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Introduction: The Company You Keep

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

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

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

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

What do these two stories tell us about perceptions of risk and their consequences? For one thing, they show the power of cognitive shortcuts in information processing. Developing countries across the globe strive to convince markets of their creditworthiness. If they fail, they remain marginalized, aid-dependent, and poor, with their only options being loans from international financial institutions – and those loans typically come with many strings attached. The prize, however, is private investment capital that can further economic growth. Countries can gain legitimacy in the eyes of creditors through gestures great and small, both domestically and abroad. They might vote in forward-looking leaders who adopt bold policy reforms or fly in

[1] Interview, L'udovit Ódor, National Bank of Slovakia, 23 July 2006.

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decorated international consultants. But economic development is full of false starts, incomplete reforms, political falls from grace, and policy reversals. If emerging markets have a history of uncertainty, how do investors know what to believe? More specifically, what acts do investors most closely monitor? The 2007 financial crisis has demonstrated amply that investors in financial markets are not shy about taking inferential shortcuts, and international agreements – specifically, the nature of the other members in those agreements – can serve as a powerful signal to investors about a country's intentions, even about its perceived identity (Anderson, 1991).

Investors use the company a country keeps as an important heuristic, or speculative formulation, through one central mechanism. Portfolio investors coordinate on public pronouncements that are easily generalizable across situations.[2] Investors may not know about the details of an organization's structure, the degree to which rules are enforced, or the speed at which attendant policies are implemented (if, in fact, they are implemented at all). But bond traders make inferences based on the already visible attributes of the better-known members of the organization, and the announcement of economic ties is a visible and public way for emerging markets to link to those countries. In an environment of high uncertainty, the peer effect of international economic organization is a commonly relatable and publicly observable way for market actors to arrive at similar assessments – even if those assessments subsequently turn out to be flawed, and even if, as is often the case, the proposed economic ties never materialize. Indeed, herd behavior may drive markets to over-rely on international organization as a heuristic in shaping their views on the risk associated with a given country.[3] But in the short term, the company a country keeps can have a big impact on a government's ability to borrow on international capital markets.

Individual bond traders can arrive at a whole host of different assessments, of course, based on their own judgments or on the differing weight they might put on various indicators. In the last fifty years, with not only the improvement of computer processing power but the availability of data to crunch, algorithms can digest scores of variables and spit out a proposed price of an asset. But bond traders also act on their own personal judgment, which stems from experience, sentiment, or their own appetites for risk. Bond traders work in environments where there is a glut of information about countries that they themselves have likely never visited; thus, they must sort through a variety of secondhand information to make their assessments about the level of risk. They must make what in decision theory is called a decision under uncertainty – a case when

[2] Behavioral finance (Thaler, 1993, 1994) and prospect theory (Kahneman and Tversky, 1979) have long argued that investors evaluate assets using interesting shortcuts; Zuckerman (2004) shows that although investors rely on classifications, these classiciations are imperfect.

[3] This phenomenon has been widely noted in many types of investment; see Kindleberger (2005) and Benartzi and Thaler (2001, 2007).

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each possible alternative is associated with a probability distribution, but those distributions are unknown (Ben-Haim, 1998).

Investors' assessments can be particularly subjective in high-uncertainty environments such as emerging markets. Eichengreen and Mody (1998) demonstrated empirically that, particularly in emerging markets, bond spreads are more a function of market sentiment than of economic fundamentals. In fact, bond traders who deal particularly with emerging markets have been accused of having "too much money and too little local knowledge or power."[4] This is in part a function of the unreliability of statistics in emerging markets and those countries' vulnerability to political or economic shocks. In such high-uncertainty circumstances, investors are particularly sensitive to overall market sentiment on particular assets, as well as to how other investors interpret the actions of emerging markets. International economic organizations, I argue, can be a powerful driver of market sentiment in high-uncertainty environments – and markets use the known members of those organizations as shorthands in their estimations of less-known members.

The argument advanced in this book makes a distinct contribution to the debate on international cooperation. International relations scholars have long advanced the importance of international institutions as a means of promoting stability and coordination among nations. This book tests that claim using a measure of uncertainty in countries from financial markets: the risk associated with sovereign bonds, a measure that is of substantive as well as theoretical interest to social scientists. The argument offers a new mechanism – the company a country keeps – through which institutions matter. In contrast to previous research, I find that the effect of the company a country keeps has little to do with the legalistic design of the organization (Koremenos, 2001, 2005; Rosendorff, 2005; McCall Smith, 2000) or the policy reform that countries undertake in order to enter (Schimmelfennig and Sedelmeier, 2005), or the unobserved factors that might drive countries both to enter certain types of organizations and to have certain kinds of risk profiles (Vreeland, 2001; von Stein, 2005), or rule enforcement in the organization (Fearon, 1998; Abbott and Snidal, 1998). Nor is the effect simply a function of being in the same neighborhood (Simmons and Elkins, 2004; Gleditsch and Ward, 2006). The argument advanced here is a new and independent mechanism through which international institutions can matter. Because these effects are independent of policy change, the inferences about a new member's quality may be undeserved – witness the severe market corrections of risk assessments in Greece, Spain, and Portugal during the eurozone crisis. But these changes in risk perception are an empirical reality.

