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Introduction

In Greek mythology, the Gods condemned Sisyphus to the absurd task of repeatedly rolling a boulder to a mountaintop only to have the rock fall back to the ground. Sisyphus has freedom, but it is limited by divine circumstances. He can brace the boulder with his shoulder, thrusting the rock with all of his body's momentum arduously up to the peak. But the rock's fate is beyond his control, rushing back down the mountain with boundless fury.

In a financially globalized world, politicians in developing countries suffer a similar fate. Hoping to lift their countries to development's pinnacle, they toil against the fierce force of globalization. They repeatedly roll the policy boulder up the mountain. Hoping to please mercurial markets, governments cut spending, hike interest rates, and balance budgets. With each economic crisis, however, the rock repeatedly tumbles back down the mountain. In this manner, financial volatility has wreaked havoc on the economies of developing countries over the last two decades.

Why are some countries able to surmount the gravity of globalization, whereas others suffer from Sisyphus-like misfortune? Let us begin by taking a brief South American sojourn to Argentina and Venezuela. With the rise of the Latin American left[1] over the last decade, many scholars and the popular press have often placed these two countries under a similar radical or populist banner. They share other political and economic characteristics too. They are both presidential, upper-middle-income countries that feature comparatively sized economies and populations.[2]

In terms of their macroeconomic approaches, however, their policy stances have often diverged. For instance, throughout the last decade, Venezuela

[1] A burgeoning scholarly literature offers a variety of classification schemes to explain the rise of the left and its consequences for Latin America (Panizza 2005; Castañeda 2006; Lynch 2007; Weyland 2009; Weyland, Madrid, and Hunter 2010; Levitsky and Roberts 2011).
[2] World Development Indicators.

has consistently intervened heavily in the economy to meet Hugo Chávez's redistributive goals. By contrast, Argentina's left was first characterized by a rigid commitment to fiscal discipline under President Néstor Kirchner before his wife Cristina Fernández steadily drifted from the economic center. What accounts for these varied approaches to economic policy making? Why, for example, would Néstor Kirchner surprisingly keep an eagle eye on the government's budget, ensuring a fiscal surplus?

This governance strategy was partly a remnant of the country's international borrowing. The government's heavy reliance on global bond markets throughout the 1990s created a creditor coordination problem that at first merely narrowed its policy freedoms, but ultimately left Argentine authorities without international financing. In fact, its 2001 debt default shut the country out from global credit markets, leaving it with few options beyond austerity.

Budget discipline also reflected the importance of inflation control in Argentina, a country where the 1980's hyperinflation destroyed middle- and lower-class incomes. In the wake of the 2001–2002 debt crisis, Argentines feared that the collapse of its currency board system, which had anchored inflation expectations throughout the 1990s, would unleash a new bout of runaway inflation. Kirchner's economic team initially embraced budget austerity, hoping to deliver an important baseline for the economic vote: low and stable inflation. To keep inflation at bay, they built primary budget surpluses[3] to signal that they were committed to living within their means. According to Roberto Lavagna, Argentina's Minister of the Economy, earlier this decade:

> Maybe the most important reason why [Argentina] was able to have a quite relevant fiscal surplus was the decision, in the middle of a deep crisis, to say no to all the special interests.[4]

Ironically, however, a hefty budget surplus also endowed Kirchner with another political asset. It created a stockpile of pesos that the Argentine president could spend freely on politically important provinces. In fact, in the years following Lavagna's November 2005 departure from Kirchner's government, the president managed a clever political feat. He signaled economic discipline to the public, businesses, and investors with budgetary surpluses, but increased the executive branch's ability to funnel discretionary spending to special interests. During the 2007 Argentine elections, for instance, the Kirchner government forecasted a 4 percent increase in real GDP growth, well below consensus estimates of 6 to 7 percent in its budget.[5] Notably, this low estimation yielded higher-than-expected tax revenues and a 2007 budget surplus. Benefiting from

[3] Throughout the book, when examining governments' budget policies, I use primary fiscal balances (net of interest payments on public debt) rather than the general government balances (inclusive of interest payments), because it is the more appropriate measure of fiscal policy stances in highly indebted countries.

