Journal of Globalization, Competitiveness & Governability / Revista de Globalización, Competitividad y Gobernabilidad / Revista de Globalização, Competitividade e Governabilidade
E-ISSN: 1988-7116

Mullins, Martin; Murphy, Finbarr; Garvey, John F.
Do Credit Derivatives Dampen Political Risk: The Case of Brazil Post 1998
Journal of Globalization, Competitiveness & Governability / Revista de Globalización, Competitividad y Gobernabilidad / Revista de Globalização, Competitividade e Governabilidade, vol. 2, núm. 2, 2008, pp. 46-59
Portal Universia S.A.
Boadilla del Monte, España

Available in: http://www.redalyc.org/articulo.oa?id=511851318002

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Do Credit Derivatives Dampen Political Risk: The Case of Brazil Post 1998

AREA: 2
TYPE: Specific Cases

¿Los derivados de crédito reducen el riesgo político? El caso de Brasil a partir de 1998
Os derivados de crédito amortecem o risco político: O caso do Brasil pós-1998

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DOI
10.3232/GCG.2008.V2.N2.02

In this paper we argue that the relationship between emerging market States, in this case Brazil, and the financial markets is changing due to developments in the area of financial risk management. The use of credit default swaps has ensured that default risk on Brazilian sovereign debt is shared by a large number of market participants. This means that the Brazil State is no longer faced with a homogenous group of investors capable of concerted action. Political risk is still present in the spreads offered by a sovereign debt issuer such as Brazil, but the dilution of the relationship between debt markets and investors means that in the future, financial crisis may be less probable.

En este documento analizamos el cambio producido en la relación entre los estados emergentes (en este caso, Brasil) y los mercados financieros. Este cambio viene dado por los desarrollos en el área de la gestión de riesgos financieros. El uso de los intercambios predefinidos de crédito ha garantizado que el riesgo preestablecido de la deuda pública de Brasil se comparta entre un amplio número de participantes del mercado. Esto significa que el estado de Brasil ya no se enfrenta a un grupo homogéneo de inversores capaces de acordar una acción conjunta. El riesgo político sigue existiendo en los spreads ofrecidos por un emisor de deuda pública como Brasil, pero el debilitamiento de la relación entre los mercados de deuda y los inversores indica que, en el futuro, las crisis financieras podrían ser menos probables.

Advogamos neste relatório que a relação entre os Estados de mercado emergente, neste caso o Brasil, e os mercados financeiros está a mudar devido a desenvolvimentos na área da gestão do risco financeiro. O uso de permutas de incumprimento de crédito assegurou que o risco de incumprimento da dívida de soberania brasileira é partilhado por grande número de participantes no mercado. Isto significa que o Estado brasileiro já não é confrontado com um grupo homogéneo de investidores capaz de uma acção concertada. O risco político continua presente nos spreads oferecido por um emissor de dívida de soberania como o Brasil, mas a diluição da relação entre os mercados de dívida e os investidores implica que, no futuro, a crise financeira pode ser menos provável.

1. Introduction

The ability of emerging economies to find long-term funding is a central component in their economic development. This paper contributes to the International Political Economy (IPE) literature by examining the role of financial innovation in changing the dynamic between the Brazilian State and the financial markets. We posit the idea that developments in the field of financial risk management, namely Credit Default Swaps (CDSs), have had an important effect on the political economy of Brazil. A credit derivative is a generic term for any contract used to specifically transfer the credit risk of debt, where the debt can be issued either by a corporation or a country. The contract assigns a value to the creditworthiness of the debt issuer, allowing the creditworthiness of the debt issuer to be isolated and traded.

This paper is an examination of the interaction between the global finance and local polity and adds some insights derived from contemporary finance in order to provide nuanced input into the ongoing debate on the impact of financial globalisation. The focus of this paper is on the role that markets for financial instruments play in Brazil and potentially play in other emerging markets. In the context of its history, Brazil is currently exhibiting an exceptionally stable financial environment. As a producer of both agricultural produce and industrial raw materials it is one of the main beneficiaries of the current so-called commodity 'super-cycle'. Other contributory factors include the development of a consensus around orthodox macro-economic policies, less partisanship in Brazilian politics, the role of international financial institutions and a more sanguine view taken by market participants towards Brazil's President, Luiz Inácio Lula da Silva and his Workers Party. However, we argue that developments in the nature and use of financial instruments may also play a role in reducing volatility.

