

Learning to Forget? Contagion and Political Risk in Brazil*

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We examine whether Brazilian sovereign spreads of over 20 percent in 2002 could be due to contagion from Argentina or to domestic politics, or both. Treating unilateral debt restructuring as a policy variable gives rise to the possibility of *self-fulfilling* crisis, which can be triggered by contagion. We explore an alternative *political-economy* explanation of panic in financial markets inspired by Alesina (1987), which stresses exaggerated market fears of an untried Left-wing candidate. To account for the fall of sovereign spreads since the election, we employ a model of Bayesian learning and analyse the effects of financial bailouts and policy pre-commitments sponsored by the IMF.

Keywords: Sovereign Spreads, Political Risk, Bayesian Learning, Time-Consistency

JEL Classifications: E61, E62, F34.

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