of electoral considerations. This assumption is derived from the insight of Veugeler's game: if we assume that the incumbent is actually trying to win, it has every incentive to signal that it is a "reliant" type and is thus unlikely to undertake any policy that would undermine this strategy. (Of course, in the hypothetical case in which the incumbent plans to bring the system down, cancel the elections and move to autarky, this would not be the case.) The assumption is also corroborated by the available empirical evidence: in the broadest samples of nationalizations or expropriations—the most noticeable instances of disruptive policies—there is no instance of an expropriation undertaken solely or even primarily for electoral concerns (see Minor, 1994). To be sure, there are some that took place in the context of electoral periods, such as the nationalization of the Mexican banks in
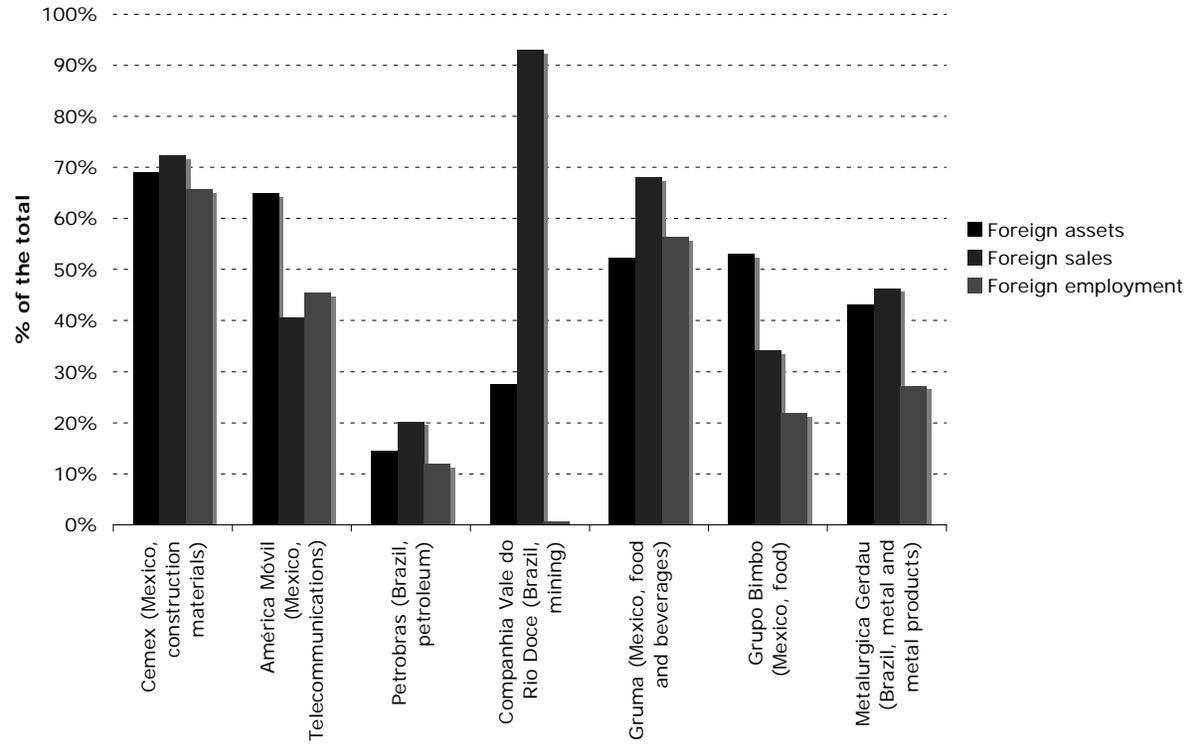
1976. However, the ostensible objective of the expropriation in that case was not to prop the incumbent's position—the PRI had no challenge—but rather to exert control over private capital, which was fleeing the country as a result of the worsening economic outlook. This is also the case of the recent expropriations and tax-rate hikes that have taken place in Latin America after the victory of radical nationalist candidates: all of them occurred *after* the elections, when there was no significant electoral advantage to be had, but rather political and economic ones. For example, the alleged "expropriation" of the investment of an American company, SAIC, in Venezuela in 2002 was not linked to electoral or even "anti-American" considerations, but rather to the ongoing effort by the Chavez Administration to exert control over PDVSA, which at the time was controlled by openly hostile Venezuelan managers, with whom SAIC had been engaged in extensive and somewhat controversial business deals in the past. (Although the case became a US-Venezuela diplomatic issue after OPIC decided to pay the claim against the expropriation policy that the company had bought.)