The ability to hedge risk, both in equity and debt markets, facilitates investments in emerging markets. Much of the IPE/Political Science literature suggests that the nature of global finance is such that it imposes strict conditions on governments in Latin America (Koelble. and LiPuma, 2006). This community of financiers is said to impose anti-democratic neo-liberal policy sets on the governments of the region. Our work will add to this debate and question if this is in fact the case and whether or not new financial strategies may lessen the imperative of foreign investors to lobby on domestic policy decisions. We propose that political risk is dampened where country risk can be effectively pooled and diversified by a broad section of the financial community. Moreover, we argue that rather than being a threat to domestic governments, greater liquidity and the global nature of these markets may result in more freedom of action for State actors. Much of the existing literature focuses on pressures and constraints on policymakers in Latin America, our paper posits the idea that the new environment may in fact be more benign.

Given that financial markets are seen as increasingly important in world polity this has profound implications across a number of disciplines. In essence, this paper argues the idea that the evolution of financial instruments may in fact lend more autonomy to emerging market countries. This is particularly important when considering the case of medium-sized, ambitious States such as Brazil. Brazil provides an appropriate case study since it has a high degree of autonomy and a favourable macro-economic situation, factors that together throw political risk into sharp relief.

Political risk is a multi-causal phenomenon and therefore straddles a number of disciplines. As a discipline, it has developed as a response to increased investment flows from North America and Europe to developing countries and the dangers posed to these investments (Jarvis and Griffiths, 2006). Political risk analysis seeks to interrogate the interaction of political authorities with economic actors. Political risk includes risks that result from governmental actions such as economic policies, fiscal policy, regulation, the development of legal instruments and relations with the other countries and international organisations. It also includes the behaviour of the wider civil society consisting of trade union and protest/pressure groups.

KEY WORDS
Emerging economies, Financial markets, Brazil, Credit Default Swaps, Credit derivatives

PALABRAS CLAVE
Economías emergentes, Mercados financieros, Brasil, "Credit Default Swap", Derivados de crédito

PALAVRAS-CHAVE
Economias emergentes, Mercados financeiros, Brasil, «Credit Default Swap», Derivados de crédito

JEL CODES
G180; E440

Historically, in Latin America, political risk has been exacerbated by the populist tendencies that have posited global finance as a malign force. Consequently, defaulting or threatening to default on debt has at times been adopted as a political strategy. This history has meant that the financial community has been cautious in its dealings with Brazil.

In considering the contribution of this paper, the inclusion of CDS data in examining this issue is groundbreaking. Previous papers on country risk have focused on movements in real interest rates and currencies as well as traditional asset classes such as the equity markets (Clark and Kassimatis, 2002). The key contribution of this paper is our examination of whether or not markets in CDSs and by implication, other hedging devices, effectively dampen political risk. This in a region of the world that in the past has been devastated by financial collapses closely related to political events.

2. Financial Markets and Emerging Market Countries

The relationship between the world's financial centres and nations at the periphery of the world economy has a long and troubled history. Polemics on the ability of financiers to exert pressure on developing nations have been produced for more than a century. Financial crises have consistently been a feature of the interaction between capital and emerging markets. As far back as the 19th century the patterns of strong inward investment followed by defaults on sovereign debt had been established (Manzocchi, 1999). Recently in Latin America, a series of devastating crises were evidenced particularly in the period between 1970 and 1995 Latin America had to endure more frequent financial shocks than either East Asia or Europe (Manzocchi, 1999).

During the 1990s there was a wave of inward investment driven in part by financial liberalisation occurring at a time of rapid globalisation in financial markets and thus were not bound by geography. Manzocchi (1999) argues that one of the characteristics of financial liberalisation is short-termism, herd instincts and bandwagon effects and for sovereign governments this situation can be highly restrictive in terms of the policy options available (Manzocchi, 1999). There are some other interesting characteristics of this capital inflow during the 1990s. Haley (1999) points to a concentration of funds in the hands of certain funds managers and moreover, that the decisions of these managers were coordinated;

I have found that these institutional investors are relatively few in number, show signs of coordination and have the capacity, singly and as a unit, to impact capital flows to developing countries. This power, a distortion of a fair and efficient market system, carries with it the ability to reward and punish developing countries according to their ability to implement and maintain reforms beneficial to foreign investors.

