

Globalization and Austerity Politics

The United States aggressively responded to the 2008–2009 global financial crisis with a flurry of economic stimulus. For the champion of laissez-faire economics, crisis-induced budget spending and interest rate cuts were an about-face from its austerity doctrine exported across the globe. Throughout the post-Cold War era, the U.S. Treasury and International Monetary Fund have tied economic aid to restrictive spending and credit policies. From Latin America to East Asia, the United States has advocated for economic stabilization policies in the face of financial crises. Surprisingly, developing country leaders often have doggedly embraced these free-market principles. Many of these countries are young democracies characterized by fervent popular pressures for growth, redistribution, and jobs, yet their politicians pursue conservative non-interventionist policies. In hard times, the political benefits of a short-term soporific should outweigh the long-term self-healing powers of laissez-faire capitalism. What's the political payoff to being a cautious steward of the economy?

The appeal of non-interventionist economic policies is even more surprising when chief executives are battling for their political survival. Political economy scholars expect politicians to swell the public purse to gain votes, particularly in newly democratized regions that are plagued by chronic unemployment and high poverty.¹ Some politicians abide by this policy making logic, known as the *political business cycle*. According to this logic, politicians are consumed with winning the vote. They create a short-term economic boom designed to curry favor with the electorate that often ends in an inflation-induced economic bust.² Their political ambition clouds any concerns about longer-term economic fallout, including higher inflation and slower economic growth.

¹ Ames 1987; Schuknecht 1996, 2000; Acosta and Coppedge 2001; Block 2002; Gonzalez 2002; Brender and Drazen 2005; Shi and Svensson 2003, 2006; Barberia and Avelino 2011.

² Nordhaus 1975; Lindbeck 1976; Tufte 1978; Ames 1987; Sachs 1989; Dornbusch and Edwards 1991; Kaufman and Stallings 1991.

Scholars have uncovered evidence of political tinkering with the economy across the globe, from Japan and Russia to Turkey, Italy, and Mexico.³ For example, facing a contentious reelection bid in December 2006, President Hugo Chávez slashed Venezuela's lofty budgetary surplus by half and spent a further whopping US\$7 billion in off-budget discretionary spending to reward his historically marginalized political base.⁴ Similarly, Russian president Boris Yeltsin ensured his 1996 reelection with a spending boom that was largely mortgaged by the privatization of Russia's natural resources.⁵ For both Chávez and Yeltsin, aggressive government intervention carried a steep inflationary cost, creating serious long-term problems for their economies.⁶

During other elections, however, political behavior does not adhere to this convention. Politicians choose not to stimulate the economy. For example, two months before his May 1995 reelection bid, Argentina President Carlos Menem surprisingly announced US\$1 billion in budget cuts, including a reduction in public salaries. Similarly, during his own reelection campaign, Brazilian President Fernando Henrique Cardoso announced an austerity package featuring tax hikes and spending cuts. Why would Menem and Cardoso slash spending during their most vulnerable hour? What accounts for this odd political choice? During elections, politicians are typically expected to use economic policy to spur growth, create jobs, and boost wages. Why would developing country politicians like Menem and Cardoso swing the political pendulum from heavy government intervention to *laissez-faire* neutrality? What accounts for this change in political preferences?

To answer these questions, this chapter offers a new framework called *political austerity cycle* theory. Austerity, or a commitment to budgetary discipline and sound monetary policies, has become a key credential of economic governance in a globalized world. Why would politicians value a seemingly long-run asset like economic stability? Politicians operate according to the same incentives, as always. They want to win elections⁷ and believe that voters respond to economic conditions.⁸

However, in many cases, their political arsenal has undergone an important transformation. Politicians have swapped large unsustainable fiscal deficits and a high-gear printing press for budget discipline and inflation control. Rather

³ Kohno and Nishizawa 1990; Krueger and Taran 1993; Limosani and Navarra 2001; Gonzalez 2002.

⁴ Venezuelan Finance Minister Cabezas's Inter-American Development Bank presentation, March 2007.

⁵ The Yeltsin government grew its budget deficit from 4.9 percent to 7.4 percent of GDP in a single year (IMF).

⁶ In a few short years, Yeltsin watched inflation more than double its 1996 levels. For Chávez, inflation had not only doubled within one year of his electoral spending spree, but quickly approached the highest levels of inflation in the world, reaching 31 percent by 2008 (IMF's International Financial Statistics).

⁷ Mayhew 1974.

⁸ Lewis-Beck 1988.

than using big budget deficits and expansive credit to boost the economy, they prefer to operate within their means. Shrouded by an orthodox budgetary framework, they reward their constituencies with line-item budgetary spending – from poverty programs to public works projects – and distance themselves from aggressive government intervention in the economy. They believe that engineering a high-growth, high-inflation cycle to win votes carries too high a political cost. In lieu of crafting such traditional political business cycles, they instead signal their commitment to sound macroeconomic management during elections.

Why have political business cycles become so costly? What determines when politicians embrace austerity and when they revert to economic stimulus? This chapter offers a theoretical framework for understanding the politics of macroeconomic policy making. The discussion unfolds as follows. The first section places my theoretical approach within the political economy literature on elections and economic outcomes. The next three sections outline the book's theoretical contributions, explaining when and why politicians might surprisingly adhere to economic orthodoxy during election periods. I argue that countries' debt structures and economic histories are key determinants of their policy choices. I frame the analytical structure according to two key decision-making dimensions: a government's financial means and political motivations. When foreign debt is comprised mostly of global bond issues rather than international bank loans, highly indebted governments often do not have the financial means to engineer an electoral boom. At the same time, when countries are plagued by past inflationary shocks, politicians often lack the motivation to create a political business cycle. Rather, a technocratic consensus for macroeconomic discipline and a perceived widening of the low-inflation constituency compels them toward good governance. Finally, I incorporate these mechanisms into a series of hypotheses about elections and economic outcomes. They are evaluated empirically in Chapters 3 to 7. Latin America is an ideal setting for testing these claims given the region's high external indebtedness and inflation volatility during the most recent wave of globalization.

2.1. THE INFLATION-UNEMPLOYMENT TRADE-OFF

Let us begin by reflecting on the political decisions that are central to economic policy making. Most macroeconomic models assume that economic choices reflect politicians' relative sensitivity to unemployment and inflation (Appendix 2.A).⁹ In fact, two major strains of intellectual thought have dominated the field of the politics of macroeconomic policy making: Keynesianism and Monetarism. The debate between these two schools centers on the inflation

⁹ Please see the Appendix as well as Barro and Gordon (1983) and Scheve (2004) for a more detailed description of the theoretical models of macroeconomic policy making.

and unemployment trade-off, popularly known as the Phillips curve trade-off.¹⁰ Both Keynesianism and Monetarism assume that politicians care about inflation and unemployment, but they offer competing accounts of the effectiveness of government intervention.¹¹

Keynesianism is more optimistic about policy maker's ability to exploit the Phillips Curve trade-off, using economic policy to permanently create new jobs and growth. When facing an economic slump, Keynesianism holds that the government can use expansionary monetary and fiscal policies to offset the adverse effects of the economic downturn. Creating new capacity and adding new jobs eventually spurs inflation, but only at very low levels of unemployment. Wages and prices are sticky. Workers may ask for higher pay, but these appeals typically occur when there is a booming economy and high demand for labor.¹² During the 2008–2009 global financial crisis, both the Bush and Obama administrations subscribed to a Keynesian view of the economy despite their partisan differences. Indeed, both administrations hoped that low interest rates and high government spending would cushion the economic shock.

By contrast, monetarism contends that inflation is a harmful by-product of expansionary economic policy. In response to economic stimulus, people adjust their inflation expectations higher. Workers demand better wages and firms raise prices. Inflation accelerates, undercutting any initial gains from the stimulus. Indeed, monetarists claim there is a natural rate of unemployment, beyond which any attempts to spur economic activity only yield further inflation.¹³ Championed by Milton Friedman, monetarism was first in vogue in the 1960s and 1970s. It offered an explanation for the 1970's puzzling rise of both inflation and unemployment. According to monetarism, the 1973 and 1979 oil shocks not only delivered a serious blow to economic growth, but also jolted inflation expectations considerably higher.¹⁴ Lofty price expectations intensified the original shocks and dampened the benefits of expansionary policy. Hence, monetarists claimed the Phillips Curve was vertical in the long run, rendering the effects of government stimulus ineffective outside of fueling further inflation (Figure 2.1).

Political Business Cycles: Developed versus Developing Countries. Building on these intellectual foundations, scholars have anticipated observing two major types of economic cycles around election periods: *opportunistic*

¹⁰ The Phillips curve is named after the British economist A. W. Phillips, who in 1958 observed a negative relationship between inflation and unemployment rates.

¹¹ The neoclassical synthesis in contemporary macroeconomics has sought to bridge the gap between Keynesian and monetarist schools of thought, advocating for economic governance to be principally conducted through an independent central bank that uses monetary policy to control inflation.

¹² Samuelson and Nordhaus 1995.

¹³ Friedman 1968, 1970.

¹⁴ Revisiting the traditional Phillips curve trade-off, Milton Friedman and Edmund Phelps constructed a steeper Phillips Curve that accounted for the growth-diminishing effect of inflation expectations.

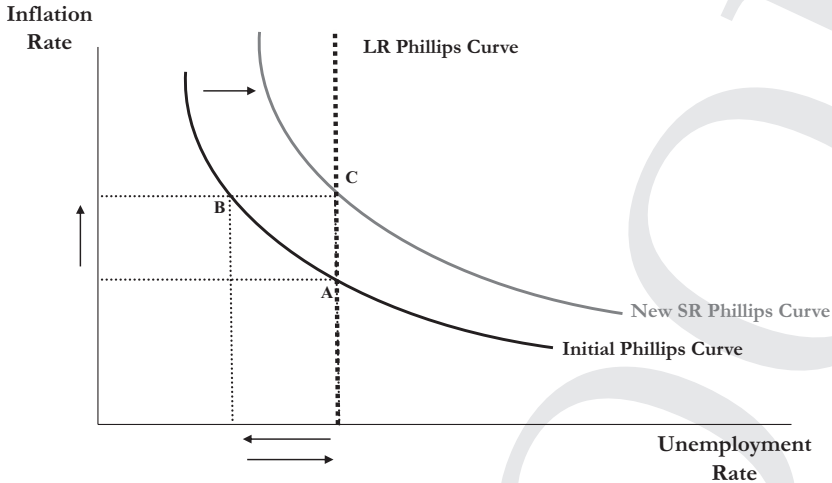


FIGURE 2.1. The Phillips Curve Trade-Off. The figure shows the tensions between Keynesian and Monetarist views. Keynesians suggest that policymakers can readily trade off unemployment and inflation. Monetarist, however, claim that this trade-off is only short-term. Moving from point A to point B, policymakers can reduce the unemployment rate below its natural level with expansionary policy, but only temporarily. Expansionary policies breed higher inflation expectations, shifting the Phillips curve rightward. Moving from point B to point C, the unemployment rate returns to its natural equilibrium, but inflation is permanently higher.

and *rational political business cycles*. The opportunistic view of economic cycles is rooted in a Keynesian view of the world but differs in its policy prescriptions. While strict Keynesians proscribe expansive macroeconomic policies in response to a demand shock, elections serve as the catalyst for political business cycles. Politicians, seeking reelection, deliver an economic boost to win votes notwithstanding the extent of the economy's spare capacity (or size of the output gap).¹⁵ They ambitiously slash interest rates and ramp up spending to create jobs and growth. However, the political choice to exploit the Phillips Curve leads to an electoral boom and bust. The aggressive expansion before elections overheats the economy instead fueling inflation, and ultimately, an economic correction following elections.

By contrast, the "rational" school of thought is rooted in a monetarist view of the world. Politicians attempt to demonstrate their competence by boosting growth and lowering unemployment, but their efforts are only fruitful in a world of incomplete information. When voters are savvy, they are wise to politicians' incentives to inflate the economy. Voters adjust their inflation expectations higher, diminishing the effect of expansionary policy. Political tinkering yields few economic gains for society, but leaves an inflationary nuisance.

¹⁵ The output gap is measured as the difference between actual GDP and potential GDP.

When do politicians stimulate the economy and when do they opt not to intervene? Political business cycle theory predicts a schism between developed and developing countries. According to political business cycle theory, reelection-minded politicians should be most likely to prime the economic pump in newly democratized regions, like Latin America, where information is less transparent and presidential power is relatively unchecked. Without independent central banks, strong legislatures, or free media, the political economy literature expects that chief executives engineer an economic bonanza notwithstanding its inflationary cost.¹⁶ Faced with widespread inequality and poverty, developing country politicians rapidly expand the economy, hoping to provide jobs and boost wages. By contrast, in developed countries, scholars have found that politicians often avoid creating political business cycles because they fear that a sophisticated, fiscally conservative electorate will punish them at the polls.¹⁷

2.2. POLITICAL AUSTERITY THEORY

Do developing country politicians also sometimes choose not to intervene in the economy? If so, what is the trigger for their orthodox economic behavior given that fiscal conservative voters are presumably less likely to be found in countries hampered by poverty and income inequality? Are politicians monetarists who are skeptical of the benefits of stimulus?¹⁸ Or, are they repressed Keynesians? Are they optimistic about the government's ability to create jobs and growth before elections, but nonetheless choose neutrality?

In the following pages, I advance a new theory that explains this variation in elite approaches to economic policy making. Building on the political models of macroeconomic policy making previously outlined, this theory seeks to account for political choices about the unemployment-inflation trade-off.¹⁹ The conventional choice of using economic stimulus to create growth and jobs has its obvious electoral benefits. But, what explains the counterintuitive choice of not tinkering with the economy? Why might politicians come to favor inflation control, even at the cost of creating more jobs and growth?

2.2.1. Financial Means

Political austerity theory argues that politicians approach this economic trade-off based on two critical policy making dimensions: financial means and political motivations. Financial means reflect the policy capacity to deliver an

¹⁶ See footnote 1.

¹⁷ See Rogoff and Sibert 1988; Rogoff 1990; Brender and Drazen 2005, 2008.

¹⁸ Monetarists would have claimed that Latin American politicians were confronted with a steeper Phillips Curve in the 1990s. Compared to earlier decades, any government attempts to spur growth and jobs would have instantaneously sparked inflation because of higher inflation expectations stemming from past price shocks.

