# Globalization and Austerity Politics in Latin America

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## Abstract

In an age of financial globalization, are markets and democracy compatible? For some globalization scholars, deepening economic integration represents a setback for democracy. In the race for international capital, governments pursue policies that favor international economic stability over domestic social stability. By contrast, other scholars argue that markets create wealth which helps stabilize democracies. In this paper, I seek to reconcile these differences by offering a new insight that goes beyond the classic globalization debate. I argue that what reduces policy autonomy is not the amount of financial integration, but rather the structure of lending to developing countries. When foreign debt is comprised mostly of international bank loans, creditors cannot muster a credible exit threat, allowing governments to prioritize economic growth and jobs. By contrast, when global bonds account for the majority of a government's external debt, creditors' ownership dispersion creates a more credible exit threat, allowing markets to more crudely impose austerity demands. In developing countries, where political priorities can literally change overnight, capital has proven to be most flighty during election years. In response to these market pressures, politicians have changed the traditional political logic. In contrast to the economic boom-bust cycles predicted by political business cycle theory, I argue that elections are more likely to be deflationary. In my large-N statistical test of 16 Latin American countries (observed between 1961 and 2009), I find that as global bonds comprise a higher share of national debt, politicians become more likely to pursue a political austerity cycle characterized by low inflation and low growth.

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# 1 Introduction

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 US 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 often pursue conservative non-interventionist policies. In hard times, the political benefits of a short-term soporific should outweigh the longer-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 policymaking logic, known as the *political business cycle*. According to this logic, politicians are consumed with wining 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.

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 $7 billion in off-budget discretionary spending to

[1] Ames 1987; Schuknecht 2000; Block 2001; Gonzalez 2002; Brender and Drazen 2005; Shi and Svensson 2006.

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

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

reward his historically marginalized political base.[4] Similarly, Russian president Boris Yeltsin ensured his 1996 re-election with a spending boom that was largely mortgaged by the privatization of Russia's natural resources.[5]

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 re-election bid, Argentina President Carlos Menem surprisingly announced $1 billion in budget cuts, including a reduction in public salaries. Similarly, during his own re-election 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 paper offers a new framework called *political austerity cycle* theory. I claim that the shift to decentralized bond market financing in the 1990s' curtailed politicians' budgetary capacity to spend on their domestic agendas. In constructing this theory, I offer a new insight that goes beyond the classic globalization literature.[6] I argue that what reduces policy autonomy is not the amount of financial integration, but rather the structure of lending to developing countries. When governments' foreign debt is composed primary of international bank loans, a centralized pool of banks (e.g. organized through syndicated loans) cannot muster a credible exit threat to discipline sovereign borrowers who veer from creditor-friendly low-inflation policies. By contrast, when global bond issuance constitutes the majority of external debt, global bond markets' ownership dispersion creates a more credible threat of capital withdrawal, allowing markets to more crudely impose creditor demands for austerity. In

[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] Cameron 1978; Lindblom 1982; Bates and Lien 1985; Frieden, 1991; Kurzer 1993; Goodman and Pauly 1993; Andrews 1994; Cerny 1995; Keohane and Milner 1996; Strange 1996; Rodrik 1997; Pauly 1997; Garrett 1998a; Garrett 1999b; McNamara 1998; Mosley 2000; Swank 2002; Rudra 2002; Mosley 2003; Wibbels and Arce, 2003; Wibbels 2006; Tomz 2007; Pepinsky 2008; Rudra 2008.

other words, government indebtedness to global bond markets limits economic options.

Why does this exit threat have credibility during elections, a time when political survival should dictate the rules of the game? Why have developing country politicians not prioritized the high growth, high inflation cycle that is in line with the expectations of political business cycle theory? Indeed, the political costs of an electoral expansion should appear long after the end of a presidential campaign. Why wouldn't politicians simply stray from the market's calls for economic orthodoxy until after elections?

I argue that when countries develop a high dependence on international debt markets, an incumbent faces an immediate and high-stakes political threat. Short-term political agendas are trumped by bond market investors' own myopia. Financial investors, fixated on short-term default risk, demand that governments choose low-inflation policies that maximize the probability of debt repayment. Otherwise, trigger-happy investors threaten to withdraw their capital and create a fierce financial shock that jeopardizes the foundation of the economic vote: people's purchasing power.

These risks are often more pronounced during election periods, when capital has proven to be most flighty in developing countries.[7] Indeed, bond investors often fret that political uncertainty can breed economic uncertainty. In highly-indebted countries, politicians have a strong incentive to assuage foreign capital with market-friendly economics. A politically-timed expansion can unnerve inflation-wary investors and ignite a currency crisis that undercuts popular living standards. In fact, scholars have found that severe exchange rate depreciation and currency crashes often trigger incumbent job loss.[8] Not surprisingly, in light of these risks, incumbents often tend to avoid election-year devaluations that chance igniting inflation.[9]

Politicians might intrinsically prefer to reflate the economy, but deflation is necessary to avoid a severe economic shock that calls their governance into question. Indeed, those governments that back their monetary and exchange rate policies with official declarations tend to earn greater inflation-fighting credibility.[10] For example, notwithstanding his leftist ideological

[7] Leblang and Bernhard 2000; Frieden and Stein 2001; and Leblang 2002; Mosley 2003; Block and Vaaler 2004; Vaaler, Schrage, and Block 2006.

[8] For example, Remmer (1991) shows that exchange rate depreciation help explain incumbent vote loss; Frankel (2005) finds that the chances of political leaders losing office in the six months following a currency crash is twice as likely as other times.

[9] Frieden and Stein 2001; Schamis and Way 2003.

[10] Guisinger and Singer 2010.

roots,[11] Brazilian President Fernando Henrique Cardoso declared his commitment to preserving Brazil's US dollar peg–the bedrock of Brazilian price stability–in a November 1997 radio address during his re-election campaign.

> "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!"[12]

These theoretical claims mark a notable departure from political business cycle theories that assert an electoral inflationary bias.[13] In fact, my large N-test of 16 Latin American countries, observed between 1961 and 2009 shows that, after the 1980s, Latin American economies rarely shift into high growth, high inflation cycle during elections. Rather, in the wake of the 1980s' debt shocks, a political austerity cycle took the place of the political business cycle. Relative to past decades, politicians became more likely to place a premium on price stability, even if they had to pay a cost of fewer new jobs and less economic growth.[14]

The paper unfolds as follows. The next section briefly reviews both the globalization and political business cycle literatures. Section 3 contains the paper's theoretical contribution; here I explain how and why politicians might come to prioritize price stability over growth and jobs. My political austerity theory claims that a reliance on international bond markets for external financing narrows the scope for economic stimulus. In Section 4, I discuss the benefits of using a Latin American laboratory to test this theory. In Section 5, I first outline the study's major empirical concepts and measures and then present the outcomes of the statistical tests. Finally, Section 6 contains a concluding discussion.

[11] Cardoso was a world-renown dependency theorist and founding member of Brazil's social democratic party.
[12] New York Times, November 5, 1997.
[13] Nordhaus 1975; Lindbeck 1976; Tufte 1978; Ames 1987.
[14] This finding is consistent with recent work by Canes-Wrone and Park (2010). Their research shows that the pre-election period in 10 OECD countries between 1975 and 2006 is characterized by a real decline in private fixed investment. This reverse electoral business cycle does not, however, depend on the structure of sovereign debt. Moreover, the cycle involves sectors of irreverisble investment, rather than growth in the total economy.

# 2 Financial Globalization and Economic Outcomes

## 2.1 The Convergence-Divergence Debate

In greek mythology, the Gods condemned Sisyphus to the absurdest task of repeatedly rolling a boulder to a mountain top only to have the rock fall back to the ground. Sisyphus has freedom, but it is limited by divine circumstances. He can brace the boulder with his shoulder, thrusting the rock with all of his body's momentum arduously up to the peak. But, the rock's fate is beyond his control, rushing back down the mountain with boundless fury. Developing country politicians in a financially globalized world suffer a similar fate. Hoping to lift their countries to development's pinnacle, they toil with austerity against the fierce force of globalization. Why do political leaders embrace conservative policies in a historically left-leaning region like Latin America? What explains the resilience of laissez-faire economics, even in the face of economic crises? It is the gravity of globalization.[15]

Throughout the world, globalization has produced a third political way that seeks the middle ground between left and right. In the wake of the Cold War, the third way gained its foothold among a medley of left-leaning politicians from the United States to Russia. Tony Blair, Bill Clinton, Fernando Henrique Cardoso, and Boris Yeltsin all embraced free market orthodoxy. Even the iconoclast Hugo Chavez resembled a third way candidate during the 1998 Venezuelan presidential election campaign. Why did centrism become en vogue in the 1990s, sapping political parties of their core principles?

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

[15] In fact, scholars have found that status-quo economic policies are quite resilient under high levels of economic interdependence. Even amid acute political tensions, governments are unlikely to change their economic behavior (Davis and Meunier 2011).

[16] Andrews 1994; Helleiner 1994; Cerny 1995; Rodrik 1997.

[17] Cardoso 1973; Lindblom 1977; Bates and Lien 1985; Frieden 1991; Kurzer 1993; Strange 1996; Keohane and Milner 1996; Pauly 1997; Rodrik 2000, Boix 2003.

By contrast, other scholars anticipate greater cross-national diversity in economic policy choices. Building on the notion of embedded liberalism,[18] they expect governments to intervene in the economy to offset globalization's dislocations.[19] Political leaders hope to strike a balance between economic and social stability.

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

For example, Mosley (2000; 2003) finds that financial market constraints are strongest in developing countries, where investors are most concerned about default risk. Tomz (2007) argues that governments comply with creditor demands because they want to build a reputation for reliability and maintain access to foreign capital. In addressing these market demands, Pepinsky (2008) finds that political coalitions account for differences in financial liberalization, with regimes that depend on the support of fixed capital owners more likely to veer from IMF orthodoxy. In developed countries, where governments typically have greater policy discretion, several scholars have found that ideational and partisan factors may also explain government choices. In the aftermath of the first oil crisis, McNamara (1998) shows that European policymakers became more accepting of a monetarist approach to economic policy, while Bearce (2003) finds that monetary policy is often reflective of partisan preferences.

Other scholars examining domestic institutions' impact on globalization have found a similar dichotomy between developed and developing countries. In developed countries with strong welfare-state institutions, Swank (2002) finds that pro-labor forces have the institutional clout to dampen neoliberal reforms. By contrast, Rudra (2002; 2008) finds that labor groups in developing countries have considerably less political power, leaving them ill-equipped to defend social spending. In fact, Wibbels (2006) concludes that global income shocks often magnify social retrenchment by closing the spigot of developing country finance. Diminished labor power under globalization also translates to the other side of the government's balance sheet, where Wibbels and Arce (2003) find that labor often incurs a higher tax burden relative to capital in

[18] Ruggie 1982.

[19] Cameron 1978; Garrett 1998a, Garrett 1999b, Garrett and Mitchell 2000.

Latin America.

In the following pages, I offer a new contribution to this globalization debate. I claim that what reduces a government's economic options is not the amount of financial integration, but rather the structure of debt in developing countries. Specifically, when countries become highly indebted to global bond markets relative to other forms of public financing, they are most likely to pursue inflation control—even at the cost of slower growth.