If we follow Haley's argument, international finance became an important player in world polity. It is not the intention of this paper to dispute this interpretation of the political economy of the 1990s but rather to argue that we have entered a new era. Previously, the risks associated with investing in emerging market countries were concentrated and this lent a degree of normative power to those locations where the risk was concentrated. Modern financial hedging mechanisms facilitate the significant diffusion of risk. In fact, one of the criticisms of contemporary financial markets is that their increased level of complexity has made it more difficult to precisely identify the location of risk. Furthermore, hedging techniques make assigning risk and/or responsibility more problematic.

This development suggests that a single powerful community such as the one described by Haley (1999) is less effective in functioning as a political actor in its relations with developing countries. Derivatives are financial contracts that allow investors to both hedge and speculate on an almost infinite range of risks. Credit derivatives belong to a non-traditional asset class that allows specialist investors such as hedge funds and insurance companies to invest in country risk. The ability of a wider community to provide funds to emerging markets for economic activity and growth while diversifying elements of political risk is an important development.

3. Financial Markets and the State

Financial markets, it is frequently argued, are politically powerful and Stiglitz (2002) notes that highly mobile capital exerts a degree of control on the actions of sovereign governments (Stiglitz, 2002). This influence is all the more apparent in countries considered as emerging markets that are dependent on inflows of capital from the world's financial centres. Increased liberalisation and greater volumes of capital increase the probability of financial upheaval in emerging markets. It is also the case that in emerging countries, financial turbulence and politics are closely linked and this naturally suggests a link between the State and financial markets (Martinez and Santiso, 2003).

The notion that the State is the main source of power is frequently questioned since a number of small and medium sized States have found themselves at the mercy of the financial markets. The part played by financial markets in emerging markets over the last couple of decades has come under intense scrutiny. Conventional ideas about the primacy of the State in international relations and in other disciplines are being re-examined. Koelble and LiPuma (2007) argue that;

Outside the metropole, the global financial markets are determining the price of money, which dramatically limits the economic sovereignty of these countries and, by doing so, delimits their policy options such that a variation of neo-liberalism becomes the rational alternative.

In their article they make an explicit connection between the explosion in derivative markets since the 1970s and an increased adherence to neo-liberal economic norms. Their argument is that modern financial markets or what they refer to as "speculative capitalism" rewards compliance and punishes those who wish to pursue policy sets that are out of line with the preferences of international capital markets. There is then a price to be paid for certain types of macroeconomic or socio-political policies and this tends to have the effect of steering governments, particularly those in the emerging markets, away from non-orthodox policies (Murillo and Martinez-Gallardo, 2007). This line of argument suggests the operation of modern, global financial markets leads to a dilution of State sovereignty.

There is a widespread sense of discomfort with the consequences of financial globalisation (Guidotti, 2007). Clearly financial markets have the ability to impose costs on those countries where the risk are perceived to be greater than elsewhere.

Placing capital at risk has to be paid for and this is achieved through increasing the spread on sovereign debt or other words, the interest payable. This undoubtedly has had an impact and to be clear, this paper is not arguing that financial markets do not have an impact on States like Brazil. Instead we suggest that modern techniques in managing financial risk mean that investors are less exposed to political risk than they were in the past.

This in turn may reduce the normative impact of the financial markets on State policy. If the risks of placing capital in the emerging markets can be reduced or transferred then the ability of the State to attract capital is enhanced. In effect, we are arguing that modern financial instruments reduce the need for surveillance and thus attenuate risk. It follows that as risk is attenuated then States in emerging markets may gain greater autonomy. Thus, these technologies of risk attenuation have profound political consequences.

4. The Brazilian Context

In terms of sovereign risk in the Americas, Brazil represents a particularly interesting example. Since the 1970s Brazil has pursued a foreign policy set independent from that of the United States. For an emerging market country to take such trajectory typically raises concerns in the financial markets. Relations with the US are often seen as a proxy for political risk and investors are wary of real or suggested divergence between Washington and a developing nation. The fear is of a sharp break with the dominant neo-liberal economic paradigm of the late 20th and early 21st century.

