## The Politics of Market Discipline in Latin America

*Globalization and Democracy* uses a multimethod approach to challenge the conventional wisdom that financial markets impose broad and severe constraints over leftist economic policies in emerging market countries. It shows, rather, that in Latin America, this influence varies markedly among countries and over time, depending on cycles of currency booms and crises exogenous to policymaking. Market discipline is strongest during periods of dollar scarcity, which, in low-savings commodity-exporting countries, occurs when commodity prices are high and international interest rates low. In periods of dollar abundance, when the opposite occurs, the market's capacity to constrain leftist governments is very limited. Ultimately, Daniela Campello argues that financial integration should force the Left toward the center in economies less subject to these cycles, but not in those most vulnerable to them.

Daniela Campello is an assistant professor of politics and international affairs at the Getúlio Vargas Foundation (FGV), Brazil. Before joining the FGV in July 2013, Campello was an assistant professor of politics and international affairs in the department of politics and at the Woodrow Wilson School of Public and International Affairs at Princeton University. Her work has been published in *Comparative Political Studies*, the *Oxford Handbook of Latin American Political Economy*, and in edited volumes published in the United States, Spain, Uruguay, and Brazil.

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# The Politics of Market Discipline in Latin America

## *Globalization and Democracy*

**DANIELA CAMPELLO**
*Getúlio Vargas Foundation (FGV), Brazil*

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# Acknowledgments

For most of my life I have been interested in the means through which economic power translates into political power.

Born and raised in Brazil, a country where inequality is huge and highly visible in daily life, I know that one does not need to be a scholar to realize that, even though democracy presupposes one person one vote, some votes matter far more than others. How they mattered and how to make sure they did not were concerns I had since very early on, and that possibly explains why, after graduating and working as an industrial engineer, I ended up pursuing an academic career in political science.

It was only during my Ph.D. studies however, when I was first exposed to the concept of a structural power of business, that I managed to turn this personal concern into a more treatable problem. From then on, my efforts have been devoted to understanding the relative power of creditors vis-à-vis voters to influence governments' choices in Latin America.

When I first formulated this problem, in the early 2000s, creditors' influence seemed determinant, almost inescapable, in a region in which governments from right to left had advanced some measure of a neoliberal program under the pressure of capital flight and IMF conditionality. In that period, these cases seemed to somehow replicate relations I observed in the last job I held in Brazil before moving to the United States, in the planning secretariat of the Rio de Janeiro state government. There, having the opportunity to watch the dynamics of multilateral conditionality very closely, I gathered that, regardless of ideology, when money is badly needed creditors rule.

Interestingly, as I explored theses questions during my Ph.D. studies at UCLA the scenario changed quite dramatically. Governments on the

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left were elected in a number of Latin American countries and, differently from what happened in previous decades, they actually pursued the redistributive and interventionist policies promised during campaigns. Interviews with fund managers and government officials in countries like Argentina, Ecuador, and Venezuela would later reveal, somewhat to my surprise, that markets' agenda had become close to irrelevant in these countries.

If there is one advantage to embarking on such a long-term project as a book, it is that reality changes over time in ways that are very informative; as this book is concluded, building and maintaining markets' confidence has become, once again, a top concern among Latin American governments. These cycles allowed me not only to develop my theory but also to test it as the wind turns once again.

Another advantage of long-term projects is that they afford the opportunity to incorporate criticisms and suggestions along the way. Even though any mistakes made here are mine, this book could not possibly be the same without the help of my advisors, colleagues, interviewees, and friends.

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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



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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 Tabarè Vazquez, 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 Roussef was unequivocal in her commitment to 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 in Latin America 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 increase governments' demands for foreign funds, 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 short-term 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 US$61.3 billion between 1971 and 1980, compared to US$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 US 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, US$305 billion of loans and US$2,403 billion of Brady bonds were traded, compared with the US$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 a broader classes of investors, and encouraged the expansion and internationalization of Latin American financial markets (Figure 1.4a and 1.4b).[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.

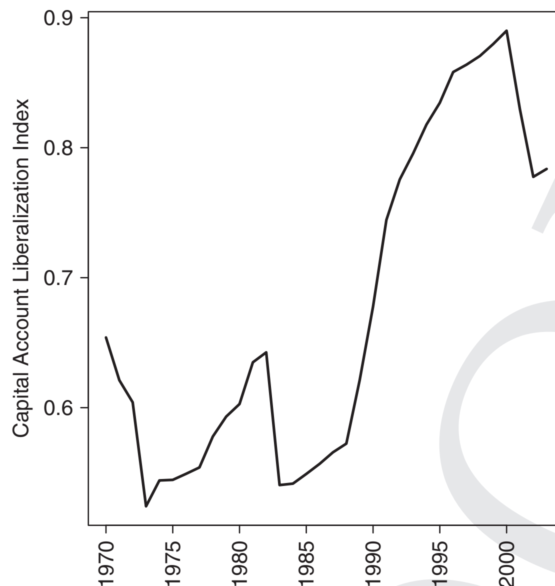


FIGURE 1.1. Capital Account Liberalization – Latin America
*Note:* The index is an unweighted average of capital account liberalization in Latin American emerging economies.
*Source*: (Lora 2001), expanded by (Biglaiser 2004).

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 1920–30s or 1970–80s. 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).

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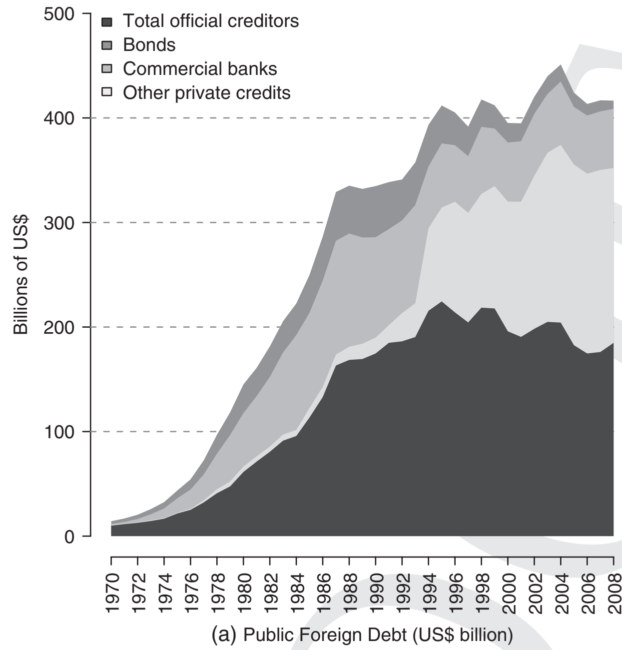
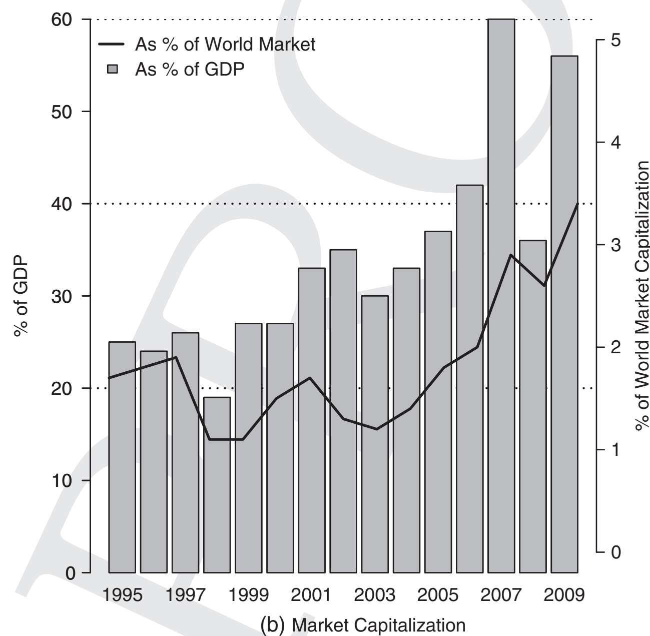