¹⁹ Political austerity theory only makes a claim about the weights politicians assign to their loss functions for inflation and unemployment; it does not make any predictions regarding the actual shape of the Phillips curve.

economic boost. There are two major ways that governments stimulate the economy. They spend more than they tax from one year to the next, widening a budget deficit that fuels economic growth. Alternatively, the central bank uses open market operations to expand the money supply. It buys government bonds, adding funds to the banking system and spurring lower interest rates. Low rates then boost consumption and investment.

Why might countries not possess such financial means? It is often difficult, for developing countries to use expansionary economic policies. Such policy actions often depend on government's fiscal space,²⁰ or the availability of budgetary resources to finance budget shortfalls. Unlike most developed countries, narrow tax bases and shallow domestic financial markets leave many developing countries with few funding options domestically.²¹ Governments can alleviate such fiscal constraints, however, by borrowing funds externally or compelling the central bank to fund deficits by printing money. When governments use foreign financing to cover their budgetary expenditures, they typically tap one of two sources: bond issuance or bank loans.

For those countries that choose to finance their funding shortfalls in global financial markets, politicians are often at the mercy of investors who are preoccupied with debt repayment.²² In order to increase the likelihood of repayment, investors demand sound fiscal and monetary policies. With a low tolerance for uncertainty, they often look unfavorable upon large, politically motivated fiscal deficits that might disrupt debt repayment flows. Such policies threaten to spark capital withdrawal and spike funding rates. Therefore, debt-ridden developing country governments frequently do not possess the policy flexibility to create an aggressive electoral expansion. By contrast, when foreign debt is comprised mostly of international bank loans, politicians have more scope for economic stimulus.

Why is international bond financing more constraining than bank lending? Certainly, it is reasonable to conclude that bankers also prefer sound macroeconomic governance. The first part of the theoretical framework, presented later in this chapter, offers an explanation. With orders of magnitude more debt holders in the case of bond markets than international banking, market debt creates a more credible threat of capital withdrawal. This exit threat enhances the power of creditors over debtors, allowing them to impose their austerity demands.

2.2.2. Political Motivations

Political motivations refer to the political incentive to use macroeconomic powers for electoral gain. According to the traditional political business cycle logic,

²⁰ Fiscal space can be defined as the availability of budget room that allows governments to provide resources for a desired purpose without any prejudice to the sustainability of a government's financial position (IMF, 2005).

²¹ Gavin and Perotti 1997.

²² Keohane and Milner 1996; Mosley 2000; Mosley 2003; Wibbels 2006.

election-minded politicians should exploit the Phillips Curve to deliver jobs and growth to their constituents notwithstanding any longer-term costs (such as fiscal deficits, inflation, or recession).²³

When might governments stray from these traditional political goals? In countries where severe inflationary shocks have scarred the electorate, I argue that politicians often invoke a different electoral calculus. Building on the psychology literature on decision making, the second part of the theoretical framework claims that politicians (and their technocratic communities) often base their economic choices on their own transformative historical experiences. For instance, German political elites today conduct economic policy with a price stability bias even years after the Weimer Republic's extraordinary trillion-fold inflation. Current German Chancellor Angela Merkel, for instance, recently stressed that "protecting people from inflation: that's what really matters."²⁴ In fact, Germany's strident opposition to looser monetary conditions during the euro crisis partly reflects the country's deep-seated inflation fears.

Like pre-World War II Germany, many crisis-plagued developing countries have suffered from chronic deficits and stubbornly high inflation that eroded living standards. In the worst cases, these severe price shocks dismantled economic and political systems. With the dangers of lofty economic expansions chiseled into their political minds, political and technocratic elites develop a consensus for sound macroeconomic governance. Notwithstanding ideological differences, they place a high weight on inflation control. They may hold a Keynesian view of the economy – maintaining their faith in the government's ability to spur economic activity – but now fear voter retribution for highly accommodative policies that risk inflation. Alternatively, they may subscribe to a monetarist view of the economy, believing that government stimulus in inflation-prone countries will have little economic effect beyond sparking more inflation. Either way, inflationary crises make political and technocratic elites less tolerant of non-orthodox stimulus.

Finally, beyond learning from history personally, politicians also fear that voters have learned from these past shocks. Deeming that a broader constituency favors low inflation – reaching well beyond the private sector – politicians from across the political spectrum gravitate toward the center on macroeconomic issues.

2.2.3. Electoral Economic Strategies: The Spendthrift or the Miser?

Political austerity theory employs these two policy making dimensions to make predictions about elections and economic outcomes in developing countries (Table 2.1). Conditional on these means and motivations, I expect a country's major macroeconomic indicators to vary both intertemporally and cross-nationally. When governments possess both the policy capacity to deliver an

²³ Inflation is most likely when there is a small output gap, or little spare capacity, in the economy.

²⁴ *La Stampa*, July 11, 2007.

TABLE 2.1. *Macroeconomic Policy Expectations: The Spendthrift or the Miser?*

		<i>Political Motivation</i>	
		<i>Low Inflation-Aversion</i>	<i>High Inflation-Aversion</i>
<i>Financial Means</i>	<i>Low Funding Constraints</i>	Expansionary Policy <i>The Traditional PBC</i> <i>(High Growth, High Inflation Cycle)</i>	Neutral-Contractionary <i>The Inflation-Averse Political Austerity Cycle</i> <i>(Moderate Growth, Low Inflation Cycle)</i>
	<i>High Funding Constraints</i>	Neutral-Contractionary <i>The Market-Induced Political Austerity Cycle</i> <i>(Moderate Growth, Low Inflation Cycle)</i>	Contractionary <i>The Political Austerity Cycle</i> <i>(Low Growth, Low Inflation Cycle)</i>

economic boost and the political incentive to use macroeconomic policy for electoral gains, they are likely to create a political business cycle. Otherwise, we should expect to observe one of three different types of political austerity cycles.

Planning a Politically Timed Boom. In assessing these means and motivations, let us first consider the sequencing of the political business cycle. Recall that the political business cycle logic expects that political strategies for the economy are often crafted several years before the election. Why? Economists have widely documented that the lag between policy decisions and economic outcomes may last as long as nine to eighteen months.²⁵ Tax cuts and spending initiatives are subject to administrative and bureaucratic delays, whereas interest rate cuts take time to feed through different channels of the economy. Investment decisions, price setting, and wage contracts are typically fairly sticky.

Therefore, chief executives have strong political motivation to lay the foundations of their economic plans several years before elections. For example, evidence from the Nixon tapes – available from the National Archives – shows that during the first year of his presidential term, Richard M. Nixon had already pressured the Federal Reserve to fire up the printing presses and expand the money supply in October 1969. Shortly after the nomination of Federal

²⁵ Long and variable lags associated with macroeconomic policy are well documented by both economists and political scientists. A lag arises when monetary policy does not immediately affect income, employment, and prices (Friedman 1970; see also Bernhard, Broz, and Clark 2002). On average, economists have found that monetary policy changes affect national income with a six- to nine-month lag and prices with a twelve- to eighteen-month lag (Friedman 1970).

Reserve Board Chairman Arthur Burns, Nixon brazenly referred to “the myth of the autonomous Fed,” telling his Federal Reserve Chairman, “I’m counting on you Arthur to keep us out of recession.”²⁶ In line with Nixon’s expectations, Chairman Burns lowered the key monetary policy target at the time – the discount rate – by 1.5 percentage points in the two years before the 1972 presidential reelection campaign.

Similarly, in my interview with Venezuelan Presidential Secretary Carmelo Lauría, the key advisor to President Jaime Lusinchi boasts that they drafted the blueprint for a political business cycle from day 1. They would carry out a much-needed fiscal retrenchment during their early years, in hopes of surfing an economic upturn in the two years before the 1988 elections.²⁷ Notably, they ultimately used fresh proceeds from their bank creditors to craft a textbook political business cycle.²⁸

Market Indebtedness Roils Political Plans. Even the best laid political plans are dependent on a government’s financial means, or its fiscal space to fund new electoral spending. In debt-burdened countries, the structure of creditor-debtor relations often influences the government’s capacity to stimulate the economy. A classic electoral engineering of the economy á la Nixon and Lusinchi is most likely when global bond markets account for a relatively low share of government’s external debt financing. Tapping alternative external financing resources, including bank lending and bilateral/multilateral aid, allows governments to avoid subjecting their policy decisions to bond market scrutiny. Moreover, governments also become less vulnerable to credit disruptions when they have access to considerable revenues from non-market sources, such as commodity income and central bank credit.

In other words, if we presume that presidents are motivated by the classic electoral calculus – providing growth and jobs to voters – and are unhindered by financial market conditionality, they are most likely to be spendthrifts. The combination of low-funding constraints and low-inflation aversion should yield a tried-and-true political strategy for winning votes: the *traditional political business cycle* (upper left quadrant of Table 2.1).

Otherwise, we should observe one of several types of political austerity cycles, characterized by low inflation and low-to-moderate growth. In the first

²⁶ For further information about Nixon’s political influence over Burns, see Tuftes (1978), Abrams (2006), and the Nixon Tapes at the National Archives and Records Administration, College Park, Maryland.

²⁷ Author’s interview with Carmelo Lauría, Caracas, Venezuela, March 5, 2007. Carmelo Lauría was the presidential secretary for Jaime Lusinchi (AD) from 1984 to 1988. He later served as Carlos Andrés Pérez’s Interior Minister following the 1992 coup. An AD party stalwart, Lauría also previously worked as Planning Minister in Pérez’s first cabinet.

²⁸ In the prelude to elections, Venezuela’s fiscal accounts swung from a 4 percent of GDP budget surplus during 1985–1986 to a 7 percent budget deficit during 1987–1988.

kind of political austerity cycle, politicians maintain the impulse to prime the economic pump. However, when the structure of sovereign debt is comprised mostly of global bond issues rather than international bank lending, market indebtedness acts as an important constraint on political behavior. Although access to international bond markets initially expands economic possibilities, a heavy reliance on bond markets often creates serious vulnerabilities. Major credit disruptions can quickly raise the financial cost of expansionary policies and suddenly foil the best laid political plans in the years, or even months, before new elections. Moreover, elections themselves are often an important source of market unrest; capital flight triggered by political uncertainty can further complicate efforts to fund election-year deficits with global finance.

Fearing capital exit, stimulus-minded politicians strike a macroeconomic compromise, often pursuing neutral (or even contractionary) economic policies that result in a *market-induced austerity cycle*. Indeed, politicians foster a low-inflation environment in hopes of assuaging investor concerns about politically induced debt disruptions, but continue to target moderate levels of growth and job creation (lower left quadrant of Table 2.1). Depending on the severity of the credit shock, however, achieving these growth targets may prove to be quite difficult.

Signaling Macroeconomic Competence. Conversely, chief executives in developing countries may have a different set of political motivations. Rather than preemptively planning an economic boom in the years preceding a national election, they instead opt for a neutral mix of economic policies that yield an *inflation-averse austerity cycle* (upper right quadrant of Table 2.1). These policies are designed to tame the inflationary beast, yet still provide for moderate growth and job creation. Similar to the political business cycle, these economic plans are typically drafted years before an election in light of the lag between economic policy choices and outcomes.

For instance, in the prelude to Chile's 1999 elections, President Eduardo Frei told his budget director, Joaquín Vial, that he was not willing to have "one iota of additional inflation." During budget talks in the summer of 1998, nearly a year-and-a-half before presidential elections, Frei told Vial that he wanted a balanced budget. In Vial's words, politicians like Frei who "had the memories of runaway inflations and massive budget deficits, they know they cannot fool around with economics. They were not willing to take risks with inflation."²⁹

In line with this view, I argue that politicians, who arrive in office after devastating inflationary crises, swapped electorally timed fiscal and monetary expansions for balanced budgets and inflation-targeting. Politicians concluded that price stabilization policies could be more effective at signaling their competence in managing the economy than vigorous growth strategies.

²⁹ Author's interview with Joaquín Vial, April 23, 2007.

The extent of the political austerity cycle, however, is conditional on a government's financial means. When governments have ample external financing resources (such as bank lending and multilateral/bilateral aid) or windfall domestic revenues (from commodity income and privatization proceeds) that are independent from global financial markets, they are less vulnerable to market downturns and credit crunches. They can deliver price stability without risking severe deflation. However, when inflation-averse governments possess heavy debt market burdens, an initial effort to control inflation can quickly become a serious drag on the economy. Unexpected credit shocks can catapult interest rates higher, raising the cost of capital for governments and firms. Economic growth often slows considerably more during election years than politicians had initially planned, producing the most severe form of austerity politics (lower right quadrant of Table 2.1). Miserly politicians relentlessly pursue low inflation; first aimed at placating a perceived inflation-sensitive electorate and then their flighty global creditors.

In the following section, I first outline the causal logic of political austerity theory, showing when I expect economics to constrain political choices in developing countries. I then examine when domestic political decisions instead shape economic outcomes. For both of these relationships, I outline how shifts in financial means and political motivations alter not only political behavior generally, but also election-year politics, yielding a political austerity cycle rather than a political business cycle.

2.3. IT'S A WONDERFUL MARKET: THE POLITICS OF BOND FINANCE

In the holiday classic, *It's a Wonderful Life*, Peter Bailey, the manager of *Bailey Building & Loan*, takes a long-term view of his borrowers. When Peter extends a loan to the taxi driver Ernie Bishop to build a house, he does not anticipate an immediate return. Rather, he expects to receive principal and interest payments over the course of many years as Ernie Bishop steadily expands his income. Indeed, *Bailey Building & Loan's* profitability depends on the livelihood of Bishop and other small businessmen and citizens of Bedford Falls.

The same logic holds for international banks that invest in a country's economic growth and development: loan portfolios are built for the long-term horizon. Reminiscent of Peter Bailey, international commercial banks have a vested interest in debtors' economic viability. During hard economic times, this shared financial fate encourages new bank lending. Hoping to forestall a severe profitability shock and protect their future business, bankers extend new funds to beleaguered borrowers. However, the perpetual promise of new funds dampens belt-tightening incentives, creating a moral hazard problem.³⁰

³⁰ See footnote 34 in Chapter 1.

