CAMBRIDGE GOVERNANCE LABS

Bond Vigilantes

How credit markets sleep through democratic collapse — and what 665 country-year observations reveal about the governance-yield nexus

Political Topology Project · Media Report M04
665 country-year observations · 34 default episodes · 91 countries
February 2026

EXECUTIVE SUMMARY

The Price of Complacency

4.7yr	62%	665	-0.35
MEDIAN SIGNAL LAG	MARKETS MOVED WRONG WAY	COUNTRY-YEAR OBSERVATIONS	GOVERNANCE-YIELD BETA

Bond markets are supposed to be the disciplinarians of sovereign governance. The "bond vigilante" thesis holds that credit markets punish profligate or authoritarian governments by demanding higher yields, thereby enforcing fiscal and institutional discipline through the price mechanism.

The evidence says otherwise. Across 665 country-year observations spanning 91 countries and 225 years of political and financial data, we find that sovereign credit markets are systematically late, frequently wrong-directional, and structurally incapable of pricing governance risk in real time. The median lag between the onset of institutional erosion and any meaningful yield response is **4.7 years**. In 62% of erosion episodes, yields moved in the *opposite* direction to the governance deterioration — tightening rather than widening as democratic institutions were dismantled.

> *The bond market does not discipline autocrats. It finances them — until the day it doesn't, at which point the repricing is sudden, catastrophic, and too late to prevent the damage that complacent capital helped cause.*

This report presents the empirical evidence for the governance-yield nexus, quantifies the lag structure, maps the current state of sovereign credit mispricing, and examines the implications for the United States — where the largest governance-yield gap in our dataset is currently widening.

SECTION 1

The Governance-Yield Nexus

The relationship between institutional quality and sovereign borrowing costs is not a theory. It is an empirical regularity, confirmed by regression analysis across our full dataset and validated by independent audit. The core finding: **a one-point decline in the Liberty Index corresponds to a 35-basis-point increase in sovereign bond yields**, holding other macro variables constant.

$$\text{Yield}_{i,t} = 33.05 - 0.35 \times \text{Liberty}_{i,t} + \varepsilon_{i,t}$$

$\beta = -0.35$ | $R^2 = 0.37$ | $n = 665$ | $p < 0.001$
Intercept = 33.05 (corrected from thesis estimate of 18.7) | Standard error = 0.04

The regression tells a clear story. At the extremes of the Liberty Index:

- **Liberty = 100 (full democracy):** Model-predicted yield = 33.05 − (0.35 × 100) = −1.95%. In practice, this means that fully free countries borrow at rates that are essentially driven by inflation expectations and monetary policy alone — governance risk contributes near zero.
- **Liberty = 0 (full autocracy):** Model-predicted yield = 33.05%. In practice, countries at this extreme either cannot borrow on international markets at all or do so at rates that make debt unsustainable.
- **Liberty = 50 (hybrid regime):** Model-predicted yield = 15.6%. This is the danger zone — high enough to create fiscal pressure but not yet crisis-level.

Log-Linear Specification

The relationship is better captured by a log-linear model, which reflects the reality that yield sensitivity to governance is non-linear — the marginal impact of institutional erosion accelerates as countries move from democracy toward autocracy.

$$\ln(\text{Yield}_{i,t}) = \alpha - 0.35 \times \ln(\text{Liberty}_{i,t}) + \varepsilon_{i,t}$$

$R^2 = 0.51$ | Improved fit over linear specification | Non-linearity confirmed

The log-linear R^2 of 0.51 means that governance quality alone explains roughly half the cross-country variation in sovereign yields — a remarkably high explanatory power for a single variable. The remaining variance is accounted for by inflation, monetary policy, external balances, commodity exposure, and reserve currency status.

> **Audit finding:** The Liberty-Yield relationship ($\beta = -0.35$, $R^2 = 0.37$) was **CONFIRMED** by independent audit. The regression specification, data, and coefficient estimates were replicated. The intercept was corrected from the thesis's original 18.7 to 33.05, a significant revision that affects predicted yields at all liberty levels.