## 2.2 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 (see Appendix A).[20] In fact, two major strains of intellectual thought have dominated the field of the politics of macroeconomic policymaking: Keynesianism and Monetarism. The debate between these two schools centers on the inflation and unemployment trade-off, popularly known as the Phillips curve trade-off.[21] Both Keynesianism and Monetarism assume that politicians care about inflation and unemployment, but they offer competing accounts of the effectiveness of government intervention.

Keynesianism is more optimistic about policymaker'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 monetary and fiscal policy to permanently lower unemployment and boost economic activity. 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 high demand for labor.[22] 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

[20] 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 policymaking.

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

[22] Samuelson and Nordhaus 1995.

economic policy. In response to economic stimulus, people adjust their inflation expectations higher. Workers demand better wages and firms raise their goods prices. Inflation accelerates, undercutting any initial gains from the stimulus. Indeed, monetarists claim there a natural rate of unemployment, beyond which any attempts to spur economic activity only yield further inflation.[23] 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 they also jolted inflation expectations considerably higher.[24] 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 (See Figure 1.1).

**Figure 1.1: The Phillips Curve Trade-Off**

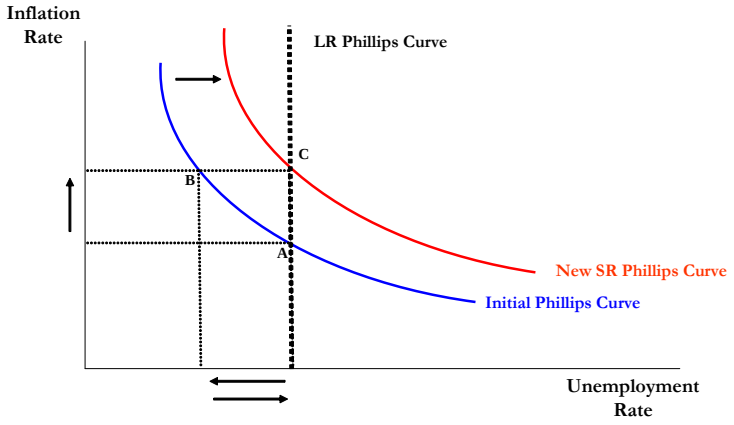



Figure 1.1 shows Keynesian and Monetarist views. Keynesians suggest that policymakers can readily trade off unemployment and inflation (moving from A to B). Monetarist, however, claim that this trade-off is only short-term. Policymakers can reduce the unemployment rate below its natural level with expansionary policy, but only temporarily (moving from A to B). Expansionary policies breed higher inflation expectations, shifting the Phillips curve rightward. The unemployment rate returns to its natural equilibrium, but inflation is permanently higher (moving from B to C).

### 2.2.1 Political Business Cycles: Developed vs. Developing Countries

Building on these intellectual foundations, scholars have anticipated observing two major types of economic cycles around election periods: *opportunistic* and *rational political business*

[23] Friedman 1968; 1970.

[24] Revisiting the traditional Phillips curve tradeoff, Milton Friedman and Edmund Phelps constructed a steeper Phillips Curve that accounted for the growth-diminishing effect of inflation expectations.

*cycles*. The opportunistic view of economic cycles is based on a Keynesian view of the world. It holds that politicians seeking re-election deliver an economic boost to win votes. They slash interest rates and ramp up spending to create jobs and pad incomes. However, the political choice to exploit the Phillips Curve leads to an electoral boom and bust. Politicians expand growth to create jobs before elections at the expense of 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.

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, re-election minded politicians should be most likely to prime the economic pump in newly democratized regions, like Latin America, where 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.[25] 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.[26]

Do developing country politicians ever choose not to intervene in the economy? If so, what is the trigger for their conservative political behavior in countries where fiscal conservative voters are less likely to be found? Are politicians monetarists who are skeptical of the benefits of stimulus? Does their politics simply mold their economics? Or, does economics mold their politics? Are they optimistic about the government's ability to create jobs and growth before

[25] Ames 1987; Schuknecht 2000; Block 2001; Gonzalez 2002; Brender and Drazen 2005; Shi and Svensson 2006.
[26] See Rogoff and Sibert 1988; Rogoff 1990; Brender and Drazen 2005, 2008.

elections, but nonetheless choose not to intervene in the economy?

In the following pages, I advance a new theory that explains this electoral logic. Building on the political models of macroeconomic policymaking outlined above, I account for why politicians might come to prioritize price stability over growth and jobs. The conventional choice of growth and job creation has its obvious electoral benefits. But, what explains the counterintuitive choice of not tinkering with the economy? What's the political benefit?

# 3 Political Austerity Theory

Political austerity theory argues that the structure of lending to developing countries has important political consequences. Facing revenue shortfalls from narrow tax bases and shallow domestic financial markets, developing country governments typically tap international capital to cover their budgetary gaps.[27] Ironically, however, when global bond issues, rather than international bank loans, account for the majority of this financing, governments ultimately have less capacity to create jobs and growth.

Beginning in the 1990s, developing country governments initially raised funds in global capital markets to expand their spending options, only to unexpectedly subject their budget decisions to financial market discipline. It's the political catch-22 of decentralized bond market finance. At low levels of bond market indebtedness, policymakers have considerable fiscal space (or the budgetary capacity to stimulate the economy). The choice to tap cheap bond market financing facilitates additional deficit spending. Should governments become too indebted to global financial markets, however, they are headed for trouble. When bonds account for a high share of governments' foreign debt, they become burdened by interest payments. Left with less fiscal space, they are more likely to heed market calls for low inflation.

## 3.1 The Structure of Lending and Creditor-Debtor Relations

Why are bond market investors more successful than bankers and foreign governments at imposing their demands for austerity? I offer a counterintuitive collective action logic to explain the market's disciplining mechanism. Informed by Mancur Olson's seminal group theory, we

[27] McNamara 1998; Mosley 2000; Mosley 2003; Wibbels 2006.

know that members in a small group often prefer to pay for some portion of a collective good than survive without it.[28]

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, creditors with financial exposure to that country gain from its ability to make steady debt repayments. Capital flows freely along the financial highway, benefiting both creditors and debtors. But, what happens to capital flows during troubled economic times. Do lenders continue to extend funds to borrowers?

### 3.1.1 Centralized Creditors and Sovereign Borrowers

Political austerity cycle theory claims that these funding decisions are determined by the extent of ownership dispersion. When creditors are centralized, they have a few options. As members of a small group, their size offers them a collective action advantage. They can either 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.

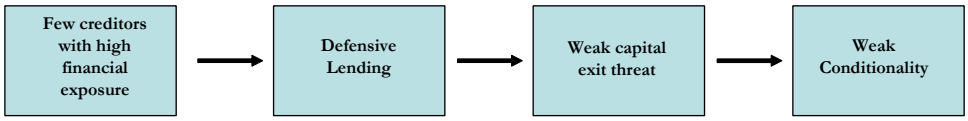
> "I am more concerned about the return of my money than the return on my money."
>
> -Mark Twain

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. Hence, creditors not only lend defensively, but they also often absorb substantial costs along the way, including rescheduling old debts.

[28] Olson 1965.

In the world of global finance, there are numerous examples of small creditor groups injecting new money into their debtors. For example, a small commercial bank cadre with high loan exposure to Latin American 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 US government repeatedly sunk cash into salvaging GM in the wake of the 2008 global financial crisis.

**Figure 1.2: Creditor Relations under Centralized Commercial Bank Lending**




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.[29] Their large stake in borrowers' solvency—along with the promise of new funds—undermines their capital exit threat and ultimately borrowers' compliance (see Figure 1.2 above). For example, during the heyday of global bank lending to developing countries in the 1970s and 1980s, government borrowers frequently missed their conditionality targets and waived out of banker and IMF-supported programs.[30]

### 3.1.2 Decentralized Credit and Sovereign Borrowers

By contrast, the second part of this counterintuitive collective action logic argues that a decentralized bond market regime considerably enhances the power of creditors relative to debtors. When bankers securitize loans, they bundle and resell them to many different bondholders scattered across the globe from London to Tokyo. How does market securitization shape political behavior?

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

[30] 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 percent and 19 percent of programs in 1983 and 1984.

According to collective action theory, a large, heterogeneous group that aims to sway government policy should experience coordination failures. Group members, with low personal stakes in the collective good, often prefer to survive without it than pay their share.[31]

In a world of decentralized finance, such collective action failures are quite common because of the ownership dispersion that is characteristic of bond markets. Investors are numerous, anonymous, and scattered internationally. By redistributing credit risk 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 borrowers' debt exposure to warrant providing new funds, or participating in costly, lengthy restructuring negotiations.

Typically, collective action failures should impede societal groups from pressuring governments. Ironically, in this case, creditors benefit from their coordination problem. It increases their sway over debtor governments. Why?

Unlike the symbiotic relationship of centralized bank lending, bondholders have a credible exit strategy. With a low stake in borrowers' solvency, bondholders can readily withdraw capital during hard economic times. Should they be concerned about debtors tumbling toward default, they can almost instantaneously cut their financial ties. If borrowers violate the market's call for conditionality, or demands for a low inflation environment,[32] creditors can sell their bonds in global markets.

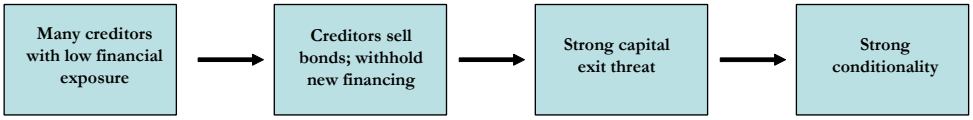
These actions can create stiff political repercussions for governments. Battered investor confidence often sparks a chain of grave financial and economic turbulence known as a "sudden stop." As witnessed during recent financial crises in Mexico (1994-1995), Russia (1998), East Asia (1998-1999) and Argentina (2001-2002), investors can literally halt financial flows overnight by dumping their bonds. Massive capital withdrawal then fuels higher interest rates, making it difficult for governments and firms to find financing. With less available financing, the economy contracts further, inciting a vicious cycle of financial outflows, budget shortfalls, and credit downgrades. Without access to global capital markets, policymakers 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

[31] Olson 1965.

[32] According to a 2000 survey, mutual fund managers rate a stable inflation environment and debt service capacity as having the greatest effect on their asset allocation (Mosley 2003).

rarely have the same flexibility.[33] With few alternative domestic funding sources, they are deeply dependent on global financial markets, leaving them at investors' mercy.

**Figure 1.3: Creditor Relations under Decentralized Bond Financing**




In light of these severe costs, decentralized bond markets often act as an enforcement mechanism for conditionality agreements (see Figure 1.3 above). 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."[34] 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.

## 3.2 From Political Business Cycles to Political Austerity Cycles

Decentralized global finance may generally be politically restraining, but why would politicians choose austerity during elections periods? Why not reflate the economy before elections and deal with the financial market fallout later?

I claim that electoral uncertainty intensifies the disciplining effect of decentralized bond markets. Short-term political agenda are displaced by bondholder's own myopia. Consumed by short-term default risk, creditors demand that debt-strapped governments foster low inflation to maximize the likelihood of debt repayment. Ironically, their capital exit threat is most potent during periods of political survival, when politicians hope to avoid a destabilizing economic shock.