(a) Public Foreign Debt (US$ billion)




(b) Market Capitalization

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 Bank Data.

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 (Strange 1986; Kurzer 1993; Cerny 1995; Dryzek 1996; Drezner 2001). 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 (Garrett 1998; Rodrik 1998; Boix 2000).

Compensation theories argued 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), Nooruddin and Simmons (2009), and Hellwig, Ringsmuth and Freeman (2008), 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, many studies find that ideological distinctions between Left and Right both within and between countries have decreased in the 1990s (Oatley 1999), 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; Weyland 2004; Song and Hong 2005).

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).

At last, economists have shown that capital flows tend to be procyclical in emerging economies (Reinhart and Rogoff 2009), which further restricts governments' ability to provide compensation and stimulate the economy in response to increasingly frequent financial crises (Griffith-Jones 2000; Wibbels 2006).

In this context, rising insecurity and increasing dislocation resulting from economic openness should curb citizens' capacity to demand, let alone obtain, compensation in Latin America (Kurtz and Brooks 2008).

Notwithstanding all these factors, it is important to note that democratic elections should create strong incentives for governments to promote compensatory policies in very unequal economies (Meltzer and Richard 1981; Boix 2003) like those Latin America. In addition, low economic institutionalization and the concentration of power in the hands of presidents convey that, once governments choose a compensatory path, they should find few institutional impediments to pursue it. The prospects for the prevalence of compensation or efficiency policies in the region remain, thus, a matter to be settled empirically.[11]

Yet whereas the empirical literature reached reasonable consensus on the somewhat limited impact of market discipline in the OECD, the same did not happen in cross-national work on Latin America.

On one side, scholars have increasingly acknowledged market pressures (Palermo 2005; Baiocchi and Checa 2008; Samuels 2008; Weyland 2009; Hunter 2011; Murillo, Oliveros and Vaishnav 2011), pointing to the "continuing influence of macroeconomic constraints" (Hunter 2011, p. 307), the need to maintain market credibility (Samuels 2008), and the "constant threat of capital flight or a fall in investors' confidence"(Baiocchi and Checa 2008, p. 117) as barriers that prevent governments from adopting a leftist agenda in the region. Palermo (2005, p. 5), for example, attributes the rightward move of the Workers' Party in Brazil to the "complications inherent to a government transition led by a party that scares the financial markets."

Notwithstanding, when it comes to comparative studies, results remain remarkably inconclusive; although some authors find negative associations between globalization and measures of the size of the State that are independent of the partisanship in office (Kaufman and Segura-Ubiergo 2001; Rudra 2002; Orestein and Haas 2005), consistent with convergence claims, others contend that political leaders in the region still retain a significant degree of autonomy to respond to

[11] The recent diffusion of cash transfer programs offers an example of the type of compensation that might be possible in the context of unequal but demobilized societies.

international market forces (Wibbels and Arce 2003; Avelino, Brown and Hunter 2005).

In sum, the scholarship dealing with the political impacts of financial integration has not yet grappled comprehensively with the mechanisms through which increasingly mobile financial investors influence governments' choices in Latin American emerging economies.

Empirically, the difficulties involved in quantifying financial integration and the paucity of reliable data exhausted the explanatory power of highly aggregated studies focused on broad associations between indicators of globalization and partisan policymaking.

A temporal coincidence further challenges the suitability of aggregate analyses to studying the political consequences of financial liberalization in Latin America. Different from the developed world, where trade was liberalized decades before finance, most countries in the region have experienced these processes simultaneously. In addition, democratization was also concomitant with economic liberalization in the majority of cases. Considering that trade, financial liberalization, and democratization are all expected to have major impacts on governments' partisan agendas and policy choices, disentangling these simultaneous effects is no simple task.

Unsatisfactory measures of capital mobility; underspecification of causal mechanisms; and the difficulties involved in disentangling the simultaneous effects of trade, financial openness, and democratization vindicate the importance of moving away from macroempirical analyses and instead focus on the microfoundations of creditors' political clout in a world of increasingly mobile capital (Mosley 2003).

This is the strategy I adopt in this book, and that allows me to establish how international creditors respond to partisanship in Latin America, how and when these responses influence the agenda of the Left in the region, and the conditions under which market discipline should lead to economic policy convergence in the long run.

**Research Project: The Politics of Market Discipline in Latin America**

This book examines how the confidence game is played by international creditors and politicians during presidential elections, unfolding an important mechanism through which market discipline works in Latin American emerging economies.

Elections are particularly important junctures for financial investors because of their potential to bring about major policy changes (Whitehead 2006). This is even more true in Latin America, where

democratization is still recent, and low levels of political institutionalization and concentration of power in the hands of the executive create substantial policy volatility.

Santiso and Frot (2010) note that over the past decades nearly all major financial crises in emerging economies have occurred in synchronization with electoral cycles. As market players perceive parties to have distinct priorities and to seek different economic outcomes, their behavior during elections is driven by expectations about how partisan changes in office will affect these outcomes and, ultimately, investment returns.

In the particular case of sovereign-debt markets, Mosley (2003) argues that investors in emerging economies not only follow governments' macro- and microeconomic agenda to form their expectations about inflation and currency risks, but also pay close attention to supply-side policies and political ideology to estimate governments' willingness and capacity to pay debt. As a result, the prospects of a left-wing agenda that prioritizes employment over inflation and social justice over growth, or that is believed to increase the chances of a default, lowers market sentiment, depresses asset prices, and ultimately triggers capital flight and speculative attacks.