The reticence of Brazil in its relations with the United States, relates to long-standing policy objectives in Brasilia and has meant that, unlike Mexico, Brazil has been unwilling to sign up to a process that would lead to the Free Trade in the Americas (FTTA) agreement. As a consequence, Brazil's economic welfare is not as closely tied to that of the United States as other countries in the region. Thus political risk in Brazil is somewhat purer in that it is not diluted by institutional arrangements with the United States, thus making it an interesting case study in examining the role played by financial markets. Moreover, the leftist hue of Lula da Silva's government throws the interests of the State and those of the financial markets into sharp relief.
Regional leadership has been a goal of the Brazilian foreign policy establishment for many decades and this has shaped the nation's engagement with other Latin American countries and with the United States. In the case of the former, the desire to be seen as the region's lead nation has meant that care is taken to foster warm relations with its neighbours. The engagement with Argentina is seen as central in this regard. In the case of relations with the US, the desire for regional leadership has conflicted with the preponderance of US power in the Western hemisphere.

This conflict of interest comes into stark relief in the debate that surround the merits of Mercosur and those of a hemispheric Free Trade Area of the Americas (FTAA). For Brazil, the establishment of the FTAA would signal the end of any pretensions of regional leadership it may have had and would firmly establish the United States as the hegemonic power in the Americas. Lula, during his 2002 election campaign compared FTAA to annexation. He has since lowered the rhetorical temperature but many of his advisors remain deeply unenthusiastic about the project (De Jonquieres and Lapper, 2003).

In Brazil we see a balancing act between the need for economic growth and a desire for autonomy. Here again, as elsewhere on the continent, there is a wariness of the power of financial markets and this is particularly the case amongst Lula da Silva natural constituency on the Left. For Brazil, hemispheric relations are shaped by the imperative of economic growth and the desire for autonomy and regional leadership (Smith, 2005). In the long terms these two goals are eminently compatible, however in the short-term, conflicts with Wall Street and the City of London are costly and so a balance needs to be struck between the two.

Lula da Silva was elected president of Brazil in 2002. It marked an important event in Brazilian politics as he was the first left wing presidency elected by the mass of the Brazilian people.[1] The financial markets exhibited uncertainty and a degree of panic as Lula took a strong lead in the polls prior to the election. In spite of this, some commentators were much more sanguine about the impact of Lula's election pointing to the high degree of continuity in policy making in Brazil and the existence of a powerful elite within the political class that has tended to set the long-term policy agenda. Klom (2003) argued that the election was unlikely to cause profound changes;

"Under a Lula government a shift in foreign policy emphasis could occur; however, the broad tradition of Brazilian foreign policy and the stabilizing 'Itamaraty factor' will ensure that Brazil does not stray far from its established path."

The itamaraty[2] is important for though it is charged with managing foreign policy it is highly influential across the government. As an institution it lends a high degree of continuity to Brazil's engagement with the wider world. The negative reaction of the markets in 2002 to the status of Lula as favourite to win the election may have failed to factor in the probable continuity in policy sets. Costa Vez (2003) argues that, although the Worker Party's policies were not a mere continuation, under Lula there was no deviation from the central policy themes of previous government (Vaz, 2007).

In the past, Brazil has been vulnerable to financial crises which have had a profound effect on the general economy and the body politic. In spite of unease in the financial markets surrounding Lula's victory in 2002, there is a sense that since 1999, there has been a gradual improvement in Brazil's standing among the world's financial community. Tabak and Staub (2007) argue that the financial system in Brazil has become much more stable than was the case prior to 1999. They propose that the introduction of floating exchange rates and the adoption of a monetary policy aimed at curbing inflation were important factors in enhancing expectations around the future of the economy (Tabak and Staub, 2007).

It is clear that the more positive view taken on Brazil and the apparent dampening of perceived risk is supported by higher commodity prices, consistent economic growth and the ability of the Lula government to restrain more radical socio-political actors. The data presented in this paper suggests that innovations in contemporary financial markets, specifically CDSs, are also a factor in Brazil's newfound financial stability.

Innovation in the financial markets ultimately confers greater resilience to emerging markets since investors now have the opportunity to reduce exposure through risk transfer mechanisms such as CDSs rather than merely sell the underlying asset. This is in contrast to recent history where financial systems in Latin America have exhibited vulnerability.