Rather than cutting back on household spending, for example, Ernie Bishop might funnel funds to more pressing needs, such as a new taxicab battery or a visit to the family doctor. Similarly, armed with fresh bank loans, sovereign borrowers may choose to spend on politically popular education and health care benefits instead of debt repayment.

When banks become heavily saddled with these bad loans, they too might teeter on the brink of insolvency. Not surprisingly, they eventually search for an exit strategy from this difficult-to-dissolve lending relationship. The cantankerous but thrifty majority shareholder, Mr. Henry F. Potter, for instance, wanted to dissolve the foundering *Bailey Building & Loan* and liquidate its assets.

In the wake of the 1980s' debt crisis, the structure of global finance experienced a transformation worthy of an alternative ending to the holiday classic, where a disenchanted George Bailey opts to follow the path of Potter rather than his father Peter. Initially, heavily exposed commercial banks engaged in Peter Bailey-style lending, offering billions of dollars in fresh funds to debt-ridden developing countries notwithstanding their credit difficulties. By the end of the 1980s, however, many senior global bank executives echoed Henry F. Potter's miserly worldview. Swimming in a wreckage of outstanding developing country debt obligations, they hoped to cut their financial losses before drowning in a sea of red. For example, Jack Clark, Citibank's senior officer for developing country debt, lamented about debtor government's tendencies to ignore conditionality embedded in the loan agreements:

We provided capital for ten years, and they didn't even have to think about turning to their domestic resources to get the very best of them . . . they've really got to think seriously about how to bring in foreign investment, attract capital, and mobilize effectively the resources they have; and they aren't doing it!³¹

Following a decade of earnings losses on their Latin American portfolios, the U.S. government and global banking institutions finally advocated a market solution to the debt problem under the banner of the Brady bond restructurings: replacing defaulted bank loans with short-term bond issuance (Figure 2.2). What was the effect of this shift in the method of government financing? International capital, behaving more like Potters than Baileys, demanded an immediate return on its capital. As a result, the global bond market became the enforcement mechanism for the conditionality that was regularly breached under the bank lending system. In Chapter 5, I extend this discussion about the historical importance of the transformation of Latin American debt. In the next section, I advance a new theoretical framework that explains how this structural shift in government debt composition diluted political control of the economy in developing countries.

³¹ Frieden 1987.

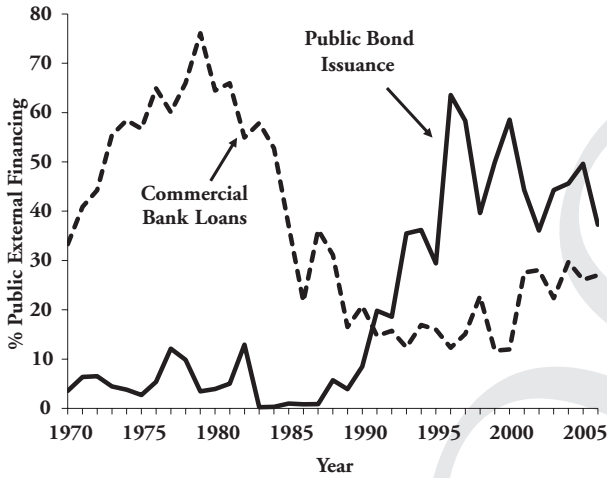


FIGURE 2.2. Bond Issuance Supplants Bank Lending (Sixteen Latin American Countries, Aggregate).

Source: Global Development Finance

2.3.1. Structure of Lending and Creditor-Debtor Relations

International creditors of all shapes and sizes have fairly similar preferences. They want borrowers to repay their debts; therefore, they endorse restrictive economic policies that ensure steady remuneration. If this is the case, why are bondholders more successful than bankers at imposing their austerity demands? Employing a counterintuitive collective action logic, I argue that bondholders operate in a strategic environment that yields a stronger disciplining effect on borrowers.

Informed by Mancur Olson's seminal group theory, we know that members in a small group often prefer to pay for some portion of a collective good than survive without it.³² In the world of finance, we can think of a country's solvency as a collective good for creditors. When a government's balance sheet is in good health, steady debt repayments benefit all creditors, no matter their size or stake in a borrower's financial affairs. That said, when a borrower encounters financial difficulties, only those creditors with the largest financial stake in the borrower's solvency are likely to commit new funds. Which creditors are most likely to provide this financial backstop? Bondholders, with dispersed ownership and small stakes in the debtor's financial future, are most likely to cut their financial ties. By contrast, I argue that centralized bankers are more apt to overcome their coordination problem and extend new funds to the sovereign borrower. Ironically, however, overcoming the collective action problem leaves bankers with less leverage over debtor government policies than bond markets.

³² Olson 1965.

Centralized Creditors and Sovereign Borrowers. What explains this surprising trend? Commercial bank lending is characterized by a small and centralized pool of creditors. As members of a small group, their size offers them a collective action advantage. They can use this advantage coercively, starving borrowers from future lending until they are repaid. Alternatively, creditors can help borrowers evade default by offering new financing, a phenomenon known as “defensive lending.”

Why would creditors extend new fund injections, rather than cut financing completely? Why is borrower solvency a collective good? There is a timeless adage that epitomizes the banker’s dilemma.

The old saying holds. Owe your banker one thousand pounds and you are at his mercy; owe him 1 million pounds and the position is reversed.

– John Maynard Keynes

Aiming to recover their money over the long term, creditors often act counterintuitively in the short term. Small creditor groups typically have highly concentrated exposures to their debtors. As a result, the return of their money is directly linked to debtors’ financial health. If they were to cut financing fully, it would only accelerate debtors’ road to default and eliminate any hope of recovering their investment. By keeping borrowers afloat, creditors are safeguarding their own balance sheets from a severe profitability shock. Therefore, creditors not only lend defensively, but they also often absorb substantial costs along the way, including rescheduling old debts.

Why not take a free ride? Why not refuse to extend new loans to beleaguered borrowers, but enjoy the benefits of other banks’ efforts to stave off sovereign bankruptcies? The cost of widespread defection is too high. If all lenders cut their credit lines, they would risk a massive default, a fatal blow to their balance sheets, and a mutually assured destruction to the entire banking consortium.

In the world of global finance, there are numerous examples of small creditor groups injecting new money into their debtors. A small commercial bank cadre with high loan exposure to development country governments renewed their lending throughout the 1980s debt crisis. Similarly, local banks were reluctant to unwind their exposure to Japanese *kereitsu* and Korean *chaebols* during the 1997–98 East Asian crisis, and the U.S. government repeatedly sunk cash into salvaging General Motors in the wake of the 2008 global financial crisis.

In exchange for new funding, creditors often require that borrowers curtail their balance sheet growth to improve their chances of debt repayment. Despite calls for conditionality, however, small creditor groups often suffer from a moral hazard problem. Their large stake in borrowers’ solvency – along with the promise of new funds – undermines their capital exit threat and ultimately borrowers’ compliance (Figure 2.3).

For example, during the heyday of global bank lending to developing countries in the 1970s and 1980s, bank steering committees were organized to

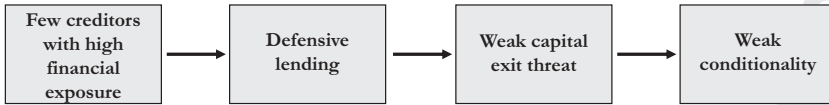


FIGURE 2.3. Creditor Relations under Centralized Commercial Bank Lending.

negotiate with borrowers. In addition to four to five major banks, bank steering committees typically included the International Monetary Fund (IMF), which often offered temporary financial assistance. In return for new loans, countries were expected to follow certain conditions and sacrifice some policy sovereignty. IMF conditionality required a commitment to *laissez-faire* economic policies – including fiscal austerity and tight monetary policy – that increased the likelihood of debt repayment.³³

Notwithstanding these calls for economic adjustment, government borrowers frequently missed their conditionality targets and waived out of banker and IMF-supported programs.³⁴ Ironically, IMF agreements alone were not a sufficient condition to ensure conservative, market-friendly behavior. The high creditor concentration characteristic of global bank lending allowed governments to retain control over their economic decisions.

Decentralized Creditors and Sovereign Borrowers. By contrast, political austerity theory argues that bond markets are plagued by collective action failures, which I claim allows bondholders to more bluntly impose their austerity demands on sovereign governments. Typically, collective action failures should impede societal groups from pressuring governments. Ironically, in this case, the coordination problem increases creditors' influence over debtor governments. Why?

In a world of decentralized finance, collective action failures are quite common because of the ownership dispersion that is characteristic of bond markets. Investors are numerous, anonymous, and scattered internationally. When credit is channeled across such a large pool of financiers, creditors not only reduce their exposure to borrowers, but also their stake in their financial futures. They hold too paltry a share of governments debt exposure to warrant incurring the costs of securing the collective good of borrower solvency. Creditors do not want to provide new funds, or participate in costly, lengthy restructuring negotiations. These predictions are in line with collective action theory,

³³ Vreeland 2003.

³⁴ Haggard (1985) finds extremely low rates of compliance with the IMF's Extended Fund Facility (EFF) from 1974–1984. Of the thirty cases studied, sixteen were cancelled and eight more were never implemented. Compliance with fiscal targets was especially poor. In a study of IMF conditionality programs, Edwards (1989) finds that conditions on the government's deficit were met in only 30 and 19 percent of programs in 1983 and 1984.

which claims that large, heterogeneous groups often experience coordination failures.³⁵

Unlike centralized bankers who must lend defensively to avoid a devastating blow to their balance sheets, bondholders can cut their financial ties to borrowers without incurring a severe profitability shock. Rather, they can sell their bonds for marginal losses in secondary markets.

What might prompt bondholders to sell their assets? Wary bondholders want assurances about governments' credit standing; they hope politicians adhere to conditionality pledges of fiscal discipline and low inflation that raise the likelihood of debt repayment. According to Mosley's (2000) mutual fund manager survey, for example, investors rate a stable inflation environment, budget discipline, and debt service capacity as having the greatest effect on their asset allocation.³⁶

When governments veer from economic discipline, these actions can create stiff political repercussions for governments known as "sudden stops." When borrowing from decentralized debt markets, governments that rely on bond markets for their funding needs are susceptible to severe reversals of international capital inflows.

According to the economics literature on sudden stops, such capital reversals are often most severe for highly indebted emerging market borrowers.³⁷ As witnessed by the financial crises in Mexico (1994–1995), Russia (1998), East Asia (1998–1999), and Argentina (2001–2002), investors can literally halt financial flows overnight by dumping their bonds.

How do these capital reversals translate to tighter macroeconomic constraints? The depressed demand for government bonds creates a higher sovereign risk premium in secondary bond markets that reflect investors' expectations about higher deficits and inflation.³⁸ Not only do higher interest rates pose a direct threat to government spending possibilities through larger interest payments, but also to the real economy by dampening consumption and investment.³⁹ They also risk inciting a vicious cycle of financial outflows, budget shortfalls, and credit downgrades.

Without access to global capital markets, policy makers cannot spend to offset the downturn. Unlike developed countries that have the capacity to stimulate their economies to protect jobs, even when faced with large-scale capital flight, cash-starved developing countries rarely have the same flexibility.⁴⁰ With

³⁵ Group members, with low personal stakes in the collective good, often prefer to survive without the collective good than pay their share (Olson 1965).

³⁶ Mosley 2003.

³⁷ Calvo 1998; Calvo and Reinhart 2000; Calvo, Izquierdo, and Talvi 2003; Kaminsky, Reinhart, and Vegh 2004.

³⁸ Mosley 2003; Reinhart et al. 2003; Ahlquist 2006.

³⁹ See footnote 37.

⁴⁰ Gavin and Perotti 1996; Calvo 1998; Obstfeld 1998; Calvo and Reinhart 2000; Mosley 2003; Kaminsky, Reinhart, and Vegh 2004; Obstfeld and Taylor 2005; Wibbels 2006; Edwards 2007.

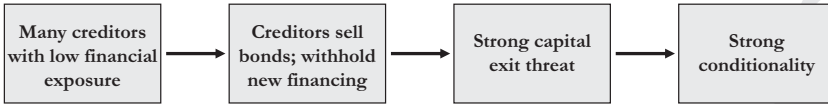


FIGURE 2.4. Creditor Relations under Decentralized Bond Financing.

few alternative domestic funding sources, they are deeply dependent on global financial markets, leaving them at investors' mercy.

In light of these severe costs, decentralized bond markets often act as an enforcement mechanism for conditionality agreements (Figure 2.4). Perhaps, the former Governor of the Central Bank of Argentina, Javier González-Fraga, put it most succinctly jesting that “markets can give you cancer and cost you your life.”⁴¹ Hoping to reduce their risk of illness, debt-dependent governments often create a low inflation “market-friendly” environment, even when it detracts from their domestic political agendas.

What Triggers the Market Disciplining Mechanism? When does conditionality gain its teeth? Does issuing an international bond immediately subject governments to these financial pressures? With bond market membership, do countries simply become hostages to the market, living and dying with booms and bust in global liquidity? Alternatively, under what conditions might markets give governments more latitude?

I argue that the market disciplining mechanism does not work instantaneously. Rather, it is a consequence of developing a high dependence on global bond markets for government financing. At low levels of financial market dependence, debt-fueled booms often occur. For example, many countries throughout Latin America initially tapped international markets to finance more government spending in the wake of the 1980s' debt crisis. Beyond Latin America's borders, Greece borrowed for years from global bond markets – boosted by its 2001 euro membership – before eventually encountering funding difficulties.

By comparison, countries are headed for trouble when they become too indebted to global financial markets. Notwithstanding ebbs and flows in global credit, countries are judged by bond investors based on their ability to make debt payments. As bonds account for a greater share of a government's financing needs, the global investment community centers its microscope on government decisions, fretting that rising debt burdens might complicate timely repayments. Countries become more vulnerable to credit shocks, whether they are instigated by external factors (such as global credit downturns) or internal factors (such as domestic economic difficulties).