Figure 2. Top 50 emerging-market based MNC's by region (2003)[1]

Legend:
- Brazil
- Mexico
- EM Asia
- Africa (South Africa)

6%
8%
8%
78%

Figure 3. Selected indicators of diversification for Brazilian and Mexican MNC's, 2003

% of the total

Categories:
- Cemex (Mexico, construction materials)
- América Móvil (Mexico, Telecommunications)
- Petrobras (Brazil, petroleum)
- Companhia Vale do Rio Doce (Brazil, mining)
- Gruma (Mexico, food and beverages)
- Grupo Bimbo (Mexico, food)
- Metalurgica Gerdau (Brazil, metal and metal products)

Legend:
- Foreign assets
- Foreign sales
- Foreign employment

Source: UNCTAD (WIR, 2005)

III. BRAZIL AND MEXICO 2006

Throughout this paper I have derived two types of electoral risk models: one based on the PBC theory (PBC model) and the other one on the obsolescing bargain (Disruptive Policies model). The first one posits that the risk associated with elections is largely economic and that it is a function of the partisan preferences and short-term electoral incentives. The second one suggests that we can explain a broader array of risks, namely those resulting from disruptive policies that may not have an effect on the overall economy but nevertheless affect some investors, by assessing the preferences of the leading candidate and the relative cost of the disruption for the government. However, I have also established that the models should be treated less as forecasting tools than as frameworks for the analysis, because they make a number of strong and questionable assumptions about the government's ability to manipulate policy and about what constitutes an "adequate" policy. Furthermore, in as much as they reflect general trends, they fail to capture the specific risk that may be borne by a given company. This is a common pitfall for most risk models (Oetzel, Bettis and Zenner; 2001) and mine are not, alas, an exception.

Having said that, I would argue that both models do shed some light as to why the current optimism about Latin American markets would be justified, and particularly so in the cases of Mexico and Brazil. Let's consider the case of Mexico first. Through the period comprising the second semester of 2005 and the first quarter of 2006, the "radical" former Mayor of Mexico City, Andres Manuel Lopez Obrador, led the opinion polls with an advantage that is varyingly estimated between 5% and 10% over his closest competitor, the incumbent party's (PAN)

candidate Felipe Calderón. In terms of the PBC model, this would lead to higher risk, since the incumbent would attempt to prop up its trailing candidate and the lead candidate has a stated preference for economic growth—higher values of $ß_t$ and I_{t+1}. However, as per the other provisions of the model, this risk is offset by: a) the relative low cost of implementing expansionary policies in the context of the petroleum markets boom, which in effect grants the government some spending leeway; and b) the commitment of the incumbent to maintaining primary surpluses. Thus, even though the discretionary spending during the January-February 2006 period rose 15.6% in real terms compared to the same period in the previous year, the primary surplus period-to-period is up 49.1% in real terms, aided by a 27.9% increase in petroleum-related income and lesser but nevertheless significant increases in other sources of fiscal revenue. And, if we are to assume that the present trend of net capital inflows, fueled by remittances and portfolio investments in the local capital markets will continue for the time being—a reasonable assumption—this spending leeway will most likely be extended to the next government, to the effect that even a fiscally profligate candidate would not have a significant impact in t+1. Finally, given the fact that none of the candidates appears to be in a position to garner a legislative majority, we should expect that any deviation from the current policy outlook would be constrained at best.