1. In previous elections, such as those in the 1950s and 1960s the electorate constituted a small percentage of the general population. The first election with a franchise that extended to the mass of Brazilian was in 1989.

2. Itamaraty, the elite within the Brazilian civil service charged with the management of the country's foreign relations

Debt is a political issue in Latin America and the porosity between politics and debt markets worries investors. In terms of risk control, CDSs are targeted at default risk and act as an outlet for the worries that arise from some of the political discourse in the region by facilitating the transfer of this default risk to counterparties in the capital system. This means that unease over Brazilian economic and political conditions are reflected in the pricing of financial instruments rather than in a breakdown in relations between the Brazilian State and overseas investment diverse communities.

5. Credit Derivatives

Credit derivatives are over-the-counter contracts whose value is determined by the credit quality of some reference entity, for example a sovereign debt issue. A liquid credit derivative market effectively allows the creditworthiness of the reference entity to be isolated and traded. According to Zhu (2006), Credit Default Swaps (CDSs) make up at least 45% of the credit derivatives market.

The structure of a CDS allows a bond investor to purchase protection against the default risk of a bond issuer in return for a periodic premium. In the event of a credit event, such as default, the bond investor receives the full par value of the asset from the CDS seller who then takes delivery of the defaulted debt. CDS contracts can be used in this manner as a hedge against default risk of a corporation or a sovereign entity. Market participants, who do not necessarily hold the relevant bond can also purchase CDS contracts to speculate on changes in the level of default risk. Thus, unlike an insurance policy, there is no requirement that the protection buyer holds the underlying asset or suffers a loss on the asset.

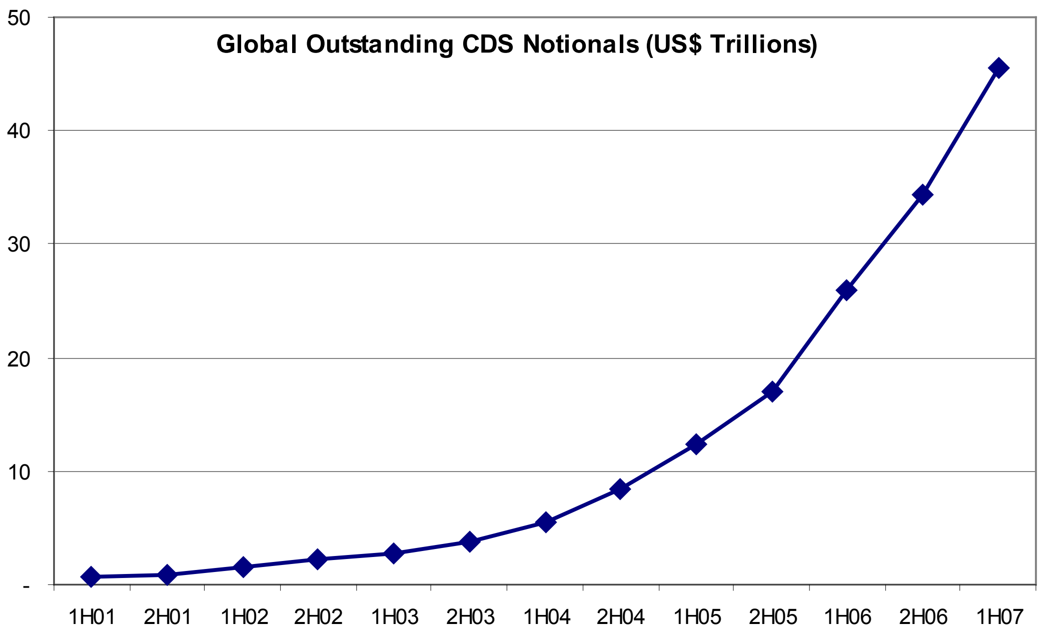
Ammer and Cai (2007) examine the dynamics between bond prices and sovereign CDS spreads in emerging markets and show that, despite short-term deviations, a stable long-term relationship exists for most countries, including Brazil. This close link between the sovereign bond and CDS markets has key implications for investors and issuers alike. Traditional bondholders can now hedge long positions by purchasing credit protection using CDS contracts, something not possible a decade previously. The sale of credit protection has encouraged broader market participation from institutional investors such as insurance companies and hedge funds. The increased availability of protection against default means that the motivation of traditional bondholders to dump their bond positions during times of stress is mitigated.