Conversely, countries that have a low exposure to global bond markets are less vulnerable to changes in global liquidity. They represent a relatively safe

⁴¹ Author's interview with Javier González-Fraga, Buenos Aires, August 16, 2006.

destination for dedicated emerging market bond portfolios that have to invest their resources in sovereign assets. For example, Chile – a country with little exposure to global capital markets – issued US\$2.4 billion of new global bonds between 2001 and 2002 despite tight global credit conditions following the September 11 terrorist attacks and neighboring Argentina’s debt crisis.⁴²

The Strength of Market Conditionality. Does the market mechanism ever fail to enforce conditionality? For instance, what if a group of bondholders account for a considerable amount of a sovereign borrower’s outstanding debt? Like bankers, do they act in the interest of the borrower? Might they forgive some debt in hopes of recovering part of their larger investment?

Let us consider Argentina’s 2001 debt default, the most acute form of capital exit. The dispersed ownership structure left bond investors with little stake in Argentina’s solvency. Their refusal to extend new credit impeded the country from financing not only its outstanding debt payments but also its expenditures. The government’s funding difficulties were the catalyst for its austere response to the 2001 crisis and eventually the government’s default.

In the aftermath of Argentina’s default, a group of creditors representing 24 percent of the original bondholders refused to agree to the terms of Argentina’s 2005 debt exchange. Given that these creditors held US\$20 billion, or nearly a quarter of Argentina’s defaulted debt, why did these “holdouts” opt for litigation? If political austerity theory is correct, shouldn’t they lend defensively? Why did they instead obtain court orders banning Argentina from raising funds in international markets?

Notwithstanding the involvement of some peak bondholder associations, I contend that the dispersion of ownership of these “holdouts” across countries and industries was too vast to muster an effective collective action campaign. They spanned the globe in all shapes and sizes, from hundreds of thousands of Japanese, Italian, and German retail bond investors to dozens of foreign corporates and further smatterings of global mutual fund managers, investment banks, and hedge funds. With nearly 100 different lawsuits across both sovereign and international jurisdictions (including the World Bank), litigation strategies differed from improving the terms of the bond exchange to a full recovery of assets.⁴³ Unlike cross-border bank lending, the financial stake of any individual bondholder’s debt was too low to warrant acting in the interest of the sovereign borrower.⁴⁴

⁴² World Bank’s Global Development Finance (GDF) Database.

⁴³ For further details, see the IMF 2005 Argentina Article IV Consultation and the Congressional Research Service’s 2010 report, titled “Argentina’s Defaulted Sovereign Debt: Dealing with the Holdouts.”

⁴⁴ Notably, in order to address this collective action problem with minority holdouts, the new bonds issued during Argentina’s 2005 debt exchange include collective action clauses (CAC) that allow a super-majority of holders to overrule holdouts and alter the financial terms of the contract in any future restructuring.

Therefore, creditor defection in the Argentine 2001 case is straightforwardly in line with my theoretical expectations. Ownership dispersion created a coordination problem that left Argentina authorities without international financing, and thus without any options beyond austerity. Alfonso Prat-Gay, Argentina's Central Bank Governor in the wake of the 2001–2002 crisis, recounts this quandary highlighting that “there was no room to maneuver on the fiscal side; the only option was a tighter fiscal stance . . . There was little fire power!”⁴⁵

In response to these constraints, the Néstor and Cristina Kirchner governments covered their budgetary shortfalls with Venezuelan bilateral financing, the development of local bond markets, and new commodity proceeds.⁴⁶ More recently, however, when strapped for cash, Cristina Kirchner reopened global creditor talks in 2010 and reached a settlement with two-thirds of the initial “holdouts.” Nevertheless, without any collective-action clauses that force full creditor participation, the remaining “holdouts” threaten to disrupt the government's eventual return to international capital markets.⁴⁷ With external funding in short supply, Cristina Kirchner has labeled the creditor ban on government financing as “the most severe restriction on the Argentine economy in recent decades.”⁴⁸

In summary, the nature of bond markets is different from bank lending. Both types of creditors hope to recover their investments. However, a long-term view is built into a bank loan portfolio, whether its composition is international or domestic. For example, when a local bank extends a loan financing the expansion of a grocery store, it awaits repayment over the course of years as the store expands its business and revenues. In the short term, it is difficult to recall the loan. Until the store is profitable, the owner is unlikely to have sufficient funds to repay both the principal and interest. Indeed, the financial interests of lenders and borrowers are intertwined.

The same logic holds for international banks that invest in a country's economic growth and development; it's a long-term horizon that allows debtors to have flexibility. By contrast, when credit is channeled through bonds rather than banks, short-term claims are inherently dispersed across a pool of global creditors that can immediately withdraw their financial commitment to borrowers. This capital exit threat narrows the policy space that debtors have to veer from “investor-friendly” balanced budgets and low inflation policies.

⁴⁵ Author's interview with Alfonso Prat-Gay, Buenos Aires, May 24, 2007. Prat-Gay was central bank governor for both Presidents Duhalde and Kirchner from 2002–2004.

⁴⁶ Argentina sold bonds worth US\$7.6 billion bilaterally to Venezuela, and US\$8.5 billion in the local currency market.

⁴⁷ These remaining creditor “holdouts” amount to 8 percent of the original bondholders, and hence, are not subject to the new 2005 collective action clauses that legally bind minority creditors to negotiated restructurings.

⁴⁸ *BBC News*, June 24, 2010.

2.3.2. Elections and Decentralized Finance

Decentralized global finance may generally be restraining, but why would politicians choose austerity during elections? Why not instead stimulate the economy before elections and deal with the market fallout later? In this section, I develop the theory's predictions about sovereign debt and elections. I claim that electoral uncertainty intensifies the disciplining effect of decentralized bond markets, making political austerity cycles more likely than political business cycles. Why? Politicians, who fund their debt in a decentralized system, must operate in a world laden with short-term incentives and high uncertainty.

Ironically, short-term political agendas are displaced by bondholder's own myopia. Portfolio bond investors do not hesitate to liquidate their exposure, given their low personal stake in borrower solvency. In fact, their livelihood often depends on minimizing even the most minor losses from bad investments. They are driven by the short-term competition of attracting new clients within the investment management industry. Given that clients evaluate fund managers on their relative quarterly and annual returns, they do not want to hold deteriorating assets that cause them to underperform industry-wide benchmarks.⁴⁹ Rather, they are likely to "cut and run" should governments struggle to refinance their obligations.⁵⁰

Bond investors are also a conservative lot that dislike uncertainty, particularly any events that threaten to impair asset values. Not surprisingly, elections in politically less predictable environments raise many concerns. Even if developing country elections do not produce a change in political leadership, investors often fret that they might yield a new set of economic priorities.⁵¹ For example, Mosley's (2000) international fund manager survey reveals upcoming elections are among the five most important factors affecting asset allocation in emerging market countries. Other scholars have also found that speculative behavior increases during election periods.⁵² In fact, developing countries typically face a higher cost of capital during election years, when both credit rating downgrades and higher bond premiums are considerably more likely.⁵³

How do politicians respond to these mercurial markets? They face a political conundrum. If they ignore these market pressures and engineer a preelection boom, they risk precipitating capital flight, a spike in their sovereign risk premium, and a destabilizing shock that undermines the economic vote. On the other hand, convincing bondholders of their good credit standing often entails adopting deflationary rather than inflationary policies.

⁴⁹ Calvo and Mendoza 2000; Mosley 2000.

⁵⁰ Two characteristics of emerging market bond financing often magnify investors' concerns about short-term default risk. First, when governments have foreign-currency debt, their repayments are subject to foreign exchange losses from devaluation/depreciation. Second, many developing countries issue debt with maturities of one year or less, creating a frequent need for refinancing.

⁵¹ Leblang 2002; Mosley 2003.

⁵² Leblang and Bernhard 2000; Frieden and Stein 2001; Leblang 2002; Mosley 2003.

⁵³ Block and Vaaler 2004; Vaaler, Schrage, and Block 2006.

Fearing the economic pain unleashed by a swift capital exit, politicians of debt-ridden countries often signal austerity to investors notwithstanding upcoming elections. Politicians do not necessarily strive for deflation, but it is often the lesser of two evils. By using fiscal discipline to convince bond investors that they are competent economic managers, politicians hope to generate a positive confidence effect that avoids a destabilizing shock that calls their governance into question.

Does this phenomenon suggest that politicians battling for survival are merely price takers in a world of decentralized finance? When might sovereign borrowers have more policy flexibility? In the following pages, I develop my theory's predictions regarding the conditions that yield both the traditional political business cycle and the globalization-spurred political austerity cycle.

High Growth, High Inflation Electoral Cycle (H1). Notwithstanding their relationships with creditors, governing politicians must first see the political benefit of creating an electoral boom. Not only must they believe that high economic growth translates into votes, they should also place a low weight on inflation control (whether they believe inflation is unlikely or that it simply has a low political cost). Should they possess such political will, their financial means ultimately determines their ability to pursue this political strategy.

Political austerity theory contends that when bond finance accounts for a small share of a country's foreign financing, politicians are likely to possess the financial means to create political business cycles. When governments are less reliant on global bond markets, their policy choices are less subject to the scrutiny of international investors and less vulnerable to capital flight.

How do governments ensure such policy autonomy? I argued earlier that new income from international bank lending can empower governments. Do other types of cross-border flows also create more economic options?

Several types of non-market foreign revenue streams – from natural resources to foreign aid – give politicians the fiscal space to spend more on their domestic agendas. Similar to the moral hazard problem that plagues bank lending, governments can spend without strong external checks on their behavior. More importantly, these proceeds – from copper mines and oil rigs to bilateral government credits – help governments avoid developing an overreliance on global capital markets. Recall that bond issuance often initially facilitates government spending, but a growing reliance on bond financing can lead to higher interest rates that crowd out other government expenditures. When governments can tap financing resources that are independent from global financial markets, it mitigates the likelihood of a market-induced credit crunch, leaving greater scope for economic expansions.

Notably, a new branch of the well-known resource curse literature identifies a similar phenomenon in the study of political regimes. High oil rents and non-tax revenues enhance governments' ability to appease citizens, and thereby

increase regime stability.⁵⁴ For example, Dunning (2008) claims that resource rents can underwrite democratic stability by reducing redistributive conflict. In the case of elections, commodity booms allow politicians to devote public funds to electoral initiatives like public works and poverty programs, rather than foreign interest payments. Moreover, with a steady stream of new revenues into government coffers, they spend without being subject to external evaluation by international investors.

In summary, my first governing hypothesis is that politicians are likely to create political business cycles when they have the financial means. This capacity is generally associated with a lower dependence on global bond markets. External financing and windfall revenues from non-market sources – including international bank lending, foreign aid, and commodity income – allow countries to avoid the market surveillance (and funding constraints) that comes with bond indebtedness.

H₁: Traditional Political Business Cycle (PBC). When stimulus-minded politicians face low-funding constraints from global bond markets, they use fiscal and/or monetary policy to boost the economy. Politicians are most likely to create conditions of high growth and low unemployment before elections, but at the cost of inflation and/or recession following elections (upper left quadrant in Table 2.1).

Market-Induced Austerity Cycle (H2). By contrast, when global bond markets account for a large share of a country's financing, the economic – and thus, the political cost – of an electoral expansion is too high, making political austerity more attractive. Why is a nation's debt structure constraining even during a president's most desperate political hour?

Let us assume once again that politicians intend to provide their supporters with economic growth and new jobs. Hoping to improve their reelection chances, they plan for an electorally timed economic boost notwithstanding its potential inflationary cost. However, a high reliance on decentralized bond financing leaves the economy vulnerable to severe credit disruptions that are often exacerbated by electoral uncertainty. Ironically, governments' efforts to create an economic boom to coincide with elections can quickly backfire by unnerving wary investors.

Remember that governments pursuing unsustainable fiscal policies not only risk disrupting debt repayment, but also spurring a higher risk premium in global bond markets. Faced with the prospect of plunging asset prices, herds of portfolio investors – without a long-term financial stake in national affairs – would rather liquidate their bonds for a marginal loss in secondary markets than risk subpar benchmark returns.

Hoping to avoid falling bond prices and spiking interest rates, governments are more apt to exhibit economic discipline during elections. Otherwise, they

⁵⁴ Dunning 2008; Morrison 2009.

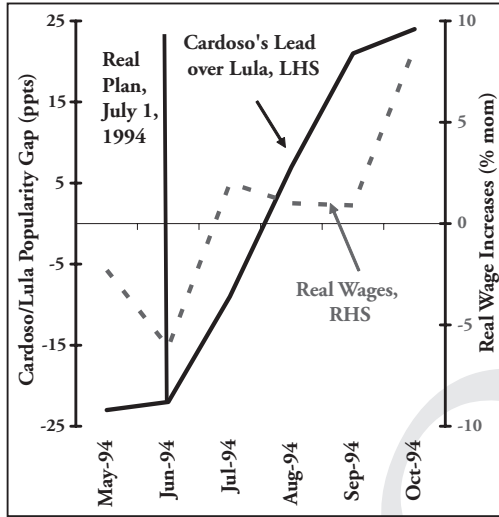


FIGURE 2.5. Political Austerity Boosts Brazilian Incomes and Cardoso's Presidential Candidacy.

Source: Datafolha Opinião Pública and IMF 1997

risk that higher interest rates will translate to other areas of the economy, simultaneously slowing government, business, and consumer spending – or in the worst-case scenario, even precipitating an abrupt income shock that undermines the economic vote. Not surprisingly, the appeal of the high growth-high inflation electoral cycle loses its luster relative to the low inflation political austerity cycle.

Ironically, in countries with a history of economic volatility, providing price stability might even prove more successful at securing the economic vote than electoral expansions. For example, in his 1994 presidential bid, Brazilian Finance Minister Fernando Henrique Cardoso bravely heralded fiscal adjustment under the Real Plan,⁵⁵ a mere three months before elections. Notwithstanding a mid-June popularity deficit of more than 20 percentage points against his contender, “Lula” da Silva of Brazil’s Worker’s Party, inflation stabilization and political austerity helped boost real wages and propel Cardoso to an impressive landslide victory in the October 1994 elections (Figure 2.5).⁵⁶

In summary, my second governing hypothesis is that politicians are unlikely to create political business cycles without having the financial means. Governments with high bond market indebtedness often face steep funding constraints, making electoral expansions both economically and politically expensive. In a globalized world, economic policy decisions are not the sole realm

⁵⁵ On July 1, 1994, Cardoso introduced the Real Plan, which called for a balanced budget, tight monetary policy, and a new stable currency anchored to the U.S. dollar.

