

# Swords & Ploughshares

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## **The Credibility of Democracy: Lula, Brazil, and the Constraints of Capital**

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### **Introduction**

On January 1, 2003, Workers' Party (PT) presidential candidate, Luis Ignacio "Lula" da Silva, was sworn in as president of Brazil. As a former metalworker and socialist trade-union leader who entered the public arena organizing strikes against the military dictatorship of the late 1970s, Lula had clearly come from outside of the elite circles which traditionally dominated Brazilian politics. His victory was interpreted by many as signaling a new direction for Brazilian democracy—not only in terms of greater political openness but also in terms of a new economic and social vision. Indeed, one of the central themes of Lula's campaign was the need to break from past policies and forge an alternative path for society.<sup>1</sup>

The 61.3 percent of the electorate who voted for Lula—the largest margin of victory for a Brazilian president since 1945—seemed to confirm the fact that the people of Brazil desired change. Eight years of market-oriented economic reforms under Lula's predecessor, Fernando Henrique Cardoso, failed to deliver many of the benefits citizens anticipated. Although inflation had been relatively stabilized, growth continued to stagnate, debt continued to mount, interest rates remained high, financial instability

loomed, and societal inequality languished at some of the highest levels in the world. Neighboring Argentina's unexpected economic meltdown in 2001 only reinforced concerns over the fragile contours of Brazil's economy. As a candidate who came directly from the working class and had long challenged the status quo, Lula and the PT seemed to offer the best hope for a profound socioeconomic and political shift.

Lula's victory in 2002, however, did not translate into the rupture with the austere economic policies of the past many were expecting. In most areas of macroeconomic policy, the Lula administration has maintained, if not intensified, the general trajectory of its predecessor's initiatives. The government has focused on enforcing strict fiscal discipline and tight anti-inflationary policies. This has undoubtedly been one of the biggest surprises of Lula's time in office.

This article will explore some of the reasons behind this surprisingly strong commitment on the part of Lula to stay in line with the orthodox economic policies of the past. Although there is not one factor that can explain the range of policies implemented by his administration, this article will focus on the particularly dramatic effects capital mobility has had on the decision-making process of the Brazilian government. It will show that financial actors have been able to impose a substantial constraint on the macroeconomic options available to Lula.

It will start by offering some background on capital liberalization and Brazil's challenges with financial instability. It will then review some of the leading literature regarding the effects of capital mobility on policymaking. This will be followed by an analysis of the market reaction to Lula in the presidential elections of 2002 and the incoming government's policy response. The article will examine how well the literature on capital mobility applies to the experience of Lula in Brazil. It will also examine the implications the case of Lula can have for other emerging market democracies seeking to carve out a social democratic alternative in an era of international economic liberalization. The article concludes by highlighting some prospects for future research.

## **The Consequences of Capital**

When President Richard Nixon suspended the convertibility of dollars into gold in 1971, it marked the end of the post-World War II Bretton Woods system of fixed exchange rates and capital controls. Consequently, many states were compelled to “float” the value of their currencies, lift restrictions against capital flows, and open up their economies to foreign investment. Together with technological advancements and innovations in offshore financial mechanisms, these changes put pressure on states to liberalize their capital markets. The effectiveness of controls increasingly deteriorated as governments faced higher costs and found it more difficult to manage financial flows.<sup>2</sup>

These developments gave rise to a tremendous increase in the rate of monetary transactions across borders,<sup>3</sup> transactions that are often erratic and irrational in nature. As a result, countries, especially in the developing world, have found themselves susceptible to the potentially devastating impact of unpredictable movements in the financial market. Studies have shown that capital flows to emerging markets are up to 80 percent more volatile than those to developed economies<sup>4</sup> and crises in these markets tend to be much more severe.<sup>5</sup>

As one of the leading emerging economies in the developing world, Brazil has had its fair share of run-ins with such financial instability. Although it did not choose to liberalize as quickly as many of its neighbors, by the early 1990s, it began a process of economic reforms aimed at attracting foreign investors and easing restrictions on capital transactions. As a result, the country found itself highly vulnerable to financial fluctuations. The Russian collapse of 1998 had a particularly adverse effect on Brazil, triggering a devaluation of the *real* and an eventual float of the exchange-rate regime.

Officials in Brazil have not been indifferent to such developments. They are cognizant of the fact that jolts in the economy can have major spillover effects on the welfare of society and the political life of a country.<sup>6</sup> Consequently, opening up capital markets introduces new factors for political decision-makers to consider. Often, the result is a greater sensitivity to the interests of financial actors.