CDS contracts have also influenced market dynamics by encouraging the participation of an expanded, heterogeneous group of financial institutions in the market for emerging market debt. This development is in contrast to traditional relationships in emerging market debt, where the dynamics of the market were influenced by the cartel-like control exercised by buyers of emerging market debt. By increasing and broadening participation in these markets the formation of small, cohesive groups of bondholders wishing to dictate economic policy to the issuing sovereignty is less probable. This heterogeneity among stakeholders ultimately affords the bond issuer greater autonomy in the economic policy decision-making process.

We suggest the presence of credit derivatives will continue to have a stabilising influence in the sovereign debt market. The contribution of these instruments is likely to remain important beyond current economic conditions. As a consequence, the development of credit derivatives are likely have a significant social benefit since they allow emerging economies raise capital at cheaper rates than would be possible in their absence.

The derivative market has grown exponentially since the late 1990's so that by mid-2007, the notional volume of outstanding single name CDS contracts was $45 trillion[3]. This trend is summarised in Figure 1. The growth of the CDS market has been facilitated by contract standardisation that has in turn encouraged greater involvement in the credit market by hedge funds and insurance companies. This growth has been propelled by the creation of market indices comprising major corporations and sovereign names[4].

Figure 1 - Outstanding CDS Notionals[5] (source: ISDA)



Brazilian government securities were the second most frequently traded emerging market instruments, with a turnover of US$1.134 trillion (Murno, 2008). Volumes in the industry's benchmark bond, Brazil's 2040 issue, stood at US$215 billion[6]. Transactions in credit derivatives are bilateral and as a consequence, identifying trading volumes by sector or by reference entity is difficult. According to the Bank for International Settlements (Upper et al. 2007), single name CDS contracts on sovereign debt accounted for 6.5% of overall CDS

3. ISDA Semi-annual report, 1H 2007. See www.isda.org

4. For example, the North American Investment Grade index of 125 corporate names, ticker CDX.NA.IG.

5. The notional amount refers to the face value of the underlying credit.

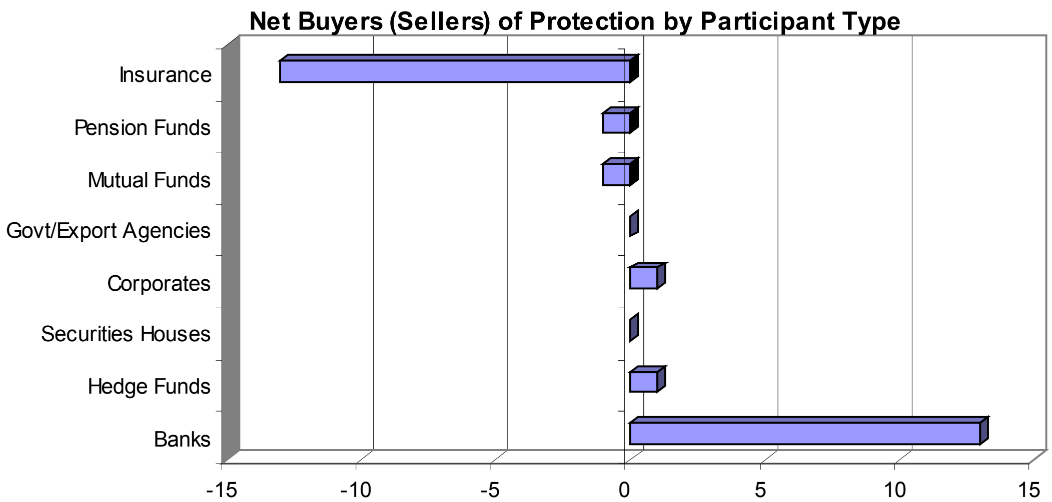
6. Bond issued August 17th 2000, maturing August 17th 2040. 11% coupon paid semi-annually.

outstanding notionals. Furthermore, EMTA (Murno, 2004) noted that Brazilian CDS contracts accounted for 12% of overall sovereign CDS activity.

We estimate that a notional US$294 Billion CDS contracts on Brazilian sovereign debt was traded in 2007. This represents 26% of the volume of the Brazilian cash market and significantly, is relatively more liquid than volumes on the Brazilian benchmark bond. This indicates a strong appetite for exposure to Brazilian credit, particularly for non-traditional cash market participants.