It should be of no surprise, thus, that in a scenario of increasing capital mobility the anticipation of these responses pushes leftist governments toward an agenda closer to investors' preferences. Most importantly, market influence materialized during elections carries long-term implications, for the sets of choices available to governments are often limited by decisions made soon after inauguration.

Both the qualitative and the quantitative evidence presented in this book confirm that sovereign bondholders do care about governments' ideological stance in Latin America, and react negatively to the election of leftist presidents. These reactions are sometimes mitigated by leftist candidates' willingness to signal their intentions to moderate their program if elected, but the credibility of such signals is limited by institutional factors.

Interestingly, investors' reactions fade when the newly elected government moderates its agenda, but otherwise higher bond spreads persist throughout left-wing administrations, indicating another way through which investors' behavior affects the economic success of a leftist government beyond the short term.

Notwithstanding their potentially negative consequences, though, creditors' behavior is not always capable of curbing governments' leftist agenda in Latin America. On the contrary, the main contribution of this

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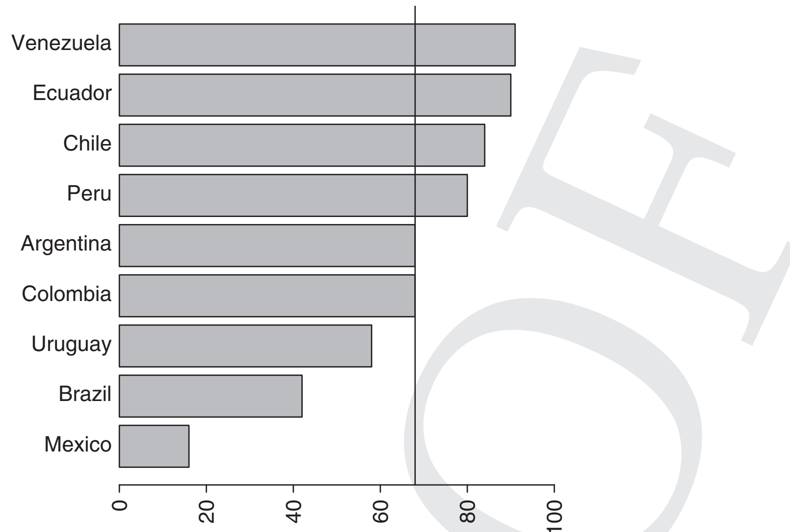


FIGURE 1.3. Commodity Exports
*Note:* Commodity as a share of total exports, year = 2000. The vertical lines denotes median share of commodities in the sample.
*Source*: World Data Bank.

PROOF

book is to show that the effectiveness of market discipline varies tremendously, not only across countries but also over time, and to explain this variation.

Comparing the economic programs leftist parties announce during electoral campaigns and the policies they enact in office, I show that investors' capacity to constrain leftist governments' agenda in Latin America varies with cycles of currency booms and crises that are exogenous to policymaking.

With the exception of Mexico, and to a lower extent Brazil, most Latin American emerging economies are essentially commodity exporters (Figure 1.3), and therefore highly vulnerable to fluctuations in international commodity prices. Moreover, low levels of domestic savings make economies in the region particularly dependent on international capital, which is itself driven by changes in international interest rates.

As a result, economists have demonstrated that a large share of capital inflows, as well as of Latin America's rates of economic growth, are fundamentally determined by changes in the international interest rates and in commodity prices (Calvo, Leiderman and Reinhart 1996; Gavin, Hausmann and Leiderman 1995; Izquierdo, Romero and Talvo 2008; Maxfield 1998). Figures 1.4a and 1.4b illustrate these relationships.

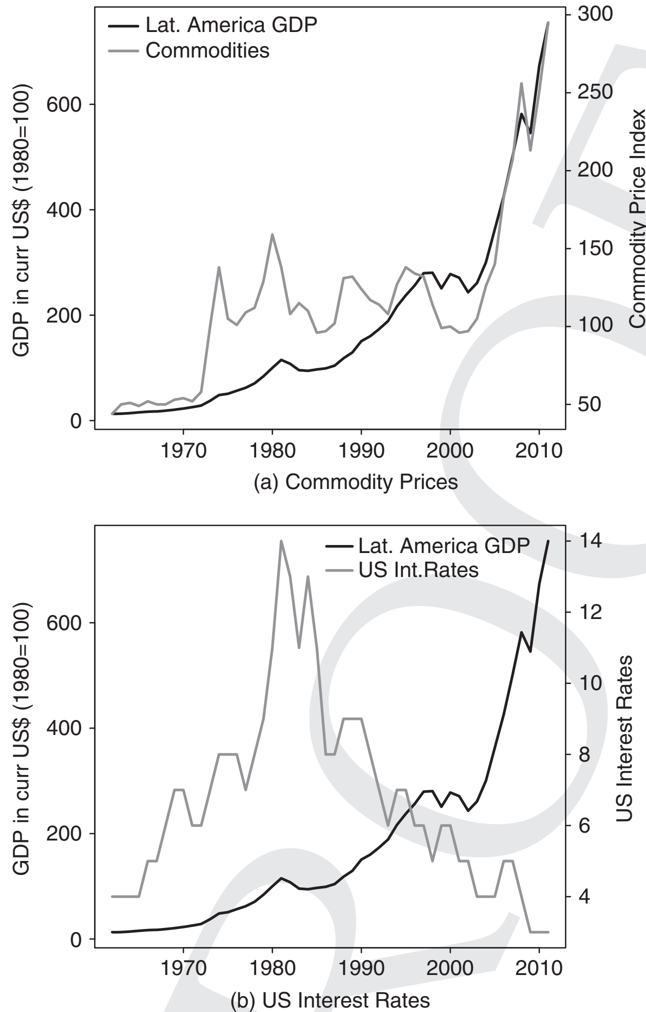


FIGURE 1.4. Commodity, Interest Rates and GDP in Latin America
*Note*: Free Market Commodity Price Index" from UNCTAD and U.S. 10-Year Treasury Constant Maturity Rate from the Federal Research Bank of Saint Louis (FRED).

Why does that dependence affect creditors' capacity to influence policymaking? It is because fluctuations in international interest rates and commodity prices alter the balance between governments' demand for foreign finance and its supply.

In periods when commodity prices are depressed, low export revenues reduce the supply of hard currency in the domestic economy and curtail

PROOF

governments' budgets, either directly, when state companies control commodity exports, or through tax revenue, when the commodity sector is in private hands. Under these circumstances, governments face an increased necessity of raising foreign funds to meet international financial obligations, in a scenario in which poor economic and fiscal prospects make sovereign bonds less appealing to international creditors.

