POLITICAL DETERMINANTS OF FINANCIAL CRISES:
A POLITICAL FLEXIBILITY APPROACH TO LATIN AMERICAN CRISES

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Abstract

Throughout the 1990s and into this century, analysts have failed to predict the emergence of major financial crises in Latin America. From the Mexican peso crisis of 1994 to the Argentine convertibility crisis of 2001, most analysts have focused on identifying possible threats to or weaknesses of an economy using current situation analysis techniques that in one way or another measure the strength of an economy to overcome probable risks. The problem is that the globalization of financial markets has exponentially increased the possible sources for macroeconomic shocks, making it very difficult to accurately analyze the risk of financial crises based on identification of probable threats.

The dynamics of today’s international financial markets call for a new type of analysis: one that does not try to predict future events, but looks at the capacity of countries to deal with an unknown future—that is, a policy flexibility analysis approach that helps us determine the ability of governments to act in order to pre-empt or prevent future financial crises. Political variables—such as the balance of political forces, actors, and institutions that determine the degree of flexibility for action a government enjoys to shape and operate its fiscal and monetary policies—are key in anticipating a country’s capacity to react positively and effectively when facing events or surprises that threaten its financial stability. By looking at the capacity of a government to act when confronted with a negative event, we can focus our analysis and understand not only the weaknesses of a country, but also how those weaknesses can be mitigated. A policy flexibility
framework allows us to move from an analysis of economic capability to one of political capability.

What governments do or fail to do politically, and the steps they take or fail to take institutionally, determine the country’s ability to pre-empt or prevent a crisis. An analysis of both the Mexican crisis of 1994 and the Argentine crisis of 2001 confirm the existence of a set of political factors that limited government action.

In attempting to accurately predict upcoming crises, we are better served not by looking at financial risk in terms of identifying threats or considering the strength of a country’s “financial armor,” but by analyzing a country’s capability and will to implement time-sensitive (and process-limited) reforms to prevent or pre-empt a crisis.

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• Dr. Riordan Roett, Director, Western Hemisphere Program, School of Advance International Studies (SAIS), Johns Hopkins University.
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Las amo...
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Chapter I

Introduction

Since the 1990s, with the evolution of open international financial markets the world has witnessed great regional economic and financial crises that few anticipated. The crises in Mexico (1994), Asia (1997), Russia (1998), Brazil (1999), and Argentina (2001) proved that because of panic reactions, bad information, or simply failed analyses, markets were unable to predict the emergence of critical financial issues. Just as with wars or important battles, code names are enough to identify some of the world’s most recent such events, among them the “Tequila Crisis,” the “Asian Tigers Crises,” the “Vodka Crisis,” and the “Tango Crisis.” Why did such failures occur? The reasons are many and range from market dynamics to wrong methodological assessments.

With respect to political risk analysis, in many cases the problem has been the use of current situation analysis and forecasting techniques that are not suited to establish risk in a globalized and interconnected world. The dynamics of today’s international financial markets call for a new type of analysis—one that does not try to identify future events, but instead looks at the capacity of countries to deal with an unknown future; in other words, a policy flexibility analysis approach that helps us determine the ability of governments to preempt or prevent future financial crises.
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To understand a country’s ability to act when faced with financial failure, we seek to assess the role political factors have played in past financial crises in Latin America and identify key variables for future analysis. By identifying relevant political variables, this dissertation aims to bring politics back into the field of risk analysis and proposes a new framework for looking at future events.

Why a New Perspective?

During the 1990s, a new development-financing paradigm came about with the appearance of new market players who funded the largest share of emerging-market financing. During the 1950s and 1960s, foreign aid accounted for more than half of all capital flows between industrial and developing countries. The 1970s were the era of private bank loans; the largest European and US banks organized banking syndicates, which controlled most of the funding to developing countries until the debt crises of the 1980s. The 1980s saw a return to foreign aid, which accounted for 43% of all developing country international funding, but the decade also gave rise to development aid through multilateral financial organizations such as the World Bank and International Monetary Fund. Foreign direct investment accounted for 25% of all funding. During the 1980s the international financial market developed dramatically, evolving into the “financial globalization” era of the 1990s. Market liberalization and technological innovation opened the international market to a much larger number of investors. From 1992 to 1995, daily foreign exchange trading grew from $900 billion to $1.3 trillion. By 1994
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Portfolio investment, including equity and bonds, accounted for 39% of capital flows to developing countries.

This new paradigm opened the door for new players and dynamics. New sources for financing emerging markets revolutionized creditor–lender relations. No longer were countries negotiating with other governments, international organizations, or large banking groups; rather, they were competing for funds available in the market. Although the amount of money available in the international market is determined by circumstances in the industrialized nations, or “push” factors such as changes in the interest rate, the way those resources are divided among developing countries depends on the receiving country’s ability to bring in the money or “pull” factors (Leslie Elliott Armijo 1999). This means that countries had to market themselves to attract investors by providing the best risk–return value.

A clear example of the change in international finance dynamics is the way the International Monetary Fund (IMF) has switched its role from a lender of last resort to “crisis prevention” by implementing, with mixed results, a policy of market reassurance. The biggest upside for a country in terms of IMF involvement in its economy is not the direct financing it receives, but the signals of stability and creditworthiness that having IMF backing means to the market. The IMF’s now infamous conditionality agreements with developing countries are nothing more than an assurance to the markets of a
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liberalization commitment. The now widely used standby credits the IMF has given to some countries are designed to maintain market confidence in a country.

The emergence of the international financial markets as the principal source of funding for emerging markets makes it more important than ever for countries to be prepared to deal with market instability. Furthermore, many emerging market countries are also going through a democratization process, which can be severely derailed by a financial crisis. From the market’s perspective, financial crises have created panic reactions that affect even the best managed and macroeconomically stable countries. A better understanding of the determinants of financial crises can lead to a more stable market that can discount in advance the risk of participating in a specific market without punishing investors and financial recipients.

Looking at Financial Crises

Political risk is specific to the situation it is supposed to analyze; for example, a model to measure the risk for foreign direct investment in the form of a hotel in Haiti will be quite different from a model designed to measure the probability of Kuwait’s defaulting on its sovereign public debt. For the purposes of this dissertation, we focus on the risk for financial crises, understood as an economic event that leads to a significant

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1Due to past failures of the IMF in policing the implementation of its conditionality agreements (e.g., Argentina in 2001), some market players perceive a decrease in its reputation and clout in reassuring the markets.
2Standby credits vary depending on the economic situation of a country. They are used primarily when questions arise about a country’s cash flow availability to cover debt repayment.
3In other cases it has helped; see Roberto Dondisch (2006).
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downward reassessment of the risk grade given to a specific country on its sovereign debt, be it because of a default, devaluation, unexpected depreciation of the currency, imposition of exchange controls, or political events that lead to political changes affecting a country’s ability or willingness to service its debt.

The Lost Art of Political Analysis…and the Reign of Economic Variables

The political risk analysis industry has grown in recent years, departing from the original analysis of risk of expropriation, “creeping expropriation,” security, and transfer risk to account for the risk faced by an ever-increasing number of international financial operations not necessarily linked to direct or physical “in country” investments. No longer limited to central banks, big corporations, or institutional investors, but now including any investor with access to the financial markets through an online account, access to investments in foreign companies and government debt is cheaper and faster than ever. As Andrew Baker, David Hudson and Richard Woodward (2005) note:

Reductions in direct controls and taxations on financial transactions, the elimination of longstanding restrictions on financial intermediaries, the expansion of lightly regulated offshore financial centers, the introduction of new technologies, and the emergence of new innovative financial products have all combined to speed the movement of finance capitals across the borders. Moreover, politically engineered processes of marketization and de-regulation in the financial services sector have served to erase the distinction between financial markets on the one hand and the international monetary and exchange regime on the other…today’s macroeconomic management problems and exchange rate issues are bound up with financial markets.
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In this context of globalized financial markets, political risk analysts have become important information agents who help set the risk-to-return ratio for investments in foreign countries’ governmental debt. Sovereign credit rating agencies in particular have the power to open or close sectors of the market to government debt. As many institutional investors are limited in the instruments in which they can invest depending on their risk rating, some have even acquired important leverage over emerging market governments’ establishment of government policies. When working correctly, political risk agencies can stabilize the markets as information facilitators, but if their ratings are erroneous, the faulty information can lead to market malfunctions.

As the field of political risk analysis grew, most companies looked for clear and concise data to establish the risk posed by the investments they were rating in simple-to-understand forms, such as a letter grade. Most firms did so by establishing econometric models that turned the focus to economic variables, leaving political variables in a supporting (as opposed to determinant) role. These models assume that economic rather than political causation is better at explaining political risk outcomes (Charles F. Doran and Roberto Dondisch 2003), and in most cases treat political events and forces as unexplained variables considered mostly to be outliers or errors in the models. Nevertheless, by looking at cases where the political risk analysts failed to identify

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4The term globalization is understood as the increase of velocity and reduction of cost for global information transfers (Charles F. Doran 2001).
5For an example of limits on sovereign bond investments, see “California Public Employees’ Retirement System Statement of Investment Policy for Active International Fixed Income—Externally Managed” dated September 13, 1999.
6This helps the market to obtain the best information available in its constant pursuit of perfect information.
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upcoming crises, we can question the validity of the current balance between economic and political variables in political risk analysis and propose options to better the science.

The subordination of political variables to economic ones in political risk analysis (especially sovereign risk) can be traced to three central factors: 1) a need for measurable and comparable variables that can be used in multicountry econometric models; 2) the field’s lack of a coherent approach on which economists, political economists, and political scientists can agree; and 3) reliance by most Wall Street firms for their analysis on economists or business management professionals rather than political scientists. As a result, analysts, especially rating agencies and banks, tend to concentrate on a country’s economic stability using a current situation analysis. In forecasting a country’s ability to correct those areas the analyst considers a weakness or a probable future source of instability. Other analysts opt to use forecasting techniques (such as the PRINCE model) in trying to predict probabilities of certain occurrences, only then looking at how prepared a country will be to deal with those situations the model predicts as most probable.

The problem with such exercises is that they limit the potential sources of instability. The reality of our global financial system is that events in one corner of the world have led to crises in another. For example, in the Argentine case, one of the main reasons for the pullout of international funding from Argentina was not the Mexican

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7 We also need to remember the tendency of today’s political scientists and internationalists to turn to clear econometric analyses as a way to counter economic studies in areas formally reserved for more the political sciences.
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The crisis of 1994 or even the Brazilian devaluation of 1999, but the Russian crisis of 1998, which led to a scaling back of investments in emerging markets in general. An increase of interest rates in the United States can lead to money outflows from emerging markets, with the increase in oil prices not only taxing countries’ economies, but—as occurred recently in Venezuela—giving a country the ability to influence other countries’ economic policies or even change the political balance inside another country. When it comes to financial risk analysis, the vast sources of instability in today’s world make a probabilities model outdated.

The Nature of the Beast

When criticizing political or country risk analyses, we need to keep three main problems in mind:

I) Risk analysis deals with probabilities of negative events and not future certainties. Therefore, it may be impossible for a model to predict a crisis. For example, an analysis that claims a 90% probability that a country will be able to abide by its sovereign debt obligations would seem like a good bet in the world’s emerging markets, allowing that country to command low risk premiums; but if that same country in fact goes into default, can we blame the model for not anticipating such an event when it expressed a 10% default probability? This is a problem with any probabilities model, but it cannot become an excuse for failed analysis.
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II) It is important to be clear about what a model is measuring or analyzing. For example, it is easy to wrongly assume that an analytical framework designed to look at security risk can be used to examine political stability in a country, when although the model may look at political stability, its purpose is different. The same thing happens in the financial sector, where sovereign credit risk analysis does in fact measure for a sort of financial risk, but that entails simply the evaluation of a country’s foreign currency credit risk (Howell 2001) and not necessarily the risk of financial crises.

III) Timing is everything. The world changes constantly, so an analysis made in 2005 for Lebanon is no longer valid. This is especially problematic in dealing with sovereign risk on a multiyear bond, or political risk for a physical investment that requires a long-term analysis.

Most political risk analysis exercises try to determine the probability that certain events of a political nature will affect an investment vehicle, whether direct investment or market instruments. Different models that go from probability tables to scenario building are used to attempt a determination of probabilities of negative events. Once these probabilities are established, they serve to ascertain a risk premium that the investment should deliver over a certain established benchmark to make such an investment desirable. The foretelling nature of such analytical frameworks is one of the main reasons they have failed to predict financial crises.
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In analyzing the political determinants of financial crises, we present a political economy analytical framework rather than a risk measurement. Our goal is not to measure the risk of a financial crisis taking place, but to anticipate a country’s capacity to deal with the threat of one.

Switching to Policy Flexibility Analysis

If we assume the globalization of financial markets has exponentially increased the possible sources for macroeconomic shocks, making it impossible to accurately analyze the risk of financial crises based on the identification of probable threats, then an analysis of the ability of governments to deal with unexpected events that threaten their economic stability is essential to understanding the risk that they will face financial crises. Political variables such as the balance of political forces, actors, and institutions that determine the degree of flexibility a government has to shape and operate its fiscal and monetary policies are the key factors in anticipating a country’s capacity to react positively and effectively when faced by events or surprises that threaten its financial stability so as to prevent or preempt an economic crisis. The analysis of such political determinants is thus essential in establishing a country’s risk of financial crisis based on its ability to act and implement reforms when faced by such a crisis.

With this hypothesis in mind, we propose taking a different approach in analyzing the risk of financial crises: Instead of trying to predict a negative event, we should concentrate on understanding the ability of a country to deal with future negative events,
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which in most cases are triggered by surprises. Because of their very nature, such events are impossible to predict. Taking a probability approach to establish the risk of such events occurring is not only difficult, but because of the limited number of cases available to create a probabilities model that works well, the results of such analyses are impossible to verify. By looking at the capacity of a government to act when faced by a negative event, we can focus our analysis and understand not only the weaknesses of a country but how can they be addressed. A policy flexibility framework allows us to move from an analysis of economic capability to one of political capability, thus allowing us to focus on the political risk of economic policymaking.

Some mainstream analytical frameworks, including the ones used by most sovereign credit risk agencies, include in some fashion an analysis of the capacity governments have to implement reforms. What differentiates most of these frameworks from the proposed flexibility analysis are 1) the relevance given to the policymaking process; 2) the analysis being based not on a government’s ability to implement reform in a normal situation, but its ability to adopt policy changes in a stress environment in which the common avenues of political discussion may not be available, what we will call a process-restricted reform; and 3) the differentiation and understanding of a country’s will and capacity to implement the needed reforms for positive action.
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By no means are we suggesting that economic analysis be disregarded; after all, we are talking about financial crises. The role of economic analysis is to show the current and projected availability of funds in a country to maintain financial stability, including repaying its debt or maintaining a certain budgetary regimen; but we argue that such analysis is only the first stage of a broader political risk exercise. Furthermore, once a threat emerges, a country’s economic policy response must be made based on the financial needs required to counter such a threat according to a macroeconomic and financial analysis; but it is the interaction of political forces that will determine what actions a government can take.

To reiterate, economic variables are necessary to understand the financial risk a country presents, especially when analyzing sovereign risk. After all, the principal factor behind a government defaulting on its debt is the lack of resources for repayment. But when it comes to a government’s reactions to prevent or preempt a financial crisis, such an analysis will be incomplete without an understanding of the political variables that shape that country’s decisionmaking process. What governments do or fail to do politically and the steps they take or fail to take institutionally determine the risk such a country presents.

Political balances set the stage for policymaking, which in turn affects the capacity of a country to reform its economic policy to counter an imminent threat. As noted above, when dealing with open markets, often the required policy changes have to
be taken quickly, and in a somewhat secret way. For instance, a decision to go from a fixed exchange system to a free-floating one cannot be discussed in parliament for a few months before such a reform is implemented, as this type of open discussion would let market players react to the government’s intention by changing their position in that country’s currency and probably create or at least worsen a crisis. Thus the kind of policy reforms that are typically needed to deal with surprises threatening to disrupt a country’s financial balance are process-limited decisions. Under these circumstances, political limits to economic policymaking are key to understanding a country’s capability to deal with the threat of a crisis.

Premises

As states are political entities by nature, any decision made by the government is a political one. Whatever the country’s institutional architecture, be it a democracy, autocracy, or dictatorship, every decision responds in different degrees to internal and external political and market pressures as well as the country’s institutional framework. In this sense, a country’s economic policymaking is subject to political constraints, and therefore the interaction of these forces is a key determinant of a country’s economic risk.

Crisis Triggers and Political Forces

First of all, we need to differentiate between the events that lead to financial crises and the political forces at play in a country’s decisionmaking process. Surprise trigger
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events such as natural disasters, political assassinations, military coups, or financial crisis in a foreign state can change the political and economic balance of a country, as well as undermine the confidence placed in such a country by the international financial markets, thus leading to a negative change in that country’s economic balance and paving the road to a financial crisis. As the term suggests, these events are difficult if not impossible to predict. The assumption guiding this work is that the large number of possible trigger events requires us not to try to analyze the events per se, but rather to look at the government’s capacity to deal with them when they arise.

Trigger events may be political in nature, but they are not political forces. As explained in the Mexican case chapter, the assassination of presidential candidate Luis Donaldo Colosio in 1994 was a political event probably carried out by political forces fighting to maintain their position in the country’s political arena. Although we need to understand both how these groups affect a country’s decisionmaking process and how a given event changes the internal balance of forces, we want to differentiate between the event itself and the fundamental forces, meaning political dynamics that undermine the central government’s ability to prevent or preempt a crisis by constraining the government’s economic policymaking flexibility. Fundamental forces affect a government’s capacity to respond to a trigger event, and thus its ability to pass time-sensitive and process-restricted reforms. Our analysis focuses the capability for government action as a response to trigger events. We assume unexpected events will affect to different degrees a country’s economic balance, but in most cases it is the way a
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government reacts to such events that determines the emergence, or at least degree, of any financial crisis.

Walk-Through

In examining the stated issues, we first present in chapter II a review of existing theory on political risk and introduce theories on policymaking, state reform, and loss imposition that will later help us analyze our two case studies. Chapter III is the first of the case studies, which analyzes the Mexican peso crisis of 1994. We present an economic analysis of the crisis as well as a political background section, which takes us to an analysis of the factors leading to the government inaction that resulted in the peso crash. Chapter IV uses a similar format to look at the Argentine convertibility crisis of 2001, focusing both on the reasons for the initial government inaction and on its inability to act at a later stage. With the information gathered in the theory review and the two case studies, chapter V presents an analytical framework based on a government’s policymaking flexibility to act in order to preempt or prevent a crisis, focusing on the differentiation between a government’s will and its capacity to act. Finally, we conclude with an overview of the dissertation and the importance of two factors affecting government action: a country’s history and dual transition processes.
CHAPTER II

Theory Review

Many authors have written on issues regarding the politics of economic reform, the analysis of sovereign and political risk, and the development of financial crises, but few have concentrated on the political determinants of financial crises. Those who have, generally do so as part of a greater analysis of economic or political crises. Although political scientists, political economists, economists, and even social psychologists have all given different perspectives on the topic, there is a lack of consensus on how to look at the political variables behind financial crises. The problem goes deeper, as many question the importance of political variables in what they consider an economic phenomenon.

In this chapter we examine some of the theories presented on political risk analysis, then explore theories dealing with policy reforms that combine economic and political causation in order to build a proposal for the analysis of political determinants of financial crises based on a government action flexibility analytical framework. We give special emphasis to theories dealing with policymaking processes, particularly the ability of governments to impose their preferences.
Political Risk

Political risk analysis has historically been done on the basis of trying to foresee the risk foreign investments face in a specific country in two main areas:

1) **Political risk**, the perceived risk from political decisions or actions that impede the development of the investment, the main ones being expropriation, creeping expropriation, contract disputes, and political turmoil (terrorism, civil war, etc.); however, not every risk category is important to every investment, and when it comes to foreign direct investment, most often there are ways to insure against such risks; and

2) **Transfer risk**, the risk that a particular country will impose restrictions on remittances of capital, dividends, interests, fees, or any other form of income generated by foreign lenders or investors.

These two main areas of concern have given way to multiple types of analysis depending on the particularities of the investment type. Among the different types of analyses, sovereign risk provides the most tools to help us understand the risk of financial crisis.

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8The introduction of laws and regulations to take away from earnings or rights of foreign investors.
Sovereign Risk

Sovereign credit risk measures the probability a country will service and repay its debts and determines the availability of foreign currency for companies in a certain country to service and repay their foreign-denominated debt. The perceived sovereign risk determines the price governments pay to make up for the risk they present to investors. The risk is measured in two ways: by the market which automatically establishes a spread between the interest rate it is willing to accept from a country as compared to the interests given out by “less risky” investments, and by rating agencies hired by governments as they launch debt instruments to the market. Government bonds in the market usually present a risk rating by at least one of the three major risk rating agencies.

The task of the credit agencies is to “assess the sovereign’s ability and willingness to generate the foreign exchange necessary to meet its obligations.”(Fitch Ratings Handbook.) To do so, each credit rating agency establishes a model to measure and grade the agency’s perception of a country’s ability to service its foreign-denominated debt in both the long and short term. However, the prediction record of such ratings has been mixed, with their shortcomings attributed to diverse problems ranging from a conflict of interests (e.g., the agencies are paid by the same countries they rate) to the business incentives they enjoy by not confronting the market with unexpected ratings. Although

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9The theory of sovereign risk first developed in the 1970s, the era of large banking syndicates and private–sovereign loans, that ended in the debt crises of the late 1970s and early 1980s. We do not go into the details of the theory presented in the 1970s, since this discussion concentrates on the particularities of the market of the 1990s and 2000s.
we are not interested in doing an overall criticism of their models, we examine them in order to identify their positive and negative factors.

Rating agencies look at distress indicators. Considering primarily economic variables, they analyze overall economic performance and concentrate on the balance between a country’s foreign currency income and its overall outstanding foreign currency-denominated debt,\textsuperscript{10} including the liquidity needed to cover its service. Sovereign rating agencies also look at a country’s economic sensibility to external shock, such as an increase in the price of energy or fall of Euromarket interest rates. Although highly concentrated in economic variables, all rating agencies analyze certain political elements mainly to get a sense of the probabilities of policy continuation and data transparency. Appendix I includes a table of top political variables analyzed by the three main rating agencies.

Although their study objective is limited to repayment, rating agencies in general take as a given the intent of a state to repay, or to make the necessary adjustments to be able to do so. We contend that such decision is at its core a political one that will be determined on the basis of a cost–benefit analysis. Thomas E. Krayenbuehl (1988) explains that the will of a government to honor its obligations is what distinguishes “political instability” from “political risk.” Although it usually goes unmeasured, a state’s decision to act in order to pay its obligations involves factors such as the country’s

\textsuperscript{10} This includes private sector debt, as the need to exchange domestic for foreign currency of private companies to service its debts plays an important role in the availability of foreign currency for a government that needs to cover its own debt.
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constitutions, political parties, quality of government, history of crises, foreign policy, economic system, social structures, ethnic and religious differences, labor relations, and legislation on foreign investments. These factors can lead to internal turmoil, rebellious conflicts, revolutions or coups, and corruption. Krayenbuehl considers that an analysis of these factors, done using either a qualitative or quantitative methodology, can usually foreshadow problems at an earlier stage than economic indicators.

Matthew Bussiere and Christina Mulder (1999) analyzed and tested statistically for the role of political instability in economic crisis from 1994 to 1997. Their results suggest that political variables improve the power of economic models to predict economic crisis and economic vulnerability. They note that the economic assumption that governments will always take the right measures to reduce economic vulnerability overlooks the reality that governments are sometimes unable to implement reforms or preventive measures because of political constraints. Their statistical study proves the importance of political variables, but also raises two important problems in implementing multicountry statistical analysis regarding an economic crisis with political variables: 1) identifying the correct variables to be examined, and 2) determining the limited availability of political indicators that can be compared across multiple cases and countries.
Anja Linder and Carlos Santiso (2002) found that the use of political variables in econometric analysis of political risk has shown mixed results. It is not clear to them that political variables (or sovereign ratings as a whole, for that matter) have been effective in predicting crises. They explain that the biggest problem of such analyses is they fail to address the system roots of political risk. The problem is that in their same-variables comparative approach, they lose the ability to understand each country’s main threats. The authors conclude their study by calling for a real understanding of what sovereign risk is and is not intended to measure, but they fail to go further to suggest alternatives or call for a non-comparative analysis in which political variables can be better used.

The Political Perspective

Economic policymaking is first of all a political process. Carsten Hefecker (1997) note, “the choice of an exchange regime is political in the sense that the decision to adopt this regime is not made by a benevolent social planner weighing the costs and benefits of a nation. Rather it is the outcome of a political process where voters and interest groups interact” defending their interests. Domestic political pressures influence and can even determine a government’s choice of international economic policies. The policymaker balances the marginal gain of political support from those interests who gain from a particular policy against the marginal loss of political support from those who lose from that policy, with the approach being one of constrained optimization.
How discretion is exercised in the setting of policy depends on the motives of policymakers. Political self-interest leads to discretion being used to maximize a political objective, such as reelection. There are several groups in society with each having a utility function, carrying a certain “power weight” that plays a balancing game with other forces that lead to policy formation. The degree to which a government’s objective will be the maximization of a composite utility function depends on its degree of benevolence, and that function may include a high weight for a government’s own interest.