The primary participants in the CDS market are banks, hedge funds, securities houses and insurance companies. The breakdown of activity by participant type is illustrated in Figure 2 and it clearly shows that banks are the dominant net credit sellers while insurance companies are the dominant credit buyers. The diverse strategic objectives of market practitioners achieved through using CDS contracts have produced an equilibrium that has been a key factor in the growth of the CDS product. We propose that this dynamic activity has an important stabilising influence in the sovereign debt market.

Figure 2 - Market Participant by Activity (Source: BBA Credit Derivatives Report 2003/2004)



Dages, Palmer and Turney (2005) report that US commercial and investment banks expressed the greatest interest in using credit derivatives to manage country risk, compared to alternative risk management instruments such as risk insurance or Non Deliverable Forwards (NDFs)[7]. Banks who hold sovereign debt are increasingly seeking partial protection from credit risk by selling credit derivatives while insurance companies are providing protection

7. Risk insurance is currently offered by the Multilateral Investment Guarantee Agency a sub-group of the World Bank.

by purchasing credit derivatives. This dynamic, afforded by CDSs, is leading to greater dispersion of credit risk among a wider variety of market participants.

At a micro level, credit derivatives allow banks and other traditional sovereign debt holders to better manage risk, diversifying and tailoring the banks portfolio. On a macro level, that credit risk is now borne by sectors of the economy that could be reluctant or incapable of holding government bonds. Ultimately this ensures that shocks are borne by a greater number of entities, thereby increasing stability of the overall system. According to Effenberger (2004), this stabilising influence has already been seen in the aftermath of major corporate credit events such as Enron, Worldcom and Delphi. Effenberger argues that these shocks were absorbed without any significant impact on the US national economy due to the widespread use of credit derivatives in these sectors.

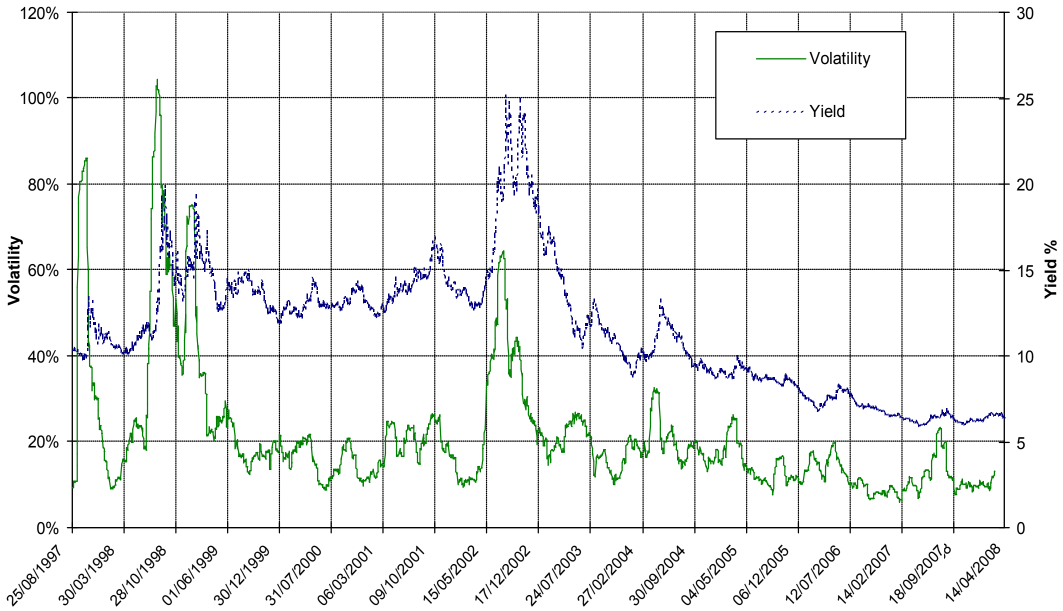
A key criticism of credit derivatives supposes that in the event of economic uncertainty, hedged bondholders are incentivized to force a bond default and thereby trigger a default payment. Contrary to this, Goderis and Wagner (2007) found that credit protection does not undermine the ability to achieve restructuring. Goveris and Wagner suggest that credit derivatives may play a positive role in the ex-post sovereign restructuring process. CDS market-making is performed by a limited number of large investment banks. This leads to criticism of credit derivatives markets as exhibiting poor transparency and a vulnerability to high-levels of market-making concentration.