⁵⁶ Cardoso won a first-round victory, taking 54.3 percent of the vote, compared to Lula’s 27 percent.

of domestic politicians and central bankers. International investors can place important financial limitations on political behavior. Indeed, the structure of creditor-debtor relations often creates financial market pressures that check traditional political incentives to use macroeconomic policy for electoral gain.

H_2 : Market-Induced Political Austerity Cycle (PAC). When stimulus-minded politicians face steep funding constraints from global bond markets, they do not use accommodative fiscal and monetary policies to boost the economy. Instead, they use a neutral mix of economic policies or even contractionary policies that yield political austerity cycles. Inflation falls before elections, but at the cost of lower economic growth and fewer new jobs (lower left quadrant in Table 2.1).

2.4. ECONOMIC RISK-AVERSION: THE POLITICS OF INFLATION CONTROL

Imagine life under hyperinflation. Before work on Monday morning, you go to Romeo and Cesare's local convenience store to purchase a loaf of bread. After seeing the clerk type its \$5 price tag into the register, you balk. Perhaps, you could buy it more cheaply at the supermarket. You withhold your purchase knowing that you will pass a supermarket during your walk home from work. When you enter the supermarket later that afternoon, you notice that the price of bread has spiked to \$7. Dismayed at the gumption of large retail merchants, you deem this price too lofty for a mere loaf of bread. You vow to instead return to your neighborhood store. When you arrive at Romeo and Cesare's store a speedy thirty minutes later, the price is no longer \$5 – not even \$7 – but rather a shocking \$10. You walk out of the store. You decide to wait until tomorrow. Perhaps with a restful night's sleep, Romeo and Cesare will return to their senses. Amazingly, the sun had only risen once by Tuesday morning, but the bread price rose three times to \$15. A simple mix of butter, flour, water, sugar and yeast tripled in price within twenty-four hours! In a little more than a week, the price shoots yet another ten times higher.⁵⁷

Unfortunately, during their democratic transitions, many developing countries were inflicted by this once rare scenario. From Argentina and Brazil to Bulgaria and Ukraine, citizens learned about the indelible consequences of hyperinflation. An inflationary spiral not only undermines rational economic behavior, but also basic economic order. Intensifying a country's troubles, economic chaos often quickly spirals into political chaos. The price system's rupture inevitably catalyzes political turnover, and in many cases, even spurs a breakdown of political order, catapulting society into a Hobbesian world where protests, rioting, looting, and deaths became commonplace.⁵⁸

⁵⁷ This anecdote is based on conversations with Argentine citizens about the rigors of living with hyperinflation.

⁵⁸ For example, following the May 1989 Argentine elections, the *New York Times* reported that 15 people died in riots and looting touched off by rising prices.

Many developing countries are haunted by severe inflation crises that have dismantled their political and social stability. Learning from these struggles, political leaders and technocratic policy communities have gravitated toward centrist, conservative policies that are unlikely to repeat past crises. Even when income shocks are characterized by much lower inflation rates than hyperinflation, crisis memories are often politically enduring. In fact, there is a fairly broad consensus that levels above 100 percent per annum inflict severe economic harm.⁵⁹ Consequently, these transformative events have changed the political logic in many developing countries.

Austerity politics might be imposed externally during credit shocks or global economic downturns, but it also has domestic roots. Politicians typically retain some discretion over economic choices. Why might they prioritize economic stability and inflation control, even if it means creating less growth and fewer new jobs? In the following pages, I develop the causal argument about the domestic politics of austerity choices.

2.4.1. Economic Decisions in Hard Times

Why would presidents center their economic agenda around such conservative ideas as inflation control? What accounts for this surprising choice? Within Latin America, many scholars have identified a broad emergence of an elite neoliberal consensus in the 1990s,⁶⁰ based on a perceived transformation of the traditional left. A new brand of leftist politicians proactively adopted these market-friendly reforms in some countries,⁶¹ whereas the traditional left either acquiesced or mounted little opposition to neoliberal movements in other countries.⁶² In a region where the government's budget is often key to addressing redistributive pressures; however, why would the left tolerate economic austerity?⁶³

In countries once savaged by inflation, I argue that politicians who experienced severe economic instability are more likely to be risk-averse, and hence, more willing to embrace more conservative, macroeconomic governance. Informed by the psychology literature on risky choices, we know that decisions often reflect both descriptive and experiential information. Both types of information help improve Bayesian reasoning; however, experiential information has a disproportionate influence on people's choices. In other

⁵⁹ Throughout this study, I employ this 100 percent annum threshold as a cutoff for inflation crises (see Chapters 3 and 6 for further details).

⁶⁰ Stokes 2001a; Murillo 2002; Weyland 2002.

⁶¹ Stokes 2001a; Weyland 2002.

⁶² Roberts 1998; Murillo 2001; Levitsky 2003; Bruhn 2004; Murillo and Martinez-Gallardo 2007.

⁶³ Baker (2008) and Baker and Greene (2011) suggest that these actions are a reflection of the region's attitudes, finding that Latin American citizens surprisingly hold centrist economic policy preferences. Similarly, Tomz (2001) finds that the majority of Argentine voters were against debt default in 1999, preferring that the government comply with its international financial commitments. My analysis, by comparison, presents a supply-side explanation for these demand-side phenomena.

words, people place greater weight on personal judgements than secondhand information from newspapers, books, or the Internet.⁶⁴ For example, drivers familiar with a town are likely to ignore the electronic bellows of their GPS computer.

Ironically, when people rely on their own experiences, they tend to often miscalculate the variance of the true population. They underestimate the likelihood of experiencing a personal trauma like an automobile accident. Fascinatingly, however, once people experience a crisis, they overestimate its likelihood, fretting about its recurrence.⁶⁵ For example, teenagers with collision-free histories often possess a sense of invulnerability. Their driving moves are often reminiscent of Bo and Luke Duke. In the wake of an accident, however, invulnerability can quickly transform into trepidation. Teenagers are more likely to heed the lessons of cautious driving if they crash their car than if they watch an after-school television special.

These findings readily translate to the policy world, where I claim that policy-makers craft economic solutions through the lens of their own macroeconomic histories. Politicians are not necessarily the shrewd operators envisioned by standard risk preference models. Instead, they are often restless, passionate people that are motivated by their “animal spirits.” Indeed, economic decision makers do not weigh all experiences and events uniformly. Rather, some historical experiences are more transformative than others, leaving a strong imprint on the worldviews of political and technocratic elites.

Economic crises are often the most salient experiences. Their political, social, and economic trauma typically cast a long shadow over elite decision making. After experiencing severe crises, political and technocratic elites tend to place a high weight on risk-averse policies that promise to avoid repeating past horrors.

The defining historical episode in many new democracies – from Latin America to Eastern Europe – has been hyperinflation. In Chile, for example, politicians have internalized the lessons of President Salvador Allende’s failed policies that ended in an inflationary shock and a 1973 coup. Even Socialists Party officials – who had once labored for President Salvador Allende’s socialist experiment – have embraced economic discipline and low inflation. For example, Senator Sergio Bitar, who served as both Michelle Bachelet’s campaign advisor and as Salvador Allende’s mining minister, today stresses the importance of fiscal discipline to the Concertación’s governing principles.

In order to understand today’s political economy, one has to understand what happened with the Popular Unity government in the 1970s. One of the most important conclusions for the entire Chilean left from this period, was the use of an expansive political economy can have gigantic political costs. Rather, the major electoral and political benefits come from a serious, stable, and responsible political economy. For fifteen years, we have maintained a high level of political discipline, knowing that populism doesn’t pay.⁶⁶

⁶⁴ Weber et al. 1993; Weber et al. 2004; Hertwig et al. 2004.

⁶⁵ Ibid.

⁶⁶ Author’s interview with Senator Sergio Bitar, Santiago, Chile, June 20, 2007. Bitar was President of la Concertación de Partidos Por La Democracia (PPD) on three different occasions:

Beyond developing country frontiers, Germany's technocratic communities have also preserved such governance lessons.⁶⁷ For instance, Hanz Tietmeyer, Germany's central bank president between 1993 and 1999, claims that hyperinflation forever changed national politics.

The inflation of 1923 left a terrible legacy for the future fate of our country... The objective of stable money was and is deeply rooted in our society. It is based on a wide consensus in broad sections of our population. It is based on a culture of stability. That is why German public opinion – particularly in critical periods – again and again proved a loyal ally of a stability-oriented monetary policy.⁶⁸

Historical lessons are not limited to economics. In foreign policy, for instance, scholars have found that historical analogies are often key elements of military and foreign affairs strategies.⁶⁹ For example, many U.S. presidents formulated their post-World War II military interventions, using the historical analogy of Munich appeasement.⁷⁰ In 1950, the Truman administration developed its thinking about the Korean peninsula in response to the failures of the Munich agreement.⁷¹ Designed by Great Britain and France (with the United States opting for neutrality), the 1938 Munich Agreement ceded Czechoslovakia's Sudetenland territory to Germany. Aiming to appease Hitler's territorial demands, the strategy opened the door to an eventual Nazi invasion of Czechoslovakia. Rather than repeat this diplomatic mistake, Truman opted to repel North Korea's incursion into its Southern neighbor's territory. Similarly, in the early 1980s, the Reagan administration anchored its Cold War policy in the Americas to the same historical metaphor. In Nicaragua, Reagan supported the contra rebels' efforts to overthrow the leftist Sandinista government, labeling domestic critics of his policy as "appeasers."⁷²

Returning to the politics of macroeconomic policy making, the relevant historical analogy in Latin America is hyperinflation and the steep political costs of macroeconomic mismanagement. Inflationary trauma that ended in a near-breakdown of the political economic system prompts politicians to place a disproportionate weight on avoiding another inflationary crisis. Even during periods of economic stability, they are more likely to place a greater relative weight on price stability than growth and job creation. This analysis offers new insights from previous work in the rich literature of economic crises and economic policy making. For example, Weyland (2002) contends that the rise of neoliberal policies reflects short-term political risk-seeking during economic

1992–1994, 1997–2000, and 2006. He was also the director of Michelle Bachelet's 2005–2006 presidential election campaign. Bitar was also a senator from Tarapacá between 1994 and 2002.

⁶⁷ Lohmann 1998.

⁶⁸ Tietmeyer 2001.

⁶⁹ Jervis 1976; Khong 1992; Levy 1994.

⁷⁰ Khong 1992.

⁷¹ Truman 1955–1956.

⁷² Khong 1992.

crises. Political leaders who face the threat of severe economic losses choose drastic austerity measures to restore stability and growth. However, Weyland's explanation does not account for the persistence of economic austerity over time.

By contrast, I argue that risk-aversion has fueled a steadfast commitment to macroeconomic orthodoxy, grounded in sound governance that does not chance repeating past problems of inflation and debt accumulation.⁷³ In fact, Chapter 6 finds that inflationary crises tend to increase the professionalization of presidential cabinets.

In the following section, I explore the roots of this inflation sensitivity by examining how this macroeconomic consensus develops among technocratic communities and why politicians would heed their risk-averse advice even years after an inflationary crisis.

2.4.2. Technocratic Communities and Inflation Saliency

How are macroeconomic decisions typically made in developing countries? In regions like Latin America, characterized by a high concentration of executive power, presidential cabinets possess considerable sway over economic choices. In fact, larger-than-life economic ministers like Domingo Cavallo, Alejandro Foxley, and Fernando Henrique Cardoso often gain a powerful voice in their country's economic affairs. How do they amass this power?

Presidents plagued by inflationary spirals appoint economic ministers that promise to contain inflation's political fallout. For instance, Brazilian President Itamar Franco appointed Cardoso to the finance minister post in May 1993, saying, "Hire who you want, and fire who you want. But remember that I need this inflation problem solved." Cardoso knew that his "success as finance minister would be measured by just one thing: whether [he] could beat inflation."⁷⁴ Similarly, facing historically unprecedented inflation, Argentine President Raúl Alfonsín appointed Juan Sourrouille to the Minister of the Economy post to stabilize the economy. Invoking the famous Nike slogan before its time, Alfonsín told Sourrouille "no me diga nada, haga!" (don't tell me anything, just do it!).⁷⁵

Given the economic trauma associated with runaway prices, slaying the inflationary beast brought hefty political rewards – as demonstrated by the political popularity of successful reformers such as Brazil's Fernando Henrique Cardoso and Argentina's Carlos Menem in the 1990s. By contrast, politicians

⁷³ Employing prospect theory, Weyland (2002) claims that politicians' value functions are s-shaped; they temporarily adopt risk-seeking orthodox policies to exit their domain of losses and reboot economic growth. By contrast, I anticipate that economic orthodoxy is a reflection of sustained risk-aversion. In line with the traditional utility functions outlined in the appendix, inflation-scarred politicians place a higher premium on price stability relative to growth and jobs.

⁷⁴ Cardoso 2006.

⁷⁵ Author's interview with Sourrouille, Buenos Aires, May 28, 2007.

who were unable to tame the inflationary beast, such as Raúl Alfonsín, were ousted from office.

Risk-Aversion's Political Rewards. What explains the success and failure of presidents' economic programs in inflation-scarred countries? During their democratic transitions, many governments pursued economic programs that have been collectively dubbed as macroeconomic populism.⁷⁶ Aiming to redistribute income and spur industrial development, they heavily intervened in their economies by running large fiscal deficits. They pursued these unsustainable economic policies during periods when they had little or no access to capital markets. Faced with a dearth of funding sources, political leaders turned to their only other financing source – the printing press.

Governments funded huge budget deficits with central bank financing. They “printed money” by ordering the central bank to expand the money supply. Governments oversaw colossal money supply expansions, causing prices to soar without bounds.⁷⁷ These policies created rampant inflation, and in some cases, generated hyperinflation.⁷⁸ Surging inflation eroded real tax revenues and exacerbated budget shortfalls.⁷⁹ Without external financing, governments responded by printing more money, which fueled even further inflation. Therefore, inflation-afflicted countries entered into a vicious cycle of ballooning deficits, booming money supply growth, and unbridled inflation. This inflationary inertia ultimately fueled a moribund period of surging unemployment and plummeting growth and wages.