[4] Comments by Roberto Lavagna at the Council on Foreign Relations in New York City on April 21, 2004.

[5] *Financial Times*, 2006.

the 2005 law known as *superpoderes*, Argentina's chief executive could reallocate extrabudgetary revenues without congressional approval. Facing minimal oversight, this law enabled Kirchner to discreetly funnel personalized line-item spending to key supporters and sectors during elections. For example, line-item budgetary spending on public transfers to the provinces increased by about 1.4 percentage points of GDP during the 2007 election year, equivalent to almost one-tenth of total government expenditures.[6] Notably, Kirchner's macroeconomic discipline, consisting of steady primary budget surpluses (Figure 1.1) and rising interest rates throughout the electoral campaign, did not quash his political impulses.[7]

Since taking the baton from her husband in 2007, economic discipline has relaxed under the presidency of Cristina Fernández de Kirchner. Argentina's microeconomic distortions have increasingly become macroeconomic distortions. She has sustained politically popular microeconomic measures, such as price controls in the energy and transportation sectors. Benefiting from a commodity boom, however, Cristina Fernández also raised government expenditures by 4 percentage points of GDP in her first two years in office.[8] Banned from international capital markets,[9] she had to finance part of this new spending domestically through the printing press. In fact, the Argentine president tweaked domestic laws and institutions to redirect central bank reserves and national pension savings toward preserving a dwindling primary budget surplus. A similar pattern is reflected in Argentina's trade policy, where Cristina Fernández maintained a trade surplus while using import licensing to protect vulnerable toy, fabric, leather, and farm machinery manufacturers.

In the prelude to Cristina's 2011 reelection bid, the president accelerated these expansionary policies, until she finally eliminated Argentina's primary budget surplus and firmly entrenched national accounts in deficit. Compared to her husband's electoral fiscal austerity, Cristina Fernández had greater latitude to engineer the macroeconomy before elections. By building new sources of non-market financing, her administration helped free Argentina from the scrutiny of global bond markets. Surfing a commodity tide, the Argentine president decided to test the bounds of the public's inflation aversion. Fueled by increased energy and transportation subsidies, a 25 percent hike in the minimum wage, higher social spending and public employment, and a cheap currency, the political business cycle returned to Argentina for the first time in

6 CEPAL's Estadísticas de Finanzas Públicas.
7 My analysis has benefited from more than forty primary interviews I conducted during my field research in Argentina in 2007. In these open-ended elite interviews, I discussed economic policy in the context of the approaching elections with politicians, government ministers, and technocratic advisers.
8 CEPAL.
9 In an effort to re-open the spigot of global market financing, Cristina Kirchner negotiated a settlement with two-thirds of the outstanding holdouts from Argentina's 2005 debt restructuring (see Chapter 2). However, legal disputes involving the remaining original bondholders, the recent YPF nationalization, and the United States' opposition to new multilateral lending would likely place a high premium on any new sovereign bond issuance.

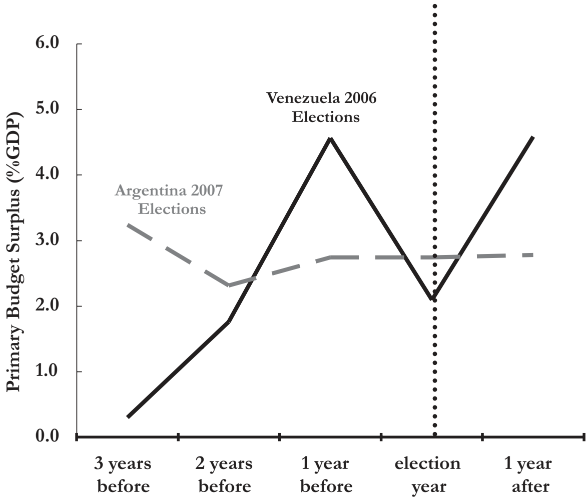

FIGURE 1.1. Fiscal Policy Stance in Presidential Elections (Argentina and Venezuela: 2002–2007).
Source: CEPAL

two decades. Ironically, however, the government has attempted to contain the fallout by artificially suppressing government inflation statistics.[10] Moreover, it has used heavy-handed foreign exchange rate controls to avoid a potentially inflation-spurring devaluation. Notwithstanding its departure from macroeconomic discipline, these actions demonstrate that the Kirchner administration remains concerned about a public backlash against rising inflation that threatens to undercut popular wages.