Pablo Spiller and Mariano Tommasi (forthcoming) looked into public policy outcomes as the result of “complex intertemporal exchanges among politicians” and applied transaction theory to understand how political institutions affect the interaction of political actors and therefore the policymaking process (a generalization of transaction cost economics theory). Their focus is not economic policy per se but the quality of all policies. They analyze the political transaction game among a country’s political actors, a process played out by the country’s political institutions and guided by history and fundamental institutions, as a determinant of policy outcomes based on the degree of cooperation among actors. The basic premise is that the ability of the country’s polity to undertake complex intertemporal cooperative agreements will determine the quality of its policies.

Spiller and Tommasi identify the following as fundamental institutions: a) constitutional powers of the president; b) basic legislative institutions; c) constitutional
and historical configuration of federalism; d) electoral rules; and e) history of democracy in the country. They propose a set of six indicators to help estimate the possibility of a government’s cooperation among institutions involved in the policymaking process along with its ability to make long-term and positive policy decisions. These indicators are chosen based on a belief that the competitive nature of a political system will not allow for full cooperation among actors, but can achieve a “best feasible” Nash equilibrium (in which each group would be better off if all groups reduced their demands.\textsuperscript{11}) The indicators are as follows:

1. The number of political actors with power over a given decision—the more actors, the least cooperation feasibility.
2. Intertemporal linkages among key political actors—the more, the better.
3. Timing and observability of moves, with an environment of transparency and no surprises among actors leading to higher cooperation.
4. Availability of enforcement technologies—norms that limit opportunistic behavior help build confidence among actors.
5. Characteristics of the arenas where key political actors undertake their exchanges, wherein the more formal and observable the arenas (such as a legislature), the better the chances for cooperation.
6. Intra-period payoff structure—the lower the short-run payoffs from non-cooperation, the higher the likelihood for cooperation to occur.

\textsuperscript{11}Although doing so unilaterally is not rational.
When we look at financial crises and the ability of governments to act to prevent or preempt them, we need to understand that we are talking about a government’s capability to implement policy changes in a time-restricted manner. Because of the tendency of markets to overreact, policies carried out to counter market forces cannot go through a public and lengthy discussion period, as the market will try to respond in advance to possible government actions. For example, a decision to go from a fixed to a free-floating exchange rate system cannot be announced publicly in advance of its adoption because the international markets will react by dumping the currency before its depreciation, thus causing a much greater loss of value of currency (overshooting effect). In this sense, understanding a country’s policymaking and reform can help us ascertain its ability to react to market surprises and macroeconomic misbalances. Hence we discuss theory on policy formation and interest groups.

**Policymaking**

The theoretical approach to policymaking processes and state autonomy have evolved from a society-centered, to a state-centered approach. The society-centered model looks at the configuration of power between interest groups (Osvaldo Santin-Quiroz 2001) and their influence over state decisionmakers. This approach parts from the
pluralist model establishing the state as a neutral arena where interest groups compete to form policy decisions. Public choice theory argues that the interaction between these groups is based on a competition of “rent seekers” in which the different groups compete to extract rents from the state by influencing self-interested politicians. The ability of interest groups to compete depends on the resources (monetary, ability to mobilize voters, capacity to hold public demonstrations, control of financial flows, or capability to launch sustained resistance movements, among other possible resources) they can muster for such competition, giving an edge to industrial, financial, and worker unions. The power of an interest group is defined by the responsiveness of the government to its interests. Pressure and interest groups have more at stake in policy outcomes than in the policies themselves.

The state-centered approach considers that in many cases the state constrains the ability of interest groups to influence policymaking. This is particularly true in developing countries where the government executive controls most of the policymaking process. In developing democracies, civil society is typically not organized as an effective pressure operation, as it is weak and fragmented, organized on ad hoc terms instead of maintaining constant presence, which thus limits its influence on government officials. The state-centered approach looks at political elites as the ultimate decisionmakers and technocrats as the ones in charge of the policymaking process who work as a benevolent group of officials interested in the public good. Policy elites are “strategic managers with a complex set of preferences, facing complex political contexts,
and seeking politically, bureaucratically and economically viable outcomes” (Santin-Quiroz 2001). These groups usually are not accountable to the electorate, because even when the political leadership is changed, the technocratic elite is left in place. For example, when Vicente Fox won the Mexican presidency in 2000 after 70 years of PRI governments, he appointed at both the Central Bank and Ministry of Finance technocrats who had worked in previous PRI administrations and were at the time still active PRI members. Using this approach, political parties are no more than cadre parties established not as policy-forming organizations, but as mass vote-getting machines. However, this does not mean the technocratic elite is by definition autonomous, as the state is constrained by institutions, political leadership, and bureaucratic capacity. These factors also help establish the balance of power among interest groups and the way they affect the decisionmaking elite.

An interesting recent report by the Inter-American Development Bank and Harvard University’s David Rockefeller Center for Latin American Studies titled “The Politics of Policies” (Ernesto Stein 2005) takes a new look at the importance of politics and institutional policymaking process in the reform of policies. While in the past, institutional capability was perceived by international financial institutions as an “unexplained residual” (Ernesto Stein 2005) and conceived simply as a question of resources and capital accumulation based on the assumption that institutional capacity follows resources, this new volume questions such a view. It accepts that the
policymaking process is as important as the policies themselves. Because the political process and the policymaking process are inseparable, there is a central link between politics and a country’s economic development. In this sense, policies cannot be judged only by their technical merits, but need to be addressed in conjunction with the processes they follow for implementation. As process matters, universal recipes do not work, because they need to be adjusted to time and place.

The study identifies characteristics and determinants of the policymaking process in Latin America, but is careful not to generalize, as each country has different factors that have evolved from its social and historical uniqueness. It looks at the policymaking process as one interaction between actors that is dependent on the incentives, preferences, and constraints of such actors. Among the actors discussed are political parties, legislatures, presidents, cabinets, bureaucracy, subnational governments, judiciaries, and civil society. The study also emphasizes the analysis of formal and informal arenas of interaction. For our topic of study, the IDB report exemplifies the recent importance international financial institutions have given politics and the acceptance that a certain policy’s chances of success cannot be judged without considering the institutional, political, and cultural context in which it is implemented. Politics determine the feasibility of policy reform implementation.
Interest Groups and Policy Formation

As Santin-Quiroz (2001) explains, “Individuals manifest their preference through organization in the form of coordinated collective action like lobbying, electoral support, labor and investment strikes, demonstrations and insurrections.” Organizations are needed to make individual voices heard. The choices an organization makes depend on its internal environment, composed of the culture or ideology of the organization and its hierarchical structure. The role and nature of the organization will also depend on the culture and institutions of society as a whole. Politically-oriented organizations act as both constraints to government action and agents for institutional change.

Interest groups interact under the rules of a country’s political, economic, and social institutions. As devised constraints that shape human interaction institutions can be a) formal, generally written regulations with physical enforcement agents; or b) informal, such as social conventions, customs and practices, and historically accepted behavior. According to Shale Horowitz and Uk Heo (2001), the strength of interest groups, both the concentrated and dispersed, is dependent on the political institutional structure and the international context (mainly international ideological trends).

Governmental Capacity to Act

Of particular importance to our study is the ability of governments to impose policies on their populations. It is not a matter of technocratic superiority or sovereign
control, but it demonstrates the feasibility that governments can take action when confronted with market surprises. As discussed earlier, when acting on economic policy in open markets, there is a need to implement policies in a short time frame and to do so without giving public notice of the government’s intentions. This is not only an issue of state autonomy, as the new policies need not only to be imposed but in the long run accepted and adopted by the policymaking players so as to assure their enforcement. At other times, the reforms needed to avoid a crisis are painful and costly to certain sectors of the population. For those reforms to be carried out, the government must be able to act and balance the policymaking process. In any case, the government’s ability to act and impose losses on sectors of its population is a key factor to analyze.

Leslie Alexander Pal and R.. Kent Weaver (2003) assess the necessity and ability of democratic governments to make policy decisions that affect a part or all of the electorate. Every decision made by a government affects a section of its population or at least benefits a group or sector to a greater degree than the rest of society. A government’s ability to make choices that inflict pain on some or all of its citizens is called its loss imposition capability. Such capability depends on the institutional architecture of the state, as well as its culture and history. Pal and Weaver (2003) focus on the differences in loss imposition ability between the United States, a presidential democracy, and Canada, a Westminster-style parliamentary system, but we will extrapolate many of their findings to analyze emerging market countries. Their approach
can be very helpful in identifying factors that limit a country’s economic policymaking. As we will see in the next chapter, the capacity of governments to impose losses on population groups will serve as a basic indicator in our government flexibility analysis framework.

Although every decision a government makes may fail to result in a Pareto optimality\textsuperscript{14}, and thus create a rift between winners and losers, it is in major decisions—those that are perceived by sectors in society (social classes, interest groups, religious groups, etc.) as changing the country’s status quo—that a government’s action can create losses that can come back to haunt it in future elections or even lead to its early demise. Considering that the prime directive for political operatives is to attain or maintain power, in these special circumstances the political ability of such a government to impose losses and avoid a political backlash will determine its likelihood of making costly decisions. Countries incapable of imposing necessary losses to achieve greater benefits for society suffer paralysis, or at least inflexibility. Pal and Weaver (2003) state that the ability of a country to make such decisions depends on the structure of its political system.

The ability to impose losses is determined by a) institutional ability to make policy choices, b) intensity and strength of opposing groups who will try to block any move, c) political strength of a government at a particular time, d) priority of issues in a government’s agenda, and e) ability of a government to escape blame.

\textsuperscript{14} Benefits all affected equally.
a) Institutional ability

The institutional framework of a country to a large degree determines a government’s ability to make policy choices that will impose important losses on society. The functional architecture of a state will divide up areas of competence for each part of the government. For instance, in a presidential system with division of powers such as the one in the United States, the executive branch has sole competence in some areas while the legislative and judicial powers have it in other areas. In most cases the policymaking faculty is shared; for example, it is the competence of the president (head of the executive branch) to send troops into action, but it is the exclusive faculty of the Senate to declare war. In a system of divided government, the executive does not always have the power to make policy choices in areas it wants to, because it must consult with other powers of government creating possible blocking points for decisions, thus limiting the executive’s loss imposition ability. In other systems, such as the Westminster-style parliamentary government in Canada, the party in power (if it is a majority in parliament) controls both the executive and legislative branches. As the party’s members of parliament are generally required to vote with their party on all important issues, the government’s ability to pass legislation that creates losses is higher.

Depending on its political architecture, a country may have few or many potential blocking or veto points that limit the executive’s loss imposition ability, be they legislative action, court review, or even referendum requirements. The failure of the
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French and Dutch governments to ratify the European Constitution in 2005 due to negative referendum results are clear examples of the limits on a government’s loss imposition ability. The institutional arrangements in a country will also help determine the access points of possible opponents to the decisionmaking process. An access point can be gained in the legislative process through lobbying or legislative inquiries. It can also be gained through the court systems. In the case of the executive, a corporatist system will grant organized and state-recognized groups access to the executive decisionmaking process. Most important are the rules under which alternatives are compared and selected in each branch of government.\textsuperscript{15}

With respect to economic policymaking, institutional frameworks are key to understanding who can make decisions and how painful they can be. For instance, the establishment of independent central banks is a way of protecting a group of policymakers from public scrutiny and allowing them to implement decisions that create losses (Sylvia Maxfield 2000).

In countries where the leadership is all-powerful, whether legally or not, informal institutional constraints are more important than the legal institutional architecture. For example, in the Mexico of the 1970s, presidential authority was unquestionable, but its policymaking ability was curtailed by its overall interest in maintaining power and the role of important interest groups that still managed to have leverage over the official political party.

\textsuperscript{15} Pal and Weaver, 2004, p. 5.
b) Strength of opponents

The nature and strength of opponents will vary depending on the type of loss and the type of issue. Losses can be concentrated on one sector of society (e.g., a tax increase on tobacco products imposes monetary losses on smokers and producers), or geographically (e.g., the construction of an airport on nationalized land will impose losses on the people whose land was confiscated). Benefits can also be concentrated or diffused. In the case of the tobacco tax, all taxpayers share the benefits, as government expenditure on health care should decrease as the tax leads to less smoking. However, in the case of the airport, the benefit is limited geographically to those who will use it.

Concentrated losses, especially on sectors of society that can mobilize to confront such policies, will create stronger competition. For example, an increase in electricity rates for industrial use will lead to strong and well-funded opposition from business interest groups. Generalized or diffused losses are typically easier to impose as no single group will take up the fight, but they can generate generalized opposition that can hurt the party in power in future elections. It is also noted that losers or “relative losers” will be more inclined to spend political and monetary capital to oppose the policy change than the benefited groups will spend in defending it.
c) Government strength and timeline

The political strength of the party or individual in government will be a determining factor in its ability to impose loss. A government can make loss-imposing decisions as long as the decrease in support it faces as a result of such decision is not enough to make it lose its leading position. Political parties holding large majorities in the legislative branch of government and controlling the executive (such as a majority government in a Westminster system) or a president with large popular approval ratings are able to withstand the backlash of their decisions.

The nature of the decision will determine the decrease in support that it generates. If the net loss is limited to party supporters who do not see representation by any other party (or change of leadership within the party) as an option, or to a group that is not organized and therefore does not mobilize, the loss of support may be small. On the other hand, if the decision generates opposition from groups that can lend their support to another party or political figure, the threat is greater.

Timing is the most important aspect of a democratic government’s strength to implement loss-imposing policies. The electoral cycle usually will dictate when the leaders or parties will be willing to make controversial decisions. The closer it is to elections and the weaker the support for the governing party, the less able the administration will be to make such decisions. Systemically, electoral periods may also lead the government to paralysis if cooperation from other parties is required to
make such decisions. In electoral periods, competing parties will avoid aiding the party in government in order to avoid assuming any part of the blame for the loss.

d) Priority of issues in a government’s agenda

The priority a government places on any particular issue will work as a qualifier of its political strength. In other words, the amount of political capital the party in power is willing to spend on any particular issue will depend on the priority it places on that issue. In many cases, to win the support necessary to establish important loss-imposing policies, governments must negotiate with opponents and yield on other policy goals the government may have; therefore, agenda priorities will determine how willing a government is to take on such negotiations. Absent an understanding of the importance of priorities, one can make the mistake of assuming the government will act on important issues simply because it can. The reality is that leaders will try to spend as little of their political capital as possible. Agenda priorities change with time and in most cases follow electoral cycles, so a government that was willing to take the blame for certain loss-imposing measures at the beginning of its term will not necessarily maintain that will as elections are near. Priorities will also qualify opponents’ reactions to certain actions. Opposition and interest groups also work with limited resources; therefore, their reaction to any single decision will be determined by the importance they place on the issue in question and their resource–return balance expectations.
e) Ability to escape blame

The structure of the political system will determine the options a government has to avoid blame over a particular decision. By deferring decisions to the courts, other branches of government, special committees, or bureaucracies that are not accountable to the public (such as independent central banks), the executive or legislative branch can avoid taking the blame for decisions. Other options for escaping responsibility are to blame international organizations or make a case for the need to follow international behavior (i.e., copying what is working in other countries).

Pal and Weaver (2004) also discuss two other variables that play an important part in determining the leeway a government has in making loss-imposing decisions. First is the role of veto players: individuals, groups, or institutions whose agreement is required for certain reforms to take place. Second is the effect of confounding variables that affect all parts of the policymaking process and are unique to each society, including the following:

a) Policy legacies. These are inherited decision procedures and previously imposed policies that can help gain public acceptance of a loss-imposing decision.

b) Globalization. Governments cope with the difficulty of imposing losses on mobile capital, and the need (especially for a smaller country) to pursue policies similar to those of its trade partners.
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c) Emulation. Countries emulate successful programs of “peer” nations or neighbors.

d) Cleavage structures and social organization. Each country has different social, geographic, and cultural balances that will determine what issue areas are most important to the population overall.

e) Political culture and ideas. A country accustomed to top-down decisions will be more willing to accept loss-imposing decisions than one suspicious of governmental intervention.

It is of the utmost importance to understand both formal and informal institutions in order to properly analyze the way interest groups interact and governments act. Little has been written on process-restricted reforms, but there is a vast body of work on the politics of economic reform—a bibliography we review to get a better understanding of the political determinants for changes to economic policy.

Economic Reform

Bernardo Muller and Carlos Pereira (2005) propose an analysis of the “costs of reform,” or determinant impediments to reforms, based on the Coase theorem of property rights and transaction costs. They take the ability of players to affect policy outcomes as property rights and negotiations as transaction costs. Under this view, they claim reforms should always be to the efficient policy point, as groups will try to prevent reductions to
their welfare unless they receive compensatory side payments that leave all parties better off. However, in Latin American countries, such an assumption does not hold, as after looking at four case studies Muller and Pereira determined that no generalization on determinants of costs of reform can be made; all cases need to be analyzed separately since they “depend on the country’s entire configuration of political institutions” (Muller and Pereira 2005).

Christian Morrison, Stephan Haggard, and Jean-Dominique Lafay (1995) explain that the economic adjustment programs that have been most successful economically are those that have succeeded politically by “building bases of support and managing political resistance.” Nevertheless, they indicate that most economists working on economic adjustment in developing countries have ignored the political dimension.

Not only do politics affect economic policy choices, but those choices also have a profound impact on a country’s political life. The division of theory into two fields of study (one being the way interests and institutions affect the timing, coherence, and credibility of adjustment policies, and the other being the political and social consequences of the adjustment process) does not help to identify the real problems emanating from and facilitating an economic adjustment program. Because past economic crises and political responses to economic adjustments are not forgotten, they affect future implementation of adjustment policies.

Morrison, Haggard, and Lafay’s (1995) analytical framework breaks the economic adjustment process into two phases: first, the political factors that contribute to
the emergence of a crisis, and second, the political economy of the adjustment process itself. Countries decide to take adjustment action when society comes to recognize a path or course is unsustainable, when governments decide to preempt a crisis, or when creditors apply pressure. International financial institutions, social groups, or the government itself can also precipitate an adjustment.

The two main political factors identified by the authors that affect the feasibility of economic adjustment reforms are 1) the existence of socio-economic groups seeking to influence policy choices in order to maximize their incomes, and 2) the need for politicians to respond to pressures in order to maintain power. These factors are present in democratic and authoritarian regimes, but are most destabilizing in weak authoritarian regimes and emerging democracies. The authors question the feasibility of launching simultaneous political and economic adjustment programs, but also note their complementing of each other.

In attempting to explain the need for an economic adjustment program that maximizes both the economic and political development of a country, Morrison and colleagues (1995) note the existence of three political dilemmas of economic reform:

1) The economic reform program is a public good, but there is always a group that is particularly affected.

2) The distributive implications of economic reform always create winners and losers, but while the winners are dispersed and see their benefits in the long term, the losers
are concentrated and experience immediate consequences, so they tend to organize against the reform.


The authors also note that when analyzing the effect of interest groups on policymaking in the developing world, one should not think of these groups as one does those in developed democracies. In the developing world, such groups can bring a government down by electoral action (in democratic states), by showing popular strength in public demonstrations, or by the violent overthrow of the government. The way they play a role is determined by the institutions of the state. Even though Morrison, Haggard, and Lafay (1995) write about the differences between emerging economies and industrialized societies, they still try to apply an analytical and statistical model universally.

Stephan Haggard and Robert R. Kauffman (1995) explored the role of politics in the establishment and consolidation of economic adjustment programs, and explained that decisionmakers operate within a matrix of international, social, and institutional incentives and constraints that set limits on the range of policy alternatives available to them. The strength of such forces, their policy preferences, and the structure of the state
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will determine whether a country will be successful in implementing stabilization and structural adjustment policies.

The authors propose a set of indicators to analyze a government’s economic adjustment program, namely a) initiation (an indicator of the timing of adjustment policies), b) content of policy reform, c) scope of the reform, and d) consolidation of the reform. Furthermore, they establish a set of categories to identify the role of politics in a country’s ability to implement economic policy reforms:

I. **International limits**, which restrict the extent to which domestic policy choices are constrained by international market forces.

II. **State level limits**, which restrict the independence of economic policymakers from interest groups, determined by the structure of the political institutions and the degree of participation of societal interest groups in the decisionmaking process.

III. **Broader spectrum of distributional politics**, which restrict the weight of social and economic interests in the reform process as they relate to distributional politics, determined by the independence of politicians from distributibutional politics in the short run.

Their findings indicate that the more independent government officials are from internal forces, the more likely they are to implement a successful economic adjustment (Haggard and Kaufman 1995).
As an example, Witold J. Henisz, and Edward D. Mansfield (2006) look at political determinants of commercial openness, noting the degree to which political factors will reduce commercial openness depends on both the number of veto points in a country’s policymaking structure and its regime type. As the number of veto points increase, the conditions on trade policy become weaker.

Federico Struzennegger and Mariano Tommasi (1998) examine economic reform in general (described as a package of economic stabilization, trade liberalization, privatization, deregulation, and related market-oriented measures) and the way economists have tended to analyze it. They argue that economists tend to give a simple overview of the political forces at play under a cover of “political motives” without explaining what such motives or their origins are, much less their consequences. The authors propose the common standards of analytical rigor be applied to economic and political behavior to get a true reading of the phenomenon and to understand such questions as why reforms are resisted, when reforms are undertaken, and why they are reversed.

Federico Struzennegger and Mariano Tommasi (1998) explain that the main political factors affecting reform are the existence of pressure groups who try to influence public policy to get income redistributed in their direction, creating a Pareto-inefficient, Nash equilibrium where each group would be better off if all groups reduced their demands, but as doing so unilaterally is not rational, this leads to a clash of interests that tends to support the status quo rather than reform.
Allan Drazen (2000) goes further by explaining that not only are interest groups hesitant to support a reform because the results are unknown; policymakers are also cautious, as they do not know which is the best policy to adopt. He puts forth two approaches to study the nonadoption and/or delay of policy change, with both being based on heterogeneity of interest and some sort of uncertainty as to the net benefits of reform. The first approach is to look at the distributional conflict of known costs and differentialized costs to different groups. The alternative is to look at the Uncertainty of Groups about the benefits they gain and their preference for the status quo. On this last approach, Raquel Fernandez and Dani Rodrik (1991) claim that resistance to uncertainty is the biggest factor that leads interest groups to resist reform. When it comes to exchange rate policies, Ernesto Lopez-Cordova (2000) explains that because alternative exchange rates have asymmetric effects on different socio-economic groups, some of these groups may actively attempt to influence the decisions adopted by monetary authorities, with the result that political factors hamper a policymaker’s ability to change currency exchange policies.

State Autonomy

As interest groups are such an important part of the decisionmaking process, and we are concerned with process-restricted reforms in which there may not be enough time to debate a policy reform through the typical channels (or it might not be convenient to allow a specific group to participate in such debates), it is important to understand how
much leeway the government has to act independently of interest groups—or in other words, the degree of state autonomy. Santin-Quiroz (2001) looks at state autonomy as the main variable in analyzing the politics of financial reform. The premise is that economic and political outcomes in a state reflect choices constrained by institutions. State decisionmakers are subject to written and unwritten rules that limit their ability to make policies. State autonomy is defined as the degree to which state decisionmakers are free to operate without interest groups and citizen pressure defining the outcomes of the policymaking process or institutions curtailing their work, which thus will determine the freedom of state officials to implement policy reforms, especially those that can affect the balance of power between existing interest groups.

Findlay (1991) gives three factors that explain the degree of state autonomy: 1) the degree of organization within society, 2) the authoritarian or democratic nature of the existing political regime, and 3) the control of the state by a small elite. Therefore, a democratic country with clean and meaningful elections and a short electoral cycle that gives citizens a right to change government officials, or a country with a strong interest-group network that historically has controlled government action, has a lower degree of state autonomy than a monarchy or a dictatorship with few pressure points in its policymaking process.
Although most of the theories reviewed above deal with the political role in economic policymaking, the United Nations Research Institute for Social Development (UNRISD) has taken a different perspective on the matter. A series of studies on “Technocratic Policy Making and Democratic Accountability” in developing democracies has looked at the limited role of legislative control over the economic policymaking process, which rests on the executive, primarily because the legislative branch lacks expertise in the matter.

The studies suggest that international pressure to “standardize macroeconomic objectives” (UNRISD 2000) leads to efforts to insulate key economic policymaking institutions from democratic scrutiny (e.g., the independence of central banks and even finance ministries in countries where the legislatures are kept in the dark because they either lack legal power to question the policymaking process, or more commonly lack the experts they need to understand complicated economic strategies and policies). In these cases, the economic policy institutions become more responsive to financial markets and financial institutions than to their citizens.

When it comes to civil society, the UNRISD reports suggest we are witnessing a change of venue for social groups who want to influence the economic policymaking process, especially workers’ unions. As their ability to pressure their own government is limited, they now try to pressure the international financial organizations and lenders. The emergence of a technocratic elite that controls economic policymaking makes it difficult for government, citizens, or organized civic groups to participate in the process,
thus limiting the development of democratic governance in emerging markets. By claiming the existence of special circumstances and backing their views with like-minded studies, the technocratic elite try to handle economic policy with autonomy. As political balances change between the executive and legislative branch and legislatures become more sophisticated, legislatures push for an oversight role in economic policymaking.