Governments adopted several different types of economic programs to end this ruthless spiral, but many proved to be ineffective. For example, under heterodox programs in Argentina, Brazil, and Peru, politicians used price and wage controls to tame inflation, while maintaining expansionary policies.⁸⁰ These policies were ultimately unsustainable, however, and instead prolonged the crisis.

By contrast, those political leaders that governed according to risk-averse, rather than risk-seeking, economic principles successfully navigated inflationary crises. They adopted fiscal discipline and sound monetary policies that lowered inflation and boosted popular incomes (for instance, Figure 2.5 shows how Cardoso's fiscal adjustment raised Brazilian real wages). Orthodox stabilization measures proved to be a much safer political choice than expansionary

⁷⁶ Dornbusch and Edwards 1991.

⁷⁷ Sachs 1989a; Dornbusch and Edwards 1991; Kaufman and Stallings 1991; Cardoso and Helwege 1992; Sachs and Larrain 1993; Mankiw 2003.

⁷⁸ Hyperinflation popularly refers to monthly price increases exceeding 20 percent, though it has been more strictly classified as monthly inflation over 50 percent (Cagan, 1956). Compounded annually, this yields an inflation rate of almost 13,000 percent!

⁷⁹ This phenomenon is known as the Olivera-Tanzi effect. Rising inflation depresses budget revenues and widens the deficit (Mankiw 2003; Sachs and Larrain 1993).

⁸⁰ Remmer 1991; Kiguel and Liviatan 1992.

policies that intensified inflationary problems. Their success in curbing inflation raised the appeal of risk-averse stabilization policies throughout technocratic communities whose countries were plagued by runaway prices.

Resilience of Economic Lessons. What keeps the political memory of hyperinflation alive? What explains the saliency of past economic lessons over time? Why fret about past policy blunders? I have argued that inflation-trauma is politically enduring, often having a disproportionate influence on present policy decisions. In the wake of these crises, presidential advisors increasingly developed a governance consensus oriented toward price stability. Ideas grounded in contemporary macroeconomics that promised to control inflation flourished in tight-knit technocratic communities. By contrast, alternative, heterodox policy solutions that could not check inflation became increasingly marginalized. Such highly interventionist policies were instead typically adopted in countries that never experienced inflationary shocks.

Why would political leaders adopt such conservative policies even years after inflation crises? Why not intervene in the economy to address growing concerns about unemployment and income inequality? Repeating past policy mistakes carries prohibitive political costs. Not only do they create grave income shocks that torpedo popular living standards, they also have electoral repercussions. In fact, scholars have found that inflation volatility can create a retrospective voting pattern. High inflation erodes electoral support, discredits political parties, and triggers presidential job loss.⁸¹ The list of crisis-induced political turnover in developing countries is impressive, including Argentina's Raúl Alfonsín's, Peru's Alan García, Bulgaria's Zhan Videnov, and Ukraine's Leonid Kravchuk.

With these inflationary costs chiseled into their minds, politicians and their technocratic advisors learn from the original policy errors that produced these catastrophic shocks. They avoid unsustainable government deficits and instead adopt sound economic policies that promise low inflation. In the most extreme cases, they adopted rigid institutional frameworks, such as Argentina's currency board, to preserve this anti-inflation consensus.⁸²

These lessons are surprisingly resilient because of the macroeconomic governance consensus that develops in these inner policy circles. Policy makers gravitate toward economic ideas that promise to prevent new bouts of inflation. In a world of Darwin, genes propagate in advantageous environments. Similarly, in the world of economic ideas, policy prescriptions survive and prosper under favorable conditions.

⁸¹ Remmer (1991) finds that high inflation and exchange rate depreciation help explain incumbent vote loss. Stokes (2001) shows that under inflationary conditions candidates favoring growth over inflation stabilization are less likely to be elected.

⁸² Galiani, Heymann, and Tommasi 2003.



FIGURE 2.6. Decision-making with High Inflation Aversion.

The contemporary macroeconomic notion, favoring control of budget deficits as a pathway to low inflation, gained prominence.⁸³ Increasingly, presidents' cabinets became more professionalized, with ministers brandishing advanced graduate degrees in modern economics.⁸⁴ Whether trained in New Keynesian⁸⁵ or monetarist⁸⁶ economics, both schools of thought emphasized prudent budgetary management and price stability.⁸⁷ Politicians sought out ministers with these credentials in hopes of protecting popular incomes. Beyond controlling inflation, they also thought that macroeconomic discipline would yield a secondary political payoff of promoting long-term growth.⁸⁸ Figure 2.6 summarizes the political logic of macroeconomic discipline in countries with a history of high inflation.

For example, in Chile, the center-left coalition that ushered in the return to democracy, known as the Concertación,⁸⁹ sought to erase the longstanding memories of roaring inflation and economic devastation associated with the last democratic episode. They governed for two decades according to the economic principles embodied by CIEPLAN,⁹⁰ the coalition's main economic think-tank. In fact, since Chile's 1990 democratic transition, four out of six of the country's finance ministers have hailed from CIEPLAN. Flagged by the slogan, "crecimiento con equidad" ("growth with equity"), CIEPLAN's agenda strikes a political and economic balance. It aims to redress the social debt of the military dictatorship without jeopardizing sound economic governance and price stability.

Inflation aversion is not limited to Chile's close-knit policy community. In Brazil, Fernando Henrique Cardoso, the finance minister who tamed hyperinflation, later wore Brazil's president sash for eight years. Gustavo Franco, a key

⁸³ See Agenor and Montiel 1999.

⁸⁴ See Chapter 6.

⁸⁵ New Keynesian economics is a school of contemporary macroeconomics that advocates for expansionary fiscal and monetary policies to offset the adverse effects of economic downturns.

⁸⁶ By comparison, monetarists are more skeptical of the benefits of government intervention fretting that it only fuels inflation expectations.

⁸⁷ See footnote 11.

⁸⁸ This technocratic belief is in line with a large body of empirical economic research that finds a salutary long-term effect of fiscal adjustment (Easterly et al. 1994).

⁸⁹ The Concertación, a coalition of center-left parties, governed Chile from 1990–2010 in the wake of its democratic transition. During this period, there were four different administrations that featured two Socialist Party (PS) presidents and two Christian Democratic Party (PDC) presidents.

⁹⁰ The Corporación de Estudios Para Latinoamérica.

member of Cardoso's original ministry advisors, was appointed central bank governor during Cardoso's presidency. Even Cardoso's successor Lula da Silva, the man who had once been his main opponent, upheld Cardoso's economic austerity. In Argentina, José Luis Machinea, Domingo Cavallo, and Roberto Lavagna each served as key members of the economic teams of more than one president, governing with a commitment to budgetary discipline.

Alan García, who returned to the Peruvian presidency sixteen years after a 1990 inflation-spurred ouster, perhaps best illustrates the extent of experiential learning among political elites. After governing through a hyperinflation episode that eroded wages and deepened poverty, García adopted a sound economic policy framework that included fiscal discipline and inflation-targeting during his second presidential life in Peru. To lead his pro-market charge, he appointed Luis Carranza Ugarte, a former banker and one of Peru's most orthodox economists, to the prominent post of Minister of Economy and Finance. He swapped his first-term interventionist policies, once deemed reckless by the International Monetary Fund (IMF), for prudent low-inflation policies that were later praised by the same institution.⁹¹ In a similar pattern to Brazil, García's successor and leftist political rival, Ollanta Humala, also embraced economic austerity. He signaled a commitment to García's low inflation policies by naming his deputy finance minister Louis Miguel Castilla as the Minister of Economy and Finance and leaving Central Bank President Julio Velarde in his post for five more years.

By contrast, when countries lack inflationary scars, cabinet officials favoring aggressive government intervention, such as Venezuelan Finance and Planning Minister Jorge Giordani, are more likely to gain influence in policy circles. Even when reformers happen to take the economic reigns in countries that have never suffered inflationary crises, such about-face policy adjustments are unlikely to be enduring given the lack of elite consensus about macroeconomic policy. For example, Minister of Trade and Industry Moisés Naím helped spearhead Venezuela's early 1990s reforms but lacked this elite consensus and met resistance from both elites and the general public.

I think that the Venezuelan public was inured to arguments about the need to go through a painful experience, or a costly reform process in order to avoid an even costlier stage because Venezuela didn't have that [past inflationary crises]... that was true for the elites too; elites thought that was something that happened to Argentinians but never to us.⁹²

When this elite consensus about economic governance is absent, politicians are more likely to give a low weight to inflation control. In fact, where inflation has never reared its ugly head, competing ideologies favoring aggressive government economic intervention are more likely to challenge the orthodox

⁹¹ *The Economist*, July 27, 2006.

⁹² Author's interview with Moisés Naím, Washington, DC, July 18, 2011.

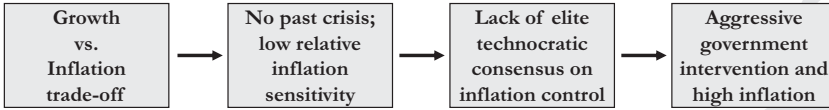


FIGURE 2.7. Decision-making with Low Inflation Aversion.

hegemony. Figure 2.7 outlines the political logic of economic decision making in countries that have never experienced inflation crises.

For example, before the first oil shock in 1973, inflation did not resonate as much of a political issue in the region. Governing in an environment where average inflation fluctuated in a 15 percentage point band around zero (Figure 2.8), the political landscape was lined with a diversity of economic views. In this setting, political elites favoring a structuralist view of the world were more likely to govern the economy believing that government spending was inflation's cure rather than its root.⁹³

In the early 1970s, for example, Chile's Unidad Popular (UP) government viewed inflation as a structural phenomenon that could be corrected with a policy mix of state-led demand stimulus and price controls.⁹⁴ In Peru, high inflation did not surface until the mid-1980s and did not reach crisis proportions until 1989.⁹⁵ Upon assuming power for the first time in 1985, President García's administration questioned the traditional thinking about inflation. The president and his advisors claimed that fiscal deficits and economic expansion were not inflationary. Rather, they were a key part of their redistributive platform aimed at boosting real wages, generating employment, and accelerating growth.⁹⁶ In their economic treatise, *El Peru Heterodox: Un Modelo Económico*, they asserted:

It is necessary to spend, even at the cost of a fiscal deficit, because this deficit transfers public resources to increased consumption of the poorest; they demand more goods, and it will bring about a reduction in unit costs, thus the deficit is not inflationary, on the contrary!⁹⁷

In both Chile and Peru, these structuralist incumbents not only aggressively intervened in their economies, but their ballooning government deficits led to runaway inflation, and ultimately, their political demise. More recently, outside of Latin America's borders, President Leonid Kravchuk followed a similar path

⁹³ Structuralists believed that inflation reflected a demand-side shortage that could be alleviated with heavy government spending. This view sharply contrasts with monetarism, which diagnosed inflation as a supply-side excess that could be cured with balanced budgets (Cardoso and Helwege 1992).

⁹⁴ Larraín and Meller 1991.

⁹⁵ Average annual inflation breached 100 percent for the first time in 1983, but did not reach crisis levels until 1989 when it surged above 3,000 percent (World Bank's World Development Indicators).

⁹⁶ For further details, see Dornbusch and Edwards 1991.

⁹⁷ See Dornbusch and Edwards 1991.

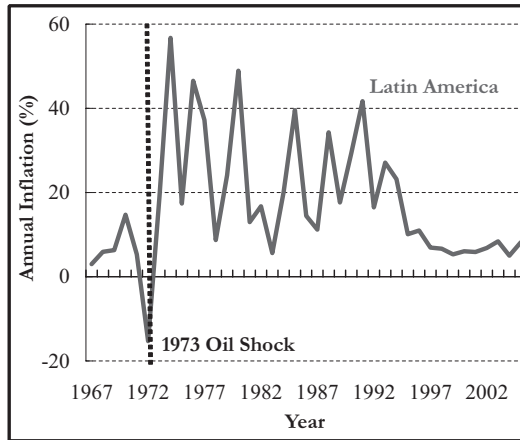


FIGURE 2.8. Latin American Inflation Troubles Begin in Mid-1970s (CPI, annual %).
Source: World Bank

during Ukraine's democratic transition. Kravchuk believed that budget deficits and cheap industrial credit were a panacea for production shortages. Before the 1994 elections, the Ukraine President lavished huge subsidies on key supporters in the agricultural and industrial sectors. Dashing his hopes for an improved economy, however, his budget deficits and credit expansion also unleashed a whopping bout of price inflation.⁹⁸ Ironically, politicians often underweight the likelihood of an inflation crisis, until they experience the economic and political trauma of such severe income shocks.

2.4.3. Inflation Aversion and Elections

I have argued that risk-aversion in the wake of economic crises explains the rise of political austerity. Developing country politicians who like Icarus, once promised to soar their economies to new commanding heights, saw their hopes dashed by inflation's piercing rays. When hyperinflation burned the economy's wax wings, economic and political chaos tore apart the fabric of society. Following these traumatic events, the promise of low inflation and more moderate growth surprisingly carried hefty political rewards.

Notwithstanding these benefits, why would politicians choose austerity during election periods? Why not briefly deviate from economic discipline to aggressively spend on important political constituents? What is the political payoff to low-inflation policies?

Austerity is typically associated with right-leaning parties in developed countries. The political economy literature traditionally divides domestic politics into two camps. Presuming the classic short-run trade-off between inflation and unemployment, it expects right-wing political parties to pursue low inflation

⁹⁸ D'Anieri, Kravchuk, and Kuzio 1999.

(at the cost of jobs and growth) and left-wing parties to prioritize high growth and jobs (at the cost of inflation). The right hopes to appeal to its business and financial constituencies, whereas the left attempts to assuage middle-class and working families' concerns.⁹⁹

But, who are the low-inflation constituencies in developing countries? Is there a similar partisan divide? Alternatively, do such partisan cleavages exist in regions such as Latin America, where party systems are less ideological than in Europe and the United States?¹⁰⁰ In this section, I develop hypotheses for two more types of political austerity cycles, each characterized by inflation-aversion.

Low-Inflation Constituency. During his presidential reelection campaign, Brazilian President Fernando Henrique Cardoso vowed to eradicate inflation in the aftermath of the 1997–98 East Asian Crisis. Notwithstanding his leftist roots, Cardoso declared his commitment to preserving Brazil's U.S. dollar peg¹⁰¹ – the bedrock of Brazilian price stability – in a November 1997 radio address.