Does this phenomenon suggest that politicians are merely price takers in a world of decentralized finance? In an era characterized increasingly by bond market financing rather than bank loans, how intense is globalization's gravity? When might creditors have less sway over government borrowers? In this section, I develop my theory's predictions regarding the conditions that

[33] Gavin and Perotti, 1996; Calvo1998; Obstfeld 1998; Calvo and Reinhart 2000; Mosley 2003; Kaminsky, Reinhart, and Vegh 2004; Obstfeld and Taylor 2005; Wibbels 2006; Edwards 2007.

[34] Author's Interview with Javier González-Fraga, Buenos Aires, August 16, 2006.

yield the political austerity cycle rather than the political business cycle.

I argue that the when governments are able to access financing sources that are independent from global markets, they have more freedom to create domestic jobs and growth. 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.[35] For example, Dunning (2008) claims that resource rents can underwrite democratic stability by reducing redistributive conflict.

Similarly, in the case of election spending, I argue that several types of centralized revenue streams—including bank lending, natural resources, foreign aid, and central bank credit—allow politicians to spend more on their domestic agendas. From copper mines and oil rigs to bilateral government and bank credits, these proceeds reduce governments' reliance on international capital markets. Governments can tap these financing sources, without subjecting policy decisions to the scrutiny of bond investors, leaving greater scope for economic expansions. With little exposure to global capital markets, countries are less vulnerable to unfavorable credits swings, capital flight, and interest rate spikes. Rather than funneling resources to interest payments on foreign debt, politicians can leverage their fiscal space to spend on an electorally-timed economic boost. Moreover, at lower levels of debt accumulation, capital is less likely to leave the country and bond investors are more likely to have an enduring view of the economy beyond elections.

By contrast, when countries become highly indebted to global financial markets, creditors are less patient. Herds of portfolio investors, without a long-term financial stake in national affairs, use the threat of capital withdrawal to discipline governments and ensure low inflation. My governing hypothesis, then, is that highly indebted governments will be more likely to oversee deflation during election periods.

> **The Political Austerity Cycle Hypothesis.** When decentralized bonds account for a high share of government's external debt, politicians should pursue price stability. Inflation falls during elections, at the cost of higher economic growth and new jobs.

But, why would politicians heed these market threats during election periods? Why not ignore financial market demands? I argue that politicians, who fund their debt in a decentralized

[35] Dunning 2008; Morrison 2009.

system, must operate in a world laden with short-term incentives and high uncertainty.

The short-term creditor horizon results from developing government's debt structure. Unlike developed country debt, the majority of sovereign debt is historically characterized by foreign-currency denominated, short-term maturity bonds. The currency mismatch and the frequent refinancing need raises the likelihood of both devaluation and default.

In addition to this baseline uncertainty stemming from short-term default risk, elections raise additional concerns for investors. In developing countries, where personalistic politics can triumph institutional checks and balances, the political climate is often much less predictable. Even if elections do not produce a change in political leadership, investors often fret that they might yield a new set of social, political, and economic priorities.[36]

Not surprisingly, when they face heightened electoral uncertainty, investors are often tempted to withdraw their capital. For example, Mosley's (2000) international fund manager survey reveals elections have a strong effect on emerging market asset allocation. Other scholars have also found that speculative behavior increases during election periods.[37] 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.[38]

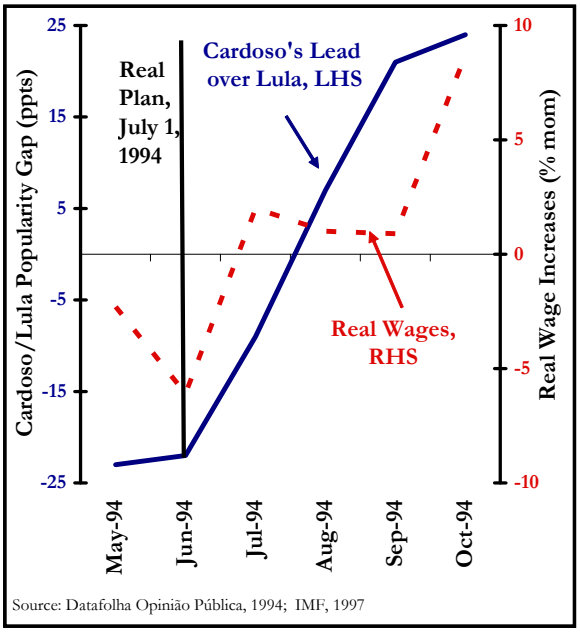
How do chief executives respond to these mercurial markets? Highly-indebted governments face a political conundrum. Ignoring market pressures can hastily weaken an incumbent's political and economic position. The choice to engineer a pre-election boom can precipitate an abrupt income shock that undermines the economic vote. Unsustainable government spending raises inflation expectations, causing investors to demand an interest rate premium. Higher interest rates on government debt quickly translate to other areas of the economy, leading to cut backs in government spending and more expensive financing costs for private firms and households.

Fearing the economic pain unleashed by a swift capital exit, politicians of debt-ridden countries often signal austerity to investors notwithstanding the upcoming election. Indeed, the appeal of the high growth-high inflation political business cycle loses its luster relative to the political austerity cycle.

Ironically, in countries with a history of economic volatility, providing price stability might

[36] Leblang 2002; Mosley 2003.
[37] Leblang and Bernhard 2000; Frieden and Stein 2001; Leblang 2002; and Mosley 2003.
[38] Block and Vaaler 2004; Vaaler, Schrage, and Block 2006.

**Figure 1.4: Political Austerity Boosts Brazilian Incomes & Cardoso's Presidential Candidacy**




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[39] a mere three months before elections. Notwithstanding a mid-June popularity deficit of more than 20 percentage point 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 land-slide victory in the October 1994 elections (see Figure 1.4 below).[40]

In summary, political austerity theory claims that when global bond markets account for a large share of a countries' financing, the economic— and hence the political cost—of an electoral expansion is too immediate to risk engaging in a political business cycle. Rather, the structure of creditor-debtor relations leaves politicians with few options beyond a political austerity cycle.

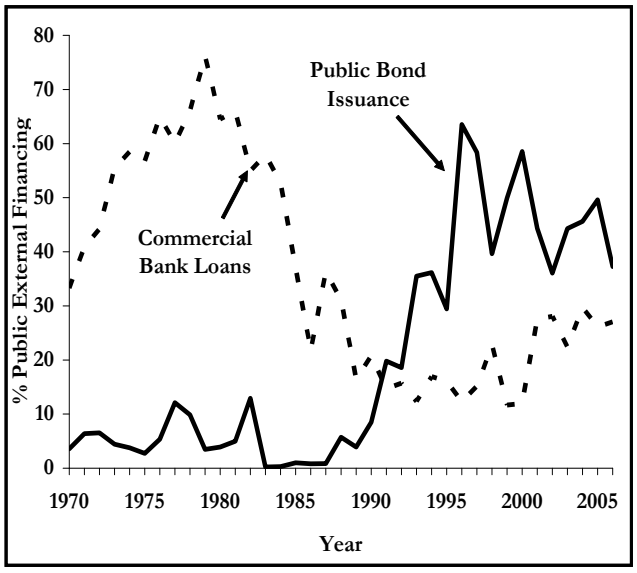
[39] On July 1, 1994, Cardoso introduced the Real Plan, which called for a balanced budget, tight monetary policy, and a new stable currency anchored to the US dollar.

[40] Cardoso won a first-round victory, taking 54.3 percent of the vote, compared to Lula's 27 percent.

# 4 The Latin American Laboratory

Latin America provides an ideal laboratory for testing theories about elections and economic outcomes. The region is inhabited by a preponderance of presidential, middle-income countries with fixed (or constitutionally-mandated) election timing and varied exposures to our study's main independent variable of interest: decentralized finance.[41] Indeed, Latin America experienced a key structural financial shock–the 1980's debt crisis, which created both intertemporal and cross-national variation in exposure to decentralized bond markets.

**Figure 1.5: Bond Issuance Supplants Bank Lending**
**(16 Latin American Countries, Aggregate)**



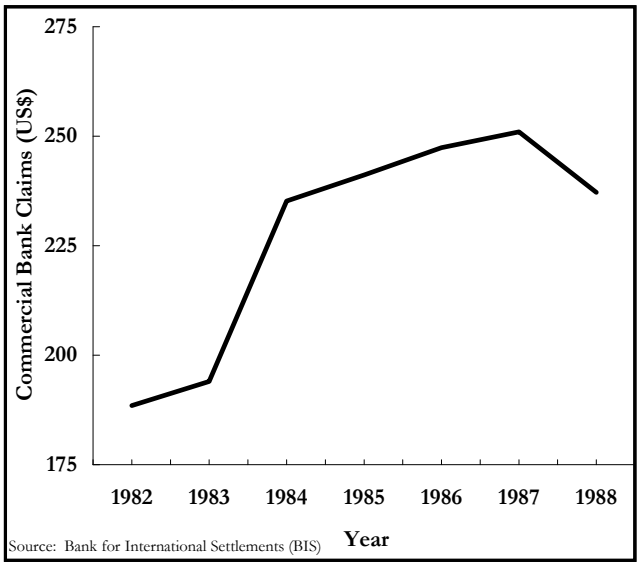

The astonishing growth of global financial activity over the last three decades in Latin America is well-documented by both economists and political scientists. However, the region's shift in its debt composition from cross-border bank lending to global capital markets has received little attention. Throughout the 1970s and 1980s, international banks provided the majority of cross-border capital flows to the region.[42] Beginning in the 1990s, however, Latin American governments increasingly tapped international capital markets to finance their spending. Under the Brady Bond restructurings, Latin American governments converted commercial bank debt, which many countries had defaulted on during the 1980s debt crisis, into market-traded debt

[41] King, Keohane, and Verba 1994.
[42] Eichengreen 2003.

held by a diversified group of global investors. With few banks extending new syndicated loans, the Brady restructurings helped fuel a surge in Latin American bond issuance. New bond issuance grew from US$0.6 billion in 1989 to a whopping US$37 billion by 1996, accounting for more than 64 percent of Latin America's total public external financing. Bond issuance replaced commercial bank loans as the region's primary funding source (see Figure 1.5).[43]

How did this dramatic change in debt financing affect creditors and debtors in Latin America? In line with the expectations of political austerity theory, I find that the shift to decentralization finance creates a collective action failure that surprisingly increases creditors' sway over their debtors. Before the Brady Bond restructuring, creditors were centralized in Latin America. During hard economic times, they often injected new money into their debtors. For example, when Mexico ignited the 1982 debt crisis by announcing a 90–day moratorium on its debt, global bankers did not respond by immediately withdrawing their capital and cutting financial ties to the region. Rather, a small core of global bankers collectively responded by providing new loans to Latin American lenders from 1982 until 1987 (see Figure 1.6 below).[44] Why?