The worst case scenario from the perspective of governments occurs when low commodity prices coincide with high international interest rates, which intensify investors' risk aversion and tendency to flee emerging economies (Reinhart 2005). In these occasions, governments' demand for foreign finance is the highest, while the supply is the lowest.

Moreover, poor fiscal prospects make default risk non-negligible. Under these conditions, as Mosley (2003) contends, bondholders' range of policy concerns extend beyond macroeconomic indicators, to encompass a wide range of microeconomic policies that have an impact on governments' capacity to repay debt.

Consequently, in these "bad times" market constraints become not only strong but also broad, and newly elected leftist presidents are faced with powerful incentives to adopt conservative economic policies expected to revert market sentiment and attract foreign finance.

Exceptionally high commodity prices have the opposite effect; abundant export revenues boost economic growth, dollar inflows, and public revenue, releasing governments' demand for foreign funds at the same time that favorable fiscal prospects make sovereign bonds more attractive to creditors. Leftist governments' greatest autonomy from market discipline occurs when high commodity prices coincide with low interest rates, which reduce investors' risk aversion and increase their propensity to divert capital to emerging economies. In these periods, governments' demand for foreign finance is at its lowest while supply is at its highest.

Likewise, negligible default risks during booms reduce investors' concerns with governments' microeconomic agenda, provided that macroeconomic indicators remain within an acceptable' range – a behavior similar to what has been claimed to be the "norm" in the OECD (Mosley 2003). Presidents ruling in "good times" are thus subject to relatively narrow market constraints, and have a wider room to advance a leftist agenda.

Figure 1.5 illustrates the different conditions Latin American governments are subject to between "good"and "bad" times. By showing the difference of central government revenue as a percentage of GDP in worst

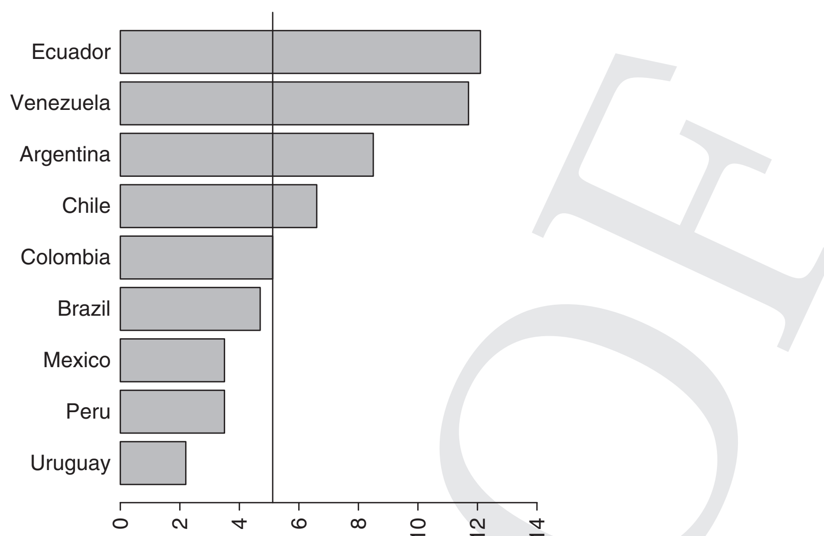


FIGURE 1.5. Government Revenues: Variation between Good and Bad Times
*Note:* Difference of central government revenues as a percentage of GDP in worst and best years between 1999 and 2010. In most cases the worst year was 1999; exceptions are Chile (2008), Peru (2002), and Uruguay (2000).
*Source*: Cepalstat.

and best years between 1999 and 2010, it offers an intuition of how governments fiscal position varies between booms and crises.[12]

The figure also indicates how this variation depends on countries' exposure to currency boom and bust cycles. Even though differences are large in most countries in the region, they are dramatic in those highly dependent on commodity exports, such as Ecuador, Venezuela, Chile, and Peru.

Finally, it is worth noting that Ecuador and Venezuela, the extreme cases, are the two countries in which not only is the economy heavily dependent on commodity exports, but also this commodity is oil. Authors have shown that, different from agricultural products, nonrenewable commodities are more subject to rent, which accrues to government revenues when prices are rising (Ananchotikul and Eichengreen 2007; Avendaño, Reisen and Santiso 2008; Collier 2007). Not surprisingly, in both countries concessions were cancelled and contracts

[12] The year 1999 was very unfavorable owing to the effects of the Asian and Russian crises, whereas a boom started in most of the region after commodity prices began to rise in 2004.

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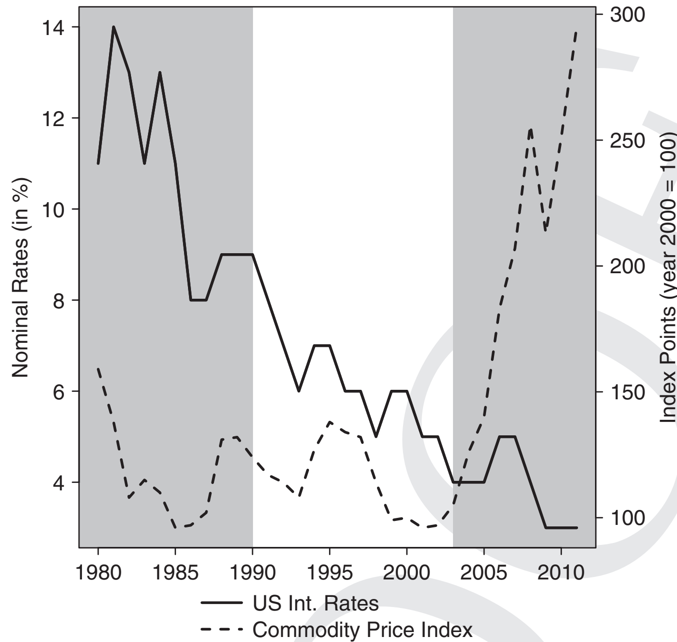


FIGURE 1.6. Commodity Prices and Interest Rates
*Source:* Commodity price index and interest rates (American bonds). Data from UNCTAD and International Financial Statistics (IMF).

renegotiated during the oil price boom, and state presence in the industry increased substantially, boosting governments' capacity to reap the effects of the bonanza.

By examining variations in the effectiveness of market discipline amid "good" and "bad" times, the theory presented here integrates, in a single framework, two phenomena that captured a great deal of attention among students of Latin American political economy: policy switches in the 1990s (Campello 2014; Drake 1991; Roberts 1996; Stokes 2001); and the resurgence of the left in the 2000s (Castañeda 2006; 2008; Edwards 2010; Roberts and Levitsky 2011; Weyland, Madrid and Hunter 2010).

As Figure 1.6 illustrates, in the first decade after the securitization of Latin American foreign debt, when financial globalization was consolidating in the region's largest economies, interest rates were still high compared to historical levels,[13] while commodity prices were stagnant for most of the period and in sharp decline after 1995.

