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Globalization, Democracy, and Market Discipline

Early in 2002, Brazil was considered an example of a successful emerging economy, praised in international financial markets for its sound economic conditions. Despite concerns over the country's public debt, long-term prospects seemed promising. Optimism was such that the president of the Brazilian central bank was elected "Man of the Year" by *Latin Finance* magazine after his successful managing of the country's 1998 financial crisis.

In the course of the year, however, the country risk doubled, stock prices fell 50 percent, and the currency plummeted – a remarkable change in market sentiment, driven by investors' anticipation that the leftist Workers' Party (PT) would win the October presidential election. Lula da Silva, PT candidate and formerly a prominent labor leader, had been a vocal opponent of the neoliberal agenda advanced by the incumbent administration, and was expected to reverse it if elected.

The consequences of this so-called confidence crisis were not circumscribed to financial markets; public accounts deteriorated and important sectors of the economy that held a high share of dollar-denominated debt were left in dire straits. Accelerating inflation further raised fears that the country's economic stabilization was in jeopardy.

Even though opponents capitalized on market fears, the crisis did not prevent voters from electing Lula by a landslide. What it did, however, was to change the balance of power within the party leadership in favor of its most conservative members, with important effects on the way the Workers' Party would govern Brazil.

PT's interlocutors with financial markets, who worked to restore investors' confidence by credibly signaling their commitment to economic orthodoxy during the campaign, would later assume key positions in the administration. A former CEO of BankBoston, and member of the opposition, was appointed head of the Brazilian Central Bank, after PT historical economists were set aside for being considered "too partisan" in financial market reports.

The government ended up adopting an investor-oriented agenda, which frustrated traditional allies and provoked the exodus of party members but sparked euphoria among market players and creditor governments. In the words of Myles Frechette, former U.S. consul general in São Paulo and then president of the Council of the Americas in New York, "There is an enormous sense of relief that Lula, despite the rhetoric of his party, has people who understand how the global economy works, and want to be players."[1]

Financial investors' capacity to influence policymaking – or to discipline governments – by "voting with the feet" is by no means limited to Brazil. In other Latin American countries such as Venezuela, Argentina, and Ecuador, speculative attacks triggered by fears of a left-wing victory in presidential elections severely constrained governments' economic programs. Beyond the region, India and South Korea, as well as Australia, New Zealand, and France, went through comparable processes.

Yet important as it seems, the experience of Latin American countries reveals that this mechanism is not always effective. First, investors sometimes do not react to prospects of a left turn in government; this is what happened, for example, in the 2005 presidential election of Tabaré Vázquez, a left-wing outsider in Uruguay's century-long two-party system. In other occasions, markets react but presidents seem to ignore it completely. Rafael Correa, after his victory in the Ecuadorean 2006 election, responded to a sharp rise in the country risk by advising nervous investors to "take a Valium."[2]

It is also perplexing to note that market discipline during elections has enduring effects in some political systems in the region but not in others. After his move to the right in 2002, Lula was reelected in 2006 promising economic policies that bore little distinction from those of his conservative opponent, and markets reacted with indifference. The same happened in the presidential race of 2010, when PT candidate Dilma Rousseff was unequivocal in her commitment with maintaining investors' confidence during the campaign.

1 Alan Clendenning, "Investors' worst fears put to rest: So much for predictions that Brazil's first elected leftist president would lead the country into a financial meltdown," *Ottawa Citizen*, April 18, 2003.

2 Monthe Hayes,"Ecuadorean Leader Eyes Wealth Distribution," The Associated Press, December 2, 2006.

In Venezuela, conversely, markets' behavior constrained the first years of Hugo Chávez's presidency but did not preclude a later reversal to his original left-wing agenda, nor its radicalization after the 2006 reelection.

The puzzles just stated suggest that, although the claim that the internationalization of financial markets increases investors' influence on policymaking is quite established among students of international political economy, the understanding of the *causal links* between investors' capacity to move capital across borders and governments' economic policymaking, as well as of the factors that mediate these relations are still tentative, particularly in the emerging world.