SECTION 2

The 4.7-Year Lag

If bond markets priced governance risk efficiently, yield changes would track liberty changes contemporaneously — or even lead them, as forward-looking investors anticipated institutional erosion. Instead, we observe the opposite: **a median lag of 4.7 years** between the onset of liberty decline and the first statistically significant yield response.

This lag is not a minor calibration issue. It is a structural failure of the sovereign credit market's risk-pricing mechanism. During the lag period, governments that are actively dismantling democratic institutions continue to borrow at rates that reflect their *prior* institutional quality — effectively receiving a multi-year credit subsidy for autocratization.

The Wrong-Way Problem

Even more concerning than the lag is the direction of mispricing. In **62% of institutional erosion episodes**, sovereign yields moved in the opposite direction to governance risk during the lag period. That is, as liberty declined, yields *fell* — the bond market was rewarding autocratization with cheaper credit.

> **The perverse signal:** In 62% of democratic backsliding episodes, bond markets sent the wrong signal — lowering borrowing costs as institutions eroded. This is not noise. It reflects structural biases in credit analysis: autocrats who seize control of fiscal policy often achieve short-term "stability" metrics (lower deficits, reduced policy uncertainty) that credit models reward.

Episode Analysis

COUNTRY	EROSION PERIOD	LIBERTY DECLINE	YIELD LAG	DIRECTION DURING LAG	OUTCOME
Turkey	2013–2025	68 → 18	6 years	Wrong (yields fell)	Yields spiked 2018+
Venezuela	2002–2017	55 → 8	10 years	Wrong (yields flat)	Default (2017)
Greece	2004–2010	82 → 65	10 years*	Wrong (yields compressed)	Default (2012)
Hungary	2010–2025	89 → 52	Ongoing	Wrong (EU convergence)	Still mispriced
Argentina	2011–2019	72 → 45	3 years	Correct (yields rose)	Default (2020)
India	2017–2025	77 → 62	Ongoing	Wrong (yields fell)	Still mispriced
United States	**2017–2025**	**94 → 48**	**Ongoing**	**Wrong (yields anchored)**	**Largest current gap**
Philippines	2016–2022	60 → 42	4 years	Wrong (yields fell)	Partial recovery
South Africa	2009–2023	83 → 64	5 years	Mixed (slow widening)	Waking
Brazil	2014–2018	80 → 60	2 years	Wrong (yields fell)	Partial recovery

*Greece lag measured from eurozone accession-era governance decline to yield repricing. Eurozone membership compressed spreads artificially.

Why Do Markets Miss So Consistently?

The 4.7-year lag is not irrational — it is the predictable consequence of how sovereign credit analysis actually works in practice. Four structural factors explain the pattern:

1. Backward-Looking Metrics

Sovereign credit models overwhelmingly rely on GDP growth, debt-to-GDP ratios, fiscal balances, and current account positions — all of which are lagging indicators. Institutional quality enters these models, if at all, through credit rating agency assessments that change slowly and with significant conservatism bias.

2. The Autocrat's Fiscal Honeymoon

Newly empowered autocrats often achieve short-term fiscal improvements. Centralizing power reduces policy uncertainty. Eliminating opposition reduces legislative gridlock. Capturing the central bank suppresses interest rates. Credit models read these signals as "stability" — precisely when they should be reading them as risk.

3. Herding and Benchmark Effects

Institutional investors are benchmarked against indices (J.P. Morgan EMBI, Bloomberg Barclays). As long as a country remains in the index, there is institutional demand for its bonds regardless of governance trends. Removal from indices happens only after crises — never as a preventive measure.

4. Reserve Currency and Currency Bloc Effects

Countries that belong to currency blocs (eurozone) or issue reserve currencies (US, UK) benefit from structural demand that suppresses yields independently of domestic governance. This is the largest single source of mispricing in our dataset and is analyzed in detail in Section 6.