**Figure 1.6: Bank Claims on Latin America**
**(US$billion, 1982-1988)**




The aim of the new lending was not only to keep debtors afloat, but also ensure that borrowers paid interest payments that were vital to banks' profitability. Creditors "were ready to spend

[43] Bilateral and multilateral lending account for the residual public financing from 1970-2005.
[44] Krugman 1994.

a great deal of time, energy, and money keeping the channels to debtors open, in expectations of future business."[45] Indeed, the financial fates of bankers and Latin American governments were strongly linked together. Based on data contained in 1985 financial reports, the ratio of bank claims on Mexico, Brazil, and Venezuela amounted to a whopping 131 and 129 percent of shareholder's equity for Bank of America and Chase Manhattan Bank respectively. In the case of Manufacturers Hanover, Citibank, and Morgan Guaranty Trust Company, their claims on Mexico, Brazil, and Argentina tallied an impressive 154, 114, and 87 percent of shareholder's equity respectively.[46] According to L. William Seidman, who was then Chairman of the Federal Deposit Insurance Corporation (FDIC), seven or eight of the ten largest banks in the U.S. were on the brink of insolvency.[47]

In exchange for these fresh funds, bank steering committees—comprised of four to five major banks and the International Monetary Fund (IMF)—often required governments to adopt the market conditionality that was advocated by Western powers.[48] Notwithstanding falling economic growth, mounting poverty, and rising income inequality across Latin America, they called for restrictive macroeconomic policies and structural reforms that imposed onerous economic adjustments on borrowers' domestic populations. Hoping to raise the likelihood of future debt repayment, they demanded borrowers comply with these loan provisions.[49]

Nevertheless, in light of the difficult-to-dissolve link between global bankers and their borrowers, Latin American governments were able to maintain considerable policy flexibility during the era of bank lending. In fact, government borrowers often missed their conditionality targets and waived out of banker and IMF-supported programs. For example, Edwards (2001) finds that IMF program interruptions were particularly frequent between 1988-1991, the period before Latin America's shift to debt securitization.

By contrast, following the 1990 Brady Bond restructurings, we see a dramatic shift in creditor behavior toward Latin America. Those countries that converted their defaulted bank loans into global bonds were the trailblazers of Latin America's new capital markets.[50] Tapping this new

[45] Frieden 1987.
[46] Bogdanowicz-Bindert 1986.
[47] As a result, FDIC officials pursued a policy of large bank regulatory forbearance. Concerned about bank profitibility, major banks were not required to increase their reserves to offset past due loans (FDIC 1997).
[48] Thacker, 1999.
[49] Vreeland 2003.
[50] Capital markets surged from $300 billion in 1990 to $1.1 trillion by 2003 (Stallings and Studart 2006).

funding source brought cheap financing to Latin America once again, but at a high financial and political cost.

Compared to international bankers' long-term horizon, decentralized bond market investors had a short-term view. Financially-vested bankers were often willing to look beyond economic downturns, allowing governments to veer from their conditionality pledges. By contrast, portfolio investors—who had a low personal stake in borrowers' financial futures—were more apt to immediately withdraw their financial commitment to borrowers. When governments fell on hard economic times, creditors often readily sold their bonds in secondary markets that operated 24-hours daily from Wall Street to London's financial district.

Roque Fernández, who led the economic team in Argentine President Menem's cabinet during this structural financing shift, notes the stark difference in creditor behavior.

> "Previous to Brady bonds, if you had a problem, the only thing you had to do was meet with five to six important banks–including Citibank, Bank of America, and JP Morgan. This steering committee would represent the rest of the banking community in negotiations. They would discuss the restructuring of overdue debt...and then the banks would produce a refinancing. For the first time during the Tequila Crisis, there was no steering committee!...[Rather], when you have an open economy to capital flows, you are at the mercy of market expectations."[51]

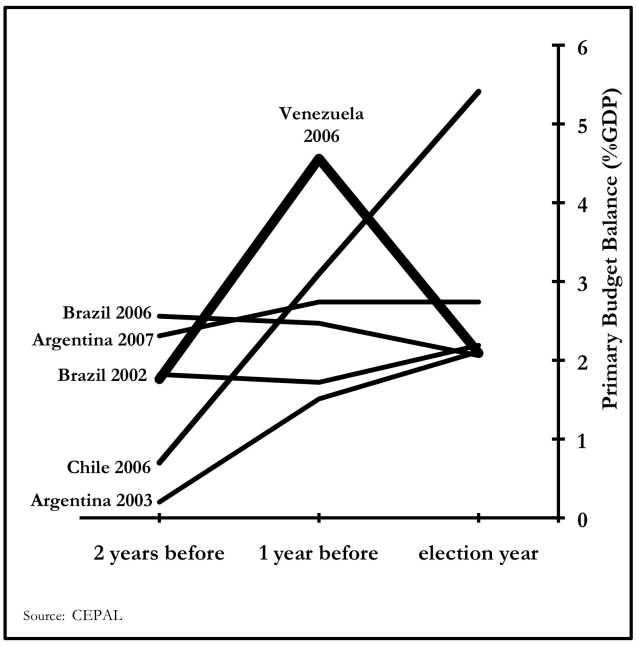
In addition to their economic teams, Latin American presidents were also keenly aware of these financing pressures. For example, during his administration, Chilean President Ricardo Lagos stressed the importance of managing day-to-day market expectations and fostering an internationally-respected investment environment.

> "In today's world, you have an examination every day according to the country risk that you are going to get from Wall Street. You simply open the Wall Street Journal, and you know the country risk of Chile..."[52]

In light of this market scrutiny, those governments that have a high exposure to global financial markets should be less likely to engage in aggressive electoral expansions. In fact,

[51] Author's Interview with Roque Fernández, Universidad de CEMA, May 23, 2007.
[52] Author's Interview with Ricardo Lagos, Brown University, April 16, 2010.

**Figure 1.7: Fiscal Policy Stance in Presidential Elections**
**(Selected Latin American Countries: 2002-2007)**




during the last decade, most Latin American governments slammed on the brakes rather than the accelerator, building up their primary budget surpluses (see Figure 1.7). Venezuela stands out as one major exception, given its ability to fund its deficits with non-market resources. During President Hugo Chávez's 2006 presidential bid, oil windfalls—accounting for more than half of government revenues—gave the Venezuelan president the fiscal space to fund a burst of economic growth before national elections.

If political austerity theory is correct, we should observe, on average, that Latin America's shift to bond market financing in the 1990s leads to lower inflation during election years. In other words, the fate of the political business cycle should be conditional on governments' debt burdens. When governments like the Chávez administration are able to fund themselves with non-market revenues—from commodity income to bank lending— they can avoid the market's disciplining mechanism. In most cases, however, Latin American governments have been highly reliant on global bond markets. Vulnerable to credit downgrades and financing shocks, governments often have fostered a low inflation environment to assuage investor uncertainty.

# 5 Statistical Tests: The Effect of Elections on the Economy

I use multivariate regression analysis to study the effect of presidential elections on economic outcomes in Latin America. Recall that the region's predominance of presidential systems makes it an ideal laboratory to examine political business cycles. The presence of election-timing that is fixed and constitutionally-mandated avoids endogeneity problems,[53] or the possibility that current economic conditions reflect political tinkering with election dates.

Employing time series cross-sectional data from 1961-2009 for 16 democratic countries, I perform a series of panel regressions. I present my findings using both fixed effects and a generalized methods of moments (GMM) estimators. The empirical analysis proceeds in two stages. First, I use a series of basic regression model to test for the traditional political business cycle, presenting evidence about the effect of elections on inflation, growth, and unemployment—typically, the economic outcomes that matter most to both politicians and voters. Second, in the crux of the analysis, I construct a series of interactive models to test for political austerity cycles. I condition decentralized debt on elections to observe its effect on the economy. All models are estimated with robust standard errors, clustered by country. In the appendix, I include a full description of these statistical models and the data sources and descriptive statistics for the regression variables outlined below.

## 5.1 Independent Variables

### 5.1.1 Elections

According to political business cycle theorists, politicians' fear of losing office compels them to aggressively intervene in the economy. In line with this theoretical premise, I limit the unit of analysis to democratically competitive Latin American elections. I classify democratic elections according to Przeworksi et. al.'s (2000) criteria. They use a minimalist democracy rule based on Robert Dahl's concept of contestation; democracies are "regimes that allow some, even if limited, regularized competition among conflicting visions and interests."[54]

[53] To confirm that the election variable is exogenous (and that the incumbent did not disregard the constitution by changing election timing), I verified that the fixed election dates in my time series (1961-2009) corresponded to constitutionally-mandated election dates.

[54] Przeworksi, et al. 2000; Dahl 1971.

Notwithstanding historical swings between dictatorship and democracy, the region has enjoyed considerable durability in democratic regimes over the last three decades. Even before the democratization wave (which began in 1978), several Latin American countries had long periods of uninterrupted democracy characterized by consecutive elections, including Chile, Colombia, Costa Rica, and Venezuela.

Using Przeworski's decision rule,[55] I code 16 Latin American democracies (see Table 1.1) between 1961 and 2009 and find a total of 132 contested elections in my data set. I study presidential rather than legislative contests because economy policy in all of the countries studied is much more heavily shaped by executive branches than by legislatures, the courts, or other governmental or societal actors.

**Table 1.1: List of 16 Latin American Countries**

| | | | |
|---|---|---|---|
| Argentina | Colombia | Guatemala | Panama |
| Bolivia | Costa Rica | Honduras | Peru |
| Brazil | Ecuador | Mexico | Uruguay |
| Chile | El Salvador | Nicaragua | Venezuela |

*Note:* The study employs least square regression estimates with fixed effects.

In testing the effect of elections on economic outcomes, I construct a binary election variable that accounts for the expected policy lag between economic policy decisions and inflation. Indeed, according to macroeconomic theory, monetary policy does not immediately influence spending, income, and employment. Rather, it effects the economy incrementally, with inflationary pressures slowly building over the course of six to eighteen months.[56]

With this in mind, I employ the binary variable, $election_{it}$, as a pre-election dummy for growth and unemployment, but as a post-election dummy for inflation, in hopes of capturing inflation's policy lag.[57] Recall that the *political business cycle* begins with economic growth and ends with high inflation. Hence, we not only want to track inflation during the election year, but also subsequent years.

[55] Przeworski et. al. (2000) classify a democracy as a regime where 1) the chief executive must be elected; 2) the legislature also needs to be elected, 3) more than one party exists, and 4) electoral alternation is a possibility.

[56] Friedman 1970; Mankiw 2003.

[57] This dummy variable construction is based on standard models that are typically used to test for political business cycles (Alesina and Roubini 1992).

I also use this binary variable to test for *political austerity cycles*. Should a political austerity cycle exist, I would anticipate observing the exact opposite pattern of the political business cycle. Growth falls in the prelude to elections, yielding lower inflation during both the election and post-election period (see the appendix for the full statistical models).

$$pre\_election_{it} = \begin{cases} 1 \text{ in the election year, and the preceding N-1 years} \\ 0 \text{ otherwise, where N=2 or 3} \end{cases}$$

$$post\_election_{it} = \begin{cases} 1 \text{ in the election year, and the subsequent years} \\ 0 \text{ otherwise} \end{cases}$$

### 5.1.2 Decentralized Debt

To test for the presence of political austerity cycles, I construct a variable, $decentralized_{it}$, to account for the constraining effect of decentralized finance. It measures global bond issuance as a percentage of government's total external financing needs. If political austerity theory is correct, when governments are highly indebted to global bond markets, governments should place more weight on inflation control. In other words, as $decentralized_{it}$ increases, global markets should serve as a natural enforcement mechanism for conditionality, placing deflationary pressure on economies during election periods.[58]

## 5.2 Control Variables

In these regressions, I also use a series of control variables to account for other economic and institutional factors that may influence the economy. Given that my sample includes many small open economies, I control for the effect of changes in the world economy (*Global Growth*) on the domestic economic climate. Similarly, because many Latin American countries lack a diversified export base, I also account for any fluctuations stemming from commodity export dependence (*Commodity Price Index*). Additionally, I include imports plus exports as a percentage of GDP to control for economic openness (*Trade*). In general, I would expect that global economic and commodity booms would boost economic growth and inflation in Latin America.