[13] Even though they had dropped significantly from the peak reached in 1982.

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During these relatively bad times, most governments still carried a heavy load of debt as a result of the 1980s crises, and were in desperate need of inflows of international capital. Yet, different from the previous decade, these new funds were to be supplied by a large number of mutual funds and investors, rather than private banks (as in the 1970s), or multilateral agencies (as in smaller and closer economies of the region). To attract this capital, governments could not send officials to personally meet with creditors, or with an IMF designated team, but needed to signal to bond markets with favorable policies.

In their need to attract foreign finance in times of scarcity, leftist presidents inaugurated between the late 1980s and early 2000s thus could hardly afford to risk enacting redistributive or interventionist policies likely to scare investors. Instead, many of them campaigned on a neoliberal agenda, and those who did not frequently abandoned their electoral promises in favor of neoliberal policies immediately after inauguration. As Santiso (2003, p. 27) observes, “Latin America’s reform fever of 1990s must be seen in the context of the urgent need for new capital inflows.”

Starting in 2003–2004, however, a sharp rise in commodity prices, concurrent with declining interest rates (Figure 1.6), turned the currency scarcity of the previous decade into unprecedented abundance. The boom widened governments’ fiscal space to various extents across the region, reducing the necessity of leftist presidents elected in the period to adopt policies aimed at attracting financial capital. It also allowed those that had previously switched to neoliberal programs to boost social expenditures without necessarily confronting market orthodoxy. As a result, after two decades marked by severe constrains, the Latin American Left was more capable of pursuing its own agenda in office.

It follows that, in the long run, market discipline should have different consequences for leftist parties depending on a country’s levels of financial integration and exposure of cycles of currency booms and crises.

Other conditions fixed, increased financial integration should moderate the agenda of leftist parties in the long run. This moderation occurs as presidents learn the costs imposed by market panic, and these costs do not vary substantially over time.

This is what happened in Brazil, Latin America’s largest financial market and an economy comparatively less dependent on commodity exports where, as a result, the fiscal effect of the boom was less marked and the consequences of a reversal of market sentiment would be more consequential.

After Lula adopted an orthodox economic agenda in response to the confidence crisis of 2002, no other viable leftist candidate ever

campaigned on the policies the Workers' Party had defended until the previous year, consolidating a convergence toward a conservative economic agenda in consonance with predictions of efficiency theories of globalization. As the Lula administration gained some wider room to maneuver after the boom, it managed to expand social policies and the role of the state in the economy, but only within the limits established by macroeconomic orthodoxy.

In economies more vulnerable to currency fluctuations, however, market constraints, and therefore presidents' room to advance a leftist agenda, vary substantially amid "good" and "bad" times. In these countries leftist governments can go from severely constrained to highly autonomous from markets, depending on the international economic scenario. As an illustration, during Chávez's first presidency public revenue increased from 18 to 29.7 percent of gross domestic product (GDP) in Venezuela. In Ecuador, it increased from 16.6 percent in 2007 to 25.8 in 2010 under Rafael Correa. In Lula's first year as the president of Brazil, as a comparison, public revenue was 21 percent of the GDP, having reached its maximum in 2010 of 24.3 percent.

It follows that in highly vulnerable countries the promise of leftist policies remains credible to investors and voters, and presidential candidates identified with the Left have an incentive to announce a leftist program whenever they believe this will boost their electoral prospects, even if they are not sure of their capacity to promote these policies in office.

Thus, volatile economies should *not* experience a moderation of the Left in the long run, as observed in more complex and diversified countries. Instead, leftist governments in these countries should pursue radical redistribution when good times create room for that, and switch to a conservative economic program in bad times when market constraints become too strong.

Once again Ecuador illustrates the point; both Lucio Gutierrez and Rafael Correa ran as left-wing outsiders, with comparable political constituencies. Gutierrez, elected in bad times, embraced a neoliberal agenda in an attempt to regain the access to international finance that Ecuador had lost after the 1999 crisis. Correa, conversely, was released by the commodity boom from the need to attract foreign funds, and was faithful to the agenda that got him elected.

The remarkable differences between Hugo Chávez's policies in his first years in office, and later when oil prices hiked (Corrales and Penfold 2011; Kaufman 2011; Murillo, Oliveros and Vaishnav 2011), are further evidence of how sharp differences in market constraints during good and bad times prevents ideological convergence in volatile

Scenario

| Vulnerability | Bad Times | Good Times |
|---|---|---|
| High | Strong and broad | Weak |
| Low | Fairly strong and broad | Fairly strong but narrow |

FIGURE 1.7. Vulnerability, International Scenario, and Strength of Market Discipline

economies.[14] Policies that limited capital mobility, which could be adopted only in a country where almost the totality of the inflows of foreign currency are under the government's control, further increased Chávez's room to maneuver.

Argentina also experienced a sharp decrease in market constraints between the governments of Carlos Menem and Fernando De La Rúa, and those of Néstor Kirchner and Cristina Fernandez. In this case, though, the change was not primarily caused by exogenous factors like in Ecuador or Venezuela, but by a prior government decision to default on the country's public (and mostly foreign-denominated) debt, which substantially reduced its external financing needs.

The room to maneuver provided by the default, which was later widened by the commodity price boom, explains Kirchner and Fernandez's lack of interest in reintegrating the Argentine economy into international financial markets, as well as their capacity to deviate quite radically from investors' macro- and microeconomic preferences, after a decade of investor-oriented policymaking under Menem and De La Rúa.

Figures 1.7 and 1.8 summarize the rationale just stated; the first indicates the nature of market discipline under different scenarios, for vulnerable and nonvulnerable economies, whereas the second displays the predicted outcome in terms of economic policymaking, in the case of left-leaning governments.

[14] As widely noted in the scholarly literature, it is no coincidence that both Chávez and Correa found it necessary to concentrate power in the hands of the presidency to advance their preferred agenda. The same happened during the 1990s when, as shown in Chapter 4, more powerful leftist presidents were the ones most likely to switch to neoliberalism.

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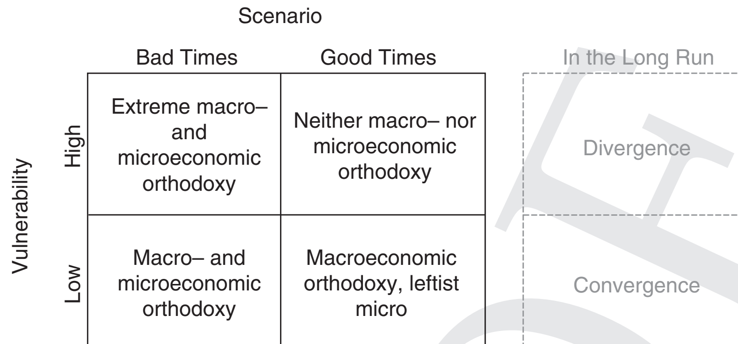


FIGURE 1.8. Vulnerability, International Scenario, and Economic Policymaking

Finally, it is important to note that governments' room for radical redistribution in good times, even in countries more subject to variations in commodity prices, is reduced as financial integration increases. Ollanta Humala, in the financially integrated and commodity-dependent Peru, moderated his agenda in response to a preelectoral confidence crisis, even having been inaugurated in the midst of a consolidated commodity price boom.