In this paper, we examine the yield on a benchmark Brazilian Government bonds[8] from June 26th 1997 to April 17th 2008. We also plot the risk or volatility of the yield, measured here as the squared daily change in the level of the yield, which is an appropriate proxy for asset volatility. From figure 3, we can observe the sensitivity of yield spreads to political uncertainty. Large jumps in yields are observed in the period surrounding the default of Argentinean debt in 1998 and in the run-up to the 2002 presidential elections. In both cases, the yield widened considerably as investors aggressively sold Brazilian government bonds on credit concerns. We also note the reduction in yield, particularly since 2004 as sound economic policy and a strong market in commodities made Brazilian sovereign debt more attractive.

(See next page for Figure 3)

8. Issued June 4th 1997 with an initial notional of €500MM.

Figure 3 - Yield and Volatility of a Brazilian Government bond benchmark issue



Interestingly, volatility in the yield on Brazilian debt has become increasing stable. This is particularly notable when considered in the context of the turmoil evident in worldwide debt markets caused by the impact of sub-prime US mortgage fears throughout the financial system. Although the sub-prime crisis is not directly related to the Brazilian bond market, it should affect Brazilian bond yields as part of a general movement towards safer investment strategies that inevitably follows a market contraction.

The World Bank expect that investment into emerging market economies is likely to fall to $600bn in 2009 from $1trillion in 2007 as the sub-prime crisis forces banks to eliminate risk from their balance sheet.[9] The level of stability exhibited by the Brazilian bond market is not fully explained by fiscal prudence and strong commodity prices. Clearly the ability of market practitioners to hedge their bond exposure through the assiduous use of protection has resulted in a less volatile market.

According to the former chairman of the Federal Reserve, Alan Greenspan,

"The CDS is probably the most important instrument in finance... What CDS (credit default swaps) did is lay-off all the risk of highly leveraged institutions – and that's what banks are, highly leveraged – on stable American and international institutions."[10]

9. From presentation by Yukiko Omura, Executive Vice President of World Bank's Multilateral Investment Guarantee Agency (MIGA) to Latin American Infrastructure Forum, Miami, April 7, 2008.

10. Speaking at the Bond Market Association's 30th anniversary celebration, New York, May 18th, 2006.

In this paper we have suggested that the credit derivative market has been a stabilizing influence in the market for Brazilian debt. This influence can be observed in the yield volatilities of the benchmark Brazilian Government Issue during a period of heightened negative sentiment in global bond markets.

6. Conclusion

Since 2003, liquidity in the CDS market is such that, for every bond seller there is a bond purchaser who buys the bond and sells the credit risk in the credit derivative market. This ability to hedge credit risk has resulted in much more stable markets. Strategic reaction to economic crises has been previously limited to selling, resulting in a sentiment driven rush to asset disposal resulting in a rapid increase in yields. This has been all the more pronounced in emerging markets and Latin America in particular leading to an elevated perception of risk exposure.

We argue that sovereign debt issuers from emerging economies now operate in a different environment. In the past, holders of emerging market debt were highly attuned to political and economic conditions, while emerging markets were particularly vulnerable to shifts in investor confidence.

In the IPE and Political Science literature there is a degree of consensus that this situation gives the owners of capital a great deal of power over States like Brazil. This asymmetry in the distribution of power suggests that States are constrained in the social and economic policies they pursue. In such an environment, State representatives are anxious to placate the fears of the international investor community.

This paper demonstrates that innovation in the financial markets in the form of CDS contracts allows political risk in emerging markets to be more effectively diversified. Consequently, emerging market debt has become a more attractive investment vehicle for a wider number of institutions. This is not to say that political risk has dissipated but rather mechanisms have been put in place to attenuate the risk. This has important implications for a range of disciplines and calls into question the more strident ideologically based position on the damaging impact of financial markets on States, sovereignty and democracy.

This new dynamic affords medium-sized States like Brazil more autonomy and may potentially have profound effects on hemispheric relations in the Americas and Brazil's wider engagement in the world.

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