The disruptive policies model tells a similar story. While the increased probability of the victory of self-confessed nationalist would merit some concern in the context of the rise of radical governments in the region, the cost of implementing any broad disruptive set of policies is too high to be deemed plausible. On the one hand, there is the network of BITs to which Mexico is party,

including the investment protection provisions in NAFTA, which cover a broad array of foreign investments in the country, none of which were undertaken in the most politically-sensitive sectors—with the possible exception of a moderate participation in the petroleum industry and the utilities sector through BOT contracts, which has thus far failed to mobilize but a few interest groups linked to these industries' unions. On the other hand, the dependence of the Mexican economy on its trade and investment relationship with the United States would render any disruption too costly. (Although, it should be noted, it would also amplify the effects of a downturn in the United States economy. However, there is little indication that such event is likely in the near future). Thus, even if we were to ascribe the highest possible value to the ideology variable, as we would do under conditions of absolute uncertainty—which would not be justified, given the ample signaling process undertaken by AMLO's economic advisors—it would be more than offset by the cost variable.

The case of Brazil induces a similar assessment. Brazil has benefited from the commodities and investment boom and maintains a primary surplus. Furthermore, the comfortable lead of the incumbent in the polls reduces the incentive to implement expansionary policies, in spite of the relative lack of growth of the Brazilian economy. And while Brazil is not nearly as constrained as Mexico with regards to the risk of disruptive policies, the lack of legislative majorities that has plagued every President since the promulgation of the 1988 Constitution, combined with the firm commitment of the major political parties to promote foreign investment in the country would seem to warrant a low level of risk. This would explain why the level of risk implied by the Brazilian sovereign spreads is nowhere

near the level registered in the context of the 2002 elections (see figure 4), when the uncertainty about Lula's policy preferences was combined with a relatively weak debt structure. And while it does not explain why the Brazilian stock market is still significantly more volatile than its Mexican counterpart, this variation may be attributable to the specific characteristics of the local stock exchange or the composition of the Bovespa index, and not necessarily or even probably, to the local political conditions. (In fact, as figure 5 shows, the volatility that was associated with the 2002 elections lasted well into the first half of Lula's Presidency, when the level of risk was relatively low.)

