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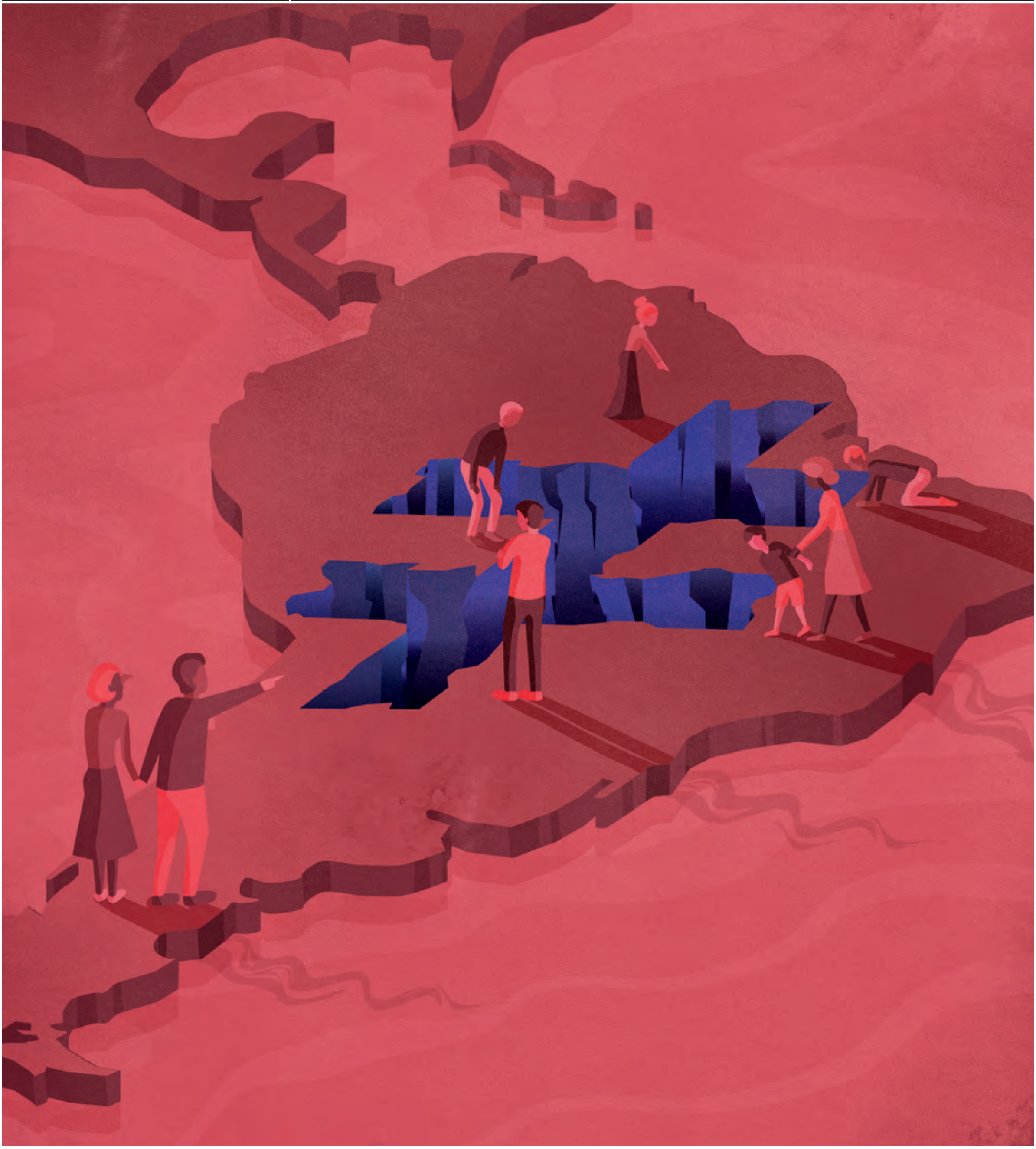
Where are Latin American economies headed?

Political swings and paradigm shifts: A historical perspective

by
Ernesto Talvi



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1.1 What's the Issue?

For the better part of the past decade, close to 80 percent of countries in Latin America were ruled by center-left and populist governments. However, this hegemony seems to be coming to an end, with center-right parties recently rising to power in Argentina, Brazil, Guatemala, Paraguay, and Peru. Should this come as a surprise? The short answer is no.

A longstanding literature in political science research has documented the existence of an economic vote (Lewis-Beck and Stegmaier, 2000). Namely, substantial evidence reveals voters in democratic countries systematically reelect incumbent governments in times of economic boom and oust them in times of economic slowdown, recession, or crisis.

So the state of the economy influences our political choices. At the same time, economies today are more interconnected than ever before. It follows that countries with synchronized business cycles should display synchronized political cycles as well (Kayser, 2009). To the extent that output fluctuations in commodity-exporting Latin American countries are to a large degree driven by common external factors (Calvo, Leiderman, and Reinhart, 1993; Izquierdo, Romero, and Talvi, 2008), economic booms and busts should then give rise to common political cycles.

1.2 Lessons of Modern history

In this essay, we provide 40 years of historical evidence that lend support to the preceding hypothesis–namely, that political cycles in Latin America are highly synchronized, mirroring economic booms and busts largely driven by common external factors.