[58] In a series of robustness checks, I replace the original $decentralized_{it}$ variable with a new measure intended to capture the effect of the 1990s Brady Bond restructurings (see section 5.3.1 for more details).

When inflation is the dependent variable, I also control for the size of the financial sector (*Domestic Financial Depth*), on the assumption that weaker financial sectors lead to higher inflation.[59] I use M2 as a percentage of GDP, or outstanding banking sector liabilities, as a proxy for financial sector size. I also include annual GDP growth (*Growth*) to control for cyclical movements in the price level.

When economic growth is the dependent variable, I control for the rate of domestic investment as a percentage of GDP (*Domestic Investment*) since investment is often a key driver of economic growth. I also include the inflation rate (*Inflation*) to control for the effect of price instability on growth. Indeed, most economic theories predict that high inflation hampers business and consumer activity.[60]

Finally, for both the inflation and economic growth regressions, I control for the primary fiscal balance as a percentage of GDP (*Fiscal Balance*)—lagged by one year to avoid any possible endogeneity—based on the assumption that fiscal stimulus drives both economic growth and inflation. I use the primary fiscal balance (net of interest payments on public debt) rather than the general government balance (inclusive of interest payments) because it is the more appropriate measure of the government's fiscal policy stance in highly-indebted countries.

How do institutions affect the political trade-off between economic growth and inflation? Do greater checks and balances on executive power lead to a demise of the political business cycle, as predicted by the developing country literature? Alternatively, when countries are under an IMF agreement, does conditionality prompt economic austerity? Similarly, does the presence of an autonomous central bank lead to greater emphasis on price stability?[61]

To account for these institutional factors, I add several control variables: including a measure of constraints on executive power (*Executive Constraints*),[62] an IMF participation dummy (*IMF*);[63] and a central bank independence index [64] that measures the legal autonomy of the

[59] In larger financial markets, individuals are more likely to have large cash holdings, savings, or investments whose real value could be eroded by inflation. Hence, there should be greater demand for price stability in countries with larger financial markets (Maxfield 1997).

[60] Barro 1996

[61] Independent central banks are generally associated with lower average inflation rates (see Bernard, Broz, and Clark 2002).

[62] I use the executive constraints (xconst) variable from the Polity IV data set. In additional robustness checks, I also employ an alternative measure of executive constraints from Henisz's (2000) Political Constraint Database.

[63] The IMF dummy is coded 1 for the country-years when there was a conditioned IMF agreement in force, 0 otherwise. I use two different measures of IMF participation from Vreeland 2003 and Dreher 2006.

[64] Polillo and Guillén (2005) update of the Cukierman, Webb, and Neyapti (1992) index.

central bank (*Central Bank Independence*).[65] Finally, based on the assumption that past economic performance influences present economic conditions, I also include a lagged dependent variable in each specification.[66]

### 5.3 Empirical Results

Do elections hurt Latin American economies? The first series of basic regression models (1,2) display the unconditional effects of the independent variables on economic outcomes in Latin America (see Table A.4 in the appendix). These effects are unconditional in that they ignore the government's debt structure at the time of the election. They test the classic political business cycle hypothesis that re-election minded politicians boost the economy before elections to win more votes. If it is correct, we should observe that growth and employment improve before elections, but at the cost of higher inflation following elections.

In these basic models, I find that inflation has the exact opposite pattern than predicted by the political business cycle literature. Surprisingly, elections are deflationary rather inflationary, lending strong support to the political austerity hypothesis. Across the first two statistical models in Table A.4, elections have a statistically significant and constraining effect on inflation. Moreover, I find no evidence that elections stimulate Latin American economies. Not only do the election coefficients for the growth regressions have the opposite sign than anticipated by the political business cycle literature, but they are also statistically insignificant. I cannot reject the null hypothesis that elections have no effect on economic growth. Rather, global growth and domestic price stability appear to be the best predictors of economic growth.

Perhaps, politicians prioritize price stability, or inflation control, during election years with the hopes of also boosting business and consumer confidence. But why would politicians in a traditionally left-leaning region believe that inflation control is the pathway to economic prosperity?

I have argued that the 1980s' severe debt shocks produced a new international financial structure that shifted economic priorities and reduced the political business cycle's political

[65] I only include the central bank independence index in additional robustness checks since it assigns numerical values to countries that do not vary over time. The country dummies, which are already included in the model, incorporate the same effect.

[66] For example, when inflation is the dependent variable, lagged inflation captures any inertial inflation effect and any unobserved factors that may explain inflation differences over time, including monetary policy changes.

premium. Following Latin America's 1980s debt restructurings—when bondholders replaced bankers as governments' major creditors—we should see a temporal shift in the political business cycle. With the birth of Latin American capital markets, electorally-induced economic cycles should be far less common. Instead, we should observe the emergence of a political austerity cycle, where presidents are likely to seek out policies that curb rather than ignite inflation.

Notably, in line with expectations, the basic regression models shows that decentralized bond finance strongly constrains inflation. The coefficient on decentralized finance is negative and highly statistically significant (see Table A.4 in the appendix). It supports my theory that policymakers became less tolerant of inflation with the explosion of capital market financing in the wake of the Brady bond restructurings. In fact, the statistically significant and positive relationship between decentralized finance and unemployment suggests that politicians might even be willing to stomach less job creation to preserve price stability. These findings for inflation and unemployment also hold in the conditional models (see Table A.5 and Table A.6 in the appendix).

Notwithstanding this general pattern, do elections intensify these relationships? Does electoral uncertainty magnify the disciplining effect of decentralized bond markets? Do politicians from highly-indebted countries pursue price stability even when their political lives are at stake? Do they opt for low inflation to assuage trigger-happy creditors who are worried about short-term default risk? Or, might politicians ignore bond market volatility and aggressively stimulate the economy in hopes of reaping the benefits of en electoral boom?

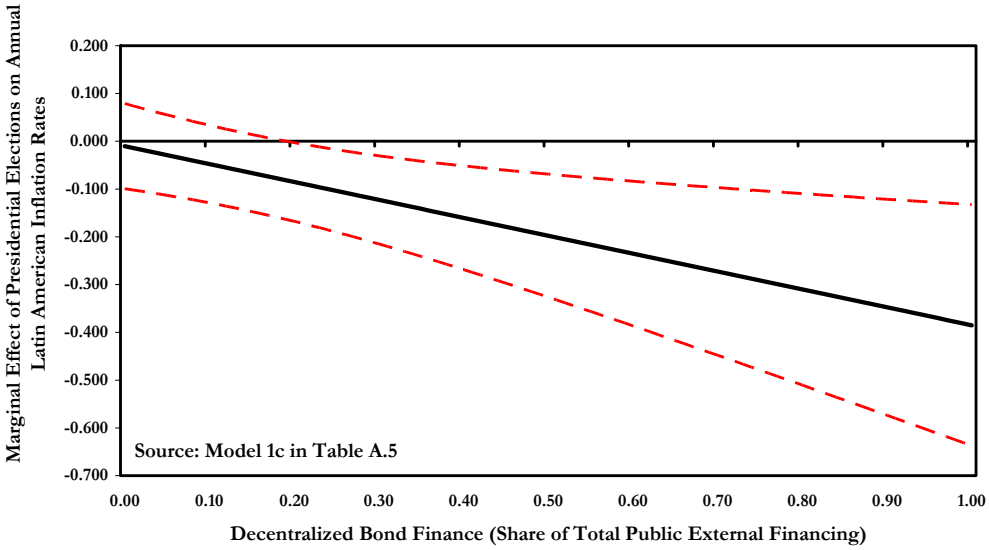
The conditional models (1a, 2a) examine the relationship between decentralized bond finance and the economy during election periods. Notably, after conditioning elections on decentralized finance, their effect on economic growth is stronger and more precisely measured than the unconditional model. In fact, I find that bond finance has a statistically significant and powerful mitigating effect on both inflation and economic growth during elections (see Table A.5 and A.6). Conversely, the lower a country's share of debt financing—or the more reliant countries are on government financing that is independent of bond markets—the more likely its politicians are to allow for higher inflation. Finally, decentralized finance retains its positive and statistically significant relationship with unemployment, but the interaction effect is not significant. This result is not terribly surprising because economists have found that employment tends to lag

general economic trends–or in the case electoral economic trends–by two to four quarters.

Results for the control variables, displayed in Table A.5 and A.6, generally correspond to expectations. The primary fiscal balance, lagged by one year, is statistically significant and inversely correlated with inflation. In other words, a tighter budget deficit is associated with lower average inflation. The effect of global economic growth is significant across all economic indicators and correlated with higher domestic growth, inflation, and lower unemployment. Not surprisingly given the region's historic inflation troubles, domestic price instability is also statistically significant and inversely related to economic growth. Finally, domestic investment is associated with higher economic growth and lower unemployment.

Overall, these findings offer strong support for the political austerity hypothesis. The higher a country's share of debt financing, the less likely its politicians are to engage in a high growth, high inflation election phase. Instead, politicians are more likely to pursue tempered growth and low inflation in hopes of avoiding capital exit, and ultimately, a destabilizing economic shock.

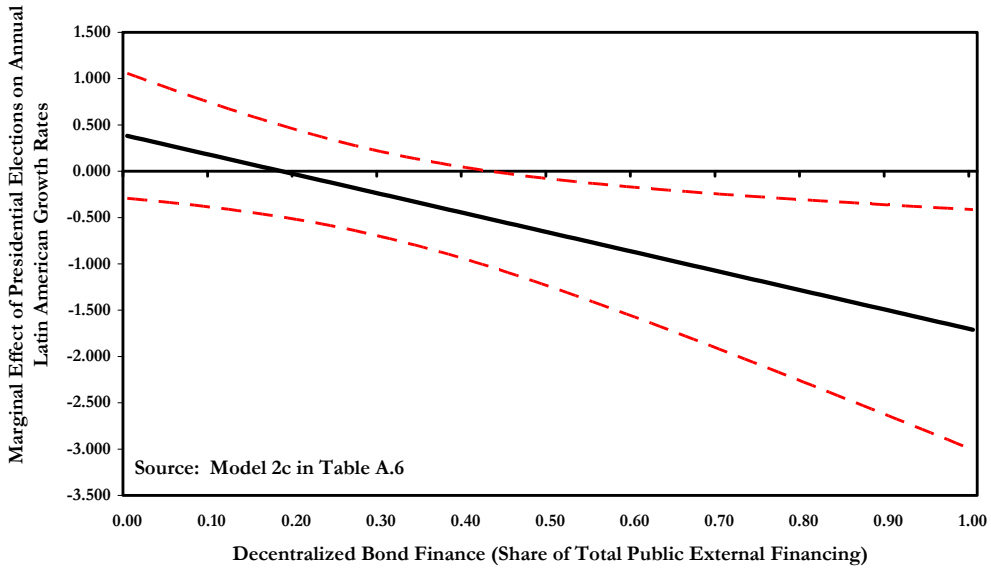
**Figure 1.8: Marginal Effect of Elections on Inflation Rates**




To provide a meaningful interpretation of this interactive relationship, we can calculate the marginal effects of elections over different values of decentralized bond finance. In figures 1.8 and 1.9 below, we observe that election-year austerity becomes more likely as governments become

increasingly reliant on debt financing. When countries first tap capital markets, high-growth, high-inflation electoral cycles remain a possibility.[67] As global bond markets account for a higher share of government financing, however, the effect of elections on inflation and economic growth is not only greater in magnitude but also more highly statistically significant. When governments depend on global bond markets for two-fifths of their external financing needs, election-year inflation and growth rates, on average, are 15 and 45 percent lower than during non-election periods. With greater indebtedness, a country's election-year mix of inflation and growth becomes even stingier. When governments tap three-fifths of their external financing needs with global bonds, average inflation and growth rates in Latin America are 21 and 87 percent lower during election periods than other periods.