In Venezuela, by comparison, inflation has little political importance. Without hyperinflation's political scars, Venezuelan presidents are typically not concerned about the potential inflationary costs of aggressive state intervention. Rather, it is quite common for politicians to overheat the economy during election periods. In fact, former Central Bank President Ruth De Krivoy discusses the lack of inflation saliency in Venezuela:

> Unless Venezuelan society goes through an inflationary process that is painful like Argentina, Chile, Peru, and Mexico... it's not enough to make people realize that inflation is a problem.[11]

Compared to Argentina's debt market woes throughout the 1990s and early 2000s, Venezuela's access to steady proceeds from non-market financing sources – mainly oil revenues from state-owned companies – often allows

[10] The Argentine statistical agency, Instituto Nacional de Estadística y Censos (INDEC), has been accused of tampering with national inflation statistics for several years. In fact, private sector Argentine economists project inflation is two to three times higher than INDEC's official rate.

[11] Author's interview with Central Bank President Ruth De Krivoy in Caracas, Venezuela, on March 9, 2007. She was president from 1992 to 1994.

the country to escape the scrutiny of global financial markets, and thus, intervene in the economy more readily and openly. For example, over the past decade, nearly half of all revenues flowing into Venezuelan government coffers were non-tax commodity revenues compared to a paltry 8 percent of non-tax revenues in Argentina.

For example, if we return to Figure 1.1, we observe that the recent 2006 Venezuelan elections also featured a very different pattern from Argentina's political austerity during the 2007 elections.[12] Against the backdrop of an already-booming economy, President Hugo Chávez aggressively stimulated the economy by slashing both interest rates and Venezuela's lofty budget surplus. If a budgetary expansion were not sufficient, Chávez also swelled off-budget discretionary spending by another 2 percentage points of GDP. Perhaps, former President Ramón José Velásquez most aptly summarizes Venezuelan politics:

> In the end, all that matters is a politician's ability to distribute benefits and carry out development projects.[13]

Not surprisingly, the pace of average annual inflation in Venezuela tripled in two short years following the elections, reaching 30 percent by the end of 2008.[14]

In summary, notwithstanding the rise of the left in Latin America, we have observed considerable variation in macroeconomic policy choices among two of the countries that are often widely labeled as populist. Their leaders sometimes revert to the electoral tendencies of past Latin American decades, but at other times, are surprisingly austere. These three election cases of the politics of macroeconomic policy are but a brief preview of the patterns observed in twenty different election cases employed in this book's comparative case study section. Indeed, the policy pendulum has swung widely from economic austerity to economic stimulus across time and space in the region.

The roots of this variation reflect both structural and individual factors. When governments have access to bountiful domestic resources – whether it is commodity income or the printing press – they have the budgetary capacity to overtly engage in macroeconomic populism. Political leaders, from Hugo Chávez to Cristina Kirchner, leverage these resources to redistribute through heavy government stimulus. By contrast, when governments must tap external

[12] These policy differences are consistent, when comparing structural rather than primary government balances. The structural balance excludes cyclical sensitive taxes and expenditures commonly referred to as "automatic stabilizers." For example, tax receipts typically increase during an economic boom, which would improve budget balances even if the government did not attempt to improve its underlying structural or non-cyclical component. Notwithstanding the commodity boom, Argentina's structural deficit increased by a tepid 0.5 percentage points of GDP during the final two years of the Néstor Kirchner's presidency, compared to Venezuela's whopping 4 percentage point structural balance deterioration during the comparable period of Hugo Chávez's presidency (IMF World Economic Outlook Database).