SECTION 3

Four Vigilante States

Not all governance-yield mismatches are created equal. We classify the current global sovereign credit landscape into four states based on the interaction between liberty trajectory and yield response. This taxonomy helps identify where markets are asleep, where they are beginning to stir, where they have already panicked — and where they have moved in exactly the wrong direction.

STATE	DEFINITION	CURRENT EXAMPLES	YIELD BEHAVIOR	INVESTOR IMPLICATION
Asleep	Liberty falling, yields flat or declining	**United States**, Hungary, India	No governance risk priced	Maximum mispricing risk; short opportunity
Waking	Liberty falling, yields rising slowly	Turkey, South Africa, Mexico	Partial repricing underway	Spread widening likely to continue
Alert	Yields spiked, crisis pricing	Venezuela, Lebanon, Argentina	Full or excessive repricing	Distressed value if recovery path exists
Wrong	Yields fell as liberty fell	India 2015–2020, Philippines, Brazil	Market rewarded erosion	Perverse signal; delayed repricing ahead

State-by-State Analysis

Asleep: The Largest Risks Are Here

The "Asleep" category contains the most dangerous mispricing in sovereign credit markets today. These are countries where institutional erosion is well underway — measurable, documented, and accelerating — but where sovereign yields have not responded at all. The bond market is pricing yesterday's governance quality, not today's.

The United States is the most consequential example. With a Liberty Index decline from 94 to 48 (a 46-point drop, the steepest in our dataset for an advanced economy) and 10-year yields anchored at approximately 4.5%, the US represents the single largest governance-yield gap in our 665-observation sample. Hungary (Liberty 52, yields suppressed by EU membership and ECB policy) and India (Liberty 62, yields anchored by domestic savings and central bank credibility) follow the same pattern at smaller scale.

Waking: The Transition Is Underway

Turkey is the canonical "Waking" case. Liberty declined from 68 to 18 over a decade, with yields remaining low through 2018 before spiking dramatically as Erdogan captured the central bank and forced rate cuts. South Africa shows a similar pattern on a longer timeline: institutional decay under Zuma-era state capture (2009-2018) was largely ignored by credit markets until the electricity crisis and fiscal deterioration of 2022-2023 forced repricing. Mexico's AMLO-era judicial reforms have begun to register in spreads, though the full governance deterioration is not yet priced.

Alert: The Horse Has Bolted

Venezuela, Lebanon, and Argentina represent episodes where the bond market eventually did reprice governance risk — but only after default was imminent or actual. In each case, the repricing was

catastrophic rather than gradual: spreads went from "investment grade" to "distressed" in months, not years. The bond vigilante arrived, but only to survey the wreckage.

Wrong: The Perverse Signal

The most intellectually troubling category. India between 2015 and 2020 saw its Liberty Index decline from 77 to 65 while 10-year government bond yields fell from 7.8% to 5.9%. The Philippines under Duterte saw a similar pattern. Brazil during the Dilma-to-Temer transition saw yields fall as governance deteriorated. In each case, the bond market's price signal told investors that the country was becoming *safer* precisely when it was becoming less free.

SECTION 4

The Game of Three Players

The governance-yield nexus is not a simple bilateral relationship between institutions and markets. It is a three-player game between autocrats, central banks, and bond markets — each with distinct objectives, information sets, and incentive structures that interact to produce the systematic mispricing we observe.

Player 1: The Autocrat

`GOAL: Preserve power + maintain access to credit markets`

The autocrat's strategic challenge is to dismantle democratic constraints while continuing to borrow on international markets at reasonable rates. This requires a delicate balancing act: enough institutional capture to prevent electoral displacement, but not so much that credit markets panic. The successful autocrat moves slowly, maintains fiscal discipline in the early years, and captures the central bank *before* capturing the fiscal apparatus — because central bank credibility is the single most effective sedative for bond markets.

Historical playbook: Orbán (Hungary), Erdogan (Turkey pre-2018), Modi (India), Bukele (El Salvador). Each maintained or improved fiscal metrics during the early stages of democratic erosion.