In order to introduce policy reform, a state needs an apparatus with significant autonomy from social forces that is supported by capital (Santin-Quiroz 2001) as well as a base of support that will permit the new policy to take place, thereby creating a new status quo. Among the variables some authors look at are: institutional framework bureaucratic capacity international forces and political leadership

**International Actors**

Barbara Stallings (in Barbara Stallings and Rogerio Studdart 2006) divides international forces according to the way they influence a country’s economic adjustment implementation. First are developments in the international goods and capital markets, which can determine the availability of external resources, thus setting limits on the range of political options available for policymakers. Second, policy is influenced by international linkages (for example, transnational social and political networks). Third, leverage of creditors on debtors may be important (for example, the establishment of conditionality agreements between individual countries and the International Monetary Fund).
Carsten Heffecker (1997) looks at policy reform in two stages: 1) agenda setting and 2) implementation. In both, state autonomy is crucial, but in each stage different actors play different roles. In agenda setting, the politics of international capital shape elite ideas and preferences or induce policies; the higher the need for international capital of the state, the greater the influence of these groups. Political leaders often become agents for international capital. The main power threat the groups face is capital flight. Through the markets, international capital groups send clear signals to host governments of their perceptions of the government’s behavior. Powerful nations such as the United States also play a role in agenda setting by pushing their own agendas and the interests of their corporate citizens.

The second stage, implementation, is where political negotiation, bureaucratic capacity, and balance of political power come into play as the state seeks ways to implement its policy preferences. Interests are accommodated and solutions found to implement reforms. Groups opposed to the set agenda can try to block it or simply attempt to coerce compensation for the pains the reform may cause them.

If a country wants to access international funding in this age, it must operate under the discipline of international mobile capital. Governments need to concentrate on signaling creditworthiness to the market; they do so by establishing economic liberalization policies and creating technocratic or independent institutions such as independent central banks (Maxfield 2000) that can operate without being challenged by

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16 We go deeper into this discussion in a paper titled “Market Diplomacy” that was presented in San Diego at the International Studies Association annual meeting, March 2006 (Roberto Dondisch 2006).
the country’s political system (James E. Mahon Jr. and Javier Corrales 2002). The leverage of market forces is dependent on the supply–demand equation existing in the market: the lower the supply and higher the demand, the more a government will have to do to get funding.

Furthermore, the greater the elasticity of supply and price, the more efficient a country can be in increasing its creditworthiness. Unlike the Cold War era, in which a country needed only to support one of the superpowers to guarantee a steady flow of aid—or, in the case of foreign direct investment, where investors are stuck in a country—in today’s world the ability of investors in the capital markets to leave the country in a moment gives them increased leverage over a host government.

It is generally accepted that businesses seek strong executives who can implement liberal economic reforms while being happy to accept semi-authoritarian, dominant-party regimes, “low-intensity democracies” (Barry K. Gills 1993), and even populist regimes as long as they maintain a pro-business market orientation (and of course stability). Investors are interested in stability and market liberalization (Armijo 1999). Nevertheless, as investors look to optimize their investments, they press for reforms that allow for financial stability and information availability. Portfolio investors seek information that will enable them to choose between investments, and when possible, make rapid arbitrage profits. International financial agents are only as powerful as the need is in the developing countries for their financing.
Javier Santiso indicates that international “financial markets do not establish the reign of the invisible hand, but rather the reign of the implicit handshake” (Javier Santiso 2003). Today’s markets are driven by fear, mania, and panic; but most important, they rely on expectations and perceptions. Players in the international confidence game include rating agencies, government officials, international organizations, and newspapers and information agents.

Conclusions

As an academic reaction to the crises of the 1990s, the fields of economics, political science, and political economy have been active in trying to understand two issues: why the crises came about, and how to implement market reform while avoiding future ones. Although the present dissertation does not focus on market reform or development per se, it will benefit from the studies on the matter in exploring the political determinants of financial crises. It is also noteworthy that systemic analysis has been emphasized: We have consciously left out theories dealing with psychological interpretation of market panic and leadership actions, although market perceptions and leaders’ agendas will be seriously considered from a systemic perspective in the following analysis.

The theories on government action, especially those dealing with loss imposition capability, will be key to understanding the flexibility governments have to react to surprises that change the economic balance and threaten the country’s stability. The
theories presented allow us to build on a proposal for the analysis of financial crises based on a government’s ability to act to prevent or preempt such a crisis.
Chapter III

The 1994 Mexican Peso Crisis:
A Political Interpretation of Financial Inaction

During the first half of the 1990s, Mexico was considered the poster child for the Washington Consensus, a darling of the IMF and World Bank, and truly a Wall Street sweetheart. However, the country—which at the time was governed by a group of people the Economist magazine had called “probably the most economically literate group that has ever governed any country anywhere”—lived through one of the worst financial crises in its history. To understand how Mexico went from being on the top of the financial world to enduring a nightmarish crisis, and especially to find out how most analysts, international organizations, and Wall Street firms failed to see the crisis coming, it is necessary to look at not only the economic causation for the crisis, but also the political one.

The 1994 peso crisis is a clear example of a crisis led by political forces. To understand why the crisis took place, it is necessary but not sufficient to analyze the

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17Appendix II presents a Table of political determinants of Government Action affecting Salinas Administration prior to the crisis
18The Washington Consensus is a phrase initially coined in the early 1990s to describe a relatively specific set of ten economic policy prescriptions that were considered by the phrase's originators to constitute a "standard" reform package promoted for crisis-wracked countries by Washington-based institutions such as the International Monetary Fund, World Bank and US Treasury Department.
19The Economist, December 14, 1991, p. 19. It is important to note that the Economist was referring to the Salinas administration, which lasted from December 1988 to December 1994, and not to Zedillo’s team (although in large part it is made up of the same people), who took office in December 1994 and oversaw the crisis itself. Nevertheless, the crisis was not an event that can be attributed only to Zedillo’s team.
MEXICAN CRISIS OF 1994

political factors played a major role in determining the Mexican government’s action and inaction that laid the groundwork for the crisis and later prohibited governmental attempts to preempt it.

The exchange rate crisis, which was followed by a liquidity one, took place because of macroeconomic fundamentals in both the domestic and international market that established a financial disequilibrium, which at some point had to be corrected (as we discuss in the economics section of this case study). However, identifying political factors, actors, events, and forces is key to understanding why the disequilibrium was tolerated, and why the market corrected it in trough a market shock rather than the Mexican government adjusting economic policy to avoid such a shock. Domestic and international politics not only triggered the crisis, but also established the foundation for the government’s inability (or unwillingness) to take corrective measures to avoid it. The failure of most Wall Street analysts to understand the political structure (both domestic and international) behind Mexico’s economic policymaking explains in large part why they erred in their predictions.

Two types of political factors led to the peso crisis: a) trigger events, meaning events that undermined investor confidence, such as the assassination of political figures and the armed movements in the south of the country; and b) fundamental forces, meaning political factors that undermined the central government’s ability to prevent the crisis and constrained its economic policymaking flexibility, especially during that crisis.
Politics were not merely the trigger of a foregone conclusion but a very important reason for its creation (Gil-Diaz Francisco and Agustin Casterns 1996). To analyze the political causation of the crisis, we first look at the economics of the crisis, identify what would have to have happened for it to have been avoided, and examine how the socio-political situation of the country and the interaction of the political forces of the time limited the government’s policymaking flexibility to deal with the problem.

The Economics of the Crisis

On December 20, 1994, Mexico suffered a currency crisis that led to a liquidity crisis and finally a recession and the collapse of the banking system. The ordeal was to become the major economic shock to Mexico in the last half century. This crisis was triggered by the government’s decision on December 19, 1994, to elevate the ceiling of the controlled exchange rate bond by 15%, which limited the flotation of the exchange rate (in effect creating a crawling peg that devaluated the peso in a controlled and constant manner versus the US dollar to make up for the differential between the inflation rates of Mexico and the United States). The decision led to an immediate 15% devaluation of the peso and a speculative attack that diminished Mexican foreign reserves. Two days later the government announced the free float of the peso. The pressure faced by the peso exchange rate that led to the decision to devalue was a result of capital exiting the country in response to both political events and economic misbalances.
At the time, most Wall Street analysts considered Mexico’s finances to be strong. The Salinas administration had been able to reduce the federal deficit from 16% of Gross Domestic Product (GDP) in 1987 to 0.3% in 1994, control inflation by lowering it to the lowest levels in 20 years, obtain real GDP growth of 3% a year, and—perhaps more important—establish clear orthodox monetary and fiscal policies as supported by the Washington Consensus. Nevertheless, Mexico was losing international competitiveness and suffering from sluggish growth compared to other emerging markets at the time. According to Rudiger Dornbush and Alejandro Werner (1994), the reason was an overvaluation of the peso by 20–25%.

![Exchange Rate Vs. Real Exchange Rate (PPI)](image)

Figure 3.1. Exchange rate vs. real exchange rate (PPI).

Source: Economist Intelligence Unit
Two factors were of particular importance in leading to a real depreciation of the peso. First, Mexico’s current account deficit was increasing significantly by 1994 (figure 3.2); private domestic savings dropped from 21% in 1989 to 11% in 1994 while domestic consumption increased by 457.7% from 1987 to 1994. An important part of the consumption increase was financed by the government through loans to both private and domestic development banks that provided “cheap money” for a public that was not accustomed to the credit culture of more advanced financial societies, leading to a boom in personal and credit card loans. Thus, even if the government had achieved negligible nominal deficit, after adding the loans that were given out to the banking system, there was a real government deficit. With neither enough domestic savings nor domestic or foreign direct investment to do so, Mexico covered the current account deficit with foreign portfolio investments.

Figure 3.2. Mexico’s Current Account. Source: Office of the Presidency (Mexico).
Second, as more opportunities for investment arose around the world, Mexico experienced negative political events leading to market nervousness and higher levels of risk. More important, US interest rates rose, diminishing the spread between US and Mexican government bonds.\textsuperscript{20} Investors started to leave the country, which because of the fixed exchange rate diminished Mexican foreign reserves.

The currency crisis led to a liquidity crisis, as Mexico did not have the foreign reserves necessary to cover the short-term liabilities due in January and February 1995. The liquidity crisis was resolved by the establishment of credit lines from the United States, Canada, and the IMF that allowed the country to convert its short-term liabilities into longer-term debt. But by the end of the ordeal, the peso had lost half its value, interest rates had shot up, companies and banks had gone bankrupt, and the people’s hope for an end to the crisis cycle had been crushed. The crisis shock rippled internationally, leading to the “Tequila Effect” that hurt the rest of the Latin American countries and later the emerging Asian economies. In time, Mexico was able to honor its foreign debt, repay its bridge loans, and reposition its economic policy to create growth, but the road was a difficult one.

**Was the Crisis Preventable?**

The answer to the question depends on one’s analysis of the inevitability of devaluation. There were those in Salina’s government, led by then-Finance Minister (and

\textsuperscript{20}Thus discounting the risk premium.
Wall Street darling) Pedro Aspe, who thought Mexico’s current account deficit was temporary, as it had been created by the inflow of foreign capital into the country, which in time should had led to productive investments that would increase production and exports that would balance the current account (Carlos Salinas de Gortari 2002). Those who subscribe to this interpretation argue that the crisis was created by the Zedillo administration’s mishandling of a speculative attack and not by macroeconomic fundamentals. They support their assessment by noting that the December speculative attack, triggered by the reemergence of the Zapatista armed movement in the southern state of Chiapas and the swearing in of the Zedillo administration, was not the first one the peso faced in 1994, as in March an attack had occurred after the assassination of the PRI presidential candidate Luis Donaldo Colosio.

In that event, the Mexican government responded by increasing interest rates and offering dollar-denominated bonds called Tesobonos. By establishing dollar-denominated debt instruments, Mexico was offering what was perceived to be “less risky” bonds while at the same time signaling its commitment to defend the exchange rate. After all, devaluation would be very expensive because of the Tesobonos dollar denomination. Any devaluation would lead to a higher repayment cost for the country. Those who put all blame on the Zedillo administration claim it failed to assure markets of its commitment to hold the exchange rate, creating nervousness in the markets and opening the doors for an attack on the currency.
Nevertheless, most analysts maintain that the current account short-term imbalance theory (i.e., when “capital inflows stop, domestic investment falls, imports are reduced, and the deficit is automatically corrected”) had been proven wrong four years earlier in the United Kingdom, and that the basic flaw of the temporary imbalance assessment was the premise that the incoming foreign capital was being converted into productive investments, when in reality the majority of the inflow was portfolio investments supporting consumption. Rogelio Ramirez de la O, a Mexican economist who was one of the first analysts to publicly express the inevitability of a devaluation and predict a currency crisis in early 1994, observed that the whole perception behind the short-term imbalance theory was unrealistic because of the existence of a distorted price system due to currency overvaluation (Rogelio Ramirez de la O 1996). With the luxury of hindsight, the prevalent economic interpretation was that as Mexico was to face a devaluation of its currency sooner or later, any policies the government used to maintain course simply served to fix a leak in a sinking boat by putting a finger over the hole. For example, the measures taken in March 1994 to face the emerging speculative attack worked in the short term, but the establishment of tight macroeconomic policies also reduced economic growth (Ramirez de la O 1996), and even though higher interest rates helped increase domestic savings, credit consumption outpaced any gain. Furthermore, the interest rate hike was short-lived and not held in place long enough to revalue the peso.
Mexico was trying to maintain what we know as the “impossible trinity”: a fixed exchange rate, perfect capital mobility, and independent monetary policy (in this case with an inflation control target; Doran and Dondisch 2004). Sooner or later, something had to give. Part of the government’s failure to take action to restore balance to the economy can be explained by the belief of some of the administration members in the short-term imbalance theory, but even they, including Pedro Aspe, at some point recognized the currency overvaluation.

The government had two options to avoid a crisis:21

1) **Maintain the fixed exchange rate but increase interest rates**, slowing or stopping capital flight, and increasing domestic savings, leading to a decrease of the current account deficit.

2) **Devalue the peso or allow for free float**, thereby improving competitiveness, allowing for higher exports, and diminishing the current account deficit. This could have been done at a controlled rate and at chosen times to prevent market distress.

Salinas chose to maintain a fixed exchange rate and maintain interest rates, in hopes that the foreign reserves would be enough to forestall any speculative attack on the currency until market forces corrected the economic imbalance. Zedillo decided to devalue, but by the time it was done it and because of the way the devaluation was

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21 Each of these decisions has economic consequences of great importance. Although they will not be analyzed here so we may concentrate on the political aspects, they are not to be overlooked.
implemented, a speculative attack had begun, with the foreign reserves being insufficient to prevent a fall in the exchange rate.

**Political Causation of the Crisis**

There are two main questions we need to ask in order to understand the role political variables played in the crisis. First, why did the government fail to act earlier to fix the current account deficit and currency overvaluation, or faster to counter the speculative attack? Second, what was the role of political variables in launching the crisis? The answer to the first question requires an analysis of the socio-political fundamental forces pressuring the government’s decisionmaking process, and the second an overview of the event triggers.

**The Fundamental Forces**

To understand the socio-political environment the Salinas administration faced, the balance of forces behind Salinas’s actions and inactions, and the political situation to which he responded in his governmental strategy, we need to look at the country’s political history and the evolution of its political parties, culture, and expectations. The 1988–1994 *sexenio*\(^{22}\) was a crossroads in the evolution of Mexico’s transition to democracy, as Salinas faced a nation ready to move on from the single party system that

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\(^{22}\) Six-year term.
had ruled since the end of the Revolution. Pro-democracy forces, together with the weakening of the image of the Partido Revolucionario Institucional, or PRI, were key factors in the economic policy decisionmaking of the time.

**Background**

After the Mexican revolution began in 1910, the country was in political turmoil. Multiple generals and caudillos\(^{23}\) rose to the presidency only to be ousted or assassinated by an emerging leader or faction. Although the revolution carried a democracy banner\(^{24}\), it never materialized. Post-revolution Mexico was dysfunctional as a state, with no central control of armed groups and factional or personal political parties. From 1920 to 1928 Presidents Obregón and Calles started to build the modern institutions of the country by establishing a central bank, a centralized military command, and a working central government, as well as laying the groundwork for the initial formation of a national party that conglomerated the most active political groups of the time.\(^{25}\)

In the 1940s, President Lázaro Cardenas finally created what was to become the *Partido Revolucionario Institucional* (Revolutionary Institutional Party), or PRI. The new party was organized around four core groups: a national farmers’ organization, a national workers’ organization, a military sector, and a social or “popular” organization that

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\(^{23}\) Revolutionary leaders.  
\(^{24}\) The cry of the revolution—“Effective suffrage, no re-election”—was a reaction to the decade-long hold on power by the Porfirio Díaz administration. The revolutionary movement was initially led by Francisco I. Madero, a supporter of liberal democratic systems.  
\(^{25}\) What was called a “Party of parties” (*Partido Revolucionario Institucional, Brief History, 2005*).
gathered in the rest of society,26 primarily the urban middle class. It portrayed itself as the protector of the revolutionary ideals.

The PRI, with its corporative organization, led Mexico for more than 70 years27 by establishing a culture of quasi-liberalism and authoritarianism wherein the president was the supreme decisionmaker. As the PRI took over the government, the party itself became a governing tool, working on mobilizing society, controlling organized social groups, and resolving conflicts throughout the land. The PRI avoided competition by co-opting those who threatened it, establishing bureaucratic loyalties based on patronage, using the state’s security apparatus to support itself, and by committing electoral fraud. The PRI corporative system was sensitive to popular concerns, receptive to big business interests, and responsive to organized groups who cooperated with the party, but excluded unorganized groups from its highly concentrated decisionmaking process (Santín-Quiroz 2001). In this system the power of the president was restricted only by the need to maintain the party machine running and by the 6-year limit on his presidency.

The six-year term limit, known as a sexenio, was probably the key to the PRI’s dominance of the country. It not only permitted the party to use its revolutionary mantra of “sufragio efectivo, no reelección” (effective suffrage, no reelection) even when the elections were rigged, but also allowed for each entering administration to blame past presidents for the country’s problems, just as an opposition party might do in a real

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26The military sector, which provided all presidents of the country until Miguel Alemán in 1946, was later excluded from the three principal party sectors: workers, farmers, and popular.
27Until the 2000 presidential elections won by Vicente Fox of the Partido Acción Nacional (PAN).
democracy, and therefore start from zero in the eyes of the people.\textsuperscript{28} For most of the 1900s the only pressure group the PRI faced was big business, and by maintaining a stable economy (and especially keeping the country peaceful, in contrast to most other Latin American countries at the time), it was able to keep its business constituents happy.

**Mexico’s Political Awakening**

The overall political and social control the PRI had over Mexico was so strong that the party was able to hold virtually every elected position in the country; in fact, in 1976 the PRI presidential candidate ran unopposed. But a series of events triggered the fall of the PRI’s overall control of the country and led to the emergence of political forces and pressure groups who would play a major role in establishing the conditions the Salinas government faced in the 1990s: a) the 1968 student movements and massacre, b) the 1985 Mexico City earthquake, and c) the 1988 fraudulent presidential election.

a) The 1968 student movements and massacre

The year 1968 was an important one in global politics. Student groups around the world organized to protest a diverse set of issues, and Mexico was no exception. A student movement developed that incorporated anarchists, communists, socialists, and pro-democracy sectors. The government reacted to the movement, as it usually did with

\textsuperscript{28}Mario Vargas Llosa called Mexico’s political system “The Perfect Dictatorship,” a party dictatorship that allowed for political pressure escape valves and sold itself as a democracy.
other problems, by spying on it, incarcerating its leaders, and trying to co-opt it, but as
the movement began to carry out public demonstrations, the government employed force
to stop it. It was imperative for the government to curtail the movement before October
12, 1968, when the Olympic Games were to begin in Mexico City; otherwise, the country
would not be able to show its modern side to the world and thus fulfill a need for
international recognition that throughout history had become an obsession for Mexican
leaders.

On October 2, 1968, the movement leaders prepared for a peaceful demonstration
at the Square of the Three Cultures outside of Mexico’s Ministry of Foreign Affairs in a
section of the city known as Tlatelolco. As the meeting took place, Army Special Forces
and regular troops entered the square shooting, sending the participating students running
for their lives. By the end of the day, 325 protesters had been killed and 2360 more taken
prisoner (Julia Preston and Sam Dillon 2004).

The Tlatelolco massacre was the first clear demonstration of a system losing its
hold on society. Not only was it unable to co-opt the movement and channel it through
the Party, but it also showed society that a popular movement had gotten out of its
control. The Tlatelolco massacre created distrust of the army from civil society and in
turn created divisions between the armed forces and the PRI. It was now clear to the
intellectual community and civil organizations that the PRI’s total authoritarian control
had to be confronted, but for that to happen, new social organizations had to emerge. The
1960s’ student movement created a new set of leaders who would eventually direct the country’s leftist and liberal movements.

b) The 1985 Mexico City earthquake

On September 19, 1985, Mexico City awoke to an earthquake measuring 8.5 on the Richter scale. In a matter of minutes, buildings throughout the downtown area fell to the ground. Hospitals and TV stations were destroyed. Thousands of people perished, with many more left homeless. The destruction was startling and the needs of those affected overwhelming, but both the federal and local governments were too slow to respond. In a country where nobody makes decisions without a clear line being set by the president, the reaction to a crisis depends on the reaction of the president himself, which in this case was unacceptably slow.

Thus citizens had no other choice but to fend for themselves, organizing into groups to resolve the problems they faced, ranging from excavating for survivors to establishing shelters and food banks. For the first time in many years, the Party was not there to help: This was the start of a new citizen decentralized movement that shook the belief that the PRI was the only organization that could protect and provide for society. Furthermore, the mismanagement of the crisis by the government29 led to the emergence of an “us versus the government” feeling in society.

29There is a public perception of mismanagement, first with President Miguel de la Madrid’s refusal of foreign aid, and then with police, rescue, and military personnel making the rescue operations even more difficult and taking advantage of the situation.
In the aftermath of the earthquake, the government faced dire circumstances. The physical damage was not only about buildings and lives, as a big part of the PRI’s social welfare system was also destroyed.\textsuperscript{30} With the economy in one of its worst moments, the government was unable—or unwilling—to reconstruct. It offered affected citizens new permanent housing options outside of the city, but these were unacceptable to most. New social groups emerged around neighborhood associations,\textsuperscript{31} which, although they did not start out as political challengers, created the foundation for opposition to the Party in Mexico City. A threshold had been crossed: Civic organizations had emerged and the Party was unable to control or even respond to them. New political cleavages the Party could not resolve turned into electoral preferences, establishing the base for the beginning of the end of the PRI system.

c) The 1988 fraudulent presidential election

Election fraud in Mexico was neither a new nor surprising phenomenon. Most of the population had for years held only low expectations for real democracy, but by 1988 things had changed. The country was just emerging from one of its worst sexenios economically. When President de la Madrid took power in 1982, he faced an economically and financially devastated country, and decided to address the problem by turning to an orthodox, free market, neo-liberal economic policy. He dismissed past import substitution and protectionist policies by opening the country to international

\textsuperscript{30}Including hospitals, clinics, labor union buildings, and low-income housing complexes.
\textsuperscript{31}Known as \textit{Asociaciones de Barrio}; .
trade, and also started to disengage the central government from participating in business by establishing the beginning of a privatization program.

The transition into an open and liberal economy was not easy. The country faced yearly inflation rates that reached up to 170%,\(^{32}\) with the peso (protected with a fixed exchange rate) being devalued by 7503%.\(^{33}\) The architect of the economic measures was a young Harvard-trained Minister of Budgeting, Carlos Salinas de Gortari.\(^{34}\)

Larger sectors of the population, mainly in urban areas, blamed the PRI for their economic misfortunes and for sustaining a corrupt and inefficient governing apparatus. Most important, they began to speak publicly about the need to challenge the PRI in the upcoming elections. With the emergence of such groups, together with the anger of big business groups worried about the state of the economy, for the first time since its creation the PRI faced a clearly divided electorate.

The political divisions were noticeable not only outside of the party, but internally. Rifts at the top became evident in the party, which for many years had been able to keep its members happy by providing them with jobs, money, and especially the knowledge that even if they were out of favor with the government of the time (as every six years the party’s leadership was renewed with the election of a new president), they

\(^{32}\) A 176.82% increase from January 1997 to 1998 (source: INEGI).

\(^{33}\) From .0264 pesos per US dollar in 1982 to 2.0074 in December 1997 (data from Banco de Mexico/INEGI).

\(^{34}\) Obtained his PhD in political economy from Harvard University.
had a better chance of landing a good job by being quiet and supporting the current leadership\textsuperscript{35} than by opposing it.

Under de la Madrid, a new group of young leaders emerged in the party, most of them US-educated and economists by training, including having past experiences working at either the Central Bank or the Ministry of Finance. These young technocrats had spectacular academic credentials, but were considered by many in the party as outsiders with only limited political savvy. Furthermore, their emergence as leaders closed the door to a previous generation of politicians.