**Figure 1.9: Marginal Effect of Elections on Growth Rates**




One potential alternative explanation for the effect of elections on economic outcomes is that they are conditioned on a country's institutional development. In fact, the developing country literature claims that weakly-constrained chief executives are more likely to craft an electoral boom-bust cycle in newer democracies. In other words, fewer institutional constraints

[67] The aforementioned marginal effects lose their statistical significance when governments have very little or no exposure to capital markets. Moreover, the interaction term in the economic growth model moves in the opposite direction.

place more power in the presidency. With economic policy left to executive discretion, Latin American presidents should prime the economic pump to improve their re-election chances.

In order to test for this alternative explanation, I reran the conditional models replacing the initial interaction term with a new institutional measure (that interacts elections with each of the two executive constraint variables outlined earlier). Nonetheless, the institutional model offers no evidence of a relationship between executive constraints and electoral booms and busts. The coefficients on the institutional interaction term for the inflation, growth, and unemployment models are statistically insignificant and small in magnitude.

In summary, these findings offer strong evidence in favor of the political austerity hypothesis that low-growth, low-inflation electoral cycles are commonplace in Latin America. Indeed, when governments in the region are highly indebted to global markets, they become burdened by interest payments. Left with less fiscal space, they are more likely to heed market calls for low inflation than when they have resources that are independent of global financial markets.

### 5.3.1 Robustness

I subjected these analyses to a battery of robustness checks and found that the correlation between decentralized bond financing and election-year inflation and growth is remarkably robust. I inserted several additional control variables into the original models (1a, 2a) to assess whether electoral economic outcomes are driven by the nature of domestic and international institutions. I included several measures of institutional constraints on executive power (*Executive Constraints*)[68] and IMF participation (*IMF*).[69] I also added a new control variable, total public debt as a percentage of GDP (*Total Public Debt*), to account for any deflationary pressures that might stem from a mounting debt burden more generally (rather than a country's debt structure). None of these made a significant change to the size, direction, or statistical significance of the key results (see models 1b-1c in Table A.5 and 2b-2c in Table A.6).

To further probe the robustness of the results, I included an alternative measure of decentralized bond financing. I replaced the original decentralize finance variable with a new

[68] Recall that I use two different measures of executive constraints: 1) the (xconst) variable from the Polity IV data set and the (polcon) variable from Henisz's (2000) Political Constraint Database.

[69] I also employ two different measures of pariticaption in IMF programs from Vreeland 2003 and Dreher 2006. The results were consistent.

binary $brady_{it}$ variable (*Brady*) indicating whether or not a country has undergone a Brady debt restructuring—a proxy for the development of global capital markets. Remember, those countries that participated in these restructurings were the leaders of Latin America's shift from bank loans to bond market financing. I suspect that countries that incurred these restructurings are more reliant on global bond markets for financing, and hence, more likely to face funding constraints from globally, dispersed financiers. Indeed, nations that endured this debt transformation should be more apt to pursue market-friendly, low-inflation environments. By contrast, prior to these restructurings or in non-Brady countries—where centralized forms of financing are more common—political business cycles remain a possibility.

For this new $brady_{it}$ variable, those countries with Brady deals receive a 1 beginning in the agreement year, while those countries that have never had a Brady deal are assigned a 0.[70]

$$brady_{it} = \begin{cases} 1 \text{ for those countries with Brady restructuring deals in place} \\ 0 \text{ otherwise} \end{cases}$$

The results are consistent with the previous findings that elections in highly-indebted countries are, on average, deflationary. The interactive coefficients for the inflation model remain negative, and are statistically significant at the 95 percent confidence level (see model 1e in Table A.5). In the conditional growth model, the existence of a Brady deal does not directly slow economic growth during elections, but does lead to more measured economic growth and higher unemployment (see model 2e in Table A.6) relative to less-indebted countries.

In additional robustness checks, I repeated all of the tests just described using the Arellano-Bond GMM estimator to control for possible endogeneity in the independent variables. For example, inflation can lead to higher interest rates, and ultimately, the accumulation of more bond market debt, creating a problem of reverse causality. Similarly, economic growth may produce higher government revenues, and an improved fiscal balance. To ensure that the results are not affected by such inconsistencies, I reformulated the empirical specification in accordance with the GMM estimator. The Arellano-Bond GMM estimator allows us to relax the assumption that the independent variables are strictly exogenous and treat these as endogenous variables. The results are reported in columns 1d and 1f in Table A.5 and 2d and 2f in Table A.6.

[70] From 1990-91, Mexico, Costa Rica, Uruguay, and Venezuela completed Brady deals. Another five countries followed with Brady agreements between 1992-1996.

The coefficients confirm our general findings. Elections occurring under decentralized bond financing are negatively correlated with inflation and growth. Overall, the GMM results support my governing hypothesis that the relationship between elections and the economy is contingent on decentralized bond finance, even if we control for possible endogeneity of the independent variables.

As a final robustness check, I modified the structure of the binary election variable to account for policy lags between economic decisions and inflation that are longer/shorter than expected. Political austerity cycle theory predicts that when countries are highly indebted to global bond markets, we should observe a deflationary effect not only in the election year, but also the subsequent year. While cash-strapped politicians might slow the economy to keep inflation at bay, the lag between economic decisions and inflation could last as long as a full year following an election. Varying this initial structure, I added a second year to the binary election variable to account for a potentially even-longer monetary policy lag. I also shifted the election variable to capture the possibility of a shorter policy lag by tracking inflation patterns that predate the electoral campaign. In none of these robustness tests did any of the results change materially.

# 6 Conclusion

## 6.1 A Political Exit from Capital's Exit Threat?

With their political survival at stake, Latin American politicians often act in surprising ways. During elections years, they frequently foster deflation, even if it detracts from their ability to deliver economic growth and jobs. What explains this puzzling behavior? In a region historically plagued by too little growth and too few jobs, are such decisions akin to political hara-kiri? Or, do they reflect a deeper, albeit counterintuitive political logic?

In this paper, I have offered a new theoretical insight regarding globalization's effect on domestic politics. It argues that what reduces policy autonomy is not the amount of financial integration, but rather the structure of lending to developing countries. The shift from bank lending to bond market financing affects political priorities by changing the nature of the relationship between debtor governments and their creditors.

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; they have a longer-term horizon that allows debtors to have flexibility.

By contrast, when credit is channeled through bonds rather than banks, shorter-term claims are inherently dispersed across a pool of global creditors that can immediately withdraw their financial commitments to borrowers. Because political uncertainty can intensify capital flight, politicians from across the political spectrum are less likely to create a political business cycle, or stray from market demands for low inflation and economic discipline.

Rather, political drivers who once raced their economies past their speed limits in the 1970s and 1980s are more likely to heed creditors' warnings when the structure of their borrowing is decentralized. In fact, my large-N statistical test of 16 Latin American countries (observed from 1961-2009) finds that politicians become more likely to pursue a low-inflation political austerity cycle as global bonds account for a higher share of national debt. Notwithstanding ideological or partisan preferences, politicians move toward the center when their creditors become international bondholders rather than bankers.

The rise of austerity politics has some important implications for developing countries. If politicians operating in global bond markets must live within their means, 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 increasing 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 discretionary spending, administer price controls in the energy and transportation sectors, and redirect central bank foreign reserves toward political and social initiatives. Ironically, markets may not only give politicians an incentive to reach macroeconomic balance, but also the incentive to develop

alternative policy tools subject to less global scrutiny.

Not surprisingly, capital market volatility has also prompted many governments to reduce their exposure to foreign bond markets in recent years. Notwithstanding its initial benefits, from fostering efficiency gains to serving as a conduit for cheap financing, unfettered capital has a crisis-prone downside. As famously noted by economic historian Charles Kindleberger, financial markets are susceptible to panics and manias. Hence, excessive borrowing leaves governments susceptible to financial booms and busts that have devastating economic consequences. Financing long-term development with short-term capital risks unleashing income shocks that can quickly undermine the economic vote. Hoping to insulate their nations from global financial volatility, developing country governments have fortified their stocks of foreign currency reserves, implemented capital controls, and developed local bond markets that are less susceptible to speculative pressures from foreign investors.

By contrast, developed country governments are only beginning to internalize the political costs of financial globalization. High levels of foreign indebtedness have placed the developed world, from Greece and Portugal to the United Kingdom and the United States, under the microscope of global capital markets. In the wake of the global financial crisis, mounting debt burdens have left Southern Europe in a cloud of speculative contagion. Investors demand budget cuts or threaten to take their capital to sunnier pastures. To prevent a financial disaster, politicians from across the political spectrum, like Greece's Socialist Prime Minister George Papandreou, have vowed to "draw blood" if necessary to appease bond market investors. Compared to Southern Europe, the United States' global reserve currency status affords it a longer-time horizon to solve its budgetary woes. However, even in this unique case, the United States' heavy reliance on short-term capital markets to fund its budget deficits has not only raised the country's credit risk, but also quickly altered its domestic discourse from the politics of possibility to the politics of austerity.

# 7 Appendix

## 7.A Macroeconomic Models

The literature on the political economy of macroeconomic policymaking 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.[71]

$$L = a(U_t - kU_{t^n})^2 \ + \ b(\pi_t)^2$$

*where* $U_t$ *= employment rate;* $U_{t^n}$ *= natural rate of unemployment;* $\pi_t$ *= 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 (e.g. 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 policymakers 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 policymakers' level of inflation aversion. A government favoring a Keynesian view is likely to tolerate a reasonably high rate of inflation in exchange for higher growth and lower unemployment. They are apt to assign a low weight to inflation relative to unemployment in their loss functions. By contrast, a government favoring a monetarist approach to policymaking 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. Hence, 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.

[71] The functional form of these loss function varies across the literature, but their main intuition is that policymakers dislike inflation and unemployment but support economic growth (Scheve, 2004; Barro and Gordon, 1983).

## 7.B Statistical Models

I use a series of basic regression models to test for evidence of traditional political business cycles. These baseline models assess the claim that elections negatively affect the economy.