Player 2: The Central Bank

`GOAL: Price stability + institutional independence (increasingly under threat)`

Central banks occupy a unique position in the three-player game. They are simultaneously a *target* of autocratic capture (because controlling monetary policy is essential for the autocrat's fiscal strategy) and a *shield* that protects bond market pricing from governance reality (because as long as the central bank is perceived as independent, the market's inflation expectations remain anchored, and yields stay low).

The critical insight: **central bank independence erosion is both a governance risk AND an inflation risk**, but bond markets typically price it only as the latter — and only after the erosion is unmistakable. Turkey's experience is instructive: the market tolerated Erdogan's pressure on the TCMB for years before the full monetary capture in 2021 triggered a lira crisis.

Player 3: The Bond Market

`GOAL: Risk-adjusted returns (but systematically mispricing governance risk)`

Bond market participants are not unintelligent — they are structurally constrained. Portfolio managers are evaluated on short-term performance against benchmarks. Credit analysts use quantitative models that privilege observable macro data over institutional quality assessments. And the entire sell-side apparatus incentivizes maintaining coverage of, and positive views on, sovereign issuers who are active in primary markets.

The result is a collective action problem: individual analysts may recognize governance risk, but the institutional machinery of sovereign credit markets systematically underweights it. The bond market's governance risk premium is roughly **2–3x too low** relative to what the historical evidence would justify.

The three-player dynamic: The autocrat captures the central bank. The captured central bank maintains the appearance of policy credibility. The bond market, reassured by central bank "independence," continues to

> lend at low rates. The autocrat uses cheap credit to consolidate power. The cycle breaks only when inflation becomes unmistakable or when the central bank's capture is so complete that even the most backward-looking credit model cannot ignore it. By that point, the democratic damage is irreversible.

SECTION 5

Four Roads to Default

Analysis of 34 sovereign default episodes in our dataset reveals four distinct pathways from governance erosion to credit collapse. Each pathway has different dynamics, different timelines, and different implications for bond markets. Understanding which road a country is on is essential for positioning ahead of the repricing event.

Classic Sovereign Default: The Overborrowing Path

1

Archetype: Argentina · Timeline: 5–15 years · Frequency: 15 of 34 episodes (44%)

The most common pathway. A government — often populist, sometimes autocratic — borrows beyond its fiscal capacity, typically financing consumption rather than investment. Institutional weakness allows the borrowing to continue long after it becomes unsustainable because the checks and balances that would normally constrain fiscal excess (independent parliament, free press, constitutional limits) have been weakened or captured.

The governance dimension is critical: countries with strong institutions almost never overborrow to the point of default because legislative oversight, independent auditors, and media scrutiny impose real-time fiscal discipline. It is institutional erosion that removes these constraints and allows the debt to accumulate.

Signal lag: Typically 3–5 years. Debt-to-GDP ratios provide visible warning, but markets consistently give countries "one more chance."

Governance Collapse: The Capital Flight Path

2

Archetype: Venezuela · Timeline: 8–15 years · Frequency: 9 of 34 episodes (26%)

The governance-specific pathway. Institutional erosion drives capital flight, which depletes reserves, which forces currency depreciation, which increases the local-currency cost of foreign-currency debt, which triggers default. The fiscal position may actually appear adequate on paper — Venezuela ran primary surpluses in several years before its default — but the governance deterioration destroys the investment climate, drives out private capital, and ultimately collapses the tax base.

This is the pathway where the governance-yield lag is longest and most dangerous. Because the fiscal metrics look acceptable until late in the process, credit models miss the deterioration entirely. Venezuela's bonds traded at investment-grade-adjacent levels until 2013 despite a decade of institutional destruction.

Signal lag: 8–12 years. The longest of any pathway. Fiscal metrics mask the rot.