This book employs a combination of formal and empirical analyses, as well as extensive case studies in Brazil, Ecuador, Venezuela, and Argentina, to unveil these links. I focus on the interaction between bondholders and politicians during presidential elections held in Latin America, and examine the following questions: How do investors react to the election of the Left? When and how do markets' reactions effectively curb governments' leftist agenda? Why does market discipline have enduring effects in some political systems, while in others leftist incumbents later revert to their original program?

I show that creditors react negatively whenever they anticipate a leftist victory in presidential elections, and punish a leftist government by charging higher interest rates to fund public debt. Yet these responses are not always consequential.

Rather, bondholders' leverage to discipline leftist governments in Latin America varies substantially depending on cycles of abundance and scarcity of foreign currency that are very common in the region and are *exogenous* to policymaking. These cycles are particularly pronounced owing to the region's dependence on commodity exports and low domestic savings. In countries that display these characteristics, economic performance turns out to be very influenced by fluctuations in commodity prices and international interest rates.

When commodity prices are high, strong export revenues reduce governments' demand for foreign currency to tap external financial obligations, at the same time that the acceleration of economic growth improves risk/return ratios, making economies more attractive to foreign finance. Low international interest rates further increase this attractiveness by making creditors more risk-prone and willing to divert capital from developed markets into the emerging world. High supply and low demand for foreign funds release governments from the urgency to attract additional finance. As a result, those on the Left elected during currency booms are in better conditions to deviate from markets' preferences and to pursue their preferred agenda.

When the opposite occurs, however, low export revenues reduce the supply of foreign currency, at the same time that slower economic growth makes countries less attractive to investors. High interest rates increase risk aversion, further depressing capital inflows. It is during these "bad times" that bondholders' negative reactions to the election of the Left are most consequential. The necessity of attracting capital in a scenario of low supply and high demand for hard currency prompts leftist presidents to abandon their original agenda in favor of policies expected to win the confidence of the international financial community.

In the long run, market discipline should have different consequences for leftist parties depending on countries' exposure to cycles of currency booms and crises. In economies that are relatively stable and less subject to these cycles, as financial integration advances the urge to build market confidence should become more constraining to leftist governments, and likely to prompt their convergence toward neoliberal policies.

More vulnerable economies, however, in which bondholders' leverage to influence policymaking varies substantially over time, should not experience the same convergence. Instead, leftist governments in these countries should display diverging patterns, embracing conservative economic policies in bad times and promoting radical redistribution in good times.

After placing the internationalization of finance in Latin America in historical perspective, the remainder of this introductory chapter examines the state of the current theoretical and empirical debates on the political implications of financial globalization, identifying contributions and discussing the main problems scholars face when attempting to explain the impact of increased capital mobility on the functioning of Latin American democracies. Next, I propose a framework to analyze the interactions between governments and markets in which income inequality, capital mobility, and economic uncertainty are key explanatory factors, and present the research project. The final section details how the book is organized.

The Globalization of Finance in Emerging Economies

Latin America, like other less developed regions, was shut out from international financial markets after the wave of defaults that followed the Great Depression (Drake 1989; Edwards 1998). After the first oil price shock in 1973, however, banks' efforts to recycle petrodollars coupled with the necessity of oil-importing countries to fund their current account paved the return of private lending to non-OECD[3] economies. Differently from the financial boom of the 1920s, when banks served as intermediaries between governments and investors, in the 1970s they became the direct financiers of governments' debt (Dornbusch 1989; Drake 1989; Sachs 1989).

The magnitude of investment flows to Latin America in this period is striking; net loans amounted to U.S.$61.3 billion between 1971 and 1980, compared to U.S.$7.3 billion between 1961 and 1970 (Thorp 1998).[4] The oversupply of international credit forced interest rates down, sometimes reaching negative real levels. Fierce competition among creditors discouraged oversight, and loans were offered with no strings attached. Most of the capital was channeled to the public sector and provided governments with plenty of room to use it at their own discretion (Stallings 1987).

The boom came to a halt in the early 1980s. The escalation of inflation in the United States prompted a sudden hike in American interest rates, dramatically raising the costs of capital between 1979 and 1982. In addition, the widespread panic caused by the Mexican default in 1982 impelled investors to reassess their exposure to risk in other less developed economies, triggering a sudden reversal of capital flows.

As a result, average real interest rates went from negative 6 percent in 1981 to 14.6 percent in 1982, and net transfers of resources across borders dropped from about 25 percent in 1978 to negative 40 percent of the region's exports in 1987 (Thorp 1998).

