How Latin American Countries Became Fiscal Conservatives:

A book review of 'Globalization and Austerity Politics in Latin America' by Stephen Kaplan

Mauricio BUGARIN *

The 1980s have been called "the lost decade" for Latin America. Following Mexico's debt moratorium in August, "by the end of 1982 Latin America had entered one of the darkest periods in its history"[1]. Latin American suffered a negative growth of −0.78 in 1982 and inflation reached 165% in Argentina, 100% in Brazil, and 124% in Bolivia. Fifteen year later, in 1997, inflation in Argentina was reduced to a mere 0.5%, in Brazil to less than 7% and to 4.7% in Bolivia and Latin American growth reached 5.4%, almost two points above the world growth average on 3.7%[2].

Stephen Kaplan's "Globalization and Austerity Politics in Latin America" (Cambridge University Press, 2013) presents a very compelling analysis of Latin American political economic history over the past 30 years shedding light on a trend towards austerity politics that has attracted so much attention and investment to the region in the past decade.

The book uses three main methodological approaches. After the introduction, it explains in Chapter 2 the main theoretic argument, the "Political Austerity Cycle" (PAC) theory and its variations, as an alternative to the traditional Political Business Cycle (PBC) theory. Then, it tests the PAC hypothesis against the PBC in Latin America in Chapter 3 ("The Political Economy of Elections"), finding evidence for the

Mauricio Bugarin was a visiting researcher at the Graduate School of International Cooperation Studies of Kobe University, GSICS, during the fall semester of 2013. The institutional support of GSICS is gratefully acknowledged. The financial support of CNPq is gratefully acknowledged. The author remains sole responsible for errors or opinions expressed here.

* Professor of Economics, Economics Department, University of Brasilia and Leader of the Economics and Politics Research Group, UnB and CNPq. e-mail: bugarin.mauricio@gmail.com. Web-page: www.bugarinmauricio.com.

PAC when certain conditions are met. Next, it analyses several country case studies to better understand and identify those conditions in the following 4 chapters, and then concludes in Chapter 8.

The book explains the debt crisis of the 1980s as an outcome of the debt structure of Latin American (LA) countries. The main tool used there is the economics of information and incentives and the rationale is straightforward. Before the debt crisis, a few international banks (mostly American) held a majority of LA debt. Naturally, these banks had strong interest in the economic stability of the debt holders and included conditionality in their loan contracts. However, the oil crises of the 1970s brought about new challenges to the entire world and LA countries were not spared. In times of economic hardships that lead to nonfulfillment of the conditionality and a possibility of not receiving their loan payments, the lenders found themselves in a dilemma. On one hand, they could stop financing those countries, but the sudden stop would probably lead to a debt default, which would bring losses to their stockholders. On the other hand, they could extend new loans in order for those countries to be able to meet their immediate obligations, in hope that the conditionality embedded in the new contracts would be met and sound economic policy would ensure future flows of payment. The borrowers, in need of funds themselves, naturally agreed with the imposed conditionality. Therefore, in order to escape immediate financial losses, the lenders were willing to extend new loans to LA countries, risking future, more significant losses.

This repeated relationship between borrowing countries in economic hardship and a reduced number of lenders that would suffer important losses if the payment flows were interrupted created a clear moral hazard problem. Indeed, the austerity conditionality was difficult to implement in socially and politically stressed countries, many of which were barely returning to democracy[3]. Furthermore, the borrowers, aware of the lenders' dilemma, understood that the likelihood of being able to renegotiate the debt was high even if they did not meet the conditionality. Therefore, the stage was set to a sequence of renegotiations with little austerity on the part of the borrowers. This was especially true in election years when electoral concerns pushed the incumbents into irresponsible policies aimed at creating (artificial) economic growth. The national (electoral cycles) and the international (the likelihood of receiving additional loans) environments both stimulated the traditional Political Business Cycle. Chapter 4, "The Electoral Boom-Bust Cycle", presents case studies supporting that hypothesis, including the electoral years of 1970 in Chile, 1978, 1983, 1988 and 2006 in Venezuela and 1984 and 1988 in Ecuador. In all cases, the incumbents had the means of fostering an artificial boom during electoral year because of the high international prices of an important item of their export, be it copper in Chile or oil in Venezuela and Ecuador. Since these incumbents were not disciplined by other mechanism, they did create typical Political Budget Cycles.

The debt crisis ignited when such renegotiation became unsustainable and the resulting default was not solved until the debt structure of LA countries was changed. This was achieved by the Brady bond restructurings, which replaced defaulted bank loans with short-term bonds, issued in the international financial market. The incentive effect of the Brady plan was immediately felt. Since now LA countries' debts were pulverized over huge numbers of smaller investors through the bond markets, which had, themselves several alternative investment opportunities, the lenders were no more subject to the dilemma previously discussed. Furthermore, risk-averse investors were ready to sell their bonds at the first sign of macroeconomic instability in the corresponding countries. Therefore, if an LA country was financially constrained and in need of foreign capital acquired by means of the bond market, the Brady restructuring plan was able to create an important mechanism of market discipline: the country had to make credible signals of austerity and sound economic policy in order to keep the flow of money. This signaling became especially important in electoral years because of the natural political unpredictability of elections. Therefore, in several cases LA incumbents were forced to become actually more austere in electoral years. Hence, this new theory, the "Political Austerity Cycle", has actually opposing predictions when compared with the Political Business Cycle theory, i.e., it is precisely when elections near that the incumbent becomes especially austere in order to signal investors that their capital is safe and, thereby, avoid sudden stops of capital flows. Chapter 5, "From Gunboat to Trading Floor Diplomacy" details this theory and presents case studies supporting the market discipline austerity cycle hypothesis. The case studies consisted of election years of 1996 and 1998 in Ecuador and the 1998 election year in Venezuela. In all cases, historic low oil prices made governments strongly dependent on foreign capitals, which, in turn, forced incumbents to choose tighter monetary and fiscal policies as well.