### 7.B.1 The Basic Regression Models

$$I_{it} = \alpha + \hat{\beta}_1 Elections_{it} + \hat{\beta}_2 X_{it} + \hat{\beta}_3 I_{i,t-1} + n_i + \varepsilon_{it} \tag{1}$$

$$Y_{it^k} = \alpha + \hat{\beta}_1 Elections_{it} + +\hat{\beta}_2 X_{it} + \hat{\beta}_3 Y_{i,t-1} + n_i + \varepsilon_{it} \tag{2}$$

where $I_{it}$ = inflation; where $k = a, b$ with $a$ = GDP growth and $b$ = unemployment*;* where $Elections_{it}$ = election variable. The index $i$ = total number of countries and $t$ = year. $X_{it}$ = vector of control variables; $I_{t-1it}$ = inflation (one year lag)*;* and $Y_{t-1it}$ = growth/unemployment (one year lag). The term $n_i$ = dummy for each country, intended to capture unobserved country effects, while $\varepsilon_{it}$ = error term.

### 7.B.2 The Interactive Regression Models

In the conditional models, I add an interaction term to test for political austerity cycles. These models examine whether more exposure to decentralized finance is likely to prompt deflation during elections (1a) and/or slower economic growth and higher unemployment (2a).

$$I_{it} = \alpha + \hat{\beta}_1 Elections_{it} + \hat{\beta}_2 f_{it} + \hat{\beta}_3 Elections_{it} * f_{it} + \hat{\beta}_4 X_{it} + \hat{\beta}_5 I_{i,t-1} + n_i + \varepsilon_{it} \tag{1a}$$

$$Y_{it^k} = \alpha + \hat{\beta}_1 Elections_{it} + \hat{\beta}_2 f_{it} + \hat{\beta}_3 Elections_{it} * f_{it} + \hat{\beta}_4 X_{it} + \hat{\beta}_5 Y_{i,t-1} + n_i + \varepsilon_{it} \tag{2a}$$

where $f_{it}$ = the share of decentralized bond finance relative to total external public debt; and $Elections_{it} * f_{it}$ = the interaction between decentralized financing and elections.

## 7.C Regression Tables

**Table A.1: Variable Definitions and Sources**
(16 Latin American countries, 1961-2009)

| | Definition & Measurement | Source(s) |
|---|---|---|
| Dependent Variables | | |
| Inflation* | Change in log CPI (annual percentage change). | World Development Indicators (WDI). |
| GDP Growth | Change in real GDP (annual percentage change). | World Development Indicators (WDI). |
| Unemployment | Change in unemployment (percentage of total labor force). | World Development Indicators (WDI). |
| Independent Variables | | |
| Election Dummy | For the inflation regressions, the binary variable takes on the value of 1 in election year and subsequent year, and 0 otherwise. For the growth regressions, the binary variable takes on the value of 1 in an election year and the preceding N-1 years, and 0 otherwise, where N = 2 or 3. | 2006-2007 Political Handbook of the World; EIU; Cheibub and Kalandrakis (2004), Global Database of Political Institutions and Economic Performance. |
| Decentralized Bond Finance | Public bond issuance as a percentage of total public external debt. | Calculated from the World Bank's Global Development Finance Database |
| Brady Dummy | Binary variable; takes on a 1 for those countries that have had a Brady restructuring deal beginning in the initial agreement year, and 0 otherwise. | Emerging Market Traders' Association (EMTA) website: www.emta.org/emarkets/brady |
| Economic Control Variables | | |
| Global GDP Growth | Average real GDP growth of G-7 economies, weighted by each country's total GDP share. | Calculated from World Bank's World Development Indicators (WDI). |
| Global Commodity Price Index** | Percentage change in global commodity (CRB) index; comprised of 17 primary commodities weighted by their importance to global trade. | Global Financial Database; Reuters's Global Commodity Index (CRB) |
| Trade Openness | Total exports plus total imports as a percentage of GDP. | Calculated from World Bank's World Development Indicators (WDI). |
| Income | log of GNP per capita, constant US$ (2000) | Calculated from World Bank's World Development Indicators (WDI). |
| Fiscal Balance | Primary budget balance--net of interest payments-- (+/-) percentage of GDP (lagged by one year). | Comisión Económica para América Latina y El Caribe (CEPAL) |
| Domestic Financial Depth | Broad money (M2), or money in circulation, as a percentage of GDP. | World Bank's World Development Indicators (WDI) |
| Domestic Investment | Domestic investment as a percentage of GDP. | World Bank's World Development Indicators (WDI) |
| Total Public Debt | Total public debt as a percentage of GDP | Calculated from the World Bank's Global Development Finance Database |
| Political Control Variables | | |
| Executive Constraints (Henisz) | Measure of political constraints; estimates the feasibility of policy change relative to institutional checks and balances. | Henisz, W.J. (2000).The Institutional Environment for Economic Growth. |
| Executive Constraints (Polity IV) | Measure of checks and balances on executive power; employs a seven-category scale from unlimited authority to executive | Polity IV Codebook and Database. |
| Central Bank Independence | Measures the autonomy of central banks as written into countries' laws and legal systems. Updates Cukierman, Webb, and Neyapti (1992) Index. | Polillo, S. and Guillen, M. (2005). Globalization Pressures and the State: The Global Spread of Central Bank Independence. *American Journal of Sociology* , 110(6). |
| IMF Participation (Vreeland, 2003) | Participation in IMF programs: Dummy variable coded 1 for country-years when there was a conditioned IMF agreement in force, 0 otherwise. | Vreeland, James Raymond (2003). *The IMF and Economic Development.* Cambridge University Press. |
| IMF Participation (Dreher, 2006) | IMF Participation: Dummy variable coded 1 for country-years when there was IMF standby or EFF agreement for at least five months, 0 otherwise. | Dreher, Axel (2006). IMF and Economic Growth: The Effects of Programs, Loans, and Compliance with Conditionality, *World Development* 34(5). |

* Average inflation is converted to its natural logarithm to minimize the influence of extreme values resulting from hyperinflation.
** Weightings: 17.6% (oil & natural gas), 17.6% (corn, soybeans, wheat), 11.8% (copper, cotton), 11.8% (livestock), 17.6% (gold, platinum, silver), 23.5% (cocoa, coffee, sugar).

**Table A.2: Descriptive Statistics for Inflation and Unemployment**
(16 Latin American countries, 1961-2009)

| | All | Decentralized Finance | Decent. Finance, Elections=1 | Decent. Finance, Elections=0 |
|---|---|---|---|---|
| **Dependent Variable** | | | | |
| Average Inflation (logCPI)* | 2.78 | 2.73 | 2.47 | 2.97 |
| # Observations | 792 | 605 | 287 | 318 |
| Average unemployment | 8.64 | 8.97 | 9.09 | 8.90 |
| # Observations | 404 | 304 | 120 | 184 |

* Average inflation converted to its natural logarithm to minimize influence of extreme values resulting from hyperinflation.

**Table A.3: Descriptive Statistics for Regression Variables**
(16 Latin American countries, 1961-2009)

| | Mean | SD | Min | Max | N |
|---|---|---|---|---|---|
| Inflation* | 2.78 | 1.32 | -2.30 | 9.57 | 792 |
| GDP Growth | 3.78 | 4.38 | -26.50 | 18.30 | 833 |
| Unemployment | 8.64 | 3.99 | 1.30 | 20.50 | 404 |
| Decentralized Bond Finance | 18.29 | 24.04 | 0.00 | 84.00 | 680 |
| Global Growth | 3.55 | 1.67 | -1.9 | 6.70 | 833 |
| Global Commodity Price Index | 3.13 | 13.75 | -36.00 | 47.60 | 833 |
| Trade Openness | 42.07 | 23.38 | 9.50 | 145.70 | 832 |
| Income | 7.77 | 0.66 | 6.45 | 9.20 | 833 |
| Fiscal Balance | 0.04 | 3.72 | -27.50 | 9.40 | 536 |
| Domestic Financial Depth | 28.52 | 14.24 | 4.70 | 88.40 | 813 |
| Domestic Investment | 5.23 | 16.68 | -64.90 | 152.20 | 722 |
| Total Public Debt | 40.89 | 62.62 | 4.00 | 824.00 | 680 |
| Executive Constraints (Henisz) | 0.29 | 0.20 | 0.00 | 0.69 | 769 |
| Executive Constraints (Polity IV) | 4.63 | 2.08 | 0.00 | 7.00 | 784 |
| Central Bank Independence | 0.50 | 0.189 | 0.21 | 0.77 | 163 |

* Average inflation is converted to its natural logarithm to minimize the influence of extreme values resulting from hyperinflation.

**Table A.4: The Effect of Elections on the Economy**

(Basic OLS Regressions with Fixed Effects )

| Dependent Variable: | Inflation[1] | Inflation | Growth | Growth | Unemp. | Unemp. |
|---|---|---|---|---|---|---|
| | (FE) | (GMM) | (FE) | (GMM) | (FE) | (GMM) |
| Independent Variable | (1) | (1) | (2) | (2) | (2) | (2) |
| Elections | -0.103* | -0.104* | -0.147 | -0.147 | -0.151 | -0.165 |
| | (0.058) | (0.056) | (0.340) | (0.325) | (0.276) | (0.273) |
| Decentralized Finance | -0.842** | -0.825** | -1.020 | -1.020 | 1.687* | 1.406 |
| | (0.355) | (0.353) | (1.861) | (1.777) | (0.979) | (1.047) |
| Global Growth | 0.079*** | 0.078*** | 0.639*** | 0.639*** | -0.293** | -0.277** |
| | (0.023) | (0.022) | (0.166) | (0.159) | (0.118) | (0.110) |
| Commodity Price Index | -0.001 | -0.001 | -0.017 | -0.017 | 0.007 | 0.009 |
| | (0.002) | (0.001) | (0.011) | (0.010) | (0.008) | (0.008) |
| Trade Openness | 0.007* | 0.007** | 0.002 | 0.002 | 0.015 | 0.013 |
| | (0.003) | (0.003) | (0.016) | (0.015) | (0.015) | (0.018) |
| Fiscal Balance (1 year lag) | -0.043*** | -0.044*** | 0.079** | 0.079** | -0.033 | -0.005 |
| | (0.009) | (0.008) | (0.034) | (0.033) | (0.038) | (0.037) |
| Income | -0.064 | -0.035 | 0.064 | 0.064 | | |
| | (0.153) | (0.169) | (1.415) | (1.351) | | |
| Domestic Financial Depth | 0.000 | -0.000 | | | -0.009 | -0.006 |
| | (0.005) | (0.005) | | | (0.013) | (0.010) |
| Annual GDP Growth | -0.050*** | -0.050*** | | | 0.035 | 0.042 |
| | (0.011) | (0.011) | | | (0.040) | (0.038) |
| Annual Inflation | | | -0.561** | -0.561** | | |
| | | | (0.229) | (0.219) | | |
| Domestic Investment | | | 0.156*** | 0.156*** | -0.040*** | -0.040*** |
| | | | (0.021) | (0.020) | (0.009) | (0.008) |
| IMF | -0.104 | -0.101 | 0.100 | 0.100 | 0.079 | 0.086 |
| | (0.096) | (0.094) | (0.307) | (0.292) | (0.378) | (0.367) |
| Executive Constraints | 0.023 | 0.023 | 0.089 | 0.089 | -0.146* | -0.134* |
| | (0.019) | (0.018) | (0.126) | (0.121) | (0.073) | (0.076) |
| | Inflation | Inflation | Growth | Growth | Unempl. | Unempl. |
| Dependent Variable (1 year lag) | 0.794*** | 0.795*** | 0.169** | 0.169** | 0.734*** | 0.734*** |
| | (0.031) | (0.031) | (0.082) | (0.079) | (0.069) | (0.069) |
| N | 457 | 440 | 428 | 412 | 218 | 193 |
| Number of Groups | 16 | 16 | 16 | 16 | 16 | 16 |
| $R^2$ | 0.78 | | 0.56 | | 0.83 | |

*p<.1; ** p<.05; *** p<.01 (two tailed tests); robust standard errors in parentheses, clustered by country.