1974-1989

The period between 1974 and 1981 was an expansionary one for Latin America. The region grew at an annual rate of 4.1 percent, compared to a historical average of 2.8 percent per year. When the price of oil rose sharply in the 1970s, the resulting "petrodollars" were recycled to emerging economies–and in massive amounts to Latin America–in the form of bank lending. These inflows financed huge increases in public spending and real estate booms across the board, fueling an economic bonanza that propped up the military dictatorships plaguing the continent. At the time, the reestablishment of stability and order by authoritarian regimes was credited with bringing about the economic boom.

And then came the "Volcker shock" as the U.S. Federal Reserve engineered a sudden hike in interest rates to 20 percent in order to defeat inflation, which at the time hovered at around 15 percent. This created a triple whammy for Latin America: the U.S. went into a deep recession, commodity prices plummeted, and capital inflows to the region came to a sudden stop and began flooding out of the region, attracted by handsome yields offered by U.S. dollar-denominated instruments. The result was a "lost decade" of economic depression and stagnant growth, with many countries suffering output contraction and collapse, along with currency, debt, and banking crises.

The political mirror image of the severe economic downturn and widespread social discontent from 1982 to1989—aided in the late 1980s by the fall of the Berlin Wall, the end of the Cold War, and the end of U.S. support for military regimes in the region—was the eventual toppling of every dictatorship in the region (except Cuba). These were replaced by democratically-elected governments, mostly to the center-right of the political spectrum, which in turn swapped the prevailing economic paradigm of import substitution, high government intervention, and overregulation for the Washington consensus: fiscal discipline, low inflation, trade and financial liberalization, privatization, and deregulation.

80%

of LAC governments were military dictatorships (1974-1989)

1990-2003

In the early 1990s, with newly democratically-elected governments installed, the debt crisis resolved through the Brady plan, and the return of low interest rates in the U.S., Latin America was again flooded by foreign capital—this time, mostly in the form of public and private sector bond lending. The consensus at the time was that these bond-driven capital inflows would bring market discipline to an ever-so-profligate region (i.e., only credit-worthy agents would be able to borrow). The ensuing bonanza was interpreted by many as definitive proof of the might of the

Washington consensus policies. The combination of sensible and credible policies with democracy seemed to have finally done the trick.

And then came the Asian crisis of 1997 and the Russian default of 1998, and the huge flight of capital from emerging markets that sent Latin American countries into another nosedive. Once again: recession, depression, and wholesale currency, debt, and banking crises.

By the early 2000s, with economic malaise and social discontent in high gear, center-right governments started to fall like dominoes and were replaced by center–left–or, in some cases, populist–governments in most of Latin America.

70%

of LAC governments were center-right (1990-2003)

2004-2014

The new crop of center-left governments did not repudiate the previous commitment to fiscal discipline, low inflation, and open markets. Rather, they built on top of it and enacted massive social redistribution programs (mostly targeted to the very poorest). These programs could only be financed owing to booming commodity prices–since 2003–and to a surge in capital inflows that peaked in 2011, as investors in developed countries searched for yield. Once again, high commodity prices and cheap and abundant capital fueled a decade-long economic boom. Once again, governments attributed their success to the policies of the reigning paradigm, one that–in this case–combined economic orthodoxy with social redistribution.

And then came the Eurozone crisis and a severe economic slowdown in China, a collapse in commodity prices, and capital flight from emerging markets as investors sought refuge in safe assets. Starting in 2012 Latin America cooled off significantly, with some countries faltering and others falling into deep recessions. After a decade of stellar growth and bright expectations, governments had willfully lulled themselves and voters into thinking their own actions were behind the boom. Dashed expectations turned into social discontent and resulted in massive street protests convened through social media. In some countries, corruption scandals added fuel to an already-sweltering fire. This malaise within Latin America has arisen at a time when the foundations of the liberal world order are being weakened by secessionist, nationalist, isolationist, and populist movements throughout the U.S. and Europe.

80%

of LAC governments were center-left or populist (2004-2014)

The political mirror image of this socioeconomic slump has been a return to center-right governments. Upon closer inspection, what the region is really witnessing is a repeat of past cycles: a repudiation of incumbents, regardless of their politics. It is only because the 2000s were dominated by left-of-center and populist governments that we are now seeing a swing to the right.

1.3 What's next?

The history of political cycles and paradigm shifts just described—from center-right to center-left and back to center-right—can be said to be evolutionary, constructed out of building blocks, with each new stage building on top of the previous one. Much like creative destruction, evolution is all about preserving what works, discarding what doesn't, and adding new, sometimes disruptive features.

By contrast, populism is about regime change: revolution, not evolution. Populist governments repealed the Washington consensus in favor of fiscal profligacy, high inflation, and extensive government intervention. Instead of espousing sensible redistribution policies such as conditional cash transfers (which aim to build human capital in order to empower the poor), populist governments redistributed wealth through what were essentially handouts that were used as a means for gaining and preserving political power. As populist regimes fail and are replaced by mainstream governments, the region is going to witness a counterrevolutionary paradigm shift rather than an evolutionary shift. The best example of this phenomenon is the end of Kirchnerismo and the dawn of Mauricio Macri's Argentina.

What policy options might the new crop of (mostly center-right) mainstream governments adopt in these times of fiscal hardship? A return to early-1980s or late-1990s-style fiscal austerity and monetary tightening seems unlikely. Instead, the new paradigm will continue to build upon what came before, preserving some of the basic tenets of the Washington consensus as well as—when feasible—the social redistribution policies enacted by center-left governments. But since resources are going to be scarce, social spending programs—and, incidentally, also infrastructure spending—will have to be redesigned with efficiency in mind, to get more bang for the buck. We have termed this new paradigm *intelligent austerity* (Talvi, 2016).

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