[13] Author's interview with President Velásquez in his Caracas house on March 23, 2007.

[14] CEPAL.

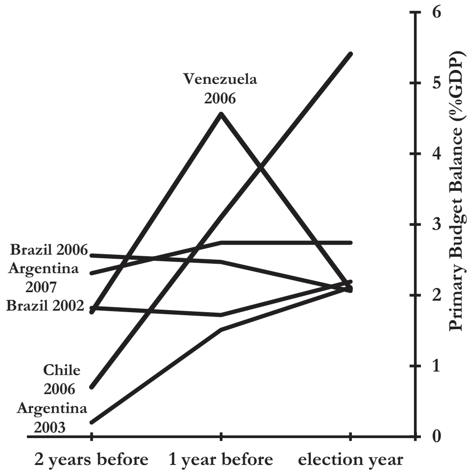

FIGURE 1.2. Fiscal Policy Stance in Presidential Elections (Selected Latin American Countries: 2002–2007).
Source: CEPAL.

borrowing through global capital markets, they are susceptible to credit disruptions that roil such political plans. Facing a treasury left barren from sagging oil prices, even a young Hugo Chávez governed like a thrifty neoliberal in hopes of appeasing foreign creditors. Notwithstanding their financing structures, individual influences on policy making are also important. Politicians like Néstor Kirchner might have left-leaning proclivities but govern more conservatively to avoid a repeat of past inflationary shocks. Behind this veil of austerity, they often raise executive discretion to find new, creative ways of targeting their support base. Alternatively, leftist presidents from inflation-scarred countries may instead choose to build state capacity more transparently by introducing new taxes and streamlining expenditures. In recent years, for example, Brazilian and Chilean governments have both opted for electoral austerity (Figure 1.2) but leveraged greater state capacity to funnel a higher share of budgetary funds toward social spending. Before elaborating on this book's cases[15] or methodology, however, let us first review its theoretical framework.

1.1. GLOBALIZATION AND ECONOMIC POLICY

Financial integration has posed a catch-22 for political elites. Cash-strapped governments have tapped international markets to increase their spending

[15] This book deals with developing countries in Latin America, which include both advanced emerging market countries such as Brazil and Chile and small developing countries such as Nicaragua and Honduras. These cases vary considerably based on both the structural and individual factors previously discussed. While the latter countries typically depend more on foreign aid, this variation in bond market exposure is essential to examining the relationship between financial market dependence and economic policy.

possibilities, only to subject their budget decisions to financial market scrutiny. Austerity, or a commitment to budgetary discipline, has become a key governance credential for developing countries that have integrated into the global economy. Facing redistributive pressures from vulnerable economic sectors, however, how do governments manage globalization's gains against domestic political costs? How do they strike a balance between market and society? When is austerity imposed externally and when is it a domestic political choice?

1.1.1. The Convergence-Divergence Debate

During the last two decades, international and comparative political economy scholars have wrestled with this question of how countries can maintain economic autonomy in an era of global capital. They have offered two competing perspectives about the impact of financial globalization on government choices. Convergence thinkers argue that financial globalization curtails domestic policy autonomy, placing new competitive challenges on national governments.[16] In the race for global capital, governments adopt laissez-faire market policies to appease mobile capital owners.[17]

Beyond global competition for capital, the diffusion literature presents an alternative explanation for economic convergence: a global paradigmatic shift away from interventionist economic policies.[18] Indeed, a social construction of laissez-faire capitalism that originated with Thatcher and Reagan scattered throughout the globe via Western diplomacy, multilateral institutions, and an Americanized global economics profession.[19]

By contrast, other scholars anticipate greater economic divergence or cross-national diversity in economic policy choices. Building on the notion of embedded liberalism,[20] they expect governments to intervene in the economy to offset globalization's dislocations.[21] Political leaders hope to strike a balance between economic and social stability.