Banking Crisis: The Sovereign Backstop Path

3

Archetype: Greece · Timeline: 2–5 years · Frequency: 7 of 34 episodes (21%)

A banking system collapses, the sovereign steps in to guarantee bank liabilities, and the combined burden of bank rescue plus existing sovereign debt exceeds the government's fiscal capacity. Greece, Ireland, Cyprus, and Iceland all followed variations of this pathway.

The governance dimension: weak regulation (itself a product of institutional capture or incompetence) allows bank risk to accumulate. The "doom loop" between banks and sovereigns is fundamentally a governance failure — properly regulated banks do not take on system-threatening exposures, and properly governed states do not issue blanket guarantees without the fiscal capacity to back them.

Signal lag: 2–4 years. Faster than other pathways because the banking crisis creates visible and quantifiable liabilities. But the *governance* weakness that enabled the banking crisis was typically a decade in the making.

Slow Erosion: The Reserve Currency Loss Path

4

Archetype: Potential US Path · Timeline: 10–30 years · Frequency: 3 of 34 episodes (9%)

The rarest and most consequential pathway. A country that issues a reserve currency or belongs to a currency bloc that suppresses its governance risk premium experiences slow institutional erosion. The reserve currency premium masks the deterioration for an extended period — potentially decades. When the reserve status eventually erodes (due to the institutional decline itself, or due to geopolitical shifts that reduce demand for the currency), the repricing is not gradual. It is sudden, massive, and unprecedented in the country's modern history.

This pathway has only three historical precedents: the decline of sterling (1914–1956), the decline of the Dutch guilder (1780s–1810s), and the decline of the Spanish real (1588–1620s). In each case, institutional deterioration preceded reserve currency loss by 20–40 years, and the eventual repricing was catastrophic.

Signal lag: 15–30 years. The longest of any pathway by a wide margin. Reserve currency status is the most powerful sedative in sovereign credit markets.

> **The US question:** Is the United States on Path 4? The governance trajectory (L=94 to L=48) is consistent with this pathway. The reserve currency premium is still intact but faces unprecedented pressures from de-dollarization trends, weaponization of the financial system, and institutional erosion. This scenario is analyzed in detail in Section 6.

SECTION 6

The American Exception

The United States presents the single most consequential test case for the governance-yield framework. With a Liberty Index score of 48 — a decline of 46 points from its 2015 level of 94 — the US has experienced the steepest institutional erosion of any advanced economy in our dataset. And yet 10-year Treasury yields remain at approximately 4.5%, barely above their post-pandemic average and well within the range that markets consider "normal."

The gap between the model's prediction and market reality is enormous.

Decomposing the Gap

US 10-Year Yield: Model vs. Actual

Raw model prediction (at L=48):

16.2%

Yield = 33.05 − (0.35 × 48) = 16.25%

Actual 10-year Treasury yield:

4.5%

Market price as of January 2026

Gap: ~1,170 basis points

The largest governance-yield gap in our 665-observation dataset

Does this gap represent a massive mispricing — or does it reflect factors that the basic model omits? The answer, confirmed by our independent audit, is: **both**.

The Reserve Currency Premium

The single most important factor the basic governance-yield regression does not capture is reserve currency status. The US dollar's role as the global reserve currency creates structural demand for Treasury securities that is independent of domestic governance quality. Foreign central banks, sovereign wealth funds, and global financial institutions hold Treasuries as reserves, collateral, and safe assets regardless of the Liberty Index.

We estimate the reserve currency premium at approximately **2,080 basis points** — the difference between what the US pays and what a non-reserve-currency country at the same governance level would pay. This premium accounts for the majority of the 1,170bp gap.

COMPONENT	YIELD IMPACT	EXPLANATION
Raw model prediction (L=48)	16.2%	Governance-yield regression applied naively
Reserve currency premium	−12.4%	Structural demand from global reserve holdings (~2,080bp)
Model with reserve adjustment	3.8%	What the governance model predicts with reserve status
Actual yield	**4.5%**	Market price
Residual gap	**+0.7%**	Small residual; market may slightly underprice governance risk even after reserve adjustment

Audit verdict: The thesis's original claim of a ~650bp governance mispricing was rated **"Overstated but directionally correct."** The reserve currency premium is real and large. However, once properly accounted for, the residual governance-yield gap for the US shrinks to approximately 70bp — meaningful but not catastrophic in current terms. The real risk is not the current gap but the potential *erosion of the reserve premium itself*.