Figure 4: Selected Sovereign Spreads 2000-
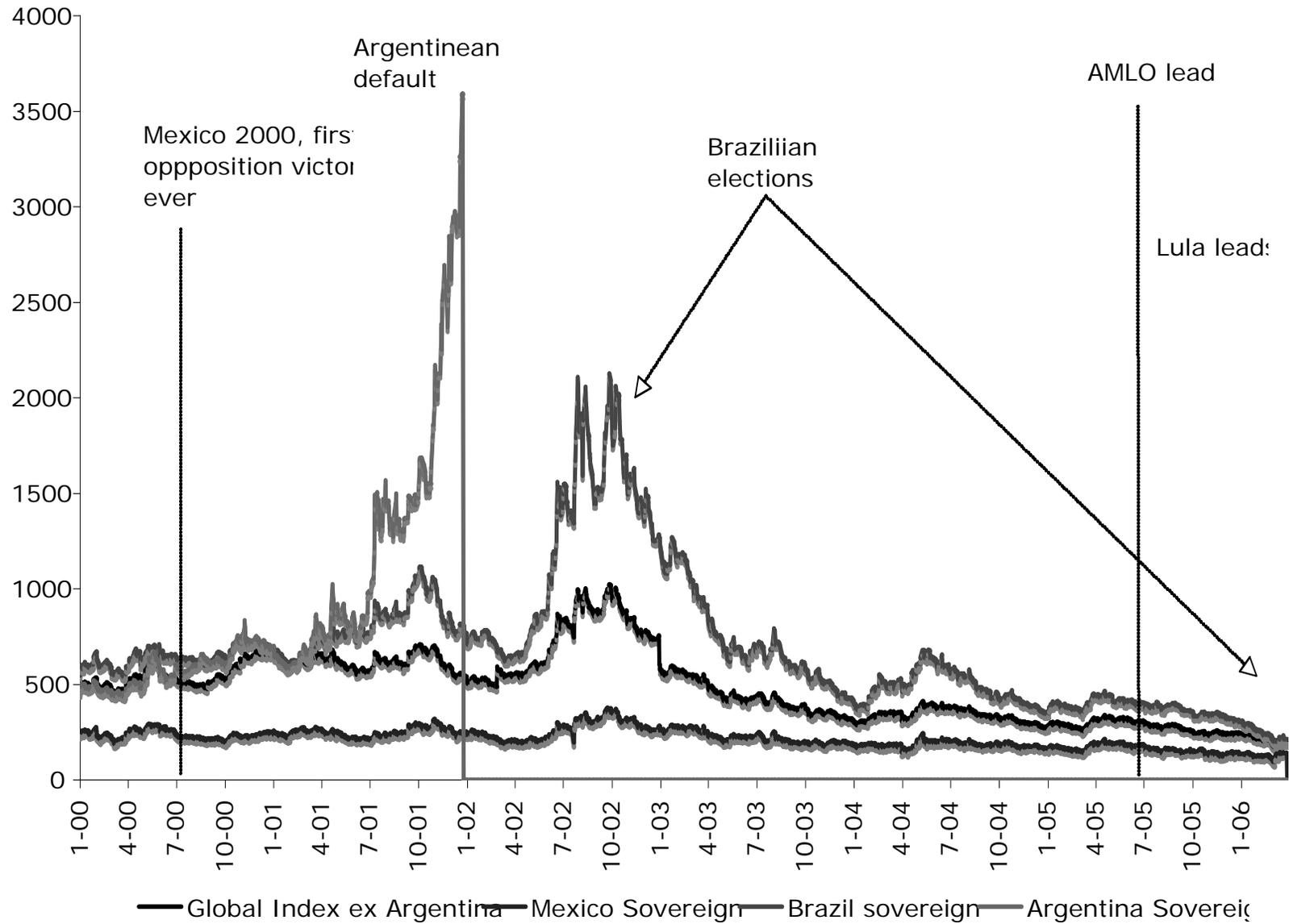
*March 2006. Data: MSHYci High Yield I