As a response to the divisions inside the party and the unpopularity it faced, two top party members from the “skipped” generation, Cuahutemoc Cardenas and Porfirio Munoz Ledo,\textsuperscript{36} launched a movement inside the party, calling for internal electoral process and the end of the “dedazo” tradition by which the outgoing president would decide who the next PRI candidate for president would be. Both leaders were forced out of the PRI, but unlike other occasions when top figures exited the party to find out that a political life without the PRI was not to be, in this case these leaders found a citizenry looking for alternatives to the PRI.

Cuahutemoc Cardenas launched a presidential campaign that reached all of the country and united most of the opposition parties, civic groups not affiliated with the PRI, and leaders from political groups (mainly from the political left, but also some from the

\textsuperscript{35}The PRI’s popular saying, “Whoever moves will not appear in the picture,” made it clear that party members had to support the organization at any cost, but for doing so, they would be rewarded with jobs and favors.

\textsuperscript{36}The first was a son of President Lazaro Cardenas, and the second one a former PRI president.
center-right), many of whom emerged from the student movements of the 1960s. His PRI counterpart, Carlos Salinas, launched a lackluster campaign despite facing surprisingly tough competition. By the end of the electoral process, the Ministry of the Interior had announced it could not provide the public with early electoral results because the computerized system, established to present election day voting trends, had “crashed.” A few days later Salinas was declared the winner and the ballots were destroyed before any independent commission could count them. 37 Salinas was officially president-elect, but the word on the street was that Cardenas had actually won. Salinas took power among shouts of fraud in the chamber of deputies; he entered the political stage as a weak and widely considered illegitimate president. Questioning and opposing the new president became a national sport.

The Salinas Administration Agenda

Carlos Salinas came to power under a new social reality. He presided over a divided country and a divided party. The revolutionary family, as the PRI referred to its members, was in turmoil. The splitting of Cardenas and Munoz Ledo had hurt it, the imposition of Salinas as its presidential candidate had shaken it, and the election results had shocked it. The two things holding the party together were its almost military sense of discipline and the fact it was still in power.

37 For a good explanation, see Opening Mexico.
The PRI was losing support among all sectors of society, from the business elite and intellectuals to the poorest of the poor, with even its right to power being questioned. The party was still the major political organization in the land, but for the first time credible opposition options were emerging who were ready to fight for their rights. Economically the country was still in trouble, as it faced huge interest debt payments and low foreign reserves. Inflation was beginning to slow down, but unlike on other occasions, the entering administration did not have the luxury of implementing expansionary fiscal policies to buy popular support.

These were challenging times. Even though the PRI still controlled the country, it would have to respond to its critics or lose power. Salinas needed to alleviate citizen economic and security concerns, as well as either reposition the PRI as the party of state or prepare it to play a role as a party in a real democracy. The popular feeling of being disenfranchised was strong, and if left unanswered could lead to an increase in calls to oust the PRI from power and even the emergence of armed groups who saw no political avenues on which to carry their fight.

Salinas understood his tenuous situation. He needed a strategy to 1) strengthen his position as president, 2) implement a structural transformation of the economy, and 3) reassert support for the PRI (Santín-Quiroz 2001).
1. **Strengthening his position**

To govern properly and implement his reforms, Salinas first needed to establish himself as the undisputed leader of the regime. The unquestionable power Mexican presidents had enjoyed in the past was not awarded to them by the constitution, but was given to them because of the control they had over the party. Salinas took steps to make it clear he was in command of both the party and the country. He assembled a cabinet that included in key political posts some of the toughest and best-established members of the PRI. He made it clear that he spoke for the party. In addition, he ordered the arrest of powerful figures who were previously considered untouchables, main among them being the leader of the powerful oil workers’ union.

Throughout his administration Salinas was very concerned about establishing his power, and particularly anxious about creating and maintaining a positive public image. He worked the usual channels through a rapprochement with those sectors of society from which he had lost support, and he was very good at using public relations campaigns inside and outside the country to market himself. Salinas became Mexico’s first “media” president. He loved the limelight and people fell for him; *Time* magazine even named him “Man of the Year."

Through smart political management, Carlos Salinas was able to bring legitimacy to his presidency from the presidential chair. But the downside of such maneuverings was that unlike previous presidents whose strength came from the party, Salinas took
his power not only from the PRI but also from his made-to-order image. Therefore, any loss of personal credibility would lead to a loss of political strength.

2. Structural transformation of the economy

Mexico needed to boost its economy without resorting to old methods such as acquiring new debt. In fact, the country faced a possible default on its debt obligations if it could not restructure them. Furthermore, the government needed funds to launch new programs. Salinas wanted to establish an economic policy of state that would outlast his term and lead to long-term growth that would pull Mexico out of its six-year crisis cycle, take it into the First World, and convert it into a developed nation.

He assembled his economic cabinet to include top-notch and financially orthodox economists and personally chaired weekly cabinet meetings with them throughout his administration. The main economic objectives were to a) satisfy the financial needs of the State, b) secure macroeconomic stability, and c) create wealth.

To satisfy the financial needs of the state, foreign capital was needed. The government established programs with the World Bank and IMF that included conditionality agreements based on the Washington Consensus. It also courted foreign capital by adopting a liberal economic policy: eliminating financial control, establishing extensive privatization programs including the reprivatization of banks, and giving autonomy to the Central Bank. The courtship of international investments
became the major influencing force in the establishment of the county’s economic policy.

To secure macroeconomic stability, Salinas followed up on his “pacto” program, which controlled inflation by negotiating among the government, the private sector, and workers’ unions to establish prices, wages, and economic policy fundamentals. Negotiations included the exchange rate regime, as workers had seen their wages reduced significantly with each devaluation of the currency. The goal was to control inflation and create confidence among market players and the government.

To create wealth, a policy was established to assist big business conglomerates, as it was argued the country needed a strong and modern business elite willing to invest in the country as well as a robust export sector able to compete in world markets. Reforms to revolutionary vestiges that condemned productivity and competitiveness were carried out, including eliminating constitutional protection for certain economy sectors and lifting foreign ownership limits.

Probably the most troublesome of these initiatives was the one directed at the farmlands. Out of the Mexican revolution came a complicated program of land reform that divided parcels of land into different legal proprietorship forms, one of them being a communal land known as an *ejido*. The laws prohibited the selling of *ejido* lands, but their size made them unproductive. A constitutional amendment lifted the prohibition on selling *ejido* land, thus threatening a major institution of Mexican
rural communal life. This event would turn out to be a trigger for the emergence of the Zapatista armed rebellion in southern Mexico.

The policy goals and implementation strategy made international investors, labor unions, business unions, and the big business elite key players in the structural transformation of the economy. Their actions would be determinant in the economic policy decisionmaking equation.

3. Reassert support for the PRI

To reestablish support for the PRI regime, Salinas set out to a) regain support among the business sector, b) strengthen support in the bureaucracy, and c) rehabilitate the PRI’s image among the lower classes.

The government made it clear the voices of business groups would be heard at the highest levels. There would be no policy surprises. New business opportunities were created with the help of government-financed programs—for example, low-cost financing for private investment in infrastructure projects, as well as opening international markets for Mexican exports.38

The middle class, the sector in which the PRI had lost the most support, had assumed the biggest costs of transforming the economic structure. The prescription was to alleviate its members’ economic concerns, even if only on a temporary basis

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38However, many of these programs were carried out through a corrupt web that limited the number of companies that received government contracts. Some such as the private highway initiative were a complete business failure that required government rescue.
until the economy recuperated, by increasing their consumption capacity through a credit boom. As for the lower class, a new and innovative instrument called the National Solidarity Program (PRONASOL) provided communities that provided their own manpower with the materials needed to build roads, schools, and other infrastructure. The program was successful both as a developmental tool and a political one, directing its resources to areas where the PRI was in need of public support.

New social demands led Salinas to recognize electoral losses to the center-right National Action Party (PAN), including three governorships. Throughout the sexenio, election results were subject to political negotiation rather than law. For most of his term, the country was at peace but under constant tension. The need to reassert support for the PRI made the Salinas administration behave as if it were on a permanent reelection campaign.

The key to implementing the strategy to reassert support for the PRI while carrying out the structural transformation of the economy was ensuring the availability of capital to pay for such programs, as most of it depended on foreign inflows of capital.

Internationalization also played a major role in Salinas’s overall strategy. By signing international agreements and adopting internationally recognized policies, the administration was ensuring the continuation of its economic policy.
The key to the puzzle turned out to be the North American Free Trade Agreement, which opened the doors for Mexican products into what was then the largest market in the world. It established an unprecedented public partnership with the United States that challenged the ever-protectionist mantra of Mexican nationalism, which had required a clear show of independence to the neighbor to the north that in many cases worked as an excuse for government actions. Salinas wanted to take Mexico into the First World, whether it was ready or not. On his watch, the country gained membership in the OECD, and was constantly discussed as the prime emerging market, the one that was about to make the leap; however, those attributes were based not on its economic or living standards, but on its potential. As long as the internal and external market believed in Mexico’s future, the present problems could be overlooked. Thus, maintaining a positive image of the country became extremely important.

**Political Limits to Policy Reform**

1) **Forces against a rise of interest rates**

A hike in interest rates could have helped prevent capital flight, especially by those investors responding to the US Federal Reserve’s increase of interest rates by 200 basis points in a one-year period. The Mexican central bank could have raised its rate by increasing its bond offers, but doing so would have hurt three important groups:
a) The **big business conglomerates**, which had grown amazingly during Salinas’s presidency, mainly by obtaining loans from both banks and the bond markets. Any increase in the interest rate would have translated into millions of dollars in extra costs. These groups also were financially backing the PRI presidential campaign, and any policy change that would hurt them directly would have been very costly to the PRI, or even mean losing the groups’ support. Even though Mexican electoral laws at the time established a campaign financing system based on government funds, party coffers were complemented by member and supporter donations. Hurting your financial backers is never good politics, and when doing so will damage your electoral prospects, it is political suicide. Even in December 1994, just as the Zedillo administration was about to devalue the peso, it was careful to discuss the move with top business representatives, a step that according to IMF reports went awry as those with privileged information were able to convert their money into dollars before the devaluation,\(^{39}\) which started the capital flight that turned into a speculative attack.

b) **Middle class-based organizations**, such as the *Asamblea de Barrios*, opposed such an action because an indebted middle class would have resented an interest hike. Thanks to the availability of loans, Mexico’s middle class was experiencing a higher standard of living than it could afford, thanks to the availability of loans for consumption. Its members would face an increase in their interest payments

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\(^{39}\)The notion the speculative attack of December was initiated by Mexican investors with privileged information has been challenged by Gil-Diaz and Casterns (1996).
that could translate into high default rates. Anger at their economic situation undoubtedly would shift toward a government that had promised them a better life and entry to the First World. Many of the newly formed political action groups were mainly middle class and upper lower class. Any action that increased interest rates could give them cause to fight against the PRI. As it turned out, after the attacks, with the hike in interest rates, a high number of companies and individuals defaulted on their loans; new groups of those who defaulted were formed, such as the *Barzon*, which initially represented farmers but grew considerably in urban areas and joined Cardenas’ PRD. Salinas was trying to regain urban middle class support for the PRI, and a political policy that increased interest rates would undermine his efforts.

c) **Bankers** were particularly afraid of increased interest rates. Although they profited by arbitrage opportunities, gaining the differential obtained by financing themselves in foreign currency at low rates and loaning to Mexicans in pesos at higher rates, their loan portfolios were heavy on consumption loans. Higher rates as discussed above might cause massive defaults that could—and eventually would—compromise many of the banks’ financial survival and lead to the default of the banking system. Just a few years earlier, bankers had paid huge amounts of money to buy the formerly nationalized banks back from the government at what was considered by financial analysts to be inflated prices. Bankers were trying to recoup their investment, and did so by launching loan campaigns that
irresponsibly compromised their financial risk–return balance. The banking sector was very close to the government, and its political muscle went unchallenged. Salinas’s overall economic development strategy required a working banking sector, but also one that would support its “subsidized consumption” strategy. Thus the government was very careful to cooperate with the banks and try not to affect them.40

2) Forces against devaluation

Just as in the case of an increase of interest rates, the devaluation of the peso, which could have prevented the crisis if done with time and care, also would have hurt key groups.

a) Bankers would be hurt by this measure. As explained above, banks were financing their peso operations with arbitrage operations. A devaluation would increase their debt amount, a move that could prove fatal to some financial institutions because of their sensitive position.

b) Labor unions had been very helpful in containing labor demands and supporting Salinas’s economic and political agenda. The establishment of the pacto was key in obtaining the unions’ support as it focused on controlling inflation which in the past had greatly hurt workers’ real income. Devaluation would give way to higher

40Ultimately the crisis proved almost fatal to most Mexican banks, with the government ending up taking over most of the default portfolio of the banks, leading to the FOBAPROA crisis that politically damaged both the PRI and PAN and cost Mexico’s taxpayers billions of dollars.
inflation, and with it the loss of wage-value. In real terms, the minimum salary had lost 39.4% of its value during de la Madrid’s administration, and 15.2% during Salinas’s term (Jose Luis Augusto Rubi-Guerrero 1997). The main concern was that losing control over labor unions could lead to the demise of the pacto, a key tool in Salinas’s economic strategy. Labor groups had been always fierce supporters of the PRI, with the largest workers’ organization in the country, the Confederation of Mexican Workers (CTM), being one of the three organizational pillars of the party; but opposition parties were trying to crack the PRI’s hold on labor unions by supporting splinter groups who wanted to form unions outside the PRI, pressuring long-serving labor leaders to show they still had a voice in government decisionmaking. A devaluation of the currency, especially one not negotiated with labor groups, could affect their unquestionable support of Salinas. Before the elections, devaluation was a political nonstarter.

c) Particularly important was Mexico’s history of recurrent devaluations. No long-term success was possible if Mexicans did not believe their country’s economic future would be stable. Because of the recurrent devaluations that seemed to come about every time a new president was to take power, business cycles in Mexico were measured in six-year periods paralleling presidential terms. Investors preferred to look at venture options with returns in the short term instead of the longer-term, much needed projects such as infrastructure development. The tradition of exiting presidents devaluing the peso to allow more flexibility to the
new administration had become an unwritten rule. Presidents before Salinas had tried to persuade the public that such practice had ended. In the 1980s, President Jose Lopez-Portillo had given enthusiastic support to the peso exchange rate, saying that “A president who devalues the currency devalues himself,” and even pledging to watch over the peso value “like a dog,” only to devalue the currency a year later (his popular nickname became “the devalued president” and his residence “the dog’s hill”). Nevertheless, Salinas appeared to have made a good sell: People believed he would not permit a big devaluation. Even his public support for the Ernesto Zedillo\textsuperscript{41} election campaign centered around the need to continue his economic stabilization and growth program for six more years. Devaluing the currency would signal to those inside and outside Mexico that in reality nothing had changed—that the country was still caught in a perpetual cycle of economic growth followed by devaluation and crisis. Salinas talked openly about the importance of changing historical devaluation expectations (Carlos Salinas de Gortari 2002) as one of the major challenges he faced, as he needed to beat the past in order to construct a better future.

3) External pressures against devaluation

a) The North American Free Trade Agreement (NAFTA) was the cornerstone of the administration’s economic strategy. It would ensure the continuation of an

\textsuperscript{41}Zedillo had served as Secretary of Budgeting under Salinas and was considered a Salinas protégé.
open market commercial policy in Mexico by opening the world’s largest market to Mexican products. However, NAFTA had to be approved by the legislative bodies of its members. Getting Canadian approval was not a problem because of its parliamentary system and the support of the majority party. In Mexico, the PRI still had control over the congress, but in the United States, things were not going so smoothly. Congressional negotiations were tough. Critics argued the United States would lose manufacturing jobs to Mexico, and that potential peso devaluations would make Mexican products cheaper so they would flood the US market and lead to more US job losses. A strong peso made it less enticing for US-based companies to move manufacturing operations to Mexico. Devaluation before the treaty entered into force on January 1, 1994 would have strengthened the case against NAFTA and jeopardized its ratification. A devaluation just after NAFTA would be a slap in the face to the American administration. Accordingly, it was reported that it had been verbally agreed that Mexico would not pursue a devaluation for some time to alleviate pressures on the US market.

b) Wall Street’s confidence in the Mexican market was essential in maintaining the much needed influx of foreign capital into the country. As Pedro Aspe had been very successful in earning the trust of international investors. He had been actively assuring investors of the government’s commitment to maintain the fixed exchange rate. His role became even more important in 1994 as political events led to market nervousness. Just as it had had to persuade Mexicans that stability
was the new economic norm, Mexico felt it needed to assure the international financial community that this was a new Mexico, a US commercial partner and OECD member committed to free markets and economic growth. An unanticipated devaluation would deal a great blow to international investment trust in Mexico.\textsuperscript{42} It is important to note that in the 1990s, the idea of having fixed and controlled exchange rates was thoroughly supported and even encouraged by the international community. Even more important in the short run was the need for foreign currency. The country required foreign currency to account for its current account deficit and make good on its financial obligations. Devaluation would lead to capital flight, because along with the value they would lose on their peso-denominated bonds and accounts, investors would lose trust in a government that had repeatedly stated it would not devalue its currency. Furthermore, unless the currency was devaluated to a sufficient rate or to a free float, a speculative attack could take place, leading to the loss of foreign reserves and a weaker position for the country’s economy.

\textbf{Personalities}

The personalities of those in government were key determinants in the actions that led to the 1994 crisis. This was not the case in other Mexican financial crises. Past

\textsuperscript{42}It would also lead to stampede flight of portfolio investments and, if the devaluation was not sufficient, to a speculative attack—as it finally did.
presidents had been willing to take blows in terms of their reputation in order to maintain popular support for the PRI. Most of them retired from public life after leaving office and publicly acknowledging the emergence of a new maximum leader of the country.

But Carlos Salinas de Gortari was different; his legacy was very important to him. He was trying to engineer the Mexican political and economic system for the next century. As president, he was the toast of the town wherever he went. After taking office as the weakest president ever emerged from the PRI, he converted himself into a political figure who commanded respect around the world. In the eyes of the international financial institutions, he personified the kind of leader developing nations should have in order to succeed. Furthermore, he had no plans to exit the public arena: He was running for the presidency of the newly formed World Trade Organization, and therefore was not about to offer himself as a scapegoat. Even after the election of Zedillo, in the five-month period between the elections and the swearing-in of the new government, Salinas made it clear he was still in charge, cooperating with Zedillo but not acceding to his demands for devaluation. Salinas proudly claimed to be the first president in 30 years not to devalue the peso (Julia Preston and Sam Dillon 2004).

Another key player was Pedro Aspe. After the assassination of President Luis Donaldo Colosio, Salinas reportedly favored Aspe to become the new PRI candidate, but

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43 After the crisis Salinas was quick to blame the Zedillo administration for what he called the “errors of December,” but his image was tarnished and he had to leave the country and settle temporarily in Ireland (a country without an extradition treaty with Mexico.) So important was his legacy to him that after seeing his brother incarcerated on charges of corruption, Salinas wrote a _non mea culpa_ book called simply _Mexico_.

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he realized that constitutionally it was an impossibility; only then did Salinas choose Zedillo, his former Secretary of Budgeting who had left the cabinet to run Colosio’s campaign. Aspe was an expert in maneuvering through the Wall Street maze. Important market players saw in Aspe a trustworthy and smart partner with whom to work. The high regard he commanded gave him strength inside the administration’s cabinet.

Aspe was not keen on devaluation because he believed the current account deficit to be temporary, but also because he was committed to control inflation. On November 20, 1994, Salinas’s economic cabinet and top economic lieutenants met with Zedillo at Salinas’s home to discuss options to stop the capital flight and halt the foreign reserves’ loss of more than $1.65 billion over the previous three days. Initially Salinas offered to devalue the peso, which was what Zedillo wanted, but Aspe blamed the reserve bleed on the market’s distrust of the entering administration’s commitment to maintain the fixed exchange rate, and thus refused to devalue, alleging there was not enough time to do it properly (Preston and Dillon 2004). Aspe offered to resign, but accepting such an offer ten days before the end of the administration would signal to the markets a break in the economic policy by the new administration and thus lead to a crisis. Therefore, the fixed exchange rate was maintained. Although Aspe’s assertion that the lack of time to do a proper devaluation was probably correct, it illustrates his power over policymaking.

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44According to the Mexican constitution, presidents of the country needed to be at least second generation Mexicans and hold no government office for a period of six months before elections. Aspe failed on both counts. Since then, a constitutional amendment has been passed that permits Mexicans with only one Mexican-born parent to hold the presidential office.
Political Determinants

MEXICAN CRISIS OF 1994

Roberto Dondisch

Political Trigger Events

Recalling certain developments that occurred in 1994 is critical to understanding the timing of the crisis. These political events triggered the speculative attack that led to the devaluation and increased the tension in the political balance within the country in a way that made it even more costly for the government to act on the economic fundamentals of the crisis.

On January 1, 1994, the night that marked the start of NAFTA and the entry of Mexico into the OECD, a moment that was supposed to symbolize the emergence of Mexico into the First World, an armed group in the southeastern state of Chiapas declared war on the Mexican Army and demanded the resignation of Mexico’s president. The group, formed mainly by indigenous Mexicans, called itself the Ejército Zapatista de Liberación Nacional, better known as the EZLN. In its declaration of war, the EZLN stated that theirs was a fight for a right to land, housing, work, food, health, independence, liberty, democracy, justice, and peace. The EZLN claimed to follow in the footsteps of Emiliano Zapata and Pancho Villa, two of the greatest figures of the Mexican revolution, and to fight for the rights of all indigenous people in Mexico. This was not a secessionist war, but an armed social movement.

The conflict was highly concentrated in the eastern part of the state, a territory that neither is strategic to the country nor represents a significant percentage of its population. The conflict, which persists to this day, is not a major security threat to Mexico. But its moral implications raised questions about the Mexican social fabric and
political and economic structure, questions that deeply affected the entire nation and gave the conflict national importance. The emergence of the EZLN was a reminder of the reality of the Mexico that lies outside the cities, a Mexico that had been forgotten by the modernization process. It was a reaction to the implementation of a new “national project” that was substituting for the one created by the Mexican revolution.

The Zapatista struggle internationalized quickly, its emblem becoming a unifying banner of the newly emerging antiglobalization movement around the world. It evolved into an armed conflict whose primary battle arena was the world’s media stage. Salinas was quick to implement a strategy that encapsulated the armed group militarily but tried to resolve the conflict politically. Even if the Zapatistas had shaken the international image Salinas had built through five years in power, there was still a chance to show the world Mexico was a modern state that would deal with the situation in a civil way.

The Zapatistas also struck a big blow to the PRI’s image, as it was now clear the party that claimed it could at least guarantee peace in the country was now unable to deliver. The financial–diplomatic core of the Mexican government reacted, trying to calm down international investors, but it was obvious that 1994, the year in which successes were to be harvested, was instead to become a year of uncertainty—and nothing affects markets more than uncertainty.

During the following months, groups claiming to support the EZLN carried out minor terrorist and subversive acts throughout central Mexico. Unlike the Zapatista movement itself, the Mexican public universally denounced the attacks. The Chiapas
uprising was being handled calmly and mostly openly, allowing the country to refocus on the upcoming presidential election and a renewed turf war among drug-trafficking cartels in northern Mexico.

Then, on March 24, 1994, while walking through a crowd in Tijuana,45 Luis Donaldo Colosio, the PRI presidential candidate and presumptive next president of the country, was assassinated. The act sent shivers throughout the world. Inside Mexico people assumed that the intellectual authors of the crime were PRI insiders, the old guard returning to the use of violence to solve political differences, signaling a regime in distress. Internationally, Mexico’s image as a modern state was hurt and Wall Street reacted nervously. The event opened the door for a speculative attack on the peso, but the government was successful in defending the currency by reaffirming its support for the exchange rate.46 The PRI named Zedillo as its new candidate, with Deputy Attorney General Mario Ruiz Massieu tasked with heading the investigation into the Colosio assassination in what turned out to be the Mexican version of the Warren Commission, which—just as in the American case—persuaded nobody.

On August 21, 1994, Zedillo was elected president by largely clean and calm elections. He benefited from the shock vote emanating from the assassination. The election reassured the market, for it looked as though the new government was to continue the economic policy of the time. Because most of the officials who were to be

45He had just finished addressing a crowd of supporters in Lomas Taurinas, a section of the city of Tijuana close to the San Diego, California, border.
46As explained in the economic section, dollar-denominated debt called Tesobonos was issued and a swap line of credit for $6.7 billion was set up by the US government to support the peso.
named to cabinet posts were members of Salinas’s administration, the change should have been a smooth one. In reality, there was infighting among the ranks and different perspectives on what to do about the economic imbalance.

On September 28, 1994, José Francisco Ruiz Massieu, the PRI Secretary General (second in the party’s hierarchy), who was favored by political analysts to become Secretary of Government (interior, the most important political position in the Mexican cabinet), was assassinated while getting into his car in Mexico City. The political war was not over, and with a new government about to take office, stability was an issue.