The Sterling Precedent

The historical analogy that matters most for the US is the decline of the British pound as a global reserve currency. Sterling's reserve status masked Britain's relative institutional and economic decline for decades — and when it finally eroded, the repricing was severe and irreversible.

PERIOD	STERLING STATUS	GILT YIELD BEHAVIOR	GOVERNANCE CONTEXT
1870–1914	Unchallenged reserve	Low, stable (2.5–3%)	Peak institutional quality
1914–1931	Shared with dollar	Rising gradually	War strain, fiscal expansion
1931–1944	Declining, bloc-based	Artificially suppressed	Imperial overstretch, war
1944–1956	Suez crisis; loss of reserve status	Sharp repricing	Imperial collapse, relative decline
1956–1976	Non-reserve currency	Sustained high yields (8–15%)	Institutional adjustment

The key feature of the sterling analogy is the *timeline*. Britain's relative institutional decline was visible from 1914, but the reserve currency premium persisted (with diminishing force) until 1956 — a 42-year lag. During that period, gilt yields understated Britain's true governance risk by an amount that we estimate at 200–400 basis points. When the premium finally collapsed after Suez, the repricing was compressed into less than five years.

US Scenarios: With and Without Reserve Status

Scenario A: Reserve Status Maintained

3.8% – 5.0%

If the US maintains its reserve currency status, the governance-yield model (adjusted for reserve premium) predicts yields in the range of 3.8% to 5.0%. This is approximately where the market is today. In this scenario, the market is correctly pricing governance risk *given* reserve status, and the remaining 70bp residual may reflect other factors (fiscal trajectory, inflation expectations).

Probability assessment: Declining. Reserve status faces structural pressure from de-dollarization, sanctions weaponization, and institutional erosion that undermines foreign confidence in US governance.

Scenario B: Reserve Status Erodes (5–10yr)

6% – 8%

If the reserve currency premium erodes by 40–60% over a 5–10 year period (similar to sterling's post-Suez trajectory), the governance-yield model predicts US 10-year yields in the range of 6% to 8%. At these levels, the US fiscal position deteriorates rapidly: interest payments would consume 30–40% of federal revenue, crowding out discretionary spending and forcing either severe austerity or debt monetization.

Probability assessment: Non-trivial and rising. The governance erosion itself is the primary threat to reserve status, creating a reflexive dynamic.

The reflexivity trap: Institutional erosion threatens reserve currency status. Loss of reserve currency status removes the premium that masks the yield impact of institutional erosion. The repricing of governance risk then accelerates the very fiscal deterioration that further undermines reserve status. This reflexive loop — once triggered — is the mechanism by which the governance-yield gap closes. The sterling precedent suggests it can happen faster than anyone expects.

SECTION 7

The Credit Lag Opportunity

The systematic mispricing of governance risk in sovereign credit markets is not merely an academic finding. It has direct, actionable implications for investors willing to take positions on the basis of institutional analysis rather than traditional macro indicators.

The Tradeable Window

The 4.7-year median lag — with a range of 3 to 12 years — creates a substantial window during which governance-aware investors can position ahead of the repricing event. The key metrics:

3–12yr	2–3x	2020	2030?
LAG RANGE (TRADEABLE WINDOW)	GOVERNANCE RISK UNDERWEIGHT	CURRENT PRICING REFLECTS	WHEN REPRICING ARRIVES

Bond markets currently underweight governance risk by a factor of **2 to 3 times** relative to what the historical relationship would justify. Current sovereign yield levels reflect governance conditions from approximately 2020 — not the institutional landscape of 2025, let alone the trajectory toward 2030. This temporal mismatch is the source of the opportunity.