You can be sure of one thing; we will not let the real lose value and let inflation come back! We may even have to pay a temporary price for this, but it's better to have higher interest rates for a while than to have salaries lose their value again. The real, and therefore the purchasing power of your salaries, will be protected!¹⁰²

Why would a world-renowned sociologist, dependency theorist, and founding member of Brazil's social democratic party (PSDB) talk about the importance of inflation control during a presidential bid? Is this political logic founded? Why not devote your political rhetoric to job and growth creation?

After experiencing severe inflationary shocks, I argue that orthodox macroeconomic policies that ensure low inflation are popular even years after the initial crisis.¹⁰³ The traditional low inflation constituency widens beyond businesses and financiers, leading to a blurring of partisan lines in economic policy making. If leftist politicians want to win elections, they believe they not only have to prove their governing credentials to a skeptical business community, but also inflation-wary voters.

Inflation politics trumped traditional partisan politics in Latin America. If a neoliberal consensus emerged among political elites,¹⁰⁴ it was because left-leaning elites perceived that they would be punished for rising prices at the

⁹⁹ Bartels 2008.

¹⁰⁰ Roberts and Wibbels 1999.

¹⁰¹ Following the success of the Real Plan in taming inflation, Cardoso's economic team created a crawling peg fixed exchange rate regime designed to allow for a steady, but modest depreciation of the Brazilian real against the U.S. dollar.

¹⁰² *New York Times*, November 5, 1997.

¹⁰³ Many scholars find high levels of initial aggregate support for such orthodox reforms at the time of economic crises (Roberts and Arce 1998; Weyland 1998; Stokes 2001b; Weyland 2002).

¹⁰⁴ Stokes 2001; Murillo 2002; Weyland 2002.

polls. By protecting incomes in countries historically plagued by past economic volatility, they hoped to provide an important baseline for the economic vote. Cardoso, for example, believed that “the poor would not tolerate inflation any longer, and the wealthy were tired of seeing business plans and investments distorted by rising prices.”¹⁰⁵

At first, this logic may appear different from developed country politics, where politicians often boost incomes in hopes of gaining votes. However, in countries that have suffered from severe income shocks, the choice to use economic policy to protect voter incomes is as politically sound as boosting voter incomes.¹⁰⁶ Latin American political elites are similar to anesthesiologists. They are unlikely to be credited for stable economic conditions, but are quickly blamed for failing to administer inflation sedation.

Even years after an inflationary crisis, when other issues (such as crime) might be at the forefront of voters’ minds, politicians still perceive voters as more intrinsically hawkish than in the past. With a commitment to economic discipline preserved in their technocratic communities, they are more likely to prioritize inflation control even if it means sacrificing potentially higher economic growth. As a result, risk-averse elites often infuse policy with an anti-inflationary bias during election periods to avoid catalyzing inflation that calls their governance into question. For example, more than a decade after inflationary crises in Brazil and Peru, historic leftists such as Presidents Lula da Silva and Alan García did not veer from macroeconomic orthodoxy while they were election-year incumbents. Both of them were committed to fiscal discipline and inflation targeting in the final years of their terms.¹⁰⁷ In a second-term public speech, for example, Lula summarized the left’s political approach.

Low inflation is vital . . . obviously, we could be growing more . . . but distributing income and controlling inflation are just as important. Controlled inflation represents an extraordinary gain for salaried workers.¹⁰⁸

Middle Income and Poor Voters. Why would politicians believe that voters do not like inflation? Similar to the provision of jobs or growth, inflation also has distributive consequences. Commonly known as an “inflation tax,” when governments choose to fund their deficits by printing money, they catalyze inflation and erode real wages. Functionally, policy makers are transferring income

¹⁰⁵ Cardoso 2006.

¹⁰⁶ In fact, the politics of exchange rate literature shows that politicians often avoid election-year devaluation to preserve voters’ purchasing power (Frieden and Stein 2001; Schamis and Way 2003). Low inflation offers the same political benefit. The exchange rate is merely one tool that politicians use to protect voters’ incomes; interest rates and balanced budgets also provide them with this political commodity.

¹⁰⁷ Lula oversaw a steady, primary budget surplus of more than 2 percent of GDP in the years leading up to the 2006 election. Similarly, notwithstanding the 2011 election year, García brought public finances back into line with Peru’s fiscal rule (plus or minus 1 percent of GDP) following some temporary drift in response to the global financial crisis (EIU country reports; CEPAL’s Bases de Datos y Publicaciones Estadística).

¹⁰⁸ *Reuters*, June 18, 2007.

away from citizens and to the government. Moreover, economists sometimes dub the inflation tax as the “cruellest tax of all” because inflation hurts the poor relatively more than the rich. Why? Wealthy individuals are generally sophisticated investors that funnel their earnings into financial assets that hedge against inflation. By contrast, the poor typically keep the majority of their earnings in cash holdings that are eroded by inflation. In addition, the poor are often more reliant on state spending, including income transfers and pensions, that are not indexed to inflation.¹⁰⁹

Many empirical studies support the notion that inflation has a distributive character, showing that high inflation increases poverty rates and lowers the incomes of the poor.¹¹⁰ In Latin America, scholars have also found that higher inflation is associated with lower real (inflation-adjusted) wages and higher income inequality.¹¹¹ For example, spiraling inflation during García’s first presidency in Peru caused real wages to decline by more than 60 percent. Real wages also tumbled during Argentina’s and Nicaragua’s battles with hyperinflation, falling by 30 and 90 percent, respectively.¹¹²

Notwithstanding the empirical record, are elite perceptions of Latin American voters correct? In his reflections about the Brazilian presidency, for instance, Fernando Henrique Cardoso claims that “inflation acted like a regressive tax that made poor people poorer.”¹¹³ Alejandro Foxley, former Chilean finance minister, emphasized a similar point in a 1990 national television address, saying, “in countries with high inflation, the workers lose all of the time.”¹¹⁴ But does this political perception reflect voter concerns?

In fact, politicians’ inflation wariness is supported by considerable scholarship showing that middle-class and poor voters fret about inflation. By the 1990s, following severe bouts of inflation across the globe, the poorest voters were ranking inflation as a top national concern in global surveys. Price stability was no longer solely the concern of right-wing constituencies and business elites. Rather, the public, including its poorest citizens, had a vested interest in low and stable inflation.

In a survey conducted by Easterly and Fischer (2000), the poorest citizens in developing countries had a 9 percent higher probability of mentioning inflation as a top national concern than the rich. In its survey of sixteen Latin American countries, the *Latinobarómetro* demonstrates steady baseline support for inflation control between 1995 and 2008 (Figure 2.9). During this period, 25.7 percent of the Latin American adult population believed that fighting inflation was “the most important issue for their country.” The popularity of inflation

¹⁰⁹ Easterly and Fischer 2001.

¹¹⁰ Cutler and Katz, 1991; Agenor 1998; Romer and Romer 1998; Easterly and Fischer 2000.

¹¹¹ Cardoso 1992; Rezende 1998.

¹¹² United Nations’ Economic Commission for Latin America.

¹¹³ Cardoso 2006.

¹¹⁴ Foxley 1993.

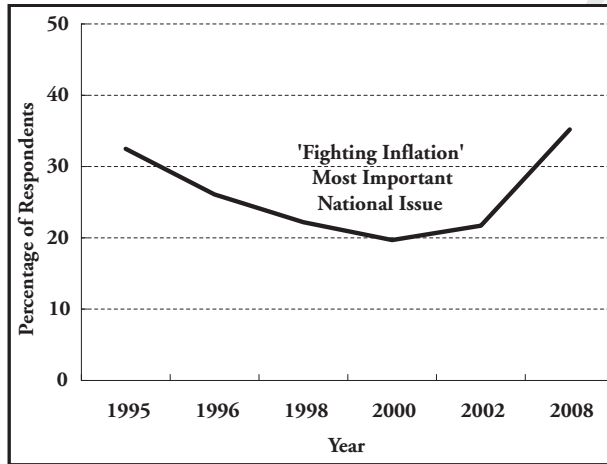


FIGURE 2.9. Support for Fighting Latin American Inflation. (Survey of 16 Latin American Countries, 1995–2008.)

Source: Latinóbarometro

control appears to be robust to framing and question wording effects.¹¹⁵ They are corroborated by a series of World Values Surveys conducted in seven Latin American countries between 1995 and 1997, showing that three-quarters of respondents believed that fighting rising prices was “very important.” By comparison, during the same period, only 40 percent responded affirmatively to the identical question in four developed countries.

In general, these surveys about inflation attitudes are broadly in line with recent findings about Latin American public opinion. Baker (2008), for example, uses public opinion data from eighteen Latin American countries to show that most of the region’s citizens strongly support free-market reforms with the exception of privatization. Similarly, the Latin American Public Opinion Project’s 2008 Americas Barometer finds that Latin Americans rank “inflation and high prices” as one of the five most serious problems facing their countries out of a list of more than thirty-five issues.

Politicians’ inflation aversion is also reflected in country-level evidence about voter attitudes. National public opinion polls and presidential approval ratings show that voters from inflation-scarred countries prioritize price stability. For example, Shiller (1997) conducts an extensive survey about global inflation attitudes, finding that the Brazilian public overwhelmingly dislikes inflation because they believe it erodes their living standards. He finds that 88 percent of Brazilian respondents agreed with the statement that “the control of inflation is one of the most important missions of Brazilian economic policy.” Moreover, a majority of Brazilians would choose low inflation, even if it meant that millions

¹¹⁵ See Sniderman and Theriault 2004; Baker 2008.

more people would be unemployed.¹¹⁶ Similarly in the prelude to Brazil's 1994 elections, national polls showed that 91 percent of respondents rated Brazil's economic situation as "poor or very poor." Most notably, however, these polls showed that more than two-thirds of Brazilians considered economic problems, including inflation, salaries, and cost of living, to be the most important national priorities.¹¹⁷

In Argentina, 67 percent of the people interviewed in a 1990 Buenos Aires survey identified inflation as the most important problem facing them and their families.¹¹⁸ In fact, during Menem's first administration, inflation was inversely correlated with the Argentine president's approval ratings: the lower the inflation rate, the greater Menem's popular appeal.¹¹⁹ Notably, public opinion polls also showed surprisingly high levels of support for Menem's economic austerity. During the 1995 reelection campaign, 43 percent of respondents supported "controlling the public deficit even if it [meant] reducing personnel and social expenditures."¹²⁰ Hyperinflation had bred a societal acceptance of austerity.

By contrast, in countries that have never experienced severe inflationary crises, there is less public support for price stability. For example, a recent 2010 Venezuelan survey finds little evidence of inflation aversion among voters,¹²¹ notwithstanding living with the highest national inflation in Latin America.¹²² A mere 8.6 percent of Venezuelan voters flagged inflation as the most important national issue, compared to 41.8 percent of citizens who named their personal safety/crime as the nation's most pressing concern. The same 2010 survey also found that only 3 percent of respondents named reducing prices/controlling inflation as a national priority when asked, "if you were president, what would be the most important issue to improving the situation of you and your family?"

Given such low levels of inflation aversion, perhaps it's not surprising that Venezuelan public officials place less weight on controlling inflation than reducing unemployment. In fact, Finance and Planning Minister Giordani recently commented when asked about the inflation-unemployment trade-off that "the fundamental variable right now is employment . . . we're concerned about inflation, but we have to make every effort to preserve jobs."¹²³

¹¹⁶ Shiller 1997.

¹¹⁷ CESOP 1994; Weyland 2002.

¹¹⁸ Echegaray and Elordi 2001.

¹¹⁹ Echegaray and Elordi 2001; Stokes 2001a.

¹²⁰ The survey was conducted by Romer and Associates/Roper Center in 1995. Survey participants were asked, "which aspects of the economic model do you agree with, and which do you disagree with?" (Romer and Associates, 1995, as cited in Stokes, 2001a).

¹²¹ A Venezuelan polling company, Consultores 21, surveyed 1,500 voters between May and June 2010, asking them to identify Venezuela's most important national problem.

¹²² In May and June 2010, Venezuela's national consumer price index, on average, rose by 30 percent on an annual basis (Venezuelan Central Bank and National Statistics Institute).

¹²³ El Universal, Caracas, April 2, 2009.

Business Community. Politicians also use sound economic governance and low inflation to convey their managerial credentials to businesses and investors. In contrast to traditional partisan models of the economy that show a political split in policies that favor businesses, politicians from across the political spectrum pander to firms and investors in inflation-ridden countries. This political convergence reflects the enormous power of business and markets.

For example, in a 2003 survey of 231 political elites, 80 percent of respondents said that business exercised “de facto powers” in Latin America. In the words of one former President, “the great de facto power of incipient democracy is private economic power.”¹²⁴ Businesses may influence government in various ways, from business associations, policy networks, and cabinet appointments to lobbying and campaign contributions.¹²⁵ Perhaps in Colombia, private sector influence has been most transparent, with more than half of former President Uribe’s cabinet appointees hailing from the business community.¹²⁶

In countries with histories of inflation volatility, politicians often heed private sector opinions given the business community’s pivotal role in providing investment, and therefore, growth and employment opportunities. If the private sector does not have confidence in a government’s ability to govern the economy, business investment can quickly falter and lead the economy adrift. As a result, left-leaning governments possess a strong incentive to prove their inflation-fighting credentials.

For example, the center-left Concertación in Chile embraced economic orthodoxy in part to demonstrate their managerial competence to a skeptical business community. Edgardo Boeninger, Aylwin’s Presidential Secretary during the democratic transition, summarizes the prevailing view among his economic team.

Convincing the business community of the center-left’s ability to govern was very important. Hence, a main economic goal of the transition was to build the trust of the business community. They were suspicious of the center-left coalition; not unreasonably presuming that it would be more statist/interventionist. The product of this skepticism was that the center-left coalition was determined to demonstrate their governability. This led to a higher degree of controls in economic policy; more prudent policy aimed at assuaging the business and investment community. Fiscal policy was orthodox, with the goal of reducing inflation.¹²⁷

A decade after Chile’s democratic transition, the Concertación continued to cite the importance of the business community’s approval. When Ricardo Lagos prepared for the presidency – the first socialist president since Salvador

¹²⁴ UNDP 2005; Schneider 2010.