Again Salinas and Aspe were able to avoid a speculative attack by promising a full investigation and calming the markets. To ensure the integrity of the investigations, Mario Ruiz Massieu, José Francisco’s brother, was assigned to lead them. But before Zedillo was sworn into power, Mario Ruiz Massieu resigned his position, claiming in a public statement that the government and the PRI were impeding the investigations into the killing of his brother and assuming that it was inside party forces who were responsible for both the José Francisco and Colosio assassinations. The market reacted strongly, with billions of dollars leaving the country.

On December 1, 1994, Zedillo took office. Soon after, the Zapatistas launched new attacks in Chiapas, making world news and prompting international and national capital to flee the country. Questions about the commitment of the new government to hold the exchange rate gave way to a speculative attack and finally the peso crisis.
Loss Imposition Capability and the Election

Salinas’s initial strategy to strengthen his presidency was a necessary move for him to be able to govern effectively. By shocking those who opposed him both inside and outside the party, he was able to ensure he that maintained control of the PRI, thus giving him the ability to implement policies that meant hefty losses for certain sectors of the population. Nevertheless, as typically occurs in advanced democracies (Weaver and Pal 2003), his loss imposition capability diminished as elections neared. This was a new phenomenon in Mexican post-revolutionary political history, as normally a president’s power would be unchallenged until he chose his successor (and thus a new leader of the party), but the need to get popular support for the PRI and ultimately the popular vote for both the federal and local elections changed the way politics were played in the country.

The institutional framework of the country, which still had not caught up with the popular pro-democracy movements and the emergence of active opposition parties, gave the president ample powers but few opportunities for blame avoidance or redirection. As the two other federal powers (legislative and judicial) were de facto subordinated to the executive, and the federal government controlled local governments either directly or through their budgets, the president was ultimately responsible in the eyes of the public. Minor mistakes could be blamed on specific ministers, but overall the president and the PRI were responsible for policy mistakes. This situation limits a government’s loss imposition capabilities even more, as unpopular decisions, or those that seem to undermine past positions and promises, undercut the president’s political capital.
Electoral processes strain government actions, and the Mexican case was no exception. In 1994, we saw a fiscally conservative administration that had been able to balance the federal budget for the first time in modern Mexican history relax its controls on expenditures, raising government spending by 1.4% of GDP\footnote{According to CountryData, going from a 1.4% of GDP surplus to a virtually balanced budget.} to gain popular support by allowing a expansive fiscal program. The presidential elections of 1994 established new limits to the government’s economic policy decisionmaking, decreasing its loss imposition ability. As the elections approached and political instability erupted, the government prioritized its strategy to strengthen the party over its economic transformation objective, making it hard to impose losses on some sectors of the society.

The pressures of gaining popular support were constant during the Salinas administration and not limited to the electoral process. In fact, when looking at electoral stress on government policymaking (understood as the need to gain popular support for the party or candidate), it would be accurate to say that Salinas faced a constant re-election situation that stressed decisionmaking throughout most of his tenure rather than only in the last year.

**Why Did Most Analysts Fail to Predict the Crisis?**

Even though the macroeconomic factors that led to the crisis were latent for more than a year before, and the current account deficit and low internal savings had been building up over time, most international observers failed to realize a crisis was
imminent. Bear Stearns restated a previous paper giving 15 reasons why the Mexican government would not devalue the currency just 15 days before it did so. Duff & Phelps Credit Ratings (now part of Fitch Ratings), reaffirmed its investment grade rating on Mexican sovereign debt just a couple of months before the devaluation. The PRS group held an 8 points risk grade (10 being the lowest risk) for exchange rate stability throughout 1994.\textsuperscript{48} As David Malpass of Bear Stearns put it, “We were wrong” (Doran and Dondisch 2004).

Yet only a few reasons have been given as to why most analysts failed to anticipate or predict the crisis:

1) The international financial community was enamored with Salinas’s economic team, believing they would be able to pull off their program and avoid any crisis no matter what the situation.

2) An international herding behavior led risk analysts to maintain their ratings and outlooks. Any revision to them would have gone against conventional beliefs.

3) A wholehearted belief existed in the economic soundness of the Washington Consensus policies that Mexico was pushing forward as well as in the stability they were supposed to bring to a country.

\textsuperscript{48}10 being the lowest risk to stability (Source: CountryData).
4) A conflict of interest existed within firms that were making a lot of money by selling Mexican bonds, leading them to turn a blind eye to the problem or risk of losing some very profitable contracts.

5) A moral hazard situation existed as investors thought the United States would never allow Mexico to default on its debt.49

Most important, most Wall Street analysts failed to realize how both the internal and external political forces at play curtailed the government’s flexibility in economic policymaking. To understand the situation, analysts would have needed to comprehend the internal political condition and overall government goals to clarify the degree of leeway the government had in its economic policymaking rather than rely only on economic figures and government statements. A big lesson to be learned is that a government’s intentions count for little if it is unable to convert them into actions and assume the cost of implementing them.

Some have argued that proof of the international market’s failure to comprehend the political and economic reality of Mexico at the time was given when the first ones to get their money out of the country were well-informed Mexicans, a point that was refuted as a “pilgrim tale” by Francisco Gil Diaz and Agustin Casterns (Gil-Diaz and Casterns 1996). In any case, it is clear the procedures followed by investment and credit rating agencies failed them in predicting the crisis.

49Which ultimately proved true.
Conclusion

The 1994 peso crisis cannot be explained without looking at political factors. Both fundamental forces and trigger events were key in the evolution and launch of the crisis. Fundamental forces curtailed the government’s flexibility in economic policymaking, and with that its ability to preempt the crisis. Trigger events rattled the markets, thus shortening the time the government had to correct the economic imbalances.

Fundamental forces increased the cost of action for the Salinas administration. As with most government decisions, a correction to the economic policy would bring with it costs to certain groups, both politically active pressure groups and non-organized sectors of society. The initial weakness of the Salinas administration and self-imposed grand goals limited its loss imposition capability, leading Salinas to try to avoid the problem instead of preempting it, in the hope that any possible crisis could be managed. The change of administrations and an environment of worsening economic indicators and new negative political effects gave way to a speculative attack that ultimately the new administration was unable to manage.

As the Salinas administration strengthened politically, its self-imposed economic and political strategy continued to hamper its ability to change its economic policy course. By 1994, when the need to correct the economy was clear, political events triggered market action that thwarted a possible solution. The mix of the two main political objectives, the structural transformation of the economy (which limited its
policymaking flexibility), and the strengthening of the PRI (which diminished its loss imposition capabilities) proved to limit the government’s ability and will to preempt the crisis and assume the costs of such an action.

Decisions that would have seemed possible to make after the Zedillo election were avoided both because the personal goals of the officials involved did not allow for them, and because the snowball effect curtailed the time available for the Mexican government to take steps to avoid a crisis. When the Zedillo administration finally acted, it did so in a tepid manner, trying to preserve the political coalition created to support Salinas’ policies, which led to a catastrophic result.
Key Political and Institutional Factors:

I. The guiding policy objective to transform the economy diminished the government’s economic policymaking flexibility.

II. The electoral process and the government’s objective of strengthening the PRI further limited its economic decisionmaking flexibility and its loss imposition capability, thus putting stress on its ability to deal with the negative political events the country faced.

III. A lack of entities to blame for policymaking decisions limited the president’s blame avoidance options.

IV. The constant search for both domestic and international approval, including courting foreign capital, limited the government’s loss imposition capabilities.

V. The creation of a public image of greatness of the president himself and of super-ministers gave individuals in government a veto power over policy changes. The personal goals of these government officials, in terms of both political legacies and professional ambitions, inserted an element that further limited the government’s economic policymaking flexibility.

VI. A constant struggle with history led the government to try to avoid devaluing the currency at any cost. The need to demonstrate the start of a new era of economic stability and development to both Mexicans and the international market was a constant and determining factor in the government’s decisionmaking.
The first major economic crisis of the post-Cold War era is a case that exemplifies the determinant role political factors play in the evolution of an economic crisis. Any risk analysis exercise must identify and understand them in order to truly capture the situation on the ground.
The Argentina default, economic, and political crisis of 2001 is an example of a failed attempt at evading an economic crisis. The main reasons the economy failed to adapt to external shocks that led it to the crisis, as well as for the failure of the initial attempts by the government of President Fernando De la Rua to correct the course, are primarily political. Fundamental forces in Argentina at the time severely restricted the ability of its central government to implement reforms to both its monetary and fiscal policies.

Unlike the Mexican case, in which internal trigger events led the way to market reactions the central government failed to counter, in Argentina the trigger events were primarily international and financial in nature. The factors leading to the Argentine crisis took a long time to develop because of the availability of international funds in the sovereign debt market that allowed the country to maintain deficits using the available money to solve political problems, even if it meant mortgaging its future while keeping its monetary and fiscal policy in place. President Carlos Saul Menem, who led the liberalization reforms of the country’s economy, missed an opportunity to implement

\[50\text{Appendix III presents a table of political determinants of Government Action affecting the Alianza’s government prior to the crisis.}\]
further reforms to prevent a future crisis in part because he prioritized short-term political objectives rather than long-term economic stability. Government inaction in the 1990s was backed by an economic argument supported by mainstream economists, who at the time thought a crisis could be avoided, arguing that the factors that had led to the economic imbalance were of a cyclical nature. As a return to positive levels was due, they reasoned, there was no need to implement a costly reform, but only to hold on during the transitional period. Unfortunately for Argentina, this prediction proved wrong, and the beginning of a political crisis in 2000 further compromised the government’s ability to deal with the challenges created by the existing market environment.

The main problems Argentina faced were not created by the international market, but they were facilitated by it. Throughout its history Argentina had used expansionary fiscal policies to permit its government to spend its way out of political and social problems. Such policies led to periods of hyperinflation that negated any chance of an economic expansion. With the establishment of the Convertibilidad program in 1992, the government was able to stop the use of the printing press to cover its spending, but by 1998 the country had returned to its overspending practice—but now it needed new sources of money to pay for it, as it could not issue unbacked currency.

The answer was found in the international sovereign debt market. By borrowing internationally, the government maintained high-spending programs. The crisis came as interest rates rose and the country ran out of resources to maintain its fiscal spending levels and to continue servicing its debt.
As detailed below, the inability of the country to curtail its spending cannot be explained merely by the lack of political will to do so, but can be attributed to fundamental forces that created many expenditure points (i.e., federal government, provincial government, courts). In addition, the government was unable to impose losses on key groups in order to carry out the painful reforms necessary to avoid a crisis.

Just as in the Mexican case, to understand the reasons behind the Argentine crisis of 2001, we need to study not only the financial and economic factors behind it, but the social and political dynamics that guided the country’s government in its policymaking. In the first part of this chapter, we look at the economic reasons for the crisis and identify the actions that had to be taken in order to prevent it. In the second part, we examine the fundamental forces and how they shaped and restricted government action from 1995 to 2001. Part 3 looks at the trigger forces behind the crisis, while part 4 is an analysis of the political limitations to government action. However, we do not go into the crisis management stage for the simple reason that the objective of this dissertation is to explore the causes of the crises and not their political management.

The Economics of the Crisis

From 1998 to 2001, Argentina faced a growing economic imbalance created by both internal and external factors that led up to an economic crisis unlike any the country had ever seen. The fixed exchange regime established through the adoption of the
Convertibility program in 1992\textsuperscript{51} established a fixed 1 to 1 parity between the Argentine peso and the US dollar. This program, combined with wage and price rigidities, led to high production prices that hurt the competitiveness of Argentine exports at a time when the world prices for them were already low. The biggest market for their exports, Brazil, had just devalued its currency by 40%, leading to a 20\% decline in Argentine exports. Furthermore, there was a contraction of private domestic consumption and investment spending that led to a curtailment in output growth.

Yet even under these circumstances, the country maintained an expansive fiscal policy underwritten by borrowing in the international markets. External shocks, particularly the Russian default of 1998, led to a worldwide decrease in investments in emerging markets, which raised both the interest spread for Argentine bonds and the cost of the country’s expansive fiscal policy, ultimately leading the country to default.

The Argentine economy proved to be resilient when it fended off market pressures during the Tequila Crisis in 1995. Although the Mexican crisis carried in its wake other countries who ended up having to give up on their fixed exchange rate, Argentina was able to maintain its peso-to-dollar convertibility regime. It suffered a short-term recession but avoided a crisis, thanks in part to a weak US dollar, high international prices for its products, opening of the Brazilian market to Argentine goods, and international investors who saw in the country a safe place to invest. Nevertheless,

\textsuperscript{51}A quasi-currency board system, known in Argentina as \textit{Convertibilidad}, that limited the country’s central bank’s ability to issue pesos by requiring it to hold US dollar reserves to account for each peso printed.
the economy maintained vulnerabilities that finally caught with it as it faced new external shocks.

The four main external shocks affecting Argentina were 1) the Brazilian devaluation of January 1999, 2) the US dollar appreciation, 3) the fall of the export prices that gave way to lower export income, and finally 4) the Russian default in August 1998 that led financial investors to a “flight to quality” behavior that raised the cost of borrowing for emerging markets. Daniel Chudnovsky, Andres Lopez, and Germán Pupato (Carlos Bruno and Daniel Chudnovsky ed. 2003) identify a lack of adjustment mechanisms available in the Convertibilidad system to face these external shocks. This situation together with the lack of fiscal discipline and low competitiveness of the domestic industry set the country on a road to crisis. Guillermo Calvo (2003) notes that the main factors behind the crisis were a) a global slowdown on capital transfers to emerging markets, b) the depreciation of currencies in emerging markets, c) a lack of capacity from the Argentine economy to increase exports, and d) the dollarization of domestic private and public debt. Ricardo Lopez-Murphy, Daniel Artena, and Fernando Navajas (2003) contend that in the absence of exchange rate flexibility, Argentina needed downward flexibility in its government spending, but instead the country faced spending rigidities that ultimately led to its default on foreign debt.
The country’s growing fiscal deficit (see fig. 1) was funded by foreign borrowing, which was increasing in cost. The government’s inability to reduce spending or increase its income led to a higher percentage of government spending used for debt service payment; the sum of the government deficits from 1995 to 2000 was more than US$25 billion. Federal government deficits increased by 29.7% from 1993 to 2001, with 55% of the increase attributable to debt service payments, 30.4% to social security payments, and 15% to transfers to the provinces.

The appreciation of the US dollar also led to an overvaluation of the Argentine peso that made exports even less competitive. According to the Inter-American Development Bank (IDB), in 1998 the peso was overvalued by 46.2%. Guillermo Perry and Luis Servén (2003) calculate a peso overvaluation of 55% by 2001.
The shocks to the export market translated into the internal market as well. As the government failed to get new loans in the international market, it started securing them internally from private banks and investment funds. This situation led to a *crowding out* effect that limited the availability of funds for the private sector and gave way to a slowdown in the internal market.

As less credit was available to the private sector, and a slowdown on exports restricted the availability of foreign currency entering the Argentine economy at a time when a de facto dollarization was taking place, the money supply was limited, leading the country to a deflationary stage of 1% a year from 1999 until the devaluation of the peso.

![Foreign Debt Composition](image)

**Fig. 4.2.** Foreign debt composition. Data: Economist Intelligence Unit.

With increasing foreign debt service obligations and decreasing foreign currency income, the government tried to apply harsh measures directed at lowering production...
costs (mainly wage reductions) to try to restart the economy. But the measures were insufficient, and their effect led to public unrest, which ultimately caused the fall of the weak government of President De la Rua. Finally, Argentina faced a political crisis that led the country’s senate to appoint five consecutive interim presidents in a 3-week period. In the end, Argentina announced a default on its sovereign debt and an end to the Convertibilidad system. Millions of Argentines lost their life savings, and international creditors are still trying to recuperate some of the many billion dollars they loaned Argentina.

**Was the Crisis Preventable?**

The Argentine case is one of failed attempts to prevent a crisis, with the reasons for the failure having to do both with the capability of the government to implement the intended reforms and their timing. By 2001 there were probably few things the government could do to avoid a crisis, although options did exist to limit its scope and impact. Government decisions to make the Convertibilidad system more flexible or even eliminate it, or to give a “haircut” to its foreign debt (negotiating with creditors who would have to decide whether to accept a cut in the amount the government owed them or face a possible default) might have worked as late as 2000. Both options would have been very painful, but the end result would have been better than the one Argentina ultimately suffered.
However, the factors that led to the economic imbalances and the failure of the country to counter the external shocks were present in Argentina long before 2001. Public debate about the weaknesses of the economy began in 1995 (even if the majority of economists and especially financial agents jumped onto the “Argentina the invincible” bandwagon soon after). So although this is a case of failed attempts in 2000 and 2001, it is also one of missed opportunities from 1996 to 1999, when the economy would have allowed for reforms to be taken in order to better position it against future shocks, or even permitted government action to counter the 1998 and 1999 shocks. But it is also a case of failed reforms in 2000, when the government was simply unable to carry out its economic programs, as we will see later in the chapter.

The way the crisis could have been avoided, or at least preempted, was to work at earlier stages to make certain the Argentine economy could live through the kind of external shocks it ultimately faced. Internally three factors limited the country’s ability to adapt to external shocks: 1) a fixed exchange rate, 2) inflexible production costs (primarily wages), and 3) an expansive fiscal policy.

The crisis could have been prevented, or at least preempted, had the country acted to correct the economic factors earlier, or at least as soon as it began to feel international shocks. But the fundamental forces in the market that prevented the government to act in 1996 were even stronger by 2000. The inability of the country to react to adverse markets led to an increase in its perceived sovereign debt risk, thus leading to higher risk premiums and increases in the cost of serving such debt. The
actions taken by the government in 2001 to correct its economic balances caused a political crisis that in turn eroded any remaining trust the market had in Argentine debt, creating even higher interest rates and ultimately Argentina’s decision to default.

Different options were available to the Argentine government to help stall a looming crisis. Government officials worked on refinancing the debt and tried to maintain financial market confidence by dealing with the IMF on standby loans, but these actions did not correct the fundamental problems of the country’s economy. Instead they simply helped to fend off any strong correction, often in the belief that the cyclical nature of Argentina’s export market and the possible weakening of the US dollar would lead to a reactivation of the country’s economy so that no major correction would be needed. Reforms also were avoided as part of a political ploy to persuade the market to maintain a bullish position on Argentine debt. But the premise of a cyclical crisis that Argentina could survive proved wrong, as the inflexibilities of the Argentine economy together with government spending were too much of a hurdle to overcome, especially as international financing eroded.

At the bottom of it all, the 2001 event was a debt crisis. It was not a matter of temporary liquidity shortage but of the country’s inability to service its debt or even finance government spending. The currency overvaluation helped to bring about a fall in foreign currency income that in turn contributed to the country’s inability to service its debt. However, the currency crisis was not the main economic event, but rather only a
secondary effect of the debt and political crisis. In facing the external trigger events that imposed new pressures on the country’s economy, the government had two basic options:

1) **Reduce overall government spending.** Increasing fiscal deficits both at the federal and provincial levels had to be covered by the international financial market. The *Convertibilidad* program was successful in controlling inflation, but although it prohibited the use of expansionary monetary policy, the government found new ways to finance its spending and maintain real fiscal deficits. The Argentine government simply switched from funding its spending from the printing press to the foreign markets, if government spending were to be controlled at all levels the need for international financing would fall.

2) **Increase foreign currency income.** To keep up with the rising cost of servicing its debt, Argentina needed to create market flexibilities that would allow its exports to be competitive. The options were to **a) devalue the currency**, or **b) create the necessary environment for production costs to adjust through market pressures** to make exports competitive even with an overvalued currency.

Although Menem had failed to launch reforms to fortify the economy in response to international financial crises, the De la Rua government failed in its reform attempts primarily because of domestic politics. Its first mistake was to try to reduce government spending not by cutting its budget or controlling provincial and court spending, but by
fighting to lower the risk premium it paid on its debt. De la Rua’s administration prioritized selling international investors on the stability of the country. In addition, its first action to increase income was to establish new and higher taxes that wound up being paid by the domestic tradable-producing sector, affecting production costs and lowering exports. It was not until later that the De la Rua government tried to create market flexibilities to counter its reluctance to end the fixed exchange rate. Unfortunately, those efforts were unsuccessful and very costly in social terms.

**Political Causation of the Crisis**

The Argentine crisis took a long time to reach its critical juncture. As the crisis approached, there were various opportunities to make corrections, but the government failed to take advantage of them. By the time the government was willing to assume a high cost to act, it was unable to implement the needed reforms. To comprehend the government’s frame of mind and the political environment faced by the administration, we need to look at the fundamental forces in the country at the time and understand their roots.

When it took office, the De la Rua government faced a daunting task. With only limited political support and lack of control over the main provinces, the courts, and ultimately congress, from the beginning it walked a tightrope, trying first to implement its political programs and later on to simply survive. To understand how the government found itself in such a situation, it is necessary to understand the historical moment when
De la Rua took power, as well as the interests of the main political forces of the time. To provide a context, we present a concise historical analysis of the country’s political evolution, then analyze the political actors at play and their interests.

Background

1890–1930: The era of high growth and stable government

By the end of the 19th century, Argentina had been able to build an impressive economy based on abundant agricultural exports. Its per capita income was higher than those of Canada and Australia, and comparable to those Germany and Switzerland. Politically the landed elite, mostly from Spanish and Italian origins, ably managed the country. Between 1870 and 1913 Argentina and Japan were the fastest growing economies in the world. But even though its economy was one of the strongest and most developed in the world, Argentina’s political development had stagnated. Economically Argentina belonged in Europe, but politically it was a match for its South American neighbors.

The landed oligarchy was not willing to share power; it tolerated peaceful opposition but restricted participation. By the 1900s, a new wave of immigrants came to Argentina, mostly Europeans who stayed in the cities and worked in commerce and industry. In time, this new group demanded political space in the elite-dominated governments. The country was divided politically between the new and old immigrants who represented not only different political viewpoints, but also had different interests.
based on their economic activities. Challenged by these new groups, the elite landowners allowed an election to take place$^{52}$ in 1916. The winner was the Radical Party, which in 1917 introduced moderate reforms that made the oligarchy nervous; their ultimate response was to end the democratic experiment in 1930 with the first of many military coups.

1930–1940: The beginning of the fall from grace: Military coups and restricted elections

The military coup was the first step in derailing the country from its previous path to becoming an industrial democracy, and started a 53-year period of cycles of military coups and restrictive democratic regimes. From 1930 to 1983, Argentina lived through 25 presidents, 22 years of military regimes, 13 years of a populist–corporatist government (under Peron), and 9 years of restricted democracy.

By the end of WWII, the reversal of Argentina’s economic fortunes had begun. By the 1950s, its economic growth was only 0.9%, compared with the rate of 5% it had in the beginning of the century. The military intervened in politics whenever it opposed policies or action of the civil leadership. This was a new era in which, as Enrique Peruzzotti (2004) notes, “…rights and constitutional guarantees were constantly violated and constitutional rules and electoral laws blatantly manipulated and bent to accommodate the political wishes of the authority in power. If an election would not

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$^{52}$The election brought universal suffrage for native-born Argentine men.
produce the expected outcome it would be annulled. If an administration did not yield to certain demands, it would be toppled.”

1940–1975: The corporatist state and the fracture of society

From 1940 to 1958 a new dynamic was in evidence. The country lived through cycles of coups and elected governments with even military governments being overthrown by new coups. From 1955 to 1983, Argentina had 18 presidents, all but one removed from power by force. The one exception was Juan Domingo Peron, who died in office in his second term (after being removed and reinstated by the military). His regime changed Argentine politics forever.

Peron rose to power in 1946 through elections. A former army colonel who took part in the 1943 military coup against the civilian government of Ramon Castillo, he became the country’s vice-president before being imprisoned in 1944, when his growing power threatened the government of Edelmiro Farrell. Peron’s success stemmed from his gaining support from the labor unions. During his first administration, he established a corporatist system in Argentina that organized labor, merchants, and small industry, giving those sectors of society a voice that would counter the historical control of power by the landed elites and armed forces.

Peron’s legacy was twofold. First, a new populist ideology based on the idea of a “third way,” a political ideology described as an “alternative that falls between capitalism and socialism” in the political spectrum, took root in the country. Second and most
important, Peron established a corporatist structure comprised of institutions and organizations that still exist and have become important political actors, giving the Argentine middle class a prime position in the country’s political system. Peron formed the *Partido Justicialista*, which is still today the largest and most powerful political party in Argentina.

Peron’s authoritarian populist government was brought down by a military coup in 1955 after years of economic troubles. Peron went into exile in Paraguay, but the civic organizations he had created ultimately proved impossible for the new military regime to control. Amid the political and economic turmoil, Peron returned to Argentina and was reelected president in 1973. But his last administration was a failure, as Peron was unable to restore political stability. He shunned the leftist groups that had supported him in the past, some of which ultimately turned to armed resistance and terrorist attacks. He died in office in July 1974.

**1976–1983: The dark times**

In 1976, another military coup overthrew the civilian government led by Peron’s second wife, Isabel. Unlike earlier military regimes that continued the basic government programs of the civilian administration they overturned while changing specific policies, the new government, led by General Jorge Videla, wanted to erase the Peronist legacies—and it was willing to take any steps necessary to do so. Argentina entered a dark period of government atrocities. Disappearances, torture, and political killings were
everyday occurrences. The military led a dirty war against the corporatist organizations created by Peron in which it would eliminate any person who stood in the way. More than 30,000 persons disappeared whose fate was never officially established; many bodies were never found.