Implications by Vigilante State

STATE	COUNTRIES	POSITIONING	RISK	EXPECTED TIMELINE
Asleep	US, Hungary, India	Underweight / short duration; CDS protection	Timing uncertainty (lag could extend)	2–7 years to repricing
Waking	Turkey, South Africa, Mexico	Short; spread widening trades	Partial repricing already occurred	1–3 years to full repricing
Alert	Venezuela, Lebanon, Argentina	Distressed value (if recovery path credible)	Further deterioration; zero recovery	Recovery-dependent
Wrong	India 2015–20, Philippines, Brazil	Monitor for state transition to "Waking"	May remain mispriced longer	Uncertain

The Carry Problem

The fundamental challenge of governance-based sovereign credit trading is that timing is uncertain within the 3–12 year window. Being early is expensive: shorting sovereign bonds or buying CDS protection against a repricing that takes 5+ years to materialize generates significant negative carry. The informed investor must balance conviction in the directional thesis against the cost of waiting for the market to agree.

This is precisely why the lag exists in the first place. Governance risk is real, measurable, and predictive — but the carrying cost of positioning for it filters out most participants, leaving only those with long

time horizons and high conviction. Pension funds, sovereign wealth funds, and endowments are the natural holders of this trade. Hedge funds with quarterly performance pressure are not.

The Structural Trade

The more practical implementation is not a directional trade but a structural portfolio adjustment. Governance analysis should be integrated into sovereign credit allocation as a *screening* mechanism rather than a *timing* mechanism:

- **Reduce exposure** to "Asleep" sovereigns by 1–2 standard deviations below benchmark
- **Increase exposure** to governance-improving countries (Poland, South Korea, Taiwan) where the lag works in reverse — markets are slow to reward governance improvements, creating positive carry opportunities
- **Hedge tail risk** in "Asleep" sovereigns using long-dated CDS or options on yield curves
- **Monitor state transitions** — the move from "Asleep" to "Waking" is the highest-value signal in governance-aware sovereign credit analysis

> **The paradox of governance-aware investing:** If enough investors incorporated governance analysis into sovereign credit allocation, the lag would shorten, the mispricing would diminish, and the bond vigilante would function as theory predicts. The persistence of the 4.7-year lag is itself evidence that the market has not yet learned this lesson.

ASSESSMENT

Current Governance-Yield Mispricing Dashboard

The following table presents the current state of governance-yield relationships for key sovereigns, showing the model-predicted yield (adjusted for reserve currency and currency bloc effects where applicable), the actual yield, and the implied mispricing.

COUNTRY	LIBERTY	RAW MODEL YIELD	ADJUSTED MODEL YIELD	ACTUAL YIELD	MISPRICING (BP)	VIGILANTE STATE
United States	**48**	16.2%	3.8%	4.5%	+70*	**Asleep**
Hungary	52	14.8%	8.2%	6.8%	−140	**Asleep**
India	62	11.4%	8.5%	7.1%	−140	**Asleep**
Turkey	18	26.7%	26.7%	24.5%	−220	**Waking**
South Africa	64	10.7%	10.7%	9.8%	−90	**Waking**
Mexico	58	12.8%	12.8%	10.2%	−260	**Waking**
Venezuela	8	30.2%	30.2%	Default	—	**Alert**
Argentina	45	17.3%	17.3%	15.8%	−150	**Alert**
Poland	82	4.4%	3.2%	5.5%	+230	**Opportunity**
Finland	100	−2.0%	1.5%	2.8%	+130	**Opportunity**

*US mispricing of +70bp is net of reserve currency premium adjustment. Without reserve adjustment, the raw mispricing is ~1,170bp. "Adjusted Model Yield" incorporates reserve currency and currency bloc (EU) effects where applicable. Negative mispricing indicates yields lower than model; positive indicates yields higher (potential long opportunity).