Figure 5: Annualized Volatility, Selected Emerging Markets and the US, January 1998-March 2006
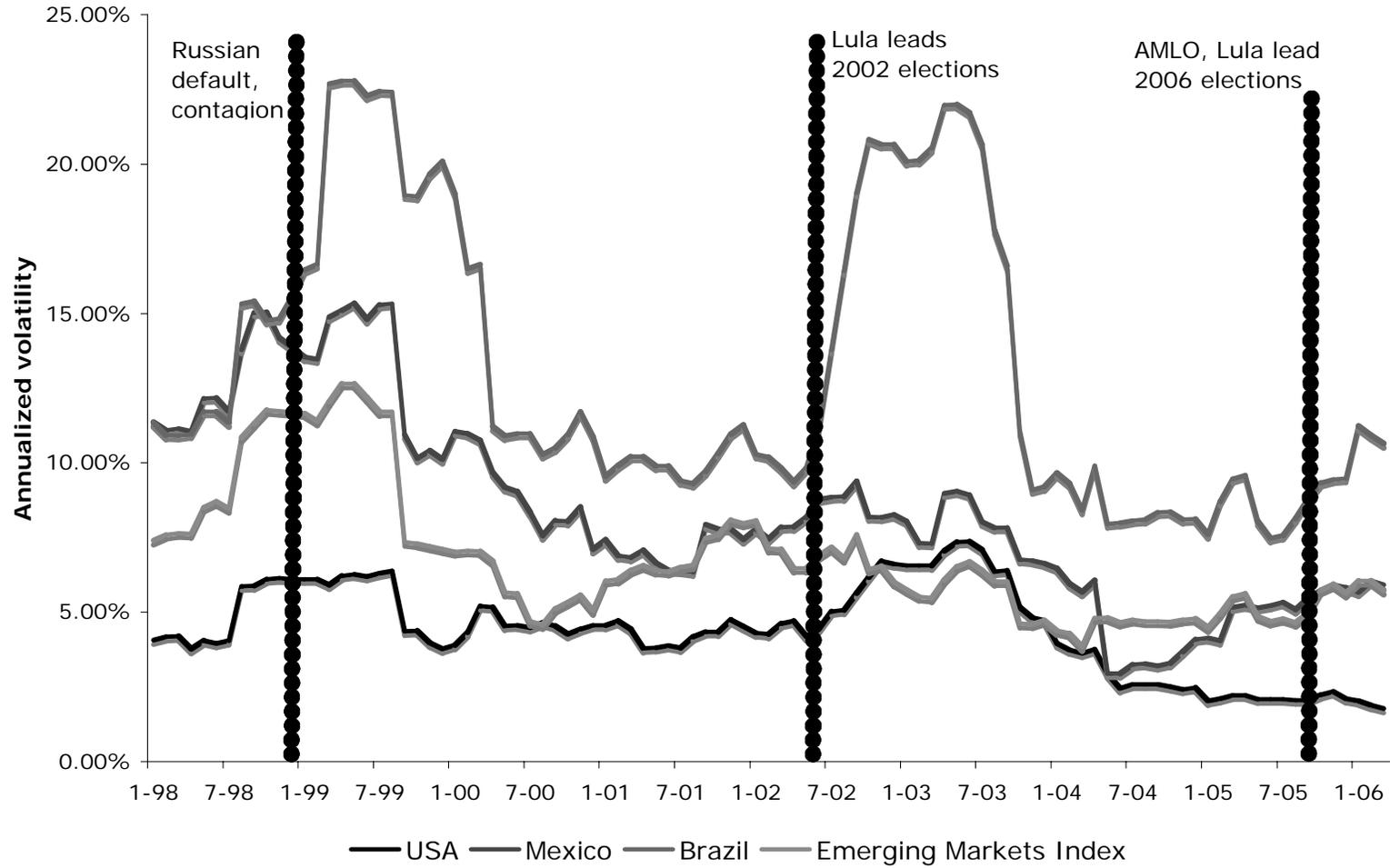
Source: derived using MSCI monthly index values, expressed in USD.

IV. CONCLUDING REMARKS: CAVEAT EMPTOR

My analysis of the cases of Mexico and Brazil might strike some observers as somewhat simplistic, and rightly so. My account of the prevailing conditions in the region and in both countries is by no means exhaustive and a more detailed look would render more nuanced observations for sure. However, the purpose of the preceding section was not to conduct an in-depth review but rather to show how the models could be used as a framework for analysis. And I feel confident that the general conclusions will stand—as do, it would appear, most observers.

A more important objection would be the lack of econometric coefficients for the variables of the model. In these barebones versions, the value and weight of each variable is determined in what some may regard as a haphazard manner, more artisanship than science. This reflects a fundamental issue with this kind of analysis: there are simply not enough data points to conduct any meaningful econometric analysis. One could of course analyze a broad sample of elections across countries in various continents—or spanning various decades in Latin America—but this would be a forced comparison at best. The region has undergone a great transformation in the past two decades. Would it be even possible to argue that a 1970´s election in Nigeria is at all comparable with the 2002 Brazilian elections, or that the 1982 Mexican elections are similar in any meaningful way with the 2000 ones? The simple fact is that the changes that have swept the region force us to consider the possibility of a paradigmatic shift and, in consequence, we might be forced to acknowledge that at this point the econometric analysis provides limited insights at best.

This is not to say that further research might not find regularities down the line. But barring that, the models' predictive power will depend on the ability of the observer to compile and process the available information—or, in the presence of uncertainty, to acknowledge the impossibility of predicting anything. They are a starting point that may well lead to different directions every time around.

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