Most recently, political economy scholars have sought to advance the convergence-divergence debate by identifying the causal mechanisms underlying policy choices.[22] These approaches explore both the nature of the external constraint and the ability of governments to insulate their populace from international market pressures.

Scholars examining financial globalization's constraints have found that market pressures are strongest in developing countries where investors are

[16] Andrews 1994; Helleiner 1994; Cerny 1995; Rodrik 1997.
[17] Cardoso 1973; Lindblom 1977; Bates and Lien 1985; Frieden 1991; Kurzer 1993; Keohane and Milner 1996; Strange 1996; Pauly 1997; Rodrik 2000; Boix 2003.
[18] Hall 1993; Babb 2001.
[19] Hall 1993; Babb 2001; Babb and Fourcade-Gourinchas 2002.
[20] Ruggie 1982; Katzenstein 1985.
[21] Cameron 1978; Katzenstein 1985; Garrett 1998a, 1998b; Garrett and Mitchell 2000.
[22] Cohen (1996) challenged political economy scholars to move beyond a general discussion of globalization as a policy constraint and instead to examine when and how the market disciplining effect works.

most concerned about default risk.[23] Why are these governments willing to comply with creditor demands? Political regimes frequently appease creditors because a reliable reputation is necessary to maintain access to foreign capital.[24] By contrast, when political regimes depend on the support of domestic fixed capital owners, they are more likely to turn inward, placing restrictions on capital mobility.[25]

In developed countries, however, international capital mobility alone is not sufficient to explain economic policy choices. Rather, scholars have found that ideational and partisan factors also explain government choices. In the aftermath of the 1973 oil crisis, for instance, policy makers became more accepting of a monetarist approach to economic policy.[26] Notwithstanding this new baseline, however, policy choices still often reflected differences in partisan preferences.[27]

Other scholars examining domestic institutions' impact on globalization have found a similar dichotomy between developed and developing countries. In developed countries with strong welfare-state institutions, pro-labor forces have the institutional clout to dampen pressures for neoliberal reforms.[28] By contrast, labor groups in developing countries have considerably less political power, leaving them ill-equipped to defend social spending.[29] In fact, global income shocks often magnify social retrenchment by closing the spigot of developing country finance.[30] Diminished labor power under globalization also translates to the other side of the government's balance sheet, where labor often incurs a higher tax burden relative to capital in Latin America.[31]

Accordingly, we should observe a high prevalence of economic orthodoxy in developing countries because they are plagued by institutional weaknesses and capital market dependence. However, I argue that the financial means and the political motivation to pursue such an economic agenda vary considerably in the developing world. Indeed, "capital's veto is not absolute."[32] Why do some countries enjoy more policy autonomy than others?

1.1.2. The Market Enforcement Mechanism

To explain this variation in economic policy choices across both time and space, I developed a new framework dubbed *political austerity cycle theory*.

23 Mosley 2000, 2003.
24 Tomz 2007.
25 Pepinsky 2008.
26 McNamara 1998.
27 Bearce 2003.
28 Swank 2002.
29 Rudra 2002, 2008.
30 Wibbels 2006.
31 Wibbels and Arce 2003.
32 Cohen 1996.

This framework offers a dual-level explanation for the rise of laissez-faire economic policies in developing countries: one rooted in the structure of government's international borrowing and one featuring the role of economic crises in shaping domestic ideational views.[33]

Chapter 2 discusses the first part of political austerity theory and argues that a key structural shift in the global financial architecture – or the method by which developing countries finance their debt – narrowed governments' policy space. I claim that the shift to decentralized bond market financing in the 1990s curtailed politicians' budgetary capacities to spend on their domestic agendas. In constructing this theory, I offer a new insight about global capital's constraints on domestic politics that goes beyond the conventional globalization straitjacket argument. I argue that what reduces policy autonomy is not the amount of financial integration, but rather the nature of creditor-debtor relations.