Amid rising popular resentment and the emergence of a human rights movement that challenged the regime in street demonstrations, the military government changed leadership and looked for ways to win popular support. But when those attempts failed, they reached for proven historical methods: taking the country into a “patriotic war.”

The Falkland Islands, or Islas Malvinas as they are known in Latin America, were the stage for such a war. This cluster of islands to the southeast of Argentina, which had no strategic or economic value for the country, were considered by the nation to have been illegally occupied by the United Kingdom in 1933. The issue is one close to the heart of most Argentines, and even today the mere mention of the English name for the islands provokes an emotional reaction. By launching a military operation to capture the islands, the regime was able to temporarily quell any internal opposition. The few who continued to speak out against the government were branded as traitors. It was especially difficult to oppose the war itself because Argentines considered it a just one.

Although the political tactic worked at first, the overall strategy was a complete failure. The military regime failed to anticipate Great Britain’s response and suffered a

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53 According to the historical account of the Argentine Foreign Ministry, on January 3, 1833, British troops landed on Puerto Soledad, expelling the Argentine administration on the islands and taking the whole archipelago in 1834.
humiliating defeat to a much more powerful enemy. Thus, the Argentine military lost whatever remaining prestige it had held. Its regime had failed to run the country efficiently, tortured and killed tens of thousands of its own citizens, and finally taken the nation into a losing war. The Falkland war would prove to be the decisive defeat of the military’s role in Argentine politics, which led to the reestablishment of democracy through a human rights movement that emerged from the ashes of the military dictatorship.

**1983–1989: The new democracy**

In 1983 a new democratic era dawned in Argentina, as without a credible military opposition, democratic elections could be held. The discredit suffered by the military regime opened the door for new leadership. Under these circumstances, Raúl Alfonsin, candidate of the Radical Party, won the election.

The new president had to deal with a stagnant economy and the emergence of a highly politicized society that was finally expressing itself after years of military tyranny. The human rights movement was able to push for the acceptance of a constitutional democracy with a working party system, but it also brought with it a very critical attitude toward elected officials and a demand for government accountability, creating a tense relationship among the elected officials, the new societal watchdogs, and an independent media.
The new party system was dominated by two parties of the past: the Unión Cívica Radical (UCR), which represented the middle class, and the Partido Justicialista (PJ) which transformed itself from a union-dominated corporatist organization into a patronage-based, regionalized, moderate umbrella party. Most important, political actors began to invest in the new electoral system and thus abandoned previous opposition to the political system.

Alfonsin’s main objective was to establish political stability in the country and respond to the calls for accountability for human rights violations. The two goals were sometimes at odds because the president needed to establish a civil–military relationship based on mutual respect and yet bring the armed forces to justice for their past actions. Alfonsin’s government worked to establish a functional judiciary, but his administration failed to create an environment of cooperation between political parties and the government that would establish a base for future democratic success. Instead, Alfonsin worked to establish a long-lasting political front that attacked and tried to delegitimize other political parties. To achieve these goals, the government used every tool at its disposal, including monetary and fiscal policies. During his administration, the economy served political priorities. To quell political unrest and strengthen his party, Alfonsin’s administration turned to expansionary monetary policy.

Unfortunately, Alfonsin’s policies led to hyperinflation. The average inflation rate from 1984 to 1989 was 740% a year, with inflation in 1989 hitting 3078%. The

54 Source: EIU Country Data.
situation was so bad that prices of goods changed throughout the day. People needed to constantly listen to the radio to learn the official prices for basic goods. Special bank accounts were established to protect citizen savings from losing their value in real terms.

By the end of Alfonsín’s administration, the situation had gotten so bad that the president’s party, which a few years earlier had symbolized a new beginning for the country, lost the presidential elections to the Partido Justicialista, the old Peronist party. Pressure on Alfonsín was so high that he resigned as soon as the new president was elected instead of staying in office throughout the transition period as stipulated in the constitution.

1990–1994: Menem I

The new president, Carlos Saul Menem, a former governor of La Rioja province who had once been incarcerated by the military regime, was an astute politician who claimed to follow the center-left agenda of his party, but in reality had no clear policy preference. Juan Corradi (Carol Wise and Riordan Roett 2000) described Menem’s personality as a leader with “Messianic caudillismo typical of provincial leaders mixed with Arab fatalism.”55 Elected on a populist agenda that included a promise of higher wages and jobs, he moved quickly to establish a governing coalition with groups that were formerly critics of his party. He was a true “political machine” who understood that the people’s main concern was inflation.

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55Carlos Menem’s family was of Arabian origin. Menem had to convert from Islam to Catholicism to run for president, as the Argentine constitution limits the presidency to those of Roman Catholic faith.
Menem’s first year in power was a difficult one; the economy was in stagnation while inflation in 1990 reached 4000%. In 1991, Menem made the single most important appointment of his administration, one that would define his presidency: Dr. Domingo Cavallo as minister of finance. Cavallo’s task was to stabilize the economy. To do so, he laid out a series of orthodox liberalization economic reforms. If the Alfonsin election of 1983 marked the modernization of Argentina’s political system, Cavallo’s program did the same for the economy. The foundation of the program was the *Convertibilidad* system established in 1992.

The new currency board-style program was intended to lend credibility to the Argentine currency and certainty to the internal market. But for it to succeed, it was necessary to take the political process, and especially politicians, out of the exchange and monetary policy. The establishment of a rigid exchange system was the shock therapy the people were looking for, a strong move that would give instant credibility to the currency and permit the reactivation of the economy while it kept the “untrustworthy” politicians “clearly responsible for the problem” out of bounds.

The system was a success in economic terms. Inflation went down to 25% by 1992 and fell to single digits by 1994; from 1990 to 1995 GDP grew 40% and exports increased by 50%. Most important, even though many other economic reforms were key in achieving those results, *Convertibilidad* became a blockbuster in political terms as well. Menem and his energetic finance minister were able to control inflation and position the country for economic development. With this success in the economic
sphere, Menem’s power increased considerably. His party had control of the senate and was the first minority in the lower house; he also had as allies governors of the two largest provinces.

But the president used his newly acquired political capital to weaken the judiciary, appointing his supporters to the Supreme Court. Instead of strengthening government institutions, he created alliances based on personal relations that allowed him to carry out economic modernization reforms that basically dismantled the neo-mercantilist state established by Peron. Menem instituted a dual strategy of macrostabilization and deep market restructuring that created a government of paradox, one that was neoliberal, pro-American, pro-free markets, and Peronist, even though the traditional definition of Peronism would have been corporatist, anti-American, and statist. He operated by issuing executive decrees that the congress and judiciary were expected to follow, lest they risk being labeled obstructionists.

Menem established a government with hyperpresidentialism (Steven Levitsky 2003), governing in a unilateral manner. He proclaimed a state of emergency that from 1989 to 1994 allowed him to issue a total of 335 “Necessity and Urgency Decrees” (NUDs) to avoid having to pass laws that would be questioned in congress and the courts.

The downside of the economic program was that the system also limited the use of monetary policy for political maneuvering. This situation became especially important as Menem decided to pursue reelection, an act that required a constitutional reform. Menem controlled the unions and courts, enjoyed overwhelming support among the
middle class and even the upper classes, but the congressmen and senators whose vote he needed to change the constitution were controlled primarily by the provincial governors. To get their support, Menem made two political moves: 1) to maintain Peronist support he returned to past practices of using budgetary politics and patronage (but unlike in the past, he could not turn to expansionary monetary policy but needed instead to borrow money); and 2) to avoid struggles with the opposition, he cut a deal with Alfonsín that would allow him to seek reelection while giving the radicals small concessions in return.

In general terms, Menem’s first term was considered a big success. Even if he did not advance toward democratic consolidation, his economic success was enough to win over Argentines and made it very difficult for anyone to attack him. His reelection campaign was based on a promise of further reforms to make certain the benefits of the economic expansion would reach everyone. But the story of his second term turned out to be very different.

1994–1998: Menem II

Menem easily won reelection, but his countrymen were no longer willing to give him a free hand, especially as they no longer feared returning to the hyperinflation era. Economic struggles resulting from international financial crises weakened his hand. Further economic and financial reforms also led to higher unemployment, while uncontrolled government spending led to an ever-rising debt burden. Provincial governments were dealing with constant deficits, in part due to the transfer to the
provinces of former federal obligations such as education expenses. On more than one occasion, the federal government had to intervene to cover provincial debt.

Luckily for the Menem administration, international funding through sovereign debt in dollars was readily available and used to spend the country out of trouble. Public expenditure increased 60% between 1990 and 2001\(^\text{56}\) (Carlos Acuna, Fernando Nunez, and Alexis Roitman 2005) while debt service payment obligations increased by 365% during the same period. The increase in debt service was a result of increases in the amount of debt and the interest paid due to sovereign risk premium increases. As Horacio Isgut\(^\text{57}\), a former top Citibank executive in Latin America and head of a bank in Argentina during the period explains, bankers were fighting for access to the market by offering money to both the federal and provincial governments without differentiating the risk between the two levels of government. They were caught in a moral hazard dynamic, under the assumption that the federal government would not let a province default on its debt.

Furthermore, there was pressure on banks from the federal government to give loans to provincial governments and even private companies. As funds available for this practice (known as “distributive politics”) were limited, the federal governments used its influence on banks to fund provincial governments or groups that needed to be compensated as a result of the policymaking process. In fact, the biggest new debtor during that period was the private sector, which generated most of its debt in US dollars.

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\(^{56}\) Although it increased by only 5% of GDP, and GDP expanded greatly during the period.

\(^{57}\) Personal interview
During Menem’s second term in power, the country’s economic situation shifted for the worst, mainly because of international events as discussed in the economics section of this chapter. The Brazilian devaluation of January 1999 was especially painful as it led to a significant decrease in Argentine exports, but it also opened a window of opportunity for the government to tweak its monetary policy. While Convertibilidad maintained a 1 to 1 peso-to-dollar fixed exchange rate, from 1990 to 2001 the real effective exchange rate (REER) marked a loss of 75% of the peso’s value, of which 55% was lost between 1997 and 2001. The situation led to a loss of competitiveness for Argentine exports and with it increases in unemployment and internal debt.

The Brazilian devaluation provided Menem with a perfect pretext to reshape the Convertibilidad system, but Menem had a political objective in mind: a third term in office. With that motive in play, once again monetary policy became a hostage of political strategy. Public spending, and the government deficit, rose not only at the federal but also at the provincial level, particularly as Menem fought with Buenos Aires province governor Eduardo Duhalde for the candidacy of the Peronist Party. The decision not to pursue economic policy reforms at the time was a case of political inaction.

The new attempt for reelection failed as Menem lost popular support. The market reforms he had implemented left behind a divided and weakened social movement. In 1996, Cavallo resigned as minister of finance as a result of both economic policy and political differences with the president. With Cavallo’s exit, Menem lost the support of the center-right. The creation of a new political party, the Front for Country in Solidarity
(FREPASO) eroded his center-left base. Furthermore, Menem’s administration suffered important political setbacks due to corruption charges that would ultimately place the president under house arrest. The Peronists’ loss of control of the legislature in 1997 served as an indicator of the collapse of popular support for the government.

The erosion of Menem’s popular support and his decision to pursue reelection (an effort ultimately truncated by the same Supreme Court judges he had appointed) split his party. His main rival within the Peronists was Buenos Aires governor Eduardo Duhalde, and his outside opposition was a new political alliance created by the two main opposition parties, the Radicales and the FREPASO. The following election would become a referendum not on policy but personality. Argentines were tired of Menem and corrupt government, but wanted to maintain the economic reforms that had led to the reactivation of the economy even if they no longer were adequate. Candidates who talked about shifting from the Convertibilidad system would most likely lose the elections. The end result was an overwhelming victory for the Alianza, not in small part owing to the Peronist infighting that would end up destroying any central authority the party had. By the end of his term, Menem, who had squandered his political capital on the pursuit of a third term, was scorned by the judges he had appointed, displaced by his own party, and reviled by society.

58The Alianza (Alliance for Work, Justice and Education) won the elections in all but one of Argentina’s provinces (Misiones). Even though the presidential elections are based on popular vote and not geographical representation, the fact the Alianza won support across the country, even in provinces under clear Justicialista control, reflects the frustration of the electorate with Menem and Duhalde.
1999–2001: The Alianza

The Alliance for Work, Justice and Education won the 1999 presidential election. The coalition was the brainchild of FREPASO leader Carlos “Chacho” Alvarez, who served as vice-president. The new president was former Buenos Aires mayor Fernando De la Rua, a compromise candidate who carried little political support inside his own party. There was a major contrast of style between Menem and De la Rua. While Menem understood the need to get support from former opponents and was a person who had the pulse of the Argentine people, De la Rua had no charisma and lacked leadership qualities.

De la Rua believed his two main tasks were 1) to carry out second-generation economic reforms following Menem’s path in response to popular economic demands, and 2) to reinforce the democratic institutions, making certain government officials would be held accountable for their actions, in response to the corruption that helped bring down the Partido Justicialista (PJ). But as he took office, it became clear the state of the economy was much worse than most thought. Exports were falling, debt rising, deficits increasing, and the public feverishly expressing their feelings against devaluation, not only because of the pride they felt for the Convertibilidad system, but because by the end of 1999 the amount of private debt held in US dollars had increased to 70% of the total. Devaluation at this stage could trigger defaults and even bankrupt the banking system.

As the Alianza neither held a congressional majority nor controlled a majority of provincial governments or the judiciary, De la Rua was compelled to govern by building
coalitions—a difficult task, especially as the opposition Peronist party was badly divided and had no clear leader with whom to negotiate. In fact, the PJ leadership was divided among three provincial governors, all with presidential aspirations. Adding to this situation, the Alianza never established a clear set of government policies and worked as a weak coalition of undisciplined parties. De la Rua preferred to govern by surrounding himself with expert economists rather than include members of the FREPASO or political operatives in his cabinet. Unlike Menem, De la Rua never launched a power-building process that would have given him the political capital he needed to govern without the use of Necessity and Urgency Decrees (NUDs), which weakened the democratic institutions of the country.

With respect to economic policy, De la Rua also had a daunting task, as he needed to get support for major shifts in economic policy. Although Menem had been able to use scare tactics against a known and hated enemy, hyperinflation, De la Rua would have to mobilize public opinion in favor of a decrease in government spending and social security payments to address such problems as trade balance deficits, competitiveness, and currency overvaluation—concepts that are difficult to explain to the general public. The job fell primarily to his first finance minister, Dr. José Luis Machinea, a well-respected economist but someone identified with the hyperinflations of the 1980s, a period during which he served as director of the Central Bank.

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59 Governors Carlos Ruckauf of Buenos Aires province, José Manuel De la Sota of Cordova province, and Carlos Reutmann of Santa Fé province.
60 His first cabinet included only two members of FREPASO.
61 He now heads the United Nations Economic Commission for Latin America and the Caribbean.
In response to the economic situation of the country, Macri established a policy directed at reassuring financial markets of Argentina’s economic soundness so as to avoid a cash flow crisis due to increasing premiums on Argentina’s sovereign risk. He also saw foreign direct investment (FDI) as the key for economic expansion. His strategy included three programs: 1) the “Impuestazo,” or big tax reform, increasing taxes on earnings and VAT; 2) a cut in public spending through a decrease in government wages and social security payments; and 3) the “Federal Compromise,” a pact negotiated bilaterally with each province through which the federal government assured the provinces that a specific amount of funds would be transferred to the provincial governments every year in exchange for the provinces renouncing their right to receive part of any extra income generated by the state from tax reforms. The response to the new policies varied by social sector; while the banks and IMF supported the program, the small and medium business sectors, union workers, and retirees opposed it. As it had no control over the unions, the government faced the first of many general strikes.

On the political front, De la Rua launched a “transparency” campaign in an attempt to assure both domestic constituencies and foreign markets of the government’s commitment to clean governance. But the transparency image was short-lived. The government was selling foreign market makers and information agencies an image of economic and political stability they knew to be false. As an assistant to then-finance minister chief of staff Pablo Gerchunoff explained, they constantly worked on how to sell market players on Argentina’s bright future, even when the information given was not
“up to date.” In one instance, Vice-President Alvarez persuaded a Wall Street risk rating firm of the stability of the government even as he was about to resign from his post.

Domestically De la Rua’s clean image suffered a blow as it became known that the government was bribing Peronist members of congress to obtain their support in passing some of their economic policy reforms. The president responded to the crisis by shaking up his cabinet. The vice-president saw his power diluted in the new cabinet. Alvarez, who was not involved in the bribery operation and who had run his campaign on an anticorruption platform, resigned in protest. Fortunately for De la Rua, the FREPASO was so divided that Alvarez’s exit did not bring an end to the Alianza.

This political instability gave way to a higher risk premium, and with it an increase in debt service payments and the fiscal deficit. To calm down the markets, Argentina negotiated a standby loan with the IMF that was supposed to make the country crisis-proof. The loan was conditioned on Argentina taking three basic steps: 1) freezing the primary fiscal deficit, 2) carrying out social security reform, and 3) freezing provincial deficits. The three conditions proved impossible to meet, in large part because of the political weakness of the government, opposition by veto players (including the courts blocking social security cutbacks), and infighting within the cabinet.

In March 2001, after losing a power play with the Central Bank president, Machinea resigned. His successor was former Defense Minister Ricardo Lopez-Murphy. The new minister was well respected by the business and international community as an orthodox economist, but carried little political weight of his own. He saw Argentina’s
economic problems as a solvency issue rather than a liquidity one. Thus he presented a plan to cut government spending in every area, including education and health services, as well as reducing the federal fund transfers to the provinces. He wanted to comply with the conditionality agreement signed with the IMF; nevertheless, his program was short-lived. De la Rua’s government did not have enough political support to pass such policies, and when it tried to use NUDs, it proved to be short on political capital. Lopez-Murphy resigned a month after taking office.

Amid growing popular unrest and a worsening economic situation, De la Rua took a desperate measure, giving the finance minister job with extended powers to one of his political opponents, former minister Cavallo. In an attempt to reclaim the role of economic savior, Cavallo took the job, believing (perhaps arrogantly) that he could turn things around. He started by 1) loosening the Convertibilidad straitjacket by making more pesos available while maintaining the exchange rate and proposing to mix the euro with the dollar in establishing an exchange basket to which the peso value would have been set, 2) instituting a competitiveness law that included deregulation measures and a decrease in production costs by lowering employers’ contributions to the social security system and new tariffs, and, most important, 3) establishing a zero-deficit law that lowered government wages and pensions by 13%. Cavallo faced strong opposition to his economic program both inside and outside the country. In Argentina, unions and the

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62 Even though Cavallo did not have strong party backing, his voice carried a lot of weight, especially among the rank and file of De la Rua’s supporters, which in conjunction with the weakened PJ made Cavallo a top opponent.
63 Cavallo has since commented that taking the job was a mistake.
Peronists launched an organized opposition in the form of general strikes and street protests, or “piqueteros,” which became part of Buenos Aires everyday life.

Internationally, the new program and even Cavallo’s appointment failed to create confidence, which made it difficult for him to introduce a debt substitution program to avoid an upcoming liquidity crisis. To make things worse, in an effort to curtail “moral hazard” behavior, the newly elected Bush administration in the United States insisted on changing the way the international financial institutions dealt with economic crisis prevention. The IMF’s decision to stop lending to or backing up the country led to a rise in the risk premium and loss of any remaining market confidence. Bankers and foreign investors called for the dollarization of the economy and offered to pay $10 billion in advance taxes to the Central Bank to fund the switch (PENT 2005). It was probably too late for Cavallo to do anything to save the economy from collapsing, but even if that were the case, he failed to do anything to cushion the blow.

By October the population had lost confidence in the Alianza government and handed it a defeat in the congressional elections. More important, Argentines were upset with the political system in general, casting about 15% of their ballots blank in a show of frustration. By November 2001, two provinces had announced a default on their debt.

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64 A program was launched that converted $16 billion due between 2001 and 2005 to mid- and long-term instruments, but the change would end up costing Argentina $66 billion.
65 The assumption by investors that the risk of a market is mitigated by the certainty that other countries or international institutions would come to its rescue in case of a crisis.
66 After many years of supporting the Argentine economic programs, the IMF decided the country was headed toward an economic crisis that would be unsolvable unless Argentina took extreme measures, such as devaluing its currency. With the refusal of Argentina to take such actions and the argument the country had failed to reach a zero-deficit situation as required by its conditionality agreement, the IMF decided to halt negotiations on any future loans and standby credits. Not only did Argentina lose its last source of cheap credit, but the IMF’s action signaled to the market an increase in the country’s risk.
Facing panic withdrawals from saving accounts, on December 1, 2001, Cavallo established the “Corralito,” under which withdrawals were limited by law. Generalized violence hit the streets, with daily looting and cries of hunger throughout the country. The mobilization took a political form as well. People went to the streets with a single cry: “Que se vayan todos”—Spanish for “All politicians must go.”

On December 20, 2001, De la Rua resigned the presidency. During the ensuing three weeks, Argentina had five different presidents, defaulted on its international obligations, and finally ended Convertibilidad. The only positive consequence of this episode was that the country’s democratic institutions had been tested to their limit and ultimately survived.

The De la Rua Government’s Objectives

President De la Rua had made his governing plan clear since the elections. His main public goals were to 1) maintain macroeconomic policies that quelled inflation while bringing in second-generation reforms to address poverty and unemployment, and 2) bring about a transparency reform that would lead Argentina to a consolidation of its democratic system. His political objectives were not as clear, but can be deduced from his public statements and actions, including changes in cabinet ministers. De la Rua wanted to 1) reform government institutions still under Menem’s or PJ control, 2) position his

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67 It is quite interesting that during the congressional elections of 2005, the main candidates were once again those whom the population had run out of office in 2001.
68 It is important to note that the party system collapsed with only a very divided PJ surviving.
party as main political force in the country, and finally, 3) position himself as indisputable leader of the Radical Party.

**Political Limits to Policy Reform**

Government action in this case required reforms in monetary, government expenditure, or employment regulation policies. The three main options the country had to evade a currency crisis or a default were to a) reduce overall government spending, b) devalue the currency, or 3) reform regulations to make domestic production costs—especially labor costs—more flexible. We now identify the main variables that prevented De la Rua’s government from successfully implementing the necessary reforms to avoid or even alleviate what ultimately became the biggest financial crisis in Argentina’s history. As noted earlier, this was a case of failed reform; therefore, we concentrate on the forces and motives that prevented the government from successfully implementing its economic plans.

Argentina is a federation of provinces whose central government has a division of power structure with executive, legislative, and judicial branches. The executive branch is ultimately responsible for economic policy, but congress has oversight authority. Depending on the specific issue, the executive had authority to either propose employment policies to congress in an effort to create market cost flexibilities or adopt those policies unilaterally. With respect to the federal budget, the executive had to
Political Determinants

negotiate with congress and the provinces, but it had the ability to control spending and manipulate parts of the taxation system unilaterally; furthermore, historically the executive has been able to pass its proposed budget with few amendments. Although each branch of the federal government is institutionally independent and a clear legal division exists between federal and provincial levels, due to the structure of the party system, provincial governors hold the power to appoint candidates to congress and thus maintain heavy influence over the representatives of their provinces in the federal congress. This gives them a strong hand when dealing with the federal executive.

When it came to currency exchange policy, things were not that simple. Part of the *raison de etre* of the *Convertibilidad* law was to make certain the executive could not tamper with the exchange rate. To prevent any action, the law stipulated the necessity for an act of congress to change the law. The strict system curtailed the executive’s ability to make time-restricted policy reforms, as any action the government wanted to make was required to go through a lengthy legislative process, which would also force the government to make its intentions public. Although in most cases clear signaling is essential for good governance, when it comes to currency exchange policy, making such information public would let the market react to the government’s intent before the government itself could act to counter the market, a situation that made any change difficult and probably very costly.

Even if the legislative framework curtailed the executive’s ability to pass time-restricted reforms, there were always other options for executive action that would allow
ARGENTINE CRISIS OF 2001

It to sidestep congress (e.g., NUDs, emergency laws, bureaucratic tactics), giving the government some authority as long as it could bear the cost of taking such actions.

The judicial branch had no direct authority over monetary policy, but it played an important role in limiting the executive’s ability to pass social reforms. Of particular interest were the court decisions to negate the cut in social security payments on which the executive and legislative had decided. The unbudgeted expenditure generated by such court orders was the main reason behind the federal government’s failed attempt to achieve a zero deficit or even to limit the deficit budget.

The country’s federalist form of government, with its division of power and democratic electoral cycles, left most of the economic policymaking process in the hands of the executive, but the lack of clear legislative majorities and the weak discipline of the major political parties opened the door for strong participation of pressure groups in the formulation of economic policy. As part of the first generation of liberal reforms established by Menem, an executive clique of economists who in theory did not respond institutionally to legislative or electoral political pressures was established. This way, independent institutions were supposed to isolate economic policymaking from public pressure. The autonomy of the Central Bank, and the historical acceptance of the quasi-independent role the minister of finance played in government served this purpose. Moreover, the ability of the executive to use emergency decrees to pass laws, regulations, and policies to circumvent the legislative also gave the government a degree of state autonomy.
Limitations to state autonomy were imposed by the strong hand held by provincial governments and the ability of the federal courts system to stop executive action. Both cases exemplify expenditure points in which political forces could derail executive action. The executive could govern without the legislative as long as it had the support of the Supreme Court; otherwise, its use of emergency decrees was limited. Unlike Menem, De la Rua did not have such control; moreover, his previous opposition to the use of NUDs made it more difficult for him to circumvent the legislative. Without strong internal support from any single group, the political cost to gain the backing of key groups for most of the reforms needed to correct economic course was very high.

