The Brazilian presidential campaign of 2002 was characterized by an unprecedented financial crisis. After eight years of a center-right government, the emergence of the Worker’s Party’s (PT) candidate as the potential winner triggered a substantial reaction among portfolio investors. The country risk doubled in the six months prior to the poll, reaching a ten-year high in the month of the election. Sudden capital flight caused the Brazilian currency to fall from US$ 0.43 in January to US$ 0.26 in September 2002, and the 15% annual inflation rate, reached in the middle of the year, threatened the country’s decade long stabilization.

While the crisis did not prevent Lula’s election, it significantly constrained the implementation of the new president’s agenda. Tight monetary and fiscal policies, as well as cuts in social spending and the launching of a social security reform that taxed retired public employees contradicted not only Lula’s campaign promises, but the program advanced by the Workers’ Party during two decades. While these policies frustrated PT’s supporters and provoked the exodus of party members, they managed to calm investors and creditor governments, putting an end to the crisis six months after the president’s inauguration.

Similar phenomena have taken place in France, Australia, Argentina, Ecuador and India, among other countries. In all these cases, financial market crises triggered by the election of progressive candidates affected the choices of recently inaugurated governments and moved their political agenda to the right of the program announced during campaign. These cases are interesting to political scientists as they exemplify one mechanism through which financial investors’ exit capacity can push political outcomes away from voters’ preferences in democratic systems, and subsidize claims that the globalization of financial markets might reduce citizens’ influence over political outcomes.

While less abundant, different stories also exist. In 2005 Uruguay, the election of Tabaré Vazquez, a left-wing outsider in the country’s century long two-party system, produced no reaction whatsoever among financial investors in the country. In Venezuela after 1998, market panic was not followed by
a switch to a conservative economic program by Hugo Chávez. It is also striking to notice that, in Ecuador, while investors’ reacted to the victory of Gutierrez in 2002, the same did not occur prior to Correa’s election in 2006, despite his unequivocally left-wing discourse and connections with the Venezuelan president.

These examples suggest that, while in some instances financial investors have the power to bend policy choices towards their preferences, that influence varies significantly, and the conditions that explain such variation deserve careful scrutiny. The goal of my dissertation is to account for these variations, explaining the conditions under which financial investors are more or less capable of exerting political power vis-à-vis voters, with a focus on less developed countries.

This dissertation contributes to the understanding of the politics of international financial markets in developing countries both theoretically and empirically. In the first chapter, I present a model of optimal taxation that depicts the way incumbents decide how much income to redistribute, subject to voters’ demands and to the prospect of capital flight. It explains why increased capital mobility exacerbates the conflict between growth and redistribution in less developed economies, and how international liquidity cycles affect this dynamic. I present the 2002 election of Lula in Brazil as an illustration of the logic explored in the model, while the two subsequent chapters test this logic more systematically.

Chapter 2 examines investors’ reaction to the prospects of increased income redistribution, observing portfolio investors’ behavior during elections in a sample of 125 cases taken place in OECD as well as in less developed countries. I find systematic evidence of capital flight occurred in cases where elections bring about a “move to the left”, confirming prior case studies on the matter. I also observe that investors’ best electoral outcome occurs when a conservative government replaces another, and argue that democracies pay a “price for change” whenever there are ideological variations in national governments. Finally, I demonstrate that, despite following a similar logic, investors’ responses to elections in less developed countries are stronger than in developed nations, which is consistent with the claims that they are also more politically constraining in the former.

In Chapter 3, I study the political consequences of capital movements, verifying whether speculative attacks occurred in the period that antecedes inaugurations affect the policy choices of new governments in a sample of 89 Latin American elections. I find that progressive presidents inaugurated in the midst of a currency crisis are the ones most likely to adopt neoliberal policies they rejected during campaign, and that political conditions such as the constitutional powers in hands of the Executive, legislative strength and the institutionalization of the party system affect presidents’ capacity to effectively switch programs. I also show that, according to the predictions of the model, the policy choices of conservative governments are not affected by capital movements.
The last two chapters are the result of field work in Brazil, Argentina, Ecuador and Venezuela, and test different implications of the model proposed in chapter 1. In chapter 5, I explain how international financial cycles influence investors’ behavior in emerging markets, comparing investors’ response to two successive elections in Venezuela and Ecuador. Chapter 6 contrasts recent governments in Brazil and Argentina in order to highlight the fundamental impact of country’s debt profile on investors’ behavior and capacity to influence policy choices. I finish the dissertation discussing the normative implications of the phenomenon studied and the role of choice in democratic politics, as well as the possible consequences of the lack thereof to the furthering of democracy in less developed countries.