CONCLUSION

The Vigilante's Verdict

The bond vigilante — that mythical enforcer of fiscal and institutional discipline through the sovereign credit market — is largely fictional. The evidence from 665 country-year observations across 91 countries is unambiguous: credit markets are structurally incapable of pricing governance risk in real time. They are late by years, wrong in direction more often than right, and subject to institutional biases that systematically reward the early stages of autocratization.

This is not a story of market irrationality. It is a story of structural constraints — backward-looking models, benchmark-driven allocation, short-term performance incentives, and the sedative effects of reserve currency status and currency bloc membership. Each of these constraints is individually rational. Collectively, they produce a sovereign credit market that functions as a lagging indicator of institutional quality rather than a leading one.

The implications are both sobering and actionable:

- **For policymakers:** Do not rely on bond markets to enforce governance discipline. By the time yields reprice, the institutional damage is done. Democratic guardrails must be maintained through domestic political will and international pressure, not market mechanisms.
- **For investors:** Governance analysis is a source of systematic alpha in sovereign credit. The 4.7-year lag creates a tradeable window, and the 2–3x underweighting of governance risk implies that the carry-adjusted returns to governance-aware allocation are positive at medium and long horizons.
- **For the United States:** The reserve currency premium is the most powerful force in sovereign credit pricing. It is currently masking the yield implications of a 46-point institutional decline. But the premium itself is not permanent — it is a function of the very institutional quality that is now eroding. The reflexive dynamic between governance decay and reserve status erosion is the defining risk in global fixed income.

> *The historical record is unambiguous: bond markets are the last to know and the first to panic. The median 4.7-year lag between institutional erosion and yield repricing represents both the market's greatest failure and the informed investor's greatest opportunity.*

Data Sources and Audit Findings

Data

- **Liberty Index:** Composite measure of institutional quality derived from V-Dem, Freedom House, Polity V, and Economist Intelligence Unit assessments, normalized to a 0–100 scale. 91 countries, annual frequency, 1800–2025.
- **Sovereign yields:** 10-year government bond yields from Bloomberg, Global Financial Data, and central bank sources. Where 10-year instruments are unavailable, the closest available maturity is used with curve adjustment.
- **Default episodes:** 34 episodes identified from Reinhart-Rogoff database, Moody's Sovereign Default History, and S&P Global Ratings records.
- **Lag measurement:** The lag is defined as the time between the first year of sustained Liberty Index decline (≥2 points over 3 years) and the first year of statistically significant yield widening (≥50bp above trend).

Audit Findings

FINDING	AUDIT RATING	DETAIL
Liberty-Yield regression (β=−0.35, R^2=0.37)	**CONFIRMED**	Coefficient and significance replicated. Intercept corrected to 33.05.
Log-linear specification (R^2=0.51)	**CONFIRMED**	Superior fit validated. Non-linearity is genuine.
4.7-year median lag	**CONFIRMED**	Median replicated. Range of 3–12 years confirmed.
62% wrong-direction episodes	**LARGELY CONFIRMED**	Point estimate sensitive to lag definition; range of 55–65%.
US governance-yield gap (~650bp)	**OVERSTATED**	Gap without reserve adjustment is real but overstated. With reserve adjustment, residual gap is ~70bp. Rated "Overstated but directionally correct."
Reserve currency premium (~2,080bp)	**CONFIRMED**	Premium estimate is plausible and consistent with cross-sectional evidence.
Four Roads to Default taxonomy	**PARTIALLY VALID**	Categories are useful heuristic. Path assignment is somewhat subjective. Path 4 (US) is speculative.

Audit summary: The Liberty-Yield relationship (β=−0.35, R^2=0.37) was **CONFIRMED** by independent audit. The reserve currency premium finding was rated **"Overstated but directionally correct."** The core thesis — that bond markets systematically misprice governance risk with a multi-year lag — is empirically robust. The US-specific claims require the reserve currency adjustment to be properly calibrated.

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665 country-year observations · 34 default episodes · 91 countries · 225 years

For methodology, replication code, and interactive visualizations: cgl-cambridge-governance-labs-political-topology.local