The negotiating processes were not transparent, and the number of actors involved in such decisions was small, usually the technocratic clique and a few political operators. In terms of public support, political culture and historical legacies played a very important role in determining the government’s economic policymaking flexibility (EPF). Fear of past hyperinflation and economic instability created popular opposition to ending the fixed currency exchange system.

As for the executive action historically used by strong leaders, Argentines have allowed their presidents to make unilateral decisions, but the emergence of some liberal institutions, especially a very critical media, increased the costs of government action. It is also important to consider the emergence of opponents to the president not only outside but inside his party, and even within his cabinet. The formation of the cabinet is normally a result of political brokering that leads to some of its members openly opposing some
administration policies without suffering public backlash. The political system rewards leadership, even when the leader is impeding government action. During De la Rua’s tenure, there was no cabinet discipline, a situation that led to the weakening of the president. However, by 1999 the armed forces were no longer a political force, and the threat of a coup was minimal.⁶⁹

De la Rua governed within a divided political system, and increasingly over a divided country. A divided congress and divided opposition could have strengthened his hand, but the weakness of the Alianza gave way to a government that since day one had been fighting for political survival. A very critical and politicized society that started organizing at the business and worker levels also created strong interest groups with diverse objectives. As the government struggled, the opposition organized—not through a political party, but via ad hoc groups and unions with few restrictions on their actions. Even the business class that was supposedly the backbone of De la Rua’s political support was divided between the financial, tradable, and non-tradable groups.

**Forces against a reduction in government spending**

a) **Government workers** were against curtailing government spending because most of the plans to lower it included public sector force reductions and reduction of government wages. Government employees enjoyed higher salaries than their private sector counterparts, a situation that led to general support for such

⁶⁹Nevertheless, as the political crisis erupted, the top generals were more popular than the civilian leadership.
measures, but state employees were organized, making them strongly opposed to any effort to reduce government spending.

b) **Provincial governments** opposed the cuts because most provinces were dependent on transfers from the central government for their budgets. The attempts to decrease overall spending, especially the zero-deficit laws, were clearly aimed at reducing lowering provincial spending and limiting, if not eliminating, their deficits. Provincial governors were very active in defending the fiscal transfers they received from the federal government, as well as their right to run fiscal deficits and use provincial debt to cover them. Congressional members working on orders from provincial governors were an important force in trying to limit spending cuts.

c) Government spending cuts threatened **retirees**, as they entailed cuts in pension payments. People who had worked all their professional lives believing their retirement was covered by their contribution to the social security system suddenly found themselves losing a significant percentage of their income. Such reforms were very painful for this group. Their opposition to government spending cuts was probably the most active, through both street and political protest and, most important, through the legal system. The courts found the government liable for the pension cuts, leading to a large expenditure that ultimately made the zero-deficit objective very hard to reach.
Forces against currency devaluation

a) **Non-tradable businesses** were against devaluating the currency for two reasons. First, most businesses held US dollar-denominated debt whose cost of repayment and servicing would go up in direct proportion to any devaluation of the peso. Second, it would increase the cost of parts and products imported to the country.

b) **Exporters** would benefit from a devaluation, which would bring a lowering of production costs and the renewed competitiveness of their exports, but by 2000 this sector was also highly indebted in US dollars.

c) **The middle class** had obtained US dollar-denominated credits for everything from mortgages to credit card debt. Any devaluation would increase its debt costs directly. Although not an organized force, its concern was public and generalized.

d) **The banking sector** saw in any devaluation a risk for massive default on consumer credits, which could bring down the banking system. Foreign banks had invested considerable amounts of money in the country’s banking system and were still trying to recoup their investment. This sector was a proponent of full dollarization over devaluation.

e) **The general population** saw in the *Convertibilidad* law an Argentine success. Any devaluation would bring with it fears of returning to the era of hyperinflation and economic instability.

f) **The provincial and federal governments** themselves would suffer greatly from a devaluation because of their outstanding foreign-denominated debt. Devaluation
of the peso could force a default in its payment if the country could not get the money it needed to cover its debt services until it saw an increase in exports bringing new foreign currency to the country.

**Forces against increasing cost flexibility**

The groups affected by such measures were mainly the labor unions, who saw the strong worker protection laws diluted in favor of employers, making it much simpler and cheaper to fire and hire personnel; furthermore, they saw their social security entitlements diluted.

**Foreign forces**

a) The International Monetary Fund (IMF), which has taken part of the blame for the Argentine crisis,\(^{70}\) had been working closely with Argentine administrations since Menem. But as many already have observed, Argentina’s monetary and fiscal policies were not in line with the typical policy reforms supported by the IMF in other countries throughout the 1990s. Argentina won over the IMF only as its Convertibilidad program proved able to resist the Mexican and Asian crises.

By the time De la Rua was in power, he was relying on IMF standby credits to gain the trust of the markets to lower the risk spread and obtain new investment and financing. The position of the IMF was to establish conditionality agreements that required Argentina to end its overall government deficits but to

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\(^{70}\)In part as a scapegoat and in part as a failed advisor (Michael Mussa 2002).
stand behind the country even when it failed to achieve the conditionality goals. A change in the IMF’s leadership, a new US administration, and the sense that Argentina’s crisis was inevitable unless the country took harsh measures led the IMF to abandon it. De la Rua needed the IMF’s backing to signal the markets about the well-being of the state, when in fact the IMF became a veto player (VP) in the sense that its criticism of the government’s programs would lead the way to a further slowdown of foreign financing. The IMF also pushed for reforms in order to create market flexibilities so as to increase its foreign currency income. Inside the IMF, some members talked about the need to devalue, but such policies were never imposed on Argentina.

b) **Market makers** were cut in the emerging market bubble that blew up with the Russian crisis. As the funding available for emerging market investments decreased, brokerage firms were trying to find investment instruments they could sell in a negative environment. Argentina was still an important client; one former member of the Goldman Sachs Latin American team explained that he spent more time in Buenos Aires than with his family in New York. As long as Argentina did not devalue, the new bonds could still be sold in the market.

c) **Financial information agents** were strong backers of a reduction in government spending. Their analysis seldom took into account other options; also, their support of the Convertibilidad system as a way to guarantee monetary stability left them with few alternatives. As the De la Rua administration began to falter,
information agents began to react negatively, downgrading the country’s risk rating and reporting on its current account deficits as well as political stability, but most failed until mid-2001 to foresee the coming crisis.

Risk rating agencies had in Argentina one of their better clients. The natural conflict created by their business relationship with the country, in addition to the misinformation given to them by the Argentine government, led them to react slowly to changes in the country’s rating, with the pressure they generated being in line with the rest of the financial information agents.

d) The then-newly elected Republican administration in the United States brought with it new ideas on how to deal with emerging market crises. The Bush administration policies were aimed at ending “moral hazard” behavior. They required countries in crisis to suffer the financial consequences of their actions and market players to be more cautious about where to invest or risk losing their money. Argentina became the first case where such a policy was implemented. The Bush administration pressured the IMF against intervening any longer, and required Argentina to negotiate directly with bondholders regarding any change to their credit terms. Unlike in the Mexican and Asian cases, the US government not only was unwilling to rescue a country financially, but it would not intervene on its behalf with market actors.

e) The international banks that had invested in Argentina were strongly against any devaluation. Not only would they lose on their investment, but as most of the
production and consumption credits they had given in the country were US dollar-denominated, they were afraid of massive defaults. The banking group even proposed dollarization as an alternative to devaluation.

Personalities

One thing De la Rua read correctly was that one key individual could wield a veto over any change to the Convertibilidad system. Domingo Cavallo, the architect of the system, was still highly regarded in Argentina, and his opposition to economic policy reforms would be very costly, creating widespread opposition. His entry into government gave credibility to De la Rua’s team. As most of the population and major political forces opposed devaluation, only Cavallo could sell an argument for altering the strict exchange system. But even he was hesitant to effect changes, and supported only minor adjustments.

The second Veto Player for government action was Vice-President Alvarez. Until his resignation, his independent style and command of the political stage made him very popular and influential. His exit from government left a weak coalition in power, while his inability or reluctance to take his party with him from government ultimately led to his loss of influence and public standing.
Trigger Events

There were four trigger events that led to the Argentine crisis, three of them of an economic nature in the international market that Argentina could not control and the fourth an internal political event that led to the weakening of the government. The late 1990s presented a few hurdles for the Argentine economy. First, an overall drop in international prices for agricultural products led to an important decline in international revenue for the country. The 1990s also saw a constant appreciation of the US dollar, which because of the fixed exchange rate Argentina had at the time led to an appreciation of the peso, making exports even more expensive in the international market. These two market phenomena created a delicate situation for the country as it was caught up in another set of international events.

The 1998 Russia default was a key moment for international emerging markets. Although the international markets had faced two big crises before the Russian default (Mexico and Asia), availability of funds for financial markets had not diminished, but simply had been redirected to what at the time were considered safer emerging markets. Having survived both crises, Argentina became a prime target for those looking for safer sovereign instruments; it benefited from an important influx of resources. The Russian default nonetheless changed financial market behavior. The market experienced a flight to quality effect that dried up resources in the international market, which in turn led to an increase in interest rates on sovereign bonds that affected Argentina directly.
The last economic trigger event was the **Brazilian devaluation** of January 1999, in which Brazil, which by that time had become Argentina’s primary export market, devalued its currency by 40%. The high costs of Argentine exports led to a reduction in its share of the market and an overall decline in Argentine exports of 20%.

On the political front, the resignation of Vice-President Carlos Alvarez led to the weakening of the De la Rua administration and the start of what became a fight for survival of his government that lasted until De la Rua’s resignation. The political capital the government needed to implement the economic policy reforms it proposed in order to avoid the upcoming crisis never materialized.

**Loss Imposition Capability**

At the time De la Rua won the presidential elections, non business interest groups were active but loosely organized. Over time the workers’ unions and other popular organizations got their act together, creating important opposition to the government and influencing its decisions. The federal executive had few pressure release options. It was difficult to use blame avoidance tactics (switching blame to the courts, congress, or provincial governments), because although unpopular, the reform programs were publicly supported by the government. Occasionally, the past administration was blamed for the economic situation and the need for reforms, but the universal support for the Convertibilidad system, the De la Rua administration’s reluctance to switch economic programs, and the need to signal a policy continuation to the foreign markets made
blaming the past administration tricky. A particular blame avoidance technique available in Argentina is the use of cabinet members as scapegoats. The *caudillismo* style of leadership in the country leads to cabinet infighting. As individual cabinet members are publicly held responsible for their actions, failed policies typically lead to cabinet shuffles that help the president avoid direct blame. This technique was used by De la Rua; however, too frequent use of such an escape route leads to a president being tarnished with a public image of failed leadership.

De la Rua was also restricted from faulting international actors\textsuperscript{71}; in particular, because his government was working closely with the IMF, and thus could not blame it for the proposed reforms. And as for the international financial markets, Argentina needed foreign investors, which made it impossible to blame them.

Ultimately, De la Rua would have to bear most of the political cost for any reforms he implemented. The emergence of active and organized interest groups made any reform costly and difficult. The government’s ability to use resources to compensate opponents for their losses was limited by its need to curtail spending. The administration’s inefficiency as a political operative made in-kind compensation very difficult to negotiate. Furthermore, once the *Alianza* disbanded, political opponents could sense “blood in the water,” making them unwilling to negotiate or at least allowed them to raise their expectations of compensation.

\textsuperscript{71}This escape mechanism was ultimately used to implement crisis management policies once De la Rua left government.
Argentina’s need for foreign investment restricted its ability to impose losses on foreign forces (FF) until after the crisis broke. Many economists have claimed that by 2000, the country’s only option was to reduce its debt via a “haircut,” a clear imposition of losses to the international financial actors, but it chose not to take that route in large part for fear of how that sector might react. As the economic situation deteriorated and the support from the IMF and Washington decreased, Argentina lost even its ability to renegotiate debt restructure under favorable terms. Other than threatening or carrying out a default, the only loss imposition instrument the country had at its disposal was its control of financial information, a power it used and misused.

By 2000, the federal government was finally willing to act. Its intention to bear the costs, although tepid at first, solidified as the economy faltered and the political crisis began. The De la Rua’s administration’s original plan for governance signaled its intention to bring second-generation economic reforms to Argentina as well as reduce the country’s economic imbalance, as long as doing so would not require tinkering with the Convertibilidad system. As the economic situation deteriorated, the government’s perceived urgency for action intensified. Politically, De la Rua wanted to return the Unión Civica Radical (UCR) to a commanding position within the political system, and to do so while confirming his leadership of the party. During Lopez-Murphy’s short tenure as finance minister, the president gave strengthening his hold on the cabinet a higher priority than the passing of economic reforms. He never felt he owed his post to FREPASO, nor did he realize he needed FREPASO to govern, a mistake that led to
executive weakness and required him to spend most of his political capital simply to survive.

Conclusion

The history of the Argentine crisis reveals failed attempts and missed opportunities to counter an economic crisis. The country’s inability to respond to the shocks to its economy was in part due to political weakness and in part to legal limits on its capacity to act. Cavallo’s Convertibilidad plan was successful in addressing the hyperinflation the country was facing, but by establishing limits on government action for what was a primarily domestic situation, it also weakened the hand of the government when it faced external pressures. The existence of a fixed exchange rate, inflexible production costs, and, most important, an ever-expanding fiscal deficit was the perfect recipe for a crisis.

Convertibilidad helped control monetary policy, but it failed to stop the overall government deficits that led to growing debt in the international market. De la Rua’s weak government was unable to pass reforms to avoid a crisis. Even when such reforms were undertaken, the existence of multiple expenditure outlets made them ineffective. Menem’s political objectives blinded him to opportunities to counter international pressures on the country’s economy. Most important, the need for the government to comply with domestic expectations on the Convertibilidad system led it to choose
between the imposition of large costs on the working class and inaction by simply trying to maintain what ultimately was an unsustainable position.

The fundamental forces at play in Argentina limited its government action capability, mainly by limiting its economic policymaking flexibility and establishing too many expenditure points, making it very costly for the government to control overall government spending. Argentina’s experience exemplifies the value of policy flexibility for countries participating in the international financial and trade markets. It also highlights the significance of international financial actors as forces in an emerging country policymaking system. Ultimately the blame for the crisis rests with the governments of Argentina and their lack of capacity to act.
Key Political and Institutional Factors

I. A constant struggle with a history of hyperinflation and executive unilateral action limited the government’s economic policymaking flexibility.

II. Public support for the *Convertibilidad* system made it costly to oppose it, or even to advocate change, and those who did usually lost their respective elections.

III. The quasi-currency board system required public discussion of any proposed move in the exchange rate, thus making limited-time reforms impossible to implement without market overreaction.

IV. Weak governments and the high cost of trying to implement reforms limited the government’s ability to take action.

V. The inability to control overall government spending was a factor due to the existence of many expenditure points, including the institutional framework that gave the provinces the ability to implement their own fiscal—and, to a certain degree, monetary—policies.

VI. Lack of entities to hold accountable for policymaking decisions limited the government’s blame avoidance options.

VII. A constant search for international financial actors’ approval and investment limited the government’s ability to impose losses on that sector.

VIII. The politicization of the judiciary increased the number of veto and expenditure points in the system.
Chapter V

Political Determinants: From Lessons Learned to an Analytical Framework

As the two previous case studies demonstrate, the inability of governments to act to prevent or preempt a financial crisis is a fundamental cause of such phenomenon. But how do we analyze the capacity of governments to take action? Is it a matter of political will? If so, how do we define political will? To extrapolate the lessons learned from the two cases and be able to apply them to analyze other cases and, most important, to anticipate a country’s ability to cope with future surprises, we now present a set of variables that are useful in determining the ability of a government to take positive action.

Determinants for Government Action

Any decision taken by a government is based on a cost–benefit analysis. The Mexican case exemplifies the political limitations for government action based on a perceived high cost for implementing reforms. The Salinas administration chose not to devalue the currency or increase interest rates to fix the financial imbalances; instead, it tried to maintain its economic policies. Even when the administration thought about
acting, it was hindered by political factors (and political actors). The strong opposition to possible measures in an electoral year, the need to get US approval for NAFTA, and the dependence on international capital limited the administration’s loss imposition capability; but most important in the Mexican case was the administration’s failure to apply the lessons of history in trying to avoid the typical end of *sexenio* devaluation. Furthermore, the priority Salinas placed on his own image and legacy in wanting to establish his presidency as one of the great ones in Mexican history (and, of course, his desire to be chosen to head the World Trade Organization) became a determining factor. Finally, the existence of a veto player within the cabinet, finance minister Pedro Aspe, also tied the government’s hands.

The Mexican case presents an opportunity to test our arguments regarding political limits to government action. When the Zedillo administration took office, the priority of policies changed and many of the limits disappeared. Furthermore, the political capital of a newly elected administration and its ability to blame the past government for any of the losses caused by needed reforms provided it with an opening to act.

Unfortunately, Zedillo’s administration gave the world a lesson in how not to preempt or manage a crisis, but it was his ability to act that is important for our study. While Salinas’s priority was his own standing and legacy, Zedillo was a “behind the scenes” man who seemed more at ease working with spreadsheets than the media; in any case, he still had six years to build a legacy. Although Salinas had to deal with a veto
player (Pedro Aspe) in the last part of its administration, Zedillo did not include Aspe in his cabinet. As for international forces, the new administration was not obligated to keep informal promises made to them by the past one; also, NAFTA had already taken effect, and even the US Secretary of the Treasury was calling for a correction of the peso’s exchange rate. Finally, while Salinas had few blame avoidance opportunities for unpopular reforms, the new administration had the ability to direct blame to the Salinas administration for any unpopular reform it needed to implement. Of course the new government still had to contend with market and international financial agent pressures, with the country’s history, and with internal opposition to reforms. In terms of imposing losses on bankers and labor unions, Zedillo’s fresh electoral win gave his administration the political capital to act; nevertheless, the desire to address the objections of such sectors and maintain the social coalition built under Salinas led the new ministers to take some actions that ultimately caused them to mismanage the government’s preventive action.

A similar situation to the one the Salinas administration faced affected Carlos Menem’s government in Argentina. Political and personal priorities led his administration to maintain fiscal and monetary policies that were unsustainable in the long run; but unlike in the Mexican case, the De la Rua administration decided not implement preemptive or preventive actions when it took power. By the time it did, it was unable to implement the needed reforms. Argentina went from inaction to inability to act. As explained in the Argentina crisis chapter, issues regarding political balance,
institutional framework, existence of multiple expenditure areas, low loss imposition capability, the decision not to criticize Menem’s economic policies (thus limiting blame avoidance opportunities), and the existence of many points in which any proposed reform could be blocked made it very difficult for De la Rua’s administration to implement positive action. De la Rua’s decision to maintain the Convertibilidad system left him with few options with which to work. Policy reforms to either reduce overall government spending or lower manufacturing costs were costly ones and imposed heavy losses on sectors of society that could not countered by the Alianza. By the time the political crisis began, the capacity of the government to correct economic imbalances was minimal at best.

Both the Mexican and Argentine roads to crisis underscore the role of political determinants to government action. While the Salinas and Menem administrations chose not to act in order to avoid paying the political costs of such actions while hoping for automatic market adjustments, De la Rua’s administration politicized monetary policy during the election, making it more difficult for it to act so that it later became politically unable to do so. In both cases, due to either reluctance or inability to act, governments failed to take preventive or preemptive actions and therefore steered their countries toward a crisis. In both cases the triggers for the crises were foreign to the government and uncontrollable; but because the fundamental forces and political priorities of the administrations made positive action too costly, it was therefore avoided.
Our challenge is to identify an analytical framework to help us understand the political determinants of government action in order to get a better perspective on the potential for governments to either preempt or prevent an economic crisis.

**What Kind of Government Action?**

The first question we need to answer is what type of action capability we are looking for. To avoid financial crisis, governments must make reforms in order to maintain, or return to, a financial balance. Reforms to the monetary policy, fiscal policy, banking governance regulations, trade policy, and social expenditure are examples of the areas governments must address in order to confront and avert a negative event.

Most important is the fact that such reforms have to be implemented quickly, often without public debate. Probably the best example is a reform to the exchange rate policy. A country that decides to go from a fixed exchange system to a free-float to counter market pressures must do so without letting the market react to such a move before it is made; otherwise, opportunistic market pressures will come into play and panic will take over, creating new imbalances and likely overshooting the equilibrium point in the exchange, which will hurt the economy and create new political pressures. Because the sensitivity of the required reforms makes them more difficult to implement, they add stress to a country’s government action capabilities.

This situation was a primary cause of the Argentine crisis. Because of the institutional apparatus created to defend the peso’s value and the weakness of the De la Rua government, the executive found it very difficult to make decisions without a public
process that opened the door to financial speculation. In Mexico, the inclusion of market players in the decisionmaking process gave these actors advance notice of the coming devaluation and led to a worsening of the crisis. What we are looking for is the ability of a government to take action, even when impeded by a contrived decisionmaking process.

**Fundamental Forces and Government Action**

Government action, defined as a government’s policymaking and reform response to a specific event or risk, is constrained by fundamental forces in the country’s political system. Leaving aside for a moment the analysis of a country’s financial capability to act, when it comes to political determinants there are two primary factors in play with respect to the flexibility of a government to act: a government’s political capability and its political will to act.

These two political factors are difficult to separate but important to differentiate. In fact, many analysts avoid distinguishing between them, arguing that political will is the main area of concern for economic policymaking reform, as if a government can always implement reforms if it is prepared to assume the cost of doing so. Because we are dealing with process-limited reforms, we need to deviate from this interpretation and understand all the political hurdles that limit government action. Each determinant of government action is in itself determined by a set of political variables that together establish whether and when governments will implement positive action to address potential financial crises.
To differentiate between will and capacity, we offer the following definitions:

- **Political capacity**: the institutional, political, and administrative ability of a government to implement reforms.
- **Political will for positive action**: a government’s acceptance of the costs it must bear in order to implement a reform.

While the first is established by a country’s institutions and actors, the second is determined by a government’s cost–benefit analysis, which takes into account the political and economic costs of implementing the necessary reforms, the government’s political capital, and its priorities. It is difficult to separate “will” from “capacity,” as a government’s capacity may depend on the amount of resources it is prepared to invest in the reform. Nevertheless, it is very important to understand each of the two as separate variables leading to possible government action. We will clarify the division between the two variables as we present the proposed analytical framework.

**Political Determinants of Government Action**

The possibility that a government will make the necessary policy changes to preempt a looming financial crisis is determined by a set of political variables that define its capacity to implement limited process policy reforms. From the two case studies and the revised theory, we can identify three variables (fig. 5.1) that determine whether and
when a government will take positive action when facing economic imbalances\textsuperscript{72}: 1) perception of a need to act, 2) authority to act, and 3) economic policymaking flexibility.

1) The perception of need for action (PN) indicates whether government officials deem it necessary, or at least probably necessary, to carry out a policy reform when facing an event. If government officials fail to acknowledge that a reform is needed or even helpful, or fail to recognize an event as a threat, there will not be

\textsuperscript{72} \quad GA = fn(PN, Aut, EPF)
government action (GA), regardless of whether the government has the authority or policymaking flexibility to carry it out. We can determine a government’s PN by analyzing the public positions it takes, comments made by key economic policymakers, and the overall economic frame of mind behind a government’s economic policy. Perceptions are also influenced by international market expectations and international actors’ analyses.

Divisions in government over PN are common and can indicate weakness in their GA capability. In some cases, these divisions are based on different analyses of the need for action. Ministers may differ not only over the overall need for reforms, but over the timing or nature of such reforms as well. All these issues are relevant to a government’s PN, but only a straightforward, generalized negative perception of a need to act will truncate GA.

For example, in the Mexican case, then-Minister of Finance Pedro Aspe first objected to the need for a reform and later differed with other policymakers on the timing of such reform. Even though differences arose during the discussions, it is clear the government knew there was a threat to economic stability, and that it needed to act in one way or another. After all, it had acted in early 1994, calming markets by offering dollar-denominated debt. Perception of need as a variable does not signal the perceived urgency for action (we will get to that later), nor the

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73Unless pressure groups succeed in changing their mind or forcing GA.
different options for action, but is simply a binary variable that either allows or closes the door for action.