Yet the opposite is not necessarily true; constraints imposed in bad times do not require that economies are financially integrated. When alternative sources of foreign currency are scarce, governments in more closed economies have an incentive to try to enter – or return to – international financial markets, as did Gutierrez in Ecuador.

This rationale contributes to explain why a "radical" Left might persist in some Latin American countries but not others, in line with Weyland's (2009) distinction between complex economies and rentier states. Nonetheless, different from Weyland, my theory predicts that this radical Left will coexist with policy switchers *in a same political system*, depending on the strength of market discipline at a given point in time. In that sense, the analysis presented here challenges expectations that the emergence of a moderate Left is country specific.[15]

[15] Flores-Macías (2012), for example, argues that the institutionalization of political systems is key to understanding different types of leftist governments in the region. Yet Ecuador's political system had been extremely fragmented and volatile for decades, but this did not prevent Gutierrez from adopting a conservative economic agenda, whereas Correa governed from the Left. In Venezuela, the collapse of the party system happened before Chávez's election, but as a president he advanced remarkably different policies under different scenarios. The levels of institutionalization of the Argentine party system did not vary markedly in the last decades, but whereas Menem and De La Rua followed an orthodox path, Kirchner deviated from investors' preferred agenda both at the macro- and at the microeconomic level. All these examples reinforce the claim that

**Plan of the Book**

This book adopts a multimethod approach to examine the politics of market discipline in Latin American emerging economies, and is organized as follows. Chapter 2 introduces a model of optimal taxation that depicts how left-wing incumbents' decision concerning levels of income redistribution is affected by increases in capital mobility associated with financial integration. Taxation here is used as a proxy for ideological position – whereas the Left taxes and redistributes to maximize the income of the poor, the Right is assumed to tax as to maximize total investment in the economy.

The model demonstrates why capital should flee economies in which elections are expected to bring about a left turn in government. This effect should be stronger in unequal democracies like those in Latin America, in which the electoral payoff of redistribution is higher and Left and Right should be more polarized.

The model also demonstrates how income inequality and investors allocative decisions determine the Left's optimal level of taxation, above which the stock of capital that flees the domestic economy outweighs the government's redistributive efforts. It indicates that, under complete information, increased capital mobility should lower this optimal level, forcing the Left to converge to right-wing levels of redistribution.

Next, I examine the conditions under which this convergence does not happen – when investors' exit threat does not moderate leftist redistributive agendas. This outcome is more likely in highly unequal countries in which investors and incumbents are uncertain about each other's behavior. I contend that this uncertainty can be either contingent or structural – contingency being associated with recent financial integration and government's little experience in dealing with mobile capital, and structural uncertainty resulting from economies' exposure to exogenous shocks – and hypothesize that countries highly vulnerable to the structural uncertainties are the ones in which ideological convergence of the Left toward the Right should not occur. The hypotheses raised in Chapter 2 are examined in the remaining chapters of the book, using statistical analyses and case studies.

Chapters 3 and 4 test the basic propositions of the model. Chapter 3 examines bondholders' reactions to government ideology, and how it varies between "good" and "bad" times in Latin American emerging

the context in which governments are inaugurated is key to understanding the strength of market discipline, which itself determines the room the Left has to advance its own agenda.

PROOF

economies. Results show that bond spreads increase as investors anticipate elections to bring about a left turn in office, and decrease when the opposite occurs, consistent with previous scholarly work on the topic (Block, Vaaler and Schrage 2005; Renno and Spanakos 2009; Santiso and Martínez 2003).

Also interestingly, higher spreads persist under left-wing administrations, but fade in case a left-wing candidate switches to an investor-friendly agenda after inauguration. Yet investors' perceptions of sovereign risk also depend on international economic factors and, other conditions fixed, worsen in bad times. In good times, not only are spreads lower irrespective of government ideology, but they also reveal no distinction between the risks imposed by conservative governments and those of the "moderate" left – which advance leftist policies within the constraints imposed by macroeconomic orthodoxy.

In Chapter 4, I examine how markets' capacity to discipline governments varies in Latin America. I look at all the presidential elections held since re-democratization, and show that left-leaning presidents inaugurated in the midst of severe currency crises are the ones most likely to embrace a neoliberal agenda. This was true when a restricted number of private banks and multilateral institutions resorted to direct leverage to influence policymaking through loans, and remained so even after the dispersion of the creditor base occurred in the 1990s.

Chapters 5 to 8 present cases studies that delve into the mechanisms through which market discipline works. Chapter 5 analyzes presidential elections held in Brazil, with two major purposes. The first is to illustrate the confidence game established between candidates and investors starting in the early campaign through the first year of the newly elected government. The other is to explore how ideological convergence occurs as candidates/presidents and investors repeatedly interact, and uncertainties about each other's behavior disappear.

After depicting the mechanisms that link investors' behavior and ideological convergence in Chapter 5, Chapters 6 and 7 explore cases in which convergence does not occur. They focus on countries that are highly vulnerable to exogenous shocks and where market's capacity to influence policymaking is subject to significant variation. I demonstrate how these shocks, and the uncertainties they produce, prevent ideological convergence from occurring.

Chapter 6 is devoted to Ecuador, where the elections of two presidents who campaigned on an analogous left-wing discourse and with the support od similar political constituencies help identify how exogenous shocks affect investors' political clout. Whereas Lucio Gutierrez was elected under a currency crisis, Rafael Correa won during a boom

sparked by a unprecedented rise in export prices. These different scenarios contribute to explaining the diverging ways by which each president dealt with investors' reactions during elections and in office. Chapter 7 presents a study of Venezuela, where Chávez's decade-long presidency further evidences the impact of exogenous shocks on bondholders' political influence. In this case, the effects of incumbency are held fixed, whereas exogenous conditions largely vary. This variation explains Chávez's renewed capacity to deviate from investors' preferences and advance his nationalistic and redistributive agenda in Venezuela.

Chapter 8 examines the case of Argentina, where the government's room to maneuver derived not from an exogenous shock but from a prior political decision to default on the country's foreign debt. This chapter explores how the default of December 2001 increased the room to maneuver of the Kirchner administration after a decade in which market confidence remained at the center of the Argentine political stage, and how Fernandez used the commodity price boom to further this process.