Suppose now that a country is not necessarily constrained by the need of foreign capital. This could happen because the country has important natural resources, such as oil, for example, in times were these resources are highly valued in international markets. Then, the market mechanism may not be strong enough to discipline the politician. That is when a second important factor may come to play an active role: inflation aversion. Indeed, the book presents compelling arguments to support the fact that populations that have experienced situations of hyperinflation become traumatized by it so that the mere risk of inflation making a comeback is sufficient to kill the hopes of electoral success of the incumbent party. In that case, the incumbent president may choose to follow sound austere economic policies in order to fight inflationary pressures in electoral years and gain the political rewards of low inflation. In that case, it is not the international bond market mechanism that disciplines politicians, but rather a national strong opposition to inflation due to past hyperinflation trauma that aligns the incentives to austerity. This situation, called the "Inflation-Averse Political Austerity Cycle" is discussed in detail along with several case studies in Chapter 6, "When Latin American Grasshoppers Become Ants". The case studies comprise Chile's post-Pinochet election years of 1993, 1999 and 2005, where the hyperinflation of the pre-dictatorship Allende government created long-lasting inflation-aversion in the population, as well as Argentina's 1999 and Brazil's 1994 and 2006 election years with more recent hyperinflation experiences[4]. In all cases studied the incumbents had the strategic opportunity to foster an artificial economic growth by means of loose fiscal and monetary policies, but in each one of these electoral years incumbents chose instead to reinforce economic austerity in order to signal to their own constituents that inflation would remain under control.

Finally, the strongest form of PAC will materialize if a country is subject to both mechanisms of discipline, that is, when the government depends on foreign bond markets and the population has developed inflation aversion due to past hyperinflation experiences. In that case, both elements condition politicians' behavior into austere policies. This is carefully discussed in Chapter 7, "The Political Austerity Cycle". The case studied there are the electoral years of 1995 and 2003 in Argentina and 1998 and 2002 in Brazil. In all four cases, the incumbents faced the treat of sudden stops of international capital flows in countries traumatized by recent hyperinflation. In each one of these elections, the incumbent president adopted unusually stringent austere monetary and fiscal policies in order to signal the soundness of their governance to foreign bond investors and the clear resolution to fight inflation to their national constituents.

Chapter 8 presents the main conclusions of the book, a discussion on the possible future of Latin America. It emphasizes the role of international credit markets on government policy choices and suggests that, when developing countries are in need of external financing, then the impersonal bonds market may actually be more effective in generating budgetary discipline and promoting better governance than traditional checks and balances institutions, such as the Central Banks, or multilateral credit institutions such as the IMF. This may be especially true for newly re-democratized countries where institutions are still consolidating. Furthermore, it emphasizes the fundamental role of inflation aversion, which also imposes budgetary discipline on the incumbents, regardless of external bond markets.

The success of these two important mechanisms in disciplining political incumbents and generating the positive outcome presented in the introduction of this review, however, may be in jeopardy due to their very success. Indeed, as inflation remains under control for decades, citizens may start to forget about the hardships of hyperinflation and may assign less political importance to its control in the medium run. This could reduce the disciplinary effect of inflation aversion. Furthermore, as the macroeconomy stabilizes in LA countries and they start accumulating foreign reserves thanks to their sound governance and the increasing world demand for commodities –of which LA countries are important world suppliers– these countries may rely much less on foreign capitals. In that case, the bond market may also loose its disciplinary grip. The case studies of oil rich Venezuela and, to a lesser extend, Ecuador and of copper-rich Chile in the 1970s in Chapter 4 show that a country may have a strong stimulus to disregard budget discipline when their commodity exports become an important source of income. In the absence of such strong incentives, one should turn to the consolidation of national institutions, such as Chile's inflation-targeting regime, to ensure social and economic prosperity in Latin America in the medium run. Democracy is consolidating in the area and Latin America is seen today as one of the regions with the oldest and best-established democracies in the developing world. The economic, political and social success of present-day Chile remains good evidence that a new era of both budgetary discipline and growth is attainable in a region blessed by natural resources even when the incumbents become gradually less disciplined by the external bond markets or by the inflation aversion of their constituents.

References

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Notes

1 Edwards (2008).

2 World Bank Indicators, http://data.worldbank.org/indicator.

3 Argentina returned to democracy in 1983 after the disastrous Falkland war against the UK and Brazil's first civilian president in over 20 years took office in 1985, to cite two important countries in the region.

4 Inflation reached 600% in 1973 in Chile, 3000% in 1989 in Argentina 2400% in 1993 in Brazil, according to the World Bank and the book under review.