Despite the severe costs of adjustment imposed by the debt service, creditors' successful use of "carrots and sticks" prevented debtor countries from renegotiating their obligations collectively. The power asymmetry established between uncoordinated debtors and a cartel of creditors that included a few large banks, with the support of their home governments and the International Monetary Fund (IMF), guaranteed debt repayment and prevented a collapse of the international financial system, as happened in the 1930s.

Yet this was done at the expense of debtor countries' policymaking autonomy (Drake 1989; O'Donnell 1985). The necessity of rolling debt and raising new capital subjected these governments to stringent conditions; restricted to macroeconomic adjustment in the early 1980s,

3 Organisation for Economic Co-operation and Development, used in reference to developed economies.
4 Values in 1980 U.S. dollars.

these evolved to include massive structural reforms from 1985 onward (Stallings 1992).[5]

The pervasive implementation of painful reforms and the limited number of sovereign defaults provide compelling evidence of creditors' strong influence over policymaking in debtor nations (Drake 1989; Lindert and Morton 1989). Occasional efforts to promote compensatory policies, as attempted by Alan García in Peru and Raúl Alfonsín in Argentina, resulted in complete failure; exclusion from the international financial community accelerated hyperinflation and further worsened the conditions of the poorest segments of the population.

A decade passed before Latin American governments finally regained access to international financial markets. This process ensued with the securitization of bank loans into sovereign bonds promoted by the Brady Plan, which allowed private banks to sell distressed debt off their balance sheets and debtor countries to issue new sovereign bonds.

The securitization of debt under the Brady Plan started in 1989; as of July 1999, twenty governments from various regions of the world had issued Brady bonds, among them Argentina, Brazil, Costa Rica, Dominican Republic, Ecuador, Panama, Peru, Uruguay, and Venezuela.[6] The impact of the plan was dramatic; in 1997, U.S.$305 billion of loans and U.S.$2,403 billion of Brady bonds were traded, compared with the U.S.$70 billion face value of loans traded in secondary markets in 1989 (Buckley 2008, p. 53).

In this same period, countries began deregulating their capital accounts (Figure 1.1), which facilitated the entry of broader classes of investors, and encouraged the expansion and internationalization of Latin American financial markets (Figure 1.2a and 1.2b).[7] This trend is evidenced not only by the greater presence of international financial intermediaries, but also by the fact that issuance and trading of local securities continued to migrate to international markets (Agnoli and Vilán 2007).

Financial globalization, which occurred as countries liberalized their capital accounts, (re)integrated into international financial markets, and

[5] See Lora, Panizza, and Quispe-Agnoli (2004) for an encompassing analysis of structural reforms advanced in Latin American countries.

[6] As reported by the Emerging Markets Trading Association, other countries were Albania, Bulgaria, Croatia, Ivory Coast, Jordan, Nigeria, Philippines, Poland, Russia, Slovenia, and Vietnam.

[7] Although the definition of an emerging market has been the subject of increasing debate, a common characteristic of these countries is that financial investment is subject not only to economic, but also to relevant political and regulatory risks. These risks are pervasive to financial markets and direct investment, and they put politics at the center of investment decisions in these countries. See the Emerging Market Trading Association website for a more encompassing definition of emerging markets.

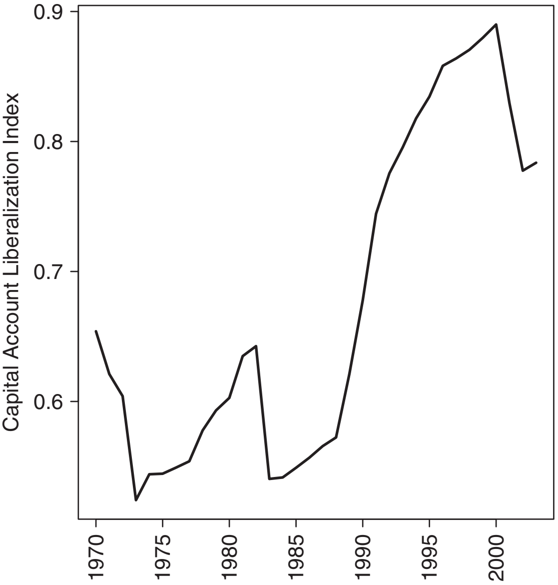

FIGURE 1.1. Capital Account Liberalization in Latin America.
Note: The index is an unweighted average of capital account liberalization in Latin American emerging economies.
Source: Biglaiser and DeRouen Jr. (2007).

accessed an increasingly broad and diversified investor base, initiated a new phase in the relations between now democratic governments and creditors, which is different in many ways from the 1920s to 1930s or 1970s to 1980s. It did not take long for scholars to start investigating these developments.