¹²⁵ Thacker 2000; Teichman 2001; Schneider 2004; Schneider 2010.

¹²⁶ Schneider 2010.

¹²⁷ Interview with former Chilean Budget Director Edgardo Boeninger, conducted on June 6, 2007. Boeninger was Budget Director under President Eduardo Frei from 1964–1969. He later became Presidential Secretary under President Patricio Alwyn from 1990–1994 and served as a Senator from 1998–2006.

Allende's catastrophic governance – he knew he had to overcome the business community's distrust for the Chilean left.

There was something implicit especially when I became President. 'Look what happened with the last Socialist President. This guy does not know how to run the economy.' We were always under suspicion . . . I didn't have to convince the business community. I had to act! It is not a question of talking. You convince them by what you do!¹²⁸

Beyond Chile, recent leftist presidents from inflation-crisis countries have followed similar courses of action. In Brazil and Peru, for example, presidential candidates have surprisingly promised austerity and inflation control during their election bids notwithstanding their leftist roots.

In an effort to calm jittery investors' concerns about a return of economic populism, Lula shed his anti-globalization image and vowed to continue Cardoso's macroeconomic policies in his *Carta ao Povo Brasileiro (Letter to the Brazilian People)*. With an eye on turbulent financial markets during the first few days of his presidency, he once again pledged that his "government would not neglect the control of inflation and [would] maintain a posture of fiscal responsibility."¹²⁹ In his two terms in office, Lula made good on these orthodoxy promises even during election campaigns, prompting former Brazilian foreign minister Luiz Felipe Lampreia to note that "there is now a national consensus against macroeconomic foolishness."¹³⁰ According to Lula's presidential predecessor, "only Nixon could go to China, and only Lula could show the world that the Latin American left could run a stable modern economy."¹³¹

During his own presidential bid, Peruvian President Ollanta Humala similarly used oaths of orthodoxy to quell private sector concerns. A newly business-clad Humala, who once backed both a 2005 Peruvian military coup and Hugo Chávez's march to socialism, instead portrayed himself as the Peruvian Lula during his 2011 presidential bid.¹³² Reminiscent of Lula's "letter to the Brazilian people," Humala pledged economic stability to the national business community in his "commitment with the Peruvian people." Hoping to abate financial market volatility, he also appointed a Wall-Street friendly economist to the finance minister post. In a national radio address, Humala further emphasized that his administration would take its cues from Brazil's economic success. "We recognize there is a successful process underway in Brazil, which has accomplished economic growth that combines social inclusion with respect for macroeconomic equilibrium."¹³³

¹²⁸ Author's interview with President Lagos, Brown University, April 16, 2010.

¹²⁹ *New York Times*, October 2002.

¹³⁰ *The Economist*, September 30, 2010.

¹³¹ Cardoso 2006.

¹³² For example, he emphasized the importance of private investment to economic development in Peru during a September 15, 2010, discussion at the Elliott School of International Affairs at George Washington University.

¹³³ *BBC News*, April 12, 2011.

Inflation-Averse Austerity Cycle (H3). Before their countries' inflation troubles, politicians were likely to view constituents as straight-forward economic voters.¹³⁴ A political business cycle was a viable political strategy for presidents fearing that they might get punished for the economy's poor performance at the polls. Politicians might craft unsustainable economic expansions to win votes, without much fear of a political backlash against inflation.

After experiencing traumatic inflationary episodes, however, politicians from inflation-ridden countries instead wrestle with a thorny economic paradox. Growth and jobs remain a political priority. Fearing retribution from both inflation-scarred voters and businesses, however, politicians realize they must also be vigilant custodians of price stability.

Under these conditions, the traditional electoral logic loses its luster. Presidents may intervene in the economy, but not so aggressively that they ignite inflation. On the other hand, politicians want to avoid making such a staunch commitment to austerity that they sow the seeds for a deflationary downturn. Seeking a macroeconomic balance between low inflation and moderate growth, politicians pursue a neutral mix of economic policies. Politicians operate according to a straightforward political logic: protecting voters' purchasing power.

In summary, my third governing hypothesis is that politicians are unlikely to create political business cycles without having the political will. I contend that policy elites from countries with past inflation crises alter their political strategies. They believe that voters will evaluate them on their ability to contain inflation as much as their ability to create economic growth. Even if the probability of sparking high inflation is low, politicians shy away from unsustainable government deficits. They do not want to risk rekindling inflation's flame, which, like a wildfire, can quickly spread without bounds. Worried about crossing the threshold of price instability, risk-averse politicians choose cautious macroeconomic policies over highly expansionary policies that jeopardize a return of inflation. By selecting policies that guarantee low inflation, politicians demonstrate to inflation-sensitive markets and electorates that they are capable of governing the economy.

H₃: Inflation-Averse Political Austerity Cycle (PAC). Past inflation crises breeds economic risk-aversion; politicians do not use accommodative fiscal and monetary policies to boost the economy before elections. Instead, they use a neutral mix of economic policies or mildly contractionary policies that yield political austerity cycles. Inflation falls during elections, but at the cost of lower economic growth and fewer new jobs. This pattern is more pronounced under left-leaning than right-leaning administrations (upper right quadrant in Table 2.1).

¹³⁴ Economic voters base their voting decision largely on the government's recent economic performance, "assigning credit or blame to the incumbent government" (see Lewis-Beck 1988; Powell and Whitten 1993; Duch and Stevenson 2004).

Low Growth, Low Inflation Austerity Cycle (H4). When high debt constraints and high inflation aversion are simultaneously present, the likely outcome is a deflationary electoral cycle characterized by slowing inflation and growth. Politicians slash spending and raise interest rates to hold inflation at bay, even if these actions curtail the pace of growth and job creation.

What is the political benefit of this most acute form of political austerity cycles? Obviously, politicians do not plan for such a deflationary electoral spiral. Rather, their hopes of balancing price stability with moderate growth are derailed by an unexpected credit shock. Recall that in countries that are heavily indebted to bond markets, politicians intending to prime the economic pump are vulnerable to credit swings and interest rate shocks that quickly foil plans for an electoral expansion.

Similarly, the extent of the political austerity cycle is conditional on a government's financial means. Inflation-averse politicians have budgetary room to maneuver when they have access to windfall revenues (such as commodity income and privatization proceeds) and non-market borrowing resources (such as bank lending) that reduce their vulnerability to global credit disruptions. They can use a neutral mix of economic policies to target moderate growth and low inflation.

However, when these same politicians are highly reliant on bond market financing, it is more difficult to achieve such economic balance. Governments are susceptible to severe credit shocks, particularly during periods of political uncertainty. Capital withdrawal sparked by electoral uneasiness can quickly launch interest rates higher and increase financing costs for both governments and firms. These "sudden stops" cause economic growth to slow more markedly than politicians planned, and yield the most pronounced type of the political austerity cycle.

H₄: Political Austerity Cycle (PAC). When inflation-averse politicians face steep funding constraints from global financial markets, they strongly contract economic policies in order to stabilize the economy. With this form of political austerity cycle, inflation and growth fall before elections most markedly (lower right quadrant in Table 2.1).

2.5. SUMMARY AND CONCLUSIONS

In this chapter, I have argued that the classical assumption of short-term policy myopia – embedded in the political macroeconomic literature – should be reexamined to account for the complexities of a globalized world. In regions such as Latin America, many politicians have embraced a long-term technocratic view that emphasizes budgetary discipline and inflation control over aggressive government intervention in the economy. Why have politicians come to value a seemingly long-term asset like economic stability? Why would they even more surprisingly choose election periods to demonstrate their commitment to

these austere governance principles? Why not instead aggressively increase the budget deficit in hopes of winning the economic vote?

Political austerity theory offers a dual explanation for this change in political logic. The first part of the theory claims that developing countries' ability to reap the rewards of preelection spending often reflects their capacity to raise external financing. Unlike their developed country counterparts, developing-country governments face significant hurdles to using counter-cyclical,¹³⁵ or expansionary policies to stimulate the economy. Shallow domestic financial markets and narrow tax bases leave many developing countries dependent upon international capital markets for financing budget expenditures.¹³⁶

Beginning in the 1990s, structural changes in the global economy – in this case, the international financial architecture – transformed the relationship between debtor countries and their international creditors. Following the 1980s debt crisis, developing country governments increasingly financed their debt with capital markets rather than cross-border bank lending. This financing shift altered the classic electoral trade-off that pitted jobs and growth against price stability.

Regardless of ideological proclivities, I contend that as these highly indebted governments developed a greater reliance on global bond markets for budget financing, they sacrificed the policy freedom to aggressively target domestic constituents with jobs and growth. This is the financial catch-22 of developing country politics. Governments tapped international markets to increase their spending options, only to subject their budget decisions to financial market discipline. This disciplining effect is often most constraining during elections, when investor uncertainty is high, and governments hope to avoid “sudden stops” of international credit that lead to higher borrowing costs and slower growth.

Notwithstanding a government's debt structure, incumbents may instead voluntarily choose the path of economic orthodoxy. The second part of political austerity theory examines when developing-country governments lack the electoral motivation to induce an economic expansion. Rather than responding to external pressures, this part of the theory contends that the low-inflation impetus is the product of a country's own economic experiences. Grounded in psychological theories of risky choice, it claims that the saliency of past inflationary trauma transforms political thinking in developing countries. Political and technocratic elites learn from the policy errors that produced these catastrophic shocks and develop a macroeconomic consensus against unsustainable government deficits. Moreover, they adopt risk-averse orthodox policies that promise to provide low inflation, an important baseline for the economic vote.

In Chapters 3 to 7, I test my theory, using a multi-method approach involving both statistical and case study evidence. I intend to show that when politicians

¹³⁵ Gavin and Perotti 1997; Kaminsky, Reinhart, and Végh 2004; Lupu 2006; Pinto 2010.

¹³⁶ Kaufman and Stallings 1991; Gavin and Perotti 1997.

operate in a globalized world, they are more likely to prioritize inflation control, even if it means potentially providing their constituents with fewer jobs and slower growth. The statistical analysis in Chapter 3 tests these two mechanisms and finds broad support for the constraining effect of bond finance and crisis history on budgetary and economic outcomes during elections.

Despite this evidence, how do we disentangle the effects of these two explanations, given the importance of both inflationary and debt shocks to the region's credit history? After buoyant credit-driven expansions produced hyperinflation, Latin American governments financed their political agendas with international bond issuance rather than the inflation tax. Not surprisingly, bond creditors initially incorporated this inflation history into their country risk assessments. In fact, the international finance literature claims that baseline borrowing rates often reflect historic economic performance.¹³⁷ That said, it also finds that interest rates account for investors' expectations about more dynamic factors, including current economic, budgetary, and credit conditions.¹³⁸ Consequently, it's plausible that a country's bond market exposure and inflation history might be related to one another, but also affect government policy and the economy through independent channels.

In the book's comparative case study chapters, I assess whether the effects of these two mechanisms are conditioned on each other. Employing elections as my unit of analysis, I examine how variation in debt structure and inflation aversion interact to yield different electoral policy and economic outcomes according to the four hypotheses outlined earlier in the chapter. Exploiting this variation across twenty different elections allows me to evaluate both the independent and interactive effects of the two main explanatory variables of bond market dependence and inflation crisis history.¹³⁹ For example, political business cycles were quite common in Chile's early democratic period before the country's inflationary shocks and bond market entry, but fail to materialize in the post-inflation crisis return to democracy, notwithstanding a lack of bond market indebtedness.

The case study chapters are also instrumental in identifying when politicians develop alternative tools to political business cycles. If politicians are more likely to live within their means today, how do they reward key political constituencies? They have several options. Governments can take a cue from Chile and Brazil and bolster state capacity by introducing new taxes, allowing them to raise social spending within a balanced budget framework. Alternatively, they can signal fiscal responsibility to investors, while increasingly employing discretionary tools – including administrative controls, subsidies, off-balance sheet spending, and clientelistic transfers – to target key domestic supporters. For example, Argentina's Kirchners modified domestic laws to boost

¹³⁷ Obstfeld and Rogoff 1996.

¹³⁸ Mosley 2003; Reinhart and Rogoff 2004.

¹³⁹ See Chapter 4 for the complete case study design.

discretionary spending, implement price controls in the energy and transportation sectors, and redirect central bank foreign reserves toward political initiatives. Ironically, financial globalization may give politicians not only an incentive to reach macroeconomic balance, but also the incentive to develop alternative policy tools subject to less global scrutiny.

2.A. APPENDIX

The literature on the political economy of macroeconomic policy making provides a theoretical structure for economic policy choices. In these models, government preferences are captured through loss functions. The Barro-Gordon loss-function is one of the most commonly employed theoretical models. It shows politicians' relative sensitivity to unemployment and inflation. Their utility varies directly with employment (or growth), yet indirectly with inflation.¹⁴⁰

$$L = a(U_t - kU_t^n)^2 + b(\pi_t)^2$$

where U_t = employment rate; U_t^n = natural rate of unemployment; π_t = inflation rate; a = relative weight of unemployment in the loss function ($a > 0$); b = relative weight of inflation term in loss function ($b > 0$); k = extent of distortions (such as unemployment compensation and income taxation) that make U_t^n exceed the efficient or socially optimal rate ($0 < k < 1$).

This loss function shows how policy makers value full employment and price stability. More specifically, the ratio of its parameters a and b captures the benefit of employment (and growth) relative to the cost of higher inflation. In other words, these parameters indicate policy makers' level of inflation aversion. A government favoring a Keynesian view is likely to tolerate some inflation in exchange for higher growth and lower unemployment. They assign a lower weight to inflation relative to unemployment in their loss functions. By contrast, a government favoring a monetarist approach to policy making does not sanction a government-induced expansion, deeming that it only yields higher inflation. To prevent inflationary pressures, they choose price stability over jobs and growth creation. They assign a higher weight to inflation relative to unemployment in their loss functions.

Building from the intuition of these models, my theory seeks to explain when inflation aversion occurs in developing countries.

¹⁴⁰ The functional form of these loss function varies across the literature, but their main intuition is that policy makers and voters dislike inflation and unemployment, but support economic growth. For a more detailed description of loss functions and macroeconomic policy making, see Barro and Gordon (1983) and Scheve (2004).