2) The authority to act (Aut) is a static variable. It tells us whether the political and regulatory system architecture gives a government the ability to implement time-sensitive steps to preempt a crisis. The lower the government’s authority to act, the more difficult GA becomes. Authority to act takes into account not only the institutional framework of a country and the laws determining economic policymaking, but also to the loopholes and tactics commonly used by the executive branch to implement a reform. Authority to act is a matter not of political ability but of the legal framework limiting an executive’s administrative functions. These tactics, such as the use of executive decrees and political control over the judiciary and the Central Bank need to be included in the analysis. Authority to act is the *de jure* requirement for GA. The authority to act is clear in the Argentine case, where even though the convertibility laws made it difficult for the government to change the fixed exchange rate, the historic ability of the executive to implement emergency decrees and name and fire the presidents of the Central Bank gave it authority to act on other possible solutions, and at least opened a window of opportunity to reform the exchange system unilaterally as long as it could muster the political capital to counter its critics. As for Mexico, the executive had complete authority.
3) Economic policymaking flexibility (EPF) is an indicator of whether a government has the political capability to make time-sensitive, process-contrived economic policy reforms. EPF is a function of the fundamental forces constraining a government’s flexibility to deal with an upcoming financial crisis. It incorporates variables measuring strength, ability, and will to determine a government’s capacity to implement economic policy reforms. Determining EPF is not as straightforward as analyzing perception of need or authority to act, as it requires an understanding of fundamental forces participating in the policymaking process of a nation.

As fig. 5.2 indicates, economic policy flexibility is determined by a country’s degree of state autonomy (SA), political balance of forces supporting or opposing a reform [including domestic forces (DF), foreign forces (FF), and veto players (VP)], the government’s ability to impose losses (LIC) on the political forces, and its will (W) to bear the cost of doing so.

![Diagram of Determinant factors of economic policymaking flexibility](image-url)

Figure 5.2 Determinant factors of economic policymaking flexibility
Political Determinants

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Of these variables, two act as “modulators” of the other four. Domestic forces and foreign forces pressure a government to act according to their own interests, so the degree of state autonomy a government has will determine how important their opposition to a policy reform will be for the government. In this sense SA “modulates” the strength of the two actors. It is important to understand that the degree of SA toward DF might not be the same as that when facing FF, or vice versa. As for veto players, they act to defend their interests, including their status as VPs. Their strength will also depend on the government’s SA. On the other hand, a government’s loss imposition capability will determine the ability of a government to counter those actors who oppose reforms. LIC is “modulated” by an important variable determining the Will of a government to assume the costs of imposing a reform. The following discussion examines these variables:

Political Balance

The domestic forces (DF) variable is an expression of the domestic forces at play within a political system. Political balance (PB) requires an analysis not only of the number and nature of pressure groups within and outside of government, but of their relative power and opposition to a specific reform. Same-party opposition, opposition parties, industrialist societies, commerce representatives, labor unions, nongovernmental organizations, and religious groups all play an important role as pressure or lobbying groups. The greater their capacity to affect governmental policies through control over
electoral forces, financial resources, media coverage, street demonstrations, and civil disobedience, the greater is their power and the higher is the cost for their government to implement policies against their wishes.

As stated in the Mexican case study, powerful political forces opposed each of the two possible government actions. While big business, middle-class organizations, and bankers opposed an increase in interest rates, labor unions and bankers (again) opposed any deviation in the exchange policy or any strong devaluation. As for Argentina, government employees, provincial governors, and retirees opposed any move to curtail government spending, while tradable and nontradable business, the middle class, the banking sector, and the provincial and federal governments all opposed a devaluation or reform to the exchange rate regime. In fact, the overwhelming popular support for the Convertibilidad system proved a strong deterrent to government action. Finally, labor unions were strongly opposed to any measures to assure that production costs became more flexible.

Foreign forces (FF) are comprised of foreign interest groups, international multilateral institutions, international financial market actors (e.g., market makers, banks, large investors), international financial information agents (rating agencies, information and research companies such as Bloomberg or EIU, etc.) or foreign governments that pressure a host government to respond to their specific interests. FFs are differentiated from domestic actors because the host government has fewer if any tools at its disposal to impose losses on them and manage the consequences of their response. Their need for
financial backing, public support, or approval is high for emerging markets, while their opposition is very costly (higher interest rates, lack of funding, etc.); therefore, their political leverage is very powerful. Most important, the majority of these actors have interests that emanate from their own business goals or home country environments. Their position frequently contradicts stances taken by domestic political forces, but their exponential power over the host government because of their financial leverage creates a difficult situation for the host government to balance when formulating policy reforms.

In both the Mexican and Argentine cases, there was a constant search for international approval of the country’s economic policies in order to court international capital. Market makers, financial information agents, and other Wall Street firms held important leverage over both governments. To reassure those actors, Mexico decided to dollarize part of its debt, making a public commitment to maintain its exchange rate system. Argentina fought for international capital until the last possible moment before the financial debacle. Some other factors are specific to each country. In Mexico, the NAFTA negotiation process limited the government’s EPF, while Argentina’s need for IMF approval made the international organization not only an important force with which to deal, but in some respects IMF became a veto player.

**Veto players (VPs)** are institutions or individuals whose support for a reform is necessary. Their opposition increases costs of the reform exponentially, making the reform unlikely unless a country’s SA or LIC is very high. VPs range from influential economists and respected (and sometimes maverick) cabinet members or former
members, to political actors regarded as defenders of specific issues, sectors of society, or past legacies.

VPs have the power to appease or exalt market players and political forces. As their name implies, their negative response to at least accepting the benefits or need for a reform makes the cost of such reform much higher, if not prohibitive. VPs are especially powerful when it comes to economic policy, as their signals are expected and read by the market, translating frequently into market overreactions. Just as the approval of former US Federal Reserve Chairman Alan Greenspan was needed in the establishment of US fiscal policy, economists, legendary union leaders, historical political leaders, and even media stars can become VPs in an emerging market, thus affecting their government’s EPF. In both the Mexican and Argentine cases, finance ministers who had won the respect of the international markets became the strongest VPs. For example, because in Argentina Vice-President Alvarez held a strong hand over the De la Rua government, his break with the president was the start down the road not only to economic catastrophe but also political crisis.

State autonomy (SA) is the degree to which state decisionmakers are free to operate without interest groups and citizen pressure defining the outcomes of the policymaking process. SA depends on the nature of the political system (democratic, authoritarian, etc.) and institutional architecture (e.g., federation, centralized government, separation of powers) of the country. Some systems allow their leaders greater leeway in policymaking than others. Some of the indicators of SA are the existence and number of
instances where organized civil society or opposition parties can block a proposed policy (the legislative process, court system, and executive policy formation); the existence of articulated opposition to the governing party; a free and well-functioning press; and government transparency and accountability. SA is also dependent on a country’s political culture and traditions, as some countries traditionally give more autonomy to their executives than others. This phenomenon is based on a country’s polity and is influenced by the political history of each country. Polity, the cultural and historical legacies of a country, can suggest what to expect in terms of popular participation or delegation of policy formation and acceptance of loss imposition by a central government, which help determine SA. As explained above, SA acts as a modulator of the political balance forces. The power to block or push for reforms is limited by the necessity of a government to act on these groups’ desires.

In the case of Mexico under Salinas, the federal government had seen its autonomy curtailed with the emergence of organized social opposition groups, the historically powerful industrial lobby, and the increasingly politically important financial sector, as well as the beginnings of a democratic institutional system; nevertheless, it maintained a powerful centralized government capable of dictating policy without major interference and few possible policy-blocking opportunities.

Argentina under De la Rua was in a different situation. The popular resentment over authoritarian governments and the institutional lack of presidential control over the provincial governments and Senate, as well as the weak political parties and a politicized
and opposition-controlled Supreme Court, limited executive powers. In addition, the existence of organized and politically active popular movements that seized the existent multiple institutional opportunities to block reforms (courts, congress, provinces, etc.) limited Argentina’s state autonomy.

**Loss Imposition Capability (LIC)**

In policy formation, there will always be groups affected by policy reforms either directly or relatively to other groups. In this game of distributional politics, the “losing” groups will want to be compensated for their loss. The greater the group’s power, the higher the compensation that will expected. In this sense, LIC is defined as the capacity of a government to impose losses on the opponents of its policymaking preferences. LIC is specific to each of the variables it affects (PB, FF, VP) and refers to the government’s capacity to 1) assume the political cost of a reform, 2) compensate a group for its loss, or 3) avoid or share the blame of such a loss with other groups, branches of government, or political figures to decrease its direct cost. The ability to impose losses (Pal and Weaver 2003) is determined by a) the institutional ability to make policy choices, b) the intensity and strength of the opposing groups that will try to block any move, c) the political strength of a government in a particular time, and d) the ability of a government to escape blame.

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74 The group feels it loses since another group gains more.
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To analyze a government’s LIC, we can identify the public support for the administration (lower approval ratings equal lower LIC), past government actions, government’s dependency on a specific group, the need for the cooperation of political opponents in order to act, political and budgetary ability to compensate groups, and structural opportunities for blame avoidance.

In the Mexican case, the economic and political capacity existed to compensate losers for any painful reforms, but any such reform would deal a blow to the credibility of the Salinas administration, which was always thought to have been implanted rather than elected to office. Furthermore, the PRI, which had justified its hold on power if nothing else for its ability to maintain social peace and stability (unlike most countries in the subcontinent), saw that claim vanish with the emergence of the Zapatista revolt. With presidential elections approaching and a real opposition brewing, the Salinas government had to act with caution so as not to hurt its candidate.

In contrast, in the case of Argentina, De la Rua’s administration’s loss imposition capability continued to diminish. Lack of funds and a need to trim the budget made compensation difficult at a time when public support for Menem’s economic programs prevented the government from criticizing the past administration on economic matters. Nor could the government switch blame to foreign investors, as it needed fresh funds. Furthermore, there were multiple interference and blocking points available to actors who wanted to block reforms (e.g., the courts, legislature, provincial government). Finally, De la Rua lost control over the legislature, and even his own party. The single blame
avoidance tool the government used repeatedly was blaming—and sacking—specific cabinet members for the losses caused by the reforms they championed.

This is where a government’s will to act comes into play. If a government perceives the need for a reform, we can assume it would like to carry it out, because presumably a country is not interested in having an economic crisis or even defaulting on its sovereign debt. Nevertheless, every action carries costs, and a government’s desire and intention to implement a reform depends on its resolve to cover those costs. Although LIC expresses the ability of governments to impose losses, when it comes to policymaking LIC will be “modulated” by the amount of resources a government is ready to invest to impose the needed losses.

**Political Will to Act**

*Will of the government to act* (W), is one of the most difficult and important variables to analyze, because it is a reflection of how much of its resources (including political capital) a government is prepared to spend in order to implement a specific reform. The crises in Mexico and Argentina occurred not because the authorities did not want to act; they arose because the political price of doing so was higher than what the governments were willing to pay. The will of a country to act is determined by three variables: agenda preference (AP), perceived urgency (PU), and constraint optimization (CO).
1) **Agenda preference** (AP) is the reform, policy, and—most important—priorities of the government. As political capital is a limited resource, governments would rather spend it on their top agenda priorities and avoid losing it by pushing for other reforms. Action on a reform can hurt a government’s ability to achieve a different political goal rated higher in its AP. A government’s AP is a window to its main objectives and reveals how willing it will be to bear the costs of a specific reform. AP is made public either formally through multi-annual government plans, or informally through official pronouncements, documents, actions, or budget priorities. A government’s AP may change over time; an administration’s agenda priorities as it enters into office are not necessarily the ones it has at the end of its regime.

In Mexico, the Salinas administration had a clear agenda to structurally transform the country’s economy and reassert support for the PRI. As the *sexenio* ended and the crisis loomed, Salinas’s need to protect his image domestically and internationally became more important. Acting to prevent or preempt a crisis required implementing policies that would damage the government’s ability to achieve its top agenda priorities. In Argentina, the De la Rua’s administration prioritized two issues: strengthening the Radical Party as a national force, and strengthening De la Rua’s position as leader of the party. To do so, De la Rua
tried to address social concerns while sidestepping controversial issues that would divide the electorate

2) **Perceived urgency** (PU) is the decisionmaker’s understanding of the time available to make the necessary reforms to prevent or preempt a crisis. The greater the PU, the more likely the government is willing to pursue such reforms. PU can be determined by focusing on changes in official stands, pronouncements, the general environment inside a country created by the press, academic institutions, and political commentators. It is clear in the Mexican case that the government never perceived an urgent need to prevent or preempt the coming crisis. Although some cabinet members were certainly concerned, both the president and finance minister thought the correction was not urgent and could be left to the incoming administration. In Argentina, where the buildup to the crisis took longer, we can see a clear change in the perception or urgency to act, including the acknowledgment that other priorities had to take a backseat while the government tried to act—but of course by then, it was too late.

3) **Constraint optimization** (CO) is the perceived balance by decisionmakers of the gain or loss of support (whether from society as a whole or a particular group especially important to the government) for the government for making reforms. Every decision a government makes is based on a cost–benefit analysis; by extension, CO is the cost–benefit consideration of whether political capital can and should be spent, and must be done from the government’s perspective and in
accordance with its agenda preference. In both the Mexican and Argentine cases, the CO equation went hand-in-hand with the PU. Neither country wanted to act. The Mexican government failed to see the urgency and therefore was not prepared to take on the costs of implementing reforms. In Argentina, as the crisis progressed, the government was more willing to assume the costs, but by that time its LIC was quite limited.

Conclusions

The analytical framework presented in this chapter, deduced from the previous two case studies and theories presented, helps us determine the capacity of governments to take positive action to prevent or preempt a financial crisis. We assumed in chapter 1 that a country’s risk of financial crisis depends on its capacity to act politically so as to avoid it. In that sense, the identified systemic and political factors establish the political determinants that affect a country’s capacity to take positive action when faced by a crisis. Furthermore, the proposed framework differentiates between political capability to act and political will (with “will” defined as a government’s acceptance of the costs of action). The differentiation of these two variables and the identification of factors determining each of them is an important step in advancing political analysis, providing a clearer understanding of the impediments to action.
Conclusion:

From a Current Situation to a Political Flexibility Analysis

At the beginning of the dissertation, we set out to find a different way of looking at the risk of financial crises in emerging markets, particularly in Latin America. The premise was that in this era of global financial markets, negative events that threaten a country’s financial stability are almost inevitable, but trying to identify the possible source or nature of such events is very difficult if not impossible. Therefore, instead of attempting to identify possible threats to or weaknesses of an economy, we would be better served by analyzing the capacity of governments to react to negative events that undermine their financial stability. By reviewing the current literature on the matter and analyzing both the Mexican crisis of 1994 and the Argentine crisis of 2001, we discovered the relevance of political determinants to government action, allowing us to form a framework to analyze risk from a political flexibility perspective instead of relying on the current situation analyses most commonly used. The proposed framework allows us to better understand the capability of countries to deal with surprise events and provides a clearer picture of the risk to their economies.
The thesis presented in the introductory chapter established the desirability of qualifying financial risk not in terms of threat identification or the strength of a country’s “financial armor,” but by analyzing a country’s capability to implement time-sensitive (and process-limited) reforms in order to prevent or preempt a crisis. The examination of both the Mexican crisis of 1994 and the Argentine crisis of 2001 confirm the existence of a set of political developments that limited the government’s actions. In both cases, political forces, actors, and objectives were determinant in establishing limits to government action. As noted above, what governments do or fail to do politically, and the steps they take or fail to take institutionally, determine the country’s ability to preempt or prevent a crisis.

**Capacity Versus Will**

This dissertation calls attention to the most basic aspect of government action: its political ability to make decisions. At the end of the day, every government must act politically and respond to groups who can exert pressure on it. The ability of governments to act will depend on their political capacity to do so and their will to assume the costs of such action. The set of variables presented throughout this work can help us identify key issues that determine the ability of governments to act, but it is certainly not an exclusive list. As stated above, this is not a risk measurement exercise, but a warning about the importance of reshaping the way we look at threats to economic
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stability. It is overall an approximation to the analysis of possible action to thwart upcoming financial crises.

At the heart of this dissertation lies the necessity to differentiate between a government’s political capacity and political will to have positive action when confronting a negative event. The debate on the meaning of will and capacity of governments to act when it comes to economic policymaking—or, for that matter, on the line that differentiates the two factors—has been a long-standing one. We differentiate between them by defining capacity as the institutional feasibility of a government to act, and will as a government’s readiness to assume the costs of the required reform.

Two Risk Factors of Special Concern

Although their effects are analyzed by the analytical framework presented in chapter V, there are two specific variables worth mentioning in this concluding chapter. First are the limits placed on a government by a country’s historical mistakes. A “fight against history” situation was an important factor guiding governmental actions both in Mexico and Argentina. In Mexico, the Salinas administration making public its goal to take the country out of the six-year currency devaluation cycles that had characterized it since the 1970s. Unless expectations changed, people would not believe in the stability of the Mexican economy, and therefore would not invest but rather take their money across the border or overseas. There was a need to prove to both the international market and, most important, the Mexican public that a new era of financial stability had begun. More
CONCLUSIONS

than an economic issue, it became a psychological one, as further devaluations would send the message that nothing had changed. In Argentina, the success of the Convertibilidad program in controlling inflation won't strong popular support, making it difficult for politicians who were famous for running large deficits at the expense of increasing money supply to manipulate the law. Both governments’ need to reckon with history to change public perceptions and gain investor confidence was an important factor in the formation of their agenda preferences; moreover, the fear of past experiences was an important factor behind the positions taken by officials who were eager to maintain political equilibrium. Both the Mexican and Argentine governments wanted not only to change momentary expectations, but to make it clear that the countries’ economies were transforming themselves into modern and stable systems.

The second factor was the existence of a dual transition, in which the countries we analyze went simultaneously through an economic liberalization and a democratization process. In such cases the necessity to make executive decisions of the magnitude required to maintain macroeconomic stability can undermine an infant democratic policymaking process. Both Mexico and Argentina were living through a dual transition: on one hand economic liberalization, on the other a political reform toward democracy. Each country was at a different point in its democratization process. While Mexico was just starting its institutionalization, Argentina was on its way to consolidation. The political reforms taking place were important factors that not only
shaped the governments’ agenda preferences, but also limited their loss imposition capability.

Going back to the Argentine case, the government’s decision to reduce spending by lowering social security spending proved to be very unpopular, and it had to be adopted in part through “executive directives” rather than a parliamentary process. This is an example where the executive tried to act unilaterally to address one of the major sources of fiscal imbalance, but in doing so not only went against the democratic institutions but took the reform process further into the sphere of politics, thus allowing the opposition to unite against such measures and weaken De la Rua’s action capability to act even further. Because governments must make tough decision fast when faced by market pressures, having a country going through a dual transition process only makes it harder.

To take the framework presented further along so as to deepen our understanding of the political factors behind financial crises, two ideas come to mind, both of which are not be explored in depth in this study, whose focus is limited to the events in Mexico and Argentina. First, we should test the framework by analyzing a case or cases where governments were able to take action to either prevent or preempt a crisis, such as the Brazilian devaluation of 1999. Second, we should take the framework out of the Latin American realm and apply it to an analysis of other financial crises, such as the Asian crises of the 1990s.
The globalization of world financial markets opens the door for economic development, but it also introduces new threats to a country’s economic stability and brings new actors to a country’s domestic policymaking process. The political nature of the state remains constant, but the factors affecting its actions have multiplied. Only by understanding the flexibility governments have to address an ever-expanding source of threats to stability can we grasp their true capacity to deal with surprises that can lead to financial crises.
APPENDIXES
# APPENDIX I. Political Factors Used By Rating Agencies

<table>
<thead>
<tr>
<th>Key political variables</th>
<th>Moody's</th>
<th>S&amp;P</th>
<th>Fitch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of rating</td>
<td>Sovereign</td>
<td>Sovereign</td>
<td>Sovereign</td>
</tr>
<tr>
<td></td>
<td><strong>1</strong> Degree and nature of political intrusiveness on the cultivation of wealth</td>
<td>Stability and legitimacy of political institutions</td>
<td>Relationship of institutions and constitution</td>
</tr>
<tr>
<td></td>
<td><strong>2</strong> Depth and experience of government bureaucrats</td>
<td>Popular participation in political processes</td>
<td>Election timetable</td>
</tr>
<tr>
<td></td>
<td><strong>3</strong> Political intrusiveness on economic Management</td>
<td>Orderliness of leadership succession</td>
<td>Degree of consensus on macroeconomic policy of main political parties</td>
</tr>
<tr>
<td></td>
<td><strong>4</strong> Political links with foreigners</td>
<td>Transparency in economic decisions and objectives</td>
<td>Method of leadership succession</td>
</tr>
<tr>
<td></td>
<td><strong>5</strong> Past behavior under stress</td>
<td>Public security</td>
<td>Rationale of political reforms</td>
</tr>
<tr>
<td></td>
<td><strong>6</strong> Regime legitimacy</td>
<td>Geopolitical risk</td>
<td>Legal framework of private property and effectiveness of tax collection system</td>
</tr>
</tbody>
</table>

**Notes:** Political factors in measuring fiscal flexibility could be important.

**Sources:** Moody's, S&P, Fitch, and The Handbook of Country and Political Risk
## APPENDIX II. Mexico:
Political Determinants for Government Action by 1993

| Historical–Political Moment | • Weakening of PRI and corporative political system  
|                            | • Pro-liberal-democracy popular movements  
|                            | • Popular questioning of the PRI  
|                            | • Popular perception of the weakening power of the president  |
| Historical Legacies and Restrictions | • In-country lack of confidence in the economy  
|                                     | • Public expectation of recurrent financial crisis  
|                                     | • Lack of trust in the government  |
| Authority to Act | YES. Presidential authority and control over federal budget, government institutions, Central Bank and most state governments  |
| Perception of Need | YES. Maintained constant surveillance over the country’s macroeconomic situation  |
| Economic Policymaking Flexibility | • Domestic Forces  
|                                   | • Constant search for popular approval  
|                                   | • Strong forces versus preventive action: Big business, banks and middle-class organizations opposed interest rate hike; labor unions and banks opposed devaluation  
|                                   | • Financial bureaucracy supported needed reforms and inflation control  |
|                                   | • Foreign Forces  
|                                   | • Need for their public approval and investment  
|                                   | • Few opportunities to impose losses  
|                                   | • Maintained high political leverage  
|                                   | • NAFTA commitments restricted action  |
|                                   | • Veto Players  
|                                   | YES, especially Pedro Aspe, secretary of the treasury  |
|                                   | • State Autonomy  
|                                   | STRONG, although lower than in the past, and constantly questioned  |
|                                   | • Loss imposition Capability  
|                                   | HIGH OVERALL. Capacity to compensate losers, few opportunities for opponents to block reforms, institutionally able to impose reforms, growing but still controlled opposition, few expenditure points, but very few “blame avoidance” opportunities  |
|                                   | • Will for Action  
|                                   | AP: 1) transform country’s economic structure, 2) reassert PRI and presidential power, 3) personal legacy  |
| Analysis | The government showed authority, perception and capacity to act, but its AP and political strategy made either a devaluation or a hike in interest rate very costly politically. Unless an imminent threat approached, their CO would be negative and therefore their W would curtail action. All action depended of the government’s will.  |
APPENDIX III. Argentina:

Political Determinants for Government Action during the Alianza’s Administration

| Historical–Political Moment | • Weakened society was no longer willing to let a government go unchecked  
|                           | • On its way to democratic consolidation  
|                           | • Dual transition  |
| Historical Legacies and Restrictions | • Fear of hyperinflation and popular trust in the Convertibilidad program.  
|                           | • Popular opposition to unilateral action by executive  |
| Authority to Act | YES, BUT LIMITED. Convertibilidad limited the executive formally, but historical precedents for bypassing the legislative  |
| Perception of Need | YES, formally described in IMF conditionality agreements  |
| Economic Policymaking Flexibility | • Domestic Forces  
|                           | • Strong support for exchange regime; but business, middle class, banks, and provincial governments opposed a reform.  
|                           | • Very strong and articulated opposition to reducing government spending (bureaucracy, provincial governors, and retirees)  
|                           | • Labor unions strongly opposed any effort to flexibilize production costs.  |
|                           | • Foreign Forces  
|                           | • Constant search for their approval and need for fresh capital  
|                           | • Need for IMF support  
|                           | • Needed to finance budget deficits  |
|                           | • Veto Players  
|                           | YES. Vice-President Alvarez, former minister Cavallo, and the IMF  |
|                           | • State Autonomy  
|                           | LOW, both institutionally and politically  |
|                           | • Loss imposition Capability  
|                           | LOW. Few resources to payoff losers, many points where reforms could be blocked, institutionally restricted ability to implement reforms, high intensity and strength of opponents, weak government, many expenditure points, politicized judiciary, and few options for blame avoidance  |
|                           | • Will for Action  
|                           | AP: 1) strengthening De la Rua’s position within his party, 2) strengthening the Radical Party.  |

Analysis  
A difficult historical moment. The government showed perception of need but had limited authority, which increased the cost of action. Since both SA and LIC were low, political costs were very high, with time W was not even an issue, the lack of resources impeded GA.
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Political Determinants

Robert Dondisch


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Curriculum Vita

Roberto Dondisch was born on January 25, 1975, in Mexico City, Mexico, where he grew up. He graduated first in his class at Universidad Iberoamericana (Mexico), with a licenciatura in international relations with a minor in international economics. He earned a Master of Arts degree in international affairs/international economics from Johns Hopkins University’s School of Advance International Studies, and a Master of Science in Foreign Service from Georgetown University, where he specialized in international security and conflict management, graduating with distinction.

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