The Politics of Financial Globalization

The structure of creditor markets that prevailed after the 1970s empowered private banks and creditor governments to use direct leverage to shape the economic policy agenda of less developed countries in the aftermath of the debt crisis (Stallings 1992; Thorp 1987).

In a world of globalized finance, however, in which the creditor base is composed of a large number of investment funds and individual savers, this strategy is no longer an option. Extreme circumstances, like the Argentine default of 2001, reveal the difficulties involved in overcoming creditors' collective action problems to force repayment.

In this new scenario, investors' influence is exerted through a more elusive mechanism, which takes place in the context of what has been referred to as a "confidence game" (Bresser-Pereira 2001; Santiso 2003).

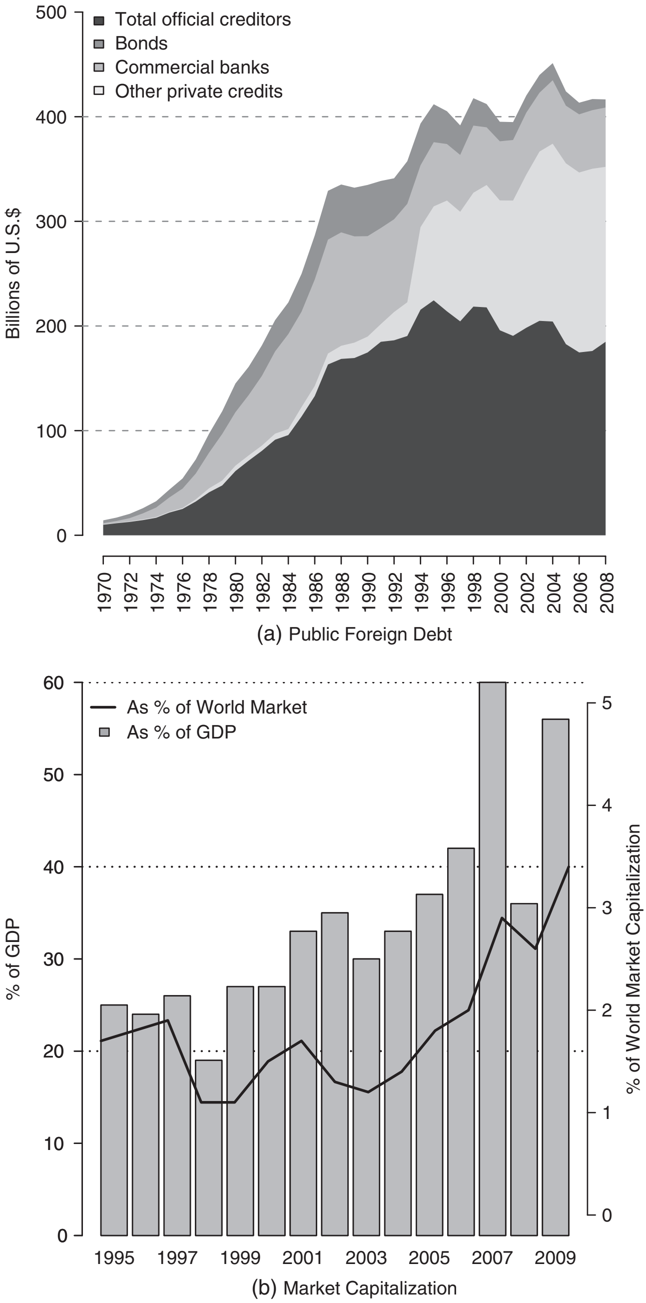

FIGURE 1.2. The Evolution of Financial Markets.
Note: Total public foreign debt outstanding and stock market capitalization of Latin American emerging economies (latter excluding Uruguay and Venezuela).
Source: World Data Bank.