I claim that creditor behavior is often conditional on governments' foreign debt structures, creating enormous differences in policy climates for sovereign borrowers. My reasoning is premised on a counterintuitive collective action logic in finance-strapped states. When governments use foreign financing to cover their budgetary expenditures, they typically tap one of two sources: bank loans or bond issuance. For both types of creditors, borrowers' financial viability is a collective good. Notwithstanding the size of their debt share, all creditors benefit from steady, uninterrupted repayments. For this reason, lenders typically encourage sovereign borrowers to pursue austere policies that maximize the likelihood of debt remuneration. When borrowers encounter financial difficulties, however, these two types of creditors create very different strategic environments for their debtors.

When a government's foreign debt is comprised mostly of international bank loans, the small number of lenders facilitates creditor coordination. Each lender has a high personal stake in the debtor's financial future. Oddly, they do not use their collective action advantage to withhold new funds from the borrower during hard economic times. If they were to concertedly cut financing, it would only accelerate the debtor's road to default and eliminate any hope of recovering their investment. Instead, the difficult-to-dissolve links that ties lender profitability to borrower's loan repayment fosters a common good of borrower solvency. To keep the borrower afloat, bankers extend fresh funds. Notwithstanding IMF conditionality clauses embedded in loan agreements, however, the promise of new funds creates a moral hazard problem.[34] The mere presence of an IMF agreement is not a sufficient condition for austerity. Rather, the influx of new money enables sovereign borrowers to drift from

[33] I follow in the tradition of other scholars who have combined the roles of both economic structure and human agency in explaining the evolution of economic policy decisions (Woods 1995; McNamara 1998).

[34] Moral hazard occurs when an individual or institution does not bear the full consequences of its actions, and therefore, does not change its behavior.

budgetary discipline. Ironically, solving their collective action problem leaves bankers with less sway over debtor government policies.

By contrast, when global bond issuance constitutes the majority of foreign debt, creditors have little incentive to coordinate to secure the common good of borrower solvency. The ownership dispersion that is characteristic of bond markets leaves creditors with a low personal stake in a borrower's future business. If a country does not demonstrate its commitment to restrictive economic policies that ensure debt repayment, bondholders can cut their financial ties without incurring a severe profitability shock. Rather, their livelihood in an investment management industry based on short-term, relative returns often depends on minimizing even the most minor losses from bad investments. They would rather sell bonds for a marginal loss in secondary markets than risk underperforming industry benchmarks. Such actions yield a higher-risk premium quickly that translates into rising funding costs for sovereign borrowers. Hoping to avoid such interest rate shocks that impair their capacity to finance large expansions, governments comply with market conditionality. Therefore, compared to vested bankers, bondholders' credible exit threat allows them to more crudely impose their austerity demands. Surprisingly, creditors benefit from their coordination problem. Normally, collective action failures should hinder societal groups from pressuring governments. In the world of bond finance, however, it enhances their influence over debtor governments.

1.1.3. The Latin American Experience

Latin America – a region noted for its hefty foreign borrowing during the most recent wave of globalization – is ideally suited for examining creditor-debtor relations. Moreover, the region endured a key structural financing shock, the 1980s debt crisis, which catalyzed the market securitization of much of the region's debt. By the early 1990s, the composition of its debt stock had swiftly transformed from bank loans to bond issuance, creating considerable variation in the structure of Latin American borrowing.

Before this debt securitization, a few large international banks accounted for most of the loans made to Latin America. They had a vested interest in the financial viability of their borrowers, even during the debt crisis. As majority owners of Latin American debt, bank profitability was directly tied to the health of their lending portfolios.[35]

However, recall that international bankers faced a credible commitment problem with their borrowers. In exchange for new loans today, borrowers pledged to implement restrictive economic policies that raised the likelihood

[35] For example, 46 percent of the top ten banks' total profits flowed from their global lending portfolios, which had a sizeable Latin American exposure. At the time of the 1982 debt crisis, the eight largest U.S. banks (such as Citibank, Chase Manhattan, and Bank of America) had claims on Latin American countries that totaled 10 percent of their assets and 217 percent of their total capital and reserves (FDIC 1997). Citibank's South American exposure alone accounted for 25 percent of its total 1980 profits.