[1]Inflation is converted to its natural logarithm to minimize the influence of extreme hyperinflation values.

A constant term is included in each regression, but not reported in the table. FE=fixed effects.

**Table A.5 The Effect of Elections on the Economy**

(OLS Regressions with Interactive Terms)

| Dependent Variable: | Inflation[1] | Inflation | Inflation | Inflation | Inflation | Inflation |
|---|---|---|---|---|---|---|
| | (FE) | (FE) | (FE) | (GMM) | (FE) | (GMM) |
| Independent Variable | (1a) | (1b) | (1c) | (1d) | (1e) | (1f) |
| Elections | 0.017 | -0.011 | -0.010 | -0.012 | 0.000 | -0.001 |
| | (0.051) | (0.054) | (0.054) | (0.052) | (0.048) | (0.046) |
| Decentralized Finance | -0.646** | -0.687** | -0.656* | -0.644** | | |
| | (0.294) | (0.332) | (0.325) | (0.319) | | |
| Election*Decentralized Finance | -0.380** | -0.375** | -0.375** | -0.372** | | |
| | (0.164) | (0.168) | (0.168) | (0.164) | | |
| Brady Restructuring | | | | | -0.416** | -0.423** |
| | | | | | (0.184) | (0.175) |
| Election*Brady | | | | | -0.238** | -0.238** |
| | | | | | (0.103) | (0.099) |
| Global Growth | 0.103*** | 0.080*** | 0.080*** | 0.079*** | 0.074*** | 0.071*** |
| | (0.017) | (0.022) | (0.022) | (0.021) | (0.022) | (0.021) |
| Commodity Price Index | -0.003 | -0.001 | -0.001 | -0.001 | -0.001 | -0.001 |
| | (0.002) | (0.002) | (0.002) | (0.002) | (0.001) | (0.001) |
| Trade Openness | 0.007** | 0.007** | 0.007** | 0.007** | 0.008** | 0.008** |
| | (0.003) | (0.003) | (0.003) | (0.003) | (0.003) | (0.003) |
| Fiscal Balance (1 year lag) | -0.042*** | -0.043*** | -0.044*** | -0.044*** | -0.046*** | -0.047*** |
| | (0.007) | (0.009) | (0.010) | (0.009) | (0.012) | (0.011) |
| Income | 0.039 | -0.048 | -0.105 | -0.081 | -0.357* | -0.259 |
| | (0.155) | (0.153) | (0.205) | (0.222) | (0.192) | (0.198) |
| Domestic Financial Depth | -0.001 | -0.000 | -0.000 | -0.000 | -0.003 | -0.003 |
| | (0.005) | (0.005) | (0.005) | (0.005) | (0.005) | (0.004) |
| Annual GDP Growth | -0.049*** | -0.050*** | -0.050*** | -0.050*** | -0.050*** | -0.050*** |
| | (0.012) | (0.011) | (0.011) | (0.011) | (0.011) | (0.010) |
| IMF | | -0.107 | -0.105 | -0.102 | -0.101 | -0.091 |
| | | (0.095) | (0.094) | (0.092) | (0.090) | (0.087) |
| Executive Constraints | | 0.019 | 0.021 | 0.021 | 0.026 | 0.026 |
| | | (0.018) | (0.019) | (0.018) | (0.018) | (0.018) |
| Total Public Debt | | | -0.041 | -0.040 | -0.055 | -0.048 |
| | | | (0.050) | (0.048) | (0.051) | (0.051) |
| | Inflation | Inflation | Inflation | Inflation | Inflation | Inflation |
| Dependent Variable (1 year lag) | 0.799*** | 0.794*** | 0.802*** | 0.803*** | 0.779*** | 0.779*** |
| | (0.026) | (0.031) | (0.030) | (0.029) | (0.039) | (0.036) |
| N | 472 | 457 | 457 | 440 | 456 | 439 |
| Number of Groups | 16 | 16 | 16 | 16 | 16 | 16 |
| $R^2$ | 0.80 | 0.79 | 0.78 | | 0.71 | |

*p<.1; ** p<.05; *** p<.01 (two tailed tests); robust standard errors in parentheses, clustered by country.

[1]Inflation is converted to its natural logarithm to minimize the influence of extreme hyperinflation values.

A constant term is included in each regression, but not reported in the table. FE=fixed effects.

**Table A.6 The Effect of Elections on the Economy**

(OLS Regressions with Interactive Terms)

| Dependent Variable: | Growth | Growth | Growth | Growth | Unempl. | Unempl. | Unempl. | Unempl. | Unempl. | Unempl. |
|---|---|---|---|---|---|---|---|---|---|---|
| | (FE) | (FE) | (FE) | (GMM) | (FE) | (FE) | (FE) | (GMM) | (FE) | (GMM) |
| Independent Variable | (2a) | (2b) | (2c) | (2d) | (2a) | (2b) | (2c) | (2d) | (2e) | (2f) |
| Elections | 0.510 | 0.424 | 0.383 | 0.383 | -0.214 | -0.149 | -0.192 | -0.188 | -0.145 | -0.161 |
| | (0.532) | (0.438) | (0.410) | (0.390) | (0.313) | (0.313) | (0.331) | (0.328) | (0.349) | (0.343) |
| Decentralized Finance | -0.073 | -0.123 | -0.531 | -0.531 | 1.589** | 1.692** | 1.552* | 1.401 | | |
| | (1.804) | (1.889) | (1.914) | (1.822) | (0.706) | (0.743) | (0.765) | (0.883) | | |
| Election*Decentralized Finance | -2.035* | -2.172* | -2.094* | -2.094** | 0.084 | -0.008 | 0.055 | 0.046 | | |
| | (1.185) | (1.076) | (1.038) | (0.989) | (0.682) | (0.687) | (0.746) | (0.706) | | |
| Brady Restructuring | | | | | | | | | 1.366** | 1.496** |
| | | | | | | | | | (0.535) | (0.674) |
| Election*Brady | | | | | | | | | -0.179 | -0.169 |
| | | | | | | | | | (0.398) | (0.394) |
| Global Growth | 0.538*** | 0.622*** | 0.633*** | 0.633*** | -0.296** | -0.293** | -0.265** | -0.250** | -0.278** | -0.277*** |
| | (0.114) | (0.170) | (0.168) | (0.160) | (0.115) | (0.117) | (0.104) | (0.103) | (0.096) | (0.098) |
| Commodity Price Index | -0.011 | -0.016 | -0.015 | -0.015 | -0.006 | 0.007 | 0.008 | 0.009 | 0.010 | 0.011 |
| | (0.010) | (0.011) | (0.011) | (0.010) | (0.008) | (0.008) | (0.009) | (0.009) | (0.010) | (0.009) |
| Trade Openness | -0.000 | 0.001 | -0.005 | -0.005 | 0.013 | 0.015 | 0.005 | -0.003 | 0.007 | 0.002 |
| | (0.016) | (0.015) | (0.013) | (0.012) | (0.015) | (0.015) | (0.015) | (0.019) | (0.015) | (0.019) |
| Fiscal Balance (1 year lag) | 0.092** | 0.078** | 0.091** | 0.091*** | -0.055* | -0.033 | -0.018 | -0.018 | -0.012 | -0.010 |
| | (0.032) | (0.033) | (0.032) | (0.030) | (0.029) | (0.039) | (0.041) | (0.037) | (0.038) | (0.032) |
| Income | 0.428 | 0.066 | 0.893 | 0.894 | | | | | | |
| | (1.336) | (1.138) | (1.186) | (1.129) | | | | | | |
| Annual Inflation[1] | -0.535** | -0.560** | -0.641** | -0.641*** | | | | | | |
| | (0.228) | (0.229) | (0.240) | (0.228) | | | | | | |
| Domestic Investment | 0.156*** | 0.158*** | 0.158*** | 0.158*** | -0.041*** | -0.040*** | -0.040*** | -0.038*** | -0.037*** | -0.035*** |
| | (0.021) | (0.021) | (0.021) | (0.020) | (0.009) | (0.009) | (0.009) | (0.009) | (0.009) | (0.008) |
| Domestic Financial Depth | | | | | -0.014 | -0.009 | -0.001 | -0.001 | -0.001 | -0.002 |
| | | | | | (0.013) | (0.013) | (0.007) | (0.007) | (0.010) | (0.010) |
| Annual GDP Growth | | | | | 0.033 | 0.035 | 0.044 | 0.047 | 0.037 | 0.035 |
| | | | | | (0.041) | (0.039) | (0.041) | (0.037) | (0.037) | (0.032) |
| IMF | | 0.089 | 0.064 | 0.064 | 0.099 | 0.079 | 0.048 | 0.025 | -0.061 | -0.075 |
| | | (0.305) | (0.310) | (0.295) | (0.339) | (0.379) | (0.374) | (0.356) | (0.338) | (0.327) |
| Executive Constraints | | 0.067 | 0.037 | 0.037 | | -0.146* | -0.131 | -0.125* | -0.132 | -0.142* |
| | | (0.117) | (0.113) | (0.108) | | (0.074) | (0.077) | (0.074) | (0.084) | (0.077) |
| Total Public Debt | | | 0.517** | 0.517*** | | | 0.270 | 0.365 | 0.277 | 0.349 |
| | | | (0.203) | (0.193) | | | (0.186) | (0.247) | (0.180) | (0.238) |
| | Growth | Growth | Growth | Growth | Unemp. | Unemp. | Unemp. | Unemp. | Unemp. | Unemp. |
| Dependent Variable (1 year lag) | 0.175** | 0.175* | 0.174* | 0.174** | 0.746*** | 0.734*** | 0.740*** | 0.744*** | 0.722*** | 0.721*** |
| | (0.080) | (0.083) | (0.083) | (0.079) | (0.067) | (0.069) | (0.070) | (0.071) | (0.056) | (0.056) |
| N | 444 | 428 | 428 | 412 | 218 | 218 | 218 | 193 | 218 | 193 |
| Number of Groups | 16 | 16 | 16 | 16 | 16 | 16 | 16 | 16 | 16 | 16 |
| $R^2$ | 0.57 | 0.56 | 0.55 | | 0.83 | 0.83 | 0.84 | | 0.83 | |

*p<.1; ** p<.05; *** p<.01 (two tailed tests); robust standard errors in parentheses, clustered by country.

[1]Inflation is converted to its natural logarithm to minimize the influence of extreme hyperinflation values.

A constant term is included in each regression, but not reported in the table. FE=fixed effects.

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