This argument comes at a time when international agreements are on the rise, particularly regional trade agreements (Mansfield and Milner, 1997, 2012; Mattli, 1999; Solingen, 2002; Pevehouse, 2002; Donno, 2010; Goertz and Powers, 2012). The number of international and regional organizations has

[4] "A nasty spillage," *The Economist,* 10 June 2006.

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grown steadily in the past decades, but their effects are far from understood. With multilateral trade talks in crisis, and with purchasing power in Asia on the rise, the accession of Russia, Vietnam, and Ukraine to the WTO may be less formative than the possible creation of a deep trade agreement that would include Australia, India, Southeast Asia, and China,[5] or the Trans-Pacific Partnership – a regional trade agreement that includes the United States, Australia, Malaysia, Singapore and Vietnam.[6] In November 2011, Vladimir Putin announced the formation of a new Eurasian Union; commentators noted that Russia would use this regional organization as a way of projecting its power in the east.[7] Realizing the assumptions that markets make about members enables a better understanding of these organizations' effects.

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

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

This book focuses on the credibility that REO membership can give to emerging markets in particular, but the basics of the argument can also extend

[5] "Asian Leaders Plan Free-Trade Area from India to New Zealand," *Bloomberg*, 15 January 2007.
[6] "At APEC, President Obama welcomes Asian trade agreement, warns Iran," *Politico*, 12 November 2011.
[7] "Russia's Putin dreams of sweeping Eurasian Union," *Associated Press*, 3 January 2012.

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to the developed world. They have resonance in any situation where information is poor and where investors take mental shortcuts to arrive at their assessments. "The company you keep" tends to operate as a heuristic device that is independent of actual changes that occur in a country as a result of international organization – that is, the reaction is often disproportionate to the reality. Given the recent crisis of asset-backed securities throughout the world, this argument has particular relevance.

The findings presented here are also of importance to the research on international development. The terms on which countries borrow can make or break emerging markets' attempts to attract international capital. Countries in that category account for 80 percent of the world's population, all but a quarter of its landmass, 66 percent of its foreign-exchange reserves, and 50 percent of its purchasing-power-parity adjusted GDP. Currently, more than 40 percent of developing-country debt is investment grade – up from just 3 percent in 1997. As governments in developing countries issue their debt on international markets, the interest rates associated with their sovereign debt have big impacts on their ability to raise revenue. And sovereign debt – government-issued debt securities, also known as government bonds – is a fast-growing category of asset; by the end of 2011, there were $31 trillion worth of government bonds in issue, up from $11 trillion in 2001.[8] Thus, the arguments and results in this book are of concern for countries hoping to raise money on international capital markets.

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

[8] "Oat cuisine," *The Economist*, 11 February 2012.

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compounded; investor positions become serially correlated, and a given fixed-income instrument can become systematically over- or undervalued, but it can still make sense for investors to follow the herd in the short run.[9]

1.1 INTERNATIONAL COOPERATION AND UNCERTAINTY

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

I put forward and test the independent effects of a mechanism that is novel in this literature. This argument about "the company you keep" is relatively new to the field of international organizations,[10] but it has a long-standing history in other areas of research. Disciplines throughout the social science have studied and theorized about so-called neighborhood effects. Researchers have observed the effects of peer groups in education and crime, of endorsements in management and finance; of labeling in sociology, of self-fulfilling prophecies in psychology, and of group ritualization in anthropology.[11] Management theory has examined the influence of an underwriters' reputation on the price of an

[9] On the irrationality of markets generally, see Kindleberger (2005) and Aspara (2010). One study shows that past experience and existing beliefs tend to guide investors, rather than logical thinking and rational decision making (Knauff et al., 2010).

[10] See Dreher and Voigt (2008); Gray (2009).

[11] For just a few examples, one study in sociology focuses on how criminal activity and drug abuse patterns tend to be replicated within neighborhoods, as a result of "collective socialization" and "contagion"(Case and Katz, 1991). Mead (1934) gives a sociological account of how the self is socially constructed and reconstructed through individuals' interactions with their community. Psychologists have studied how labeling can have negative impacts on the mentally ill (Scheff, 1966). Becker (1963) studies the effects of deviance from social groups on the behavior of an individual.

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asset (Carter and Manaster, 1990) and the self-fulfilling power of stereotypes (Chen and Bargh, 1997).