## **Financial Market Constraints**

While most studies on financial liberalization have focused on the economic implications of financial flows, many analysts have also sought to understand the policy implications capital flows can have on governance throughout the world. In 1994, David M. Andrews addressed this issue when he put forward what he called the “capital mobility hypothesis.”<sup>7</sup> Andrews contended that the post-Bretton Woods era of widespread capital mobility has constituted a significant structural change in the international system and serves to constrain national macroeconomic policies, which diverge from conventional market trends. The policy options available to officials are, he argued, minimized by the negative repercussions which can be brought to bear on those who stray too far from the preferred standards of the international financial community. Similarly, Susan Strange maintained that the volatile growth of international financial globalization has resulted in a significant loss of control for states over their economies and society.<sup>8</sup>

Most of these works on the constraints of international capital ultimately point to what Paul Krugman has called the “confidence game.”<sup>9</sup> This refers to the assumed need for countries to “mollify market sentiment” by catering to the perceptions and prejudices of investors. Disregarding the interests of investors can result in debilitating flights of capital and the withholding of much needed foreign funds. The danger lies in the fact that policymakers must conform to the sentiments of market actors and not necessarily to the needs and desires of their citizens.

However, one shortcoming of much of the research on capital mobility is its lopsided focus on developed economies. This may be understandable given the fact that the developed world accounts for the vast majority of international financial activity. Yet, capital flows to emerging markets in regions such as Eastern Europe, Asia and Latin America are steadily increasing and their impact is likely to be more pronounced given the relative scarcity and higher volatility of capital in these parts of the world. Indeed, the few studies that have looked at capital mobility’s effects on governance in developing countries have found that a much wider range of government policy is susceptible to capital market pressure in the developing as opposed to the developed world.<sup>10</sup> This is

especially found to be the case in newly developing democracies, where institutions are less established, the leverage of investors is more pronounced, and the policies of a new administration are often viewed with greater suspicion.<sup>11</sup>

Interestingly enough, the suggestion that capital mobility limits policy options for governments is actually conceded by many proponents of financial liberalization. In fact, some view the constraints on policy imposed by increasing capital flows as a “collateral benefit” of liberalization. Financial market discipline over macroeconomic policies, it is argued, leads to the adoption of more efficient practices and needed economic reforms.<sup>12</sup> Thomas Friedman has most famously dubbed such discipline the “Golden Straitjacket”: a series of allegedly beneficial macroeconomic policies which countries find themselves forced to implement in order to gain credibility and attract trade and capital inflows. These policies include such things as “tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around.”<sup>13</sup> The dramatic decline in annual inflation rates experienced around the world over the last two decades is another perceived benefit credited to the opening of financial markets.<sup>14</sup>

Clearly, the above policies identified as those preferred by financial actors display a bias against the expansionary policies of traditional welfare state initiatives.<sup>15</sup> But what happens when a social democratic government is elected on a platform of such initiatives? Will financial markets react negatively and effectively bar their implementation? What will be the implication of such an obstacle for the future of social democratic policies and what effect will this have on the democratic legitimacy of such governments?

In the case of Lula in Brazil, several studies have shown that the potential for a social democratic shift in 2002 was indeed met with a consequential negative reaction among financial actors.<sup>16</sup> The main concern was over Lula’s left-wing background and the possibility that he would usher in a break from the orthodoxy of Cardoso. Runs against the currency and the stock market occurred as a result, despite Lula’s initial reassurances and the positive assessment of Brazil’s overall economic state.

However, despite studies showing a capital market response to a potential social democratic shift in Brazil, most literature analyzing Lula’s policies assign responsibility

for the continuation of orthodox economic policies by his administration to other factors. Instead of capital market discipline circumscribing the options available for Lula, it is argued that his policies represent an ideological and structural shift that has developed within the PT throughout the 1990s; that Lula changed his economic policy as part of his moderation strategy to win votes; or, that his government has “seen the light” and understands orthodoxy to be the proper macroeconomic approach to attracting investment.<sup>17</sup> Although all of these explanations may include elements of truth in them, this article argues that the larger, overriding causal variable dictating the direction of Lula’s policies has been the threat posed by capital mobility. Understanding financial market constraints is the key to understanding Lula’s macroeconomic policies, and these other factors should be understood as falling under its umbrella. In order to assess the merits of this hypothesis, it is important for us to first take a more detailed look back at the financial reaction to Lula’s 2002 climb to the presidency.