Chapter 9 builds on the analyses presented in Latin American case studies and that evidences the little effectiveness of market discipline in emerging economies during currency booms, by looking at the opposite case – how sovereign bondholders influence policymaking in developed economies during currency crises. I depict the experience of the eurozone's periphery – Greece, Portugal, and Spain – and show that under extreme currency pressures not only bondholders behaved very similarly to the way they do when investing in emerging economies, but also that in these circumstances leftist governments embraced to orthodoxy and converged toward an investor-oriented economic agenda as it had been shown to happen in Latin America.

The last chapter summarizes the findings presented in the book and analyzes their potential implications for policymaking and for the prospects of democratic accountability in Latin America, in a scenario of increasing financial integration.

PROOF

10

# Conclusion: Markets' Vote and Democratic Politics

In the years of exuberance that preceded the global financial crisis of 2008, the very notion of an existing trade-off between votes and capital seemed outdated in Latin American emerging economies. On the contrary, the decade had been marked by exceptional optimism, both in financial markets and among voters.

Evidence of this win–win scenario, dramatic decreases in sovereign bond yields occurred in parallel to very high levels of presidential popularity and a wave of reelections in the region, irrespective of the quality or ideology of the administration.

Moreover, different from the 1980s and 1990s when most leftist governments in Latin America abandoned their original program in favor of a neoliberal agenda, the 2000s witnessed a widespread "move to the Left," which became subject to much debate among political economists focused on the region.

Following the "great recession," an opposite trend observed in Europe – an alleged"move to the right" – has also attracted increasing attention of the specialized media[1] and academics (Lindvall 2011; Magalhães 2012).

Left-wing parties lost vote share in the majority of elections held since 2009 (Bartels 2011)[2]; most importantly, however, left-leaning governments have to a large degree abandoned their agenda in favor of a orthodox economic policies, as seen in the previous chapter. Bartels finds

[1] "Center-Right Parties Gain in Europe," *The New York Times*, November 9, 2009; "The voters take their revenge," *The Economist*, June 17, 2004;"Swing low, swing right," *The Economist*, June 11, 2009.

[2] Even though Bartels (2011) documented the Left's loss, he argues that this was more than an ideological shift, and evidence of retrospective vote in Europe.



PROOF

that, all else equal they may have spent slightly less on stimulus programs than their right-wing counterparts.

The theory presented in this book suggests that these trends are different manifestations of the same mechanism; they reflect substantial changes in creditors' capacity to influence policymaking, which in both cases were prompted by exogenous economic conditions.

Whereas an unprecedented boom in commodity prices, coupled with high international liquidity, provided leftist governments in the emerging world with increased room to maneuver in the 2000s, capital scarcity following the American subprime mortgage crisis contributes to explain the peak of market discipline in Europe after 2008. With the crisis, resources to fund current account deficits were suddenly no longer available to countries that had become used to growing with foreign savings, the same way Latin American emerging markets did in the early 1990s. In an attempt to reattract these funds, left-wing governments have acquiesced to markets' demands, which extended to include not only macroeconomic orthodoxy, but also policies and institutional changes that should be implemented toward this end.

## REINSTATING THE ARGUMENT

The conventional wisdom among students of the political consequences of financial globalization is that capital mobility affects policymaking in distinct ways in developed and emerging economies. It has been argued that bondholders' influence is stronger in the latter, where low domestic savings make governments more dependent on foreign finance and low levels of societal organization limit citizens' capacity to influence the political agenda.

Moreover, scholars have contended that the range of policies subject to market pressures is also different in emerging and developed economies. In the former, a negligible risk of sovereign default allows investors to make allocative decisions based on a relatively narrow range of indicators related to governments' macroeconomic agenda. In the emerging world, however, where default risk is frequently considerable, bondholders have incentives to closely follow a broader range of policies, as well as politics itself, to calculate governments capacity and willingness to pay sovereign debt. Thus, in the emerging markets bondholder influence is not only strong but also broad.

This book challenged both claims, by showing that market discipline varies substantially in the emerging world, over time and among countries, and so does the range of policies over which it is exerted. I argued that to understand this variation in the particular case of Latin American

low-savings-commodity-exporting economies, it is necessary to consider cycles of currency booms and crises that are exogenous to governments or investors' decisions, and that are driven by fluctuations on commodity prices and international interest rates.

During currency booms, which occur when commodity prices are high and international interest rates are low, low demand and high supply of hard currency reduce governments' need to attract additional flows of financial capital, providing those on the Left with room to deviate from investors' preferred policies.

Under currency crises, conversely, when commodity prices are low and international interest rates are high, high demand and low supply of hard currency boost governments' need to attract capital inflows, forcing the Left toward adopting investor-oriented agenda.

Because currency booms and crises affect governments' capacity – and arguably willingness – to pay sovereign debt, they also influence the range of policies bondholders are likely to consider when making investment decisions. In good times, a negligible risk of default increases markets' complacency with more redistributive or interventionist microeconomic policies, provided that leftist government advance them within the limits of macroeconomic orthodoxy.

The long-term implication of this theory is that, in countries more vulnerable to cycles of currency booms and crises, the effectiveness of market discipline changes markedly over time, with the international scenario sometimes creating room for a leftist agenda that deviates from markets' preferences.

This creates incentives for the Left to commit with radical redistribution in such countries, independently of whether it will be or not capable of advancing it. Ultimately, this implies there is no long-term convergence of the Left toward the Right; voters recognize ideological differences, as do investors, who perceive these countries as riskier and policymaking as more volatile.

In economies less vulnerable to these currency cycles, the effectiveness of market discipline does not vary significantly over time. Thus, once the Left learns the constraints imposed by investors' capacity to flee the economy, it moderates its agenda accordingly. Attempts to return to a radical discourse should not be credible, either to voters or to markets. These cases should confirm the predictions of efficiency theories of globalization, as increased capital mobility should promote a convergence of the Left toward an investor-oriented economic agenda.

## CONTRIBUTION OF THE BOOK

Most studies devoted to the politics of financial globalization in the emerging markets in the past decade attempted to apply theories developed in the context of the Organisation for Economic Co-operation and Development (OECD) to the reality of these economies. In doing so, scholars resorted to large-*N* statistical analyses to identify broad associations between increased capital mobility and the size of the state, often captured by levels of social expenditures, as well as to investigate the intervenient role of partisanship in this relation.

While offering a fruitful starting point for the study of globalization in emerging economies, this literature lacked a clear specification of the mechanisms through which the internationalization of finance affects policymaking. It also suffered serious limitations from an empirical perspective, the most important being its inadequacy to deal with the simultaneous effects of trade and financial liberalization, and democratization, processes that occurred concurrently in most emerging markets and that should affect partisanship, policymaking, and the State.