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

This book examines all those possible mechanisms from both a theoretical and an empirical perspective. My key argument is that, in assessing the risk premia on sovereign debt, investors are looking for two types of information. One is on a country's ability to service its debt. This information can be gleaned relatively easily, by looking at macroeconomic indicators and past performance. But governments change; new policies are enacted; and reading the tea leaves for developing countries can be a difficult task, particularly when getting solid priors on the second type of information: a country's willingness to service its debt. This is where "the company you keep" comes in. Visibly bad behavior among a developing country's closest friends can make financial markets skittish about the reliability of that country by extension, because markets assume that countries form ties with nations they hope to emulate. Conversely, investors cut slack to emerging markets that themselves have histories of behaving badly if they join groups of countries that have upstanding reputations. Joining different groups can potentially affect a country's *ability* to service its debt, through the economic benefits where trade integration occurs – but the company it keeps fills in the blanks about its *willingness* to honor its debt obligations. This peer effect is distinct from the material benefits that may emerge as a result of international organization. Markets may not get this right, as the current financial crisis in the eurozone shows: simply being, for example, in the same club as Germany does not mean that every other country adopted fiscal discipline. But this heuristic was nonetheless a powerful driver of European sovereign spreads for years.

By looking at the role of international organizations on investor confidence, and by parsing out many different aspects of those organizations and their members that might influence third parties, this book makes important theoretical and empirical distinctions that enhance our understanding of what matters in institutions. I show how being in the same neighborhood is *not* equivalent to being in the same club – and how, to extend the metaphor, the requirements for entry, the rules of membership and the structure of the building are less important than the quality of the members in a particular club. In more technical terms, I demonstrate that the impacts of international organization on a country's perceived creditworthiness are not a function of selection

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(the underlying propensity of an actor to choose like-minded groups). Nor can those impacts be explained away by the policy reform that countries undertake either before or during membership in a particular organization. The quality of members can have substantial effects, particularly when those members give their blessing to policy reform in new members, as in the case of the European Union. In the context of international organization, the company you keep has an impact on a country's standing in financial markets. The rational expectations hypothesis hinges on the assumption that all market participants have equal access to the same data, and that those actors also share one model of how the world works. Because IO membership is elective, unlike geography, it makes a strong statement about the types of countries that a country considers its peers, and thus serves as a potential expression of willingness to pay. Regions are static across time, whereas IO membership is dynamic – not only at the moment when countries themselves join, but also when the addition or exit of still other countries either dilute or reinforce the brand.

1.2 Why Emerging Markets? Why Sovereign Debt?

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

Taking those components in turn, why focus specifically on emerging markets, a category that excludes both the more developed countries and the very poorest? Richer countries have other indicators from which investors can make inferences about their debt; those deeper markets are better understood, and there is less need for heuristic shortcuts in assessing their creditworthiness. The poorest countries do not issue their debt on international markets, because their levels of risk are so great that an insufficient number of international creditors are willing to lend to them. By contrast, emerging markets occupy a middle ground – not so poor that they are fundamentally untrustworthy and not creditworthy, and not so rich that it is easy for investors to gather information about them. They are still at the stage where investors want to give them credit but have differing opinions about the risks of doing so.[12] Particularly

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

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for countries with a patchy track record in the global marketplace, keeping good international company will give them a credibility boost in the eyes of investors. This is not an argument that applies to countries that are experiencing such low economic growth that their main sources of revenue are from aid. The countries under consideration here are not ravaged by war or suffering widespread famine or disease. Rather, they are all at stages of economic development where they might have buyers for their debt on international markets. Thus, they are at a point where their future may be uncertain, but there is an opportunity for investors to bet on that future – and possibly reap rewards from the risk. Elucidating the mechanism that describes why this might be the case can help us gain an understanding of how institutions work, and which aspects of them carry weight in specific settings.

In terms of the second component, spreads on sovereign debt – the gap between the risk associated with one country relative to a comparable more stable security, such as U.S. Treasury bills – is but one way of operationalizing reputation. Scholars in the social sciences are increasingly turning to financial market data for empirical work on a number of topics relating to international behavior and domestic policy.[13] What can this measure of government capability and willingness to repay its debt tell political scientists, and how does it differ from other economic indicators? I offer three main justifications for my choice of dependent variable: one is theoretical, the second is practical, and the third is the substantive implication. Spreads on sovereign debt are superior as a measure of uncertainty to many other indicators; its level of detail and relative availability give it an edge over other economic indicators; and finally, a country's cost of borrowing can have important implications for its ability to raise capital on international markets.

Countries can gain international legitimacy by running military demonstrations, winning wars, throwing summits, or hosting international sporting events.[14] This is admittedly a very specific claim about how a particular audience (international bond traders) regards international organization. Yet sovereign debt (and market measures more generally) have gained great traction in political science as a means of measuring and operationalizing otherwise elusive concepts, such as uncertainty (Root, 2005), reputation (Tomz, 2007), and credibility (Jensen and Schmith, 2005). Many of the propositions about the power of institutions center on how they decrease uncertainty, a concept that is difficult to measure directly. Investment data are particularly useful in testing such claims, because measuring and pricing uncertainty is one of the market's fundamental operating principles. Especially in volatile emerging markets, investors stand to gain or lose vast sums of money on the basis of their

[13] See, for example, Ferguson and Schularick (2006); Tomz (2007); Stasavage (2007); Mitchener and Weidenmier (2008).

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

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