In this game, exit is the most likely response of uncoordinated sovereign bondholders to prospects of unfavorable government policies,[8] and signals that either affect or reveal market sentiment become of increasing concern to investors and governments alike.

The first generation of studies on the political implications of financial globalization in Latin America attempted to reproduce research originally focused on OECD countries, and revolved around the debate between what became known as *efficiency* and *compensation* theories.

Efficiency theories[9] posit that the easier it is for asset holders to move capital across borders, the stronger become the incentives for governments to implement policies that increase domestic rates of return on investment (Cerny 1995; Drezner 2001; Dryzek 1996; Kurzer 1993; Strange 1986). Policies deemed unfavorable to financial investment should be subject to the disciplining effects of capital markets; other conditions fixed, investors should exit economies in which they anticipate their adoption. Depending on the magnitude of this exit, countries may experience anything from rises in the cost of capital to speculative attacks, with deleterious economic and political consequences.

As financial integration advances, thus, compensation theorists predicted that market discipline would force governments of different ideological leanings to converge around the neoliberal model of minimal state and deregulation preferred by international financial players. Governments' competition for cross-border capital should promote this convergence not only within, but also between countries.

The response came from theorists who acknowledged the pressures imposed by increased economic integration, yet contended that citizens' demands for compensation and protection could counterbalance – and potentially offset – investors' enhanced leverage to influence policymaking (Boix 2000; Garrett 1998; Rodrik 1998).

Compensation theories argue that parties on the Left, which typically retain stronger support from poorer citizens and labor unions and are ideologically committed to income redistribution, should respond to globalization by furthering welfare policies aimed to maintain social and political stability. Partisan distinctions are therefore predicted to persist,

8 See Hirschman (1977) for a discussion of exit, voice as means of expressing policy preferences, and Santiso (2003) for a comprehensive analysis of how these concepts apply to the operation of integrated financial markets.

9 See Cohen (1996) and Mosley (2003) for an extensive review of the literature dedicated to OECD countries. Examples of recent work that builds on this framework include Dreher, Sturm, and Ursprung (2008), Hellwig, Ringsmuth, and Freeman (2008), Nooruddin and Simmons (2009), Potrafke (2009), and Yi (2011).

as long as electoral benefits exceed the economic costs leftist governments incur when responding to their core constituencies.

Significant policy distinctions should also remain among countries' political systems, since governments' capacity to pursue a successful leftist agenda depends on domestic social and economic structures and institutions. Garrett (1998), for example, contends this can occur only in countries where encompassing labor unions are able to restrain wage growth and inflationary pressures when the economy is close to full employment.

Empirical work on the political consequences of globalization in the developed world has found considerable support for the compensation hypothesis; more integrated economies have been shown to have larger public sectors (Quinn 1997; Rodrik 1998), and divergence in welfare regimes remains significant in the OECD (Kitschelt, Lange, Marks, and Stephens 1999). Although some authors observe macroeconomic convergence coexisting with distinct partisan strategies in supply-side policies (Garrett 1998), others contend that not even macroeconomic policies converge when properly controlled for exchange rate regimes (Oatley 1999). Nevertheless, studies found that ideological distinctions between Left and Right both within and between countries have decreased in the 1990s (Boix 2000; Garrett 1998), suggesting that it might be early to completely dismiss efficiency claims.

As the prevalence of efficiency or compensation strategies in democratic systems is considered to depend on the balance between citizens' capacity to mobilize around economic interests and investors' ability to impose market discipline, the skepticism with respect to governments' likelihood to adopt compensatory policies in Latin America should be of no surprise.

Citizens' political clout is arguably modest in countries where levels of societal mobilization are low, democratization is still recent, and clientelism is widespread.[10] The absence of strong and encompassing labor unions, labor market informality, and a tradition of corporatism further compromise labor's capacity to shape the political agenda (Kurtz 2004; Song and Hong 2005; Weyland 2004).

Likewise, the dependence on foreign sources of finance due to low levels of domestic savings potentializes the impacts of market sentiment on the economy, and therefore financiers' leverage to influence policymaking.

[10] *Clientelism* is defined as transactions between politicians and citizens whereby material favors are offered in return for political support at the polls (Wantchekon 2003).