Departing from this previous strategy, this book aimed to shed light on the *micro-foundations* of the confidence game between investors and governments in Latin American emerging economies. With a particular focus on the period that surrounds national elections, the analysis used a variety of theoretical approaches and empirical evidence to establish an important mechanism through which market discipline works.

I started by proposing a simple model that demonstrated why, other conditions fixed, capital should flee economies when elections bring about a left turn in government, and do the opposite when the Right wins. The model also showed why investors' increased mobility should curb leftist governments' capacity to deviate from markets economic policy preferences, and force the left to converge toward a conservative agenda. Finally, it explored the role of uncertainty in the relations between investors and governments, examining the conditions under which this uncertainty should forestall ideological convergence in the long run.

To probe the predictions of the model, this book started by establishing how financial markets, and in particular bondholders, effectively respond to government ideology in emerging economies, as well as how this response changes during currency booms and crises. The analysis revealed that investors perceive the Left as riskier, and reduce their position in countries where a left-wing candidate is anticipated to win the presidency. Yet investors' risk perception also depend on the international scenario, with market sentiment worsening in bad times of low

commodity prices and high international interest rates, and improving when the opposite occurs.

Interestingly, in "good times" bondholders also seem to be indifferent between a "moderate left," which advances redistributive and interventionist microeconomic agenda within the limits of macroeconomic orthodoxy, and conservative governments. Negative reactions are restricted to the so-called "radical left," which deviates from market preferences both in the micro and in the macroeconomic realm.

Next I examined the conditions under which markets' response to ideology influenced policymaking. A study of presidential elections held in Latin America since re-democratization revealed an important source of variation in investors' capacity to influence government's economic agenda. It showed that among leftist candidates, the ones elected during currency crises were the most likely to renounce campaign promises and switch to a neoliberal program. Political factors mattered; party institutionalization offers some barrier to switches, whereas the constitutional powers in hands of the president facilitate them. Somewhat surprisingly, switches are more likely to occur in institutionalized party systems, and I hypothesized that this happens because in such systems presidents can rely on voters' long-term electoral commitment.

The case studies presented in Chapters 5 to 8 detailed the confidence game between investors and governments that occurs during elections, and revealed how exogenous conditions determine the effectiveness of market discipline. They explored the process through which markets' reactions to the Left during elections were translated into political pressures for the adoption conservative economic programs, and how this dynamic varied among periods of currency booms and crises.

Chapter 9 complemented this analysis by demonstrating that, as much as in good times investors's influence over emerging market governments is narrower than claimed in the globalization literature, in bad times it becomes broader even in the developed world.

Even though this book investigates the workings of market discipline in Latin America, the claims made here can be extended to emerging market democracies in other regions, where financial integration has increased dramatically in the past decade or so. Besides the shorter term hypothesis that market discipline is more effective during currency crises, and less so during booms, it should be possible to observe whether left-wing governments persist in the long run in economies more vulnerable to these cycles, compared to those more stable in which the Left should move rightward.

## IMPLICATIONS FOR DEMOCRACY

This book examined the trade-offs democratic governments face as they become increasingly exposed not only to citizens' but also to financial investors' demands. These trade-offs can be particularly pressing when voters and investors disagree about the direction policymaking should take.

In response to the criticisms directed to the primacy of markets over politics after the global crisis of 2008, a column in *The Economist* argued that "if you don't want to be bothered about the bond markets, don't borrow from them."[3] It added "the finance ministers of Norway and Saudi Arabia have no cause to worry about their borrowing costs because they are net creditors."

In fact, if policies demanded by financial markets always imposed losses on citizens that exceeded the benefits associated with capital inflows, investors' influence would not pose a problem for democratic governments. Ultimately, electoral pressures would limit other incentives governments might have to respond to mobile capital holders. Not borrowing, as suggested by *The Economist*, could be a reasonable option. In some way, irrespective of the legal barriers imposed by "holdouts," this seems to have been the conclusion reached by presidents Néstor Kirchner and Cristina Fernández in Argentina.

If, conversely, most policies demanded by creditors were also broadly favorable to citizens, investors' influence would not be problematic for democratic governments. In this win–win game, not rarely pictured by the specialized media and assumed in academic work, in responding to markets governments would end up advancing voters' interests as well. Their real motivation, for any practical purpose, would be irrelevant.

The trade-off between votes and capital is complex exactly because financial investment carries numerous advantages while also frequently imposing harsh costs. This complexity arises as governments risk losing benefits associated with receiving these funds by responding to voters' demands, or to anger voters by paying the sometimes exceedingly high costs of satisfying creditors' preferences.

Apart from the important debate about the economic consequences of the volatility of international capital flows, from a political standpoint the experience of emerging economies after financial integration has been one in which voters were, on many occasions, left with comparably little say on policymaking.

[3] "Voters versus creditors," *The Economist*, November 19, 2011.

Once the constraints imposed by capital mobility are acknowledged, and the left adopts conservative economic policies, very often leftist voters have nowhere to go in their search for alternative agendas. In more volatile economies, where this convergence does not occur, leftist governments' capacity to advance a redistributive is still quite contingent on external conditions, at least when it comes to Latin American emerging markets. Moreover, the uncertainty about how long these conditions will persist also creates deleterious short-term incentives likely to compromise much needed investment in the long term.

Democratic theory emphasizes the centrality of electoral mechanisms of accountability, and the quality of democracies is frequently believed to depend on some measure of governments' responsiveness to citizens' preferences. At the same time, students of the politics of financial globalization, regardless of their identification with convergence or divergence theories, acknowledge that the influence of mobile capital holders on policymaking is strengthened as global investment options expand. Moreover, many among them acknowledge that measures oriented toward confidence building are not always the most sensible in the longer term.

The question, then, becomes how much room to maneuver governments should have to respond to citizens' demands for a system to be conceived of as a healthy democracy. Can a political system be recognized as democratic if politicians compete for office under stable and fair rules, yet the policies they implement are fundamentally the same?

Even the weakest form of accountability established by theories of retrospective voting is not necessarily valid in a world of mobile capital, as it subsumes that policy competition necessarily follows electoral competition. Accepting that voters in emerging democracies evaluate their incumbents ex post, how far can they punish a government for implementing policies that constitute "the only game in town"?

Consider the Brazilians who elected Lula da Silva in the expectation that he would reverse the policies adopted by the former center-right government, as promised during the presidential campaign. Their only realistic alternative available for punishing the PT in the following election would be to vote for the center-right candidate of the same party of Lula's predecessor, who promised by and large the same policies that the PT historically rejected but ended up adopting in office. In that sense, a choice not very different from that available to the post-crisis Portugal or Spain, and that points to the existing limits on the prospects of democratic responsiveness in a scenario of increased financial integration.

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