### **The Market Coup**

In March 2002, public opinion polls on the upcoming elections began to appear showing a very strong standing for Lula and his Workers’ Party. By April, as this trend in poll results continued, investors started worrying about the potential victory of an anti-establishment figure such as Lula. The financial sector had generally praised the “technically competent” economic management of the incumbent Cardoso administration<sup>18</sup> and was not interested in seeing them replaced by the social-democratic platform of the PT. In official discourse, the disapproval of Lula’s candidacy was translated into concern over his “competence,” questions about his “credibility,” “uncertainty” over who would form his cabinet, and fears that he would “mismanage” the economy. As Lula’s standing in the polls improved, the financial markets increasingly reacted by withdrawing their capital and demanding a greater premium for their investment.

Beginning in May 2002, major investment firms proceeded to downgrade their ratings of Brazil. In June, the Moody’s credit ranking agency reduced Brazil’s currency credit

rating to “negative” because of what it described as a “sharply negative change in investor sentiment that has emerged in recent weeks” due to “perceived uncertainties associated with the outcome of the October [presidential] election.”<sup>19</sup> In the months that followed, a series of political risk analyses, cautious reports, and further downgrades of Brazil, were issued by analysts and brokers wary over a Lula victory.<sup>20</sup>

At the same time, the Brazilian currency, the *real*, quickly fell to a historic low and continued to drop as Lula took a commanding lead over his opponents. To stem this growing tide of financial jitters over his campaign, Lula released his infamous “Letter to the Brazilian People,” in which he proclaimed his willingness to respect the country’s contracts and obligations. The markets weren’t convinced; the *real* continued to drop in July and the stock market dipped.<sup>21</sup> Brokers refused to purchase securities that matured after December 31<sup>st</sup> and bond spreads jumped above 2000 bps. These deteriorating conditions raised concerns that Brazil was on its way to a default similar to Argentina’s. Even investors who were indifferent to Lula’s showing in the polls now began to cut their losses. It seemed as if the initial panic was now taking a life of its own, spurring a self-fulfilling downward cycle.

As Lula continued to try to ease the fears of financial actors—including making several personal trips to the Sao Paulo Stock Exchange and holding conciliatory meetings with Cardoso—the government concluded a new \$30 billion deal with the International Monetary Fund (IMF). Along with the three other main candidates, Lula again met with Cardoso and agreed to abide by the parameters of the IMF agreement, including the goal of a primary surplus of 3.75 percent of GDP. Although the *real* rebounded slightly following this announcement, the confidence game was still in full swing and would not relent. Lula was simply being deemed unsatisfactory. It looked as if Brazil was in the throgs of an intransigent “market coup.”<sup>22</sup>

By October, the currency had lost 40 percent of its value and the stock market had plunged by a third. The financial community continued to fear a default and seemed unable to come to terms with the possibility of a social-democratic shift in Brazil’s

economy. As the *Financial Times* pointed out, “Financial markets fear that victory for the leader of the PT would result in a substantial increase in public spending and state intervention and a reduced commitment to debt repayment.”<sup>23</sup> The markets were calling for a stronger guarantee of Lula’s willingness to continue Cardoso’s policies. In the end, the panic would not subside until the months following Lula’s electoral victory in October.

*Source:* Datafolha Surveys, Central Bank of Brazil

Naturally, the first priority of the incoming Lula government was to calm financial worries. In a speech delivered to journalists in Sao Paulo, following his election, Lula assured investors that the government “would honor contracts” and control inflation. He also hinted to the fact that radical reforms would not be carried out as quickly as many hoped when he stated, “The historic needs of the working class cannot be satisfied overnight.”<sup>24</sup> Unsatisfied with mere pledges, the financial sector demanded to know who would be appointed to key posts such as the finance ministry and Central Bank. “So far, the signs are good,” said Marcelo Cavaleiro of Hedging-Griffo, a Sao Paulo brokerage firm. “He calmed things down in his speech. Now we have to see if he consolidates the good start.”<sup>25</sup> The investors became more pleased when Lula selected the fiscally conservative former mayor of Ribeiro Preto in the south, Antonio Palocci, to be finance minister and named other market-oriented officials to his cabinet. Following these announcements, the *real* began to rally and bond spreads shrunk dramatically.

Once in government, the Lula administration proceeded to abide by the conditions of Brazil’s IMF loan, raised interest rates to lower inflation, and significantly cut the state budget in order to achieve a surplus of 4.25 percent of GDP—exceeding the IMF’s requirement of 3.75 percent. Paying off the large foreign debt and maintaining economic stability trumped Lula’s earlier pledges to initiate social change. His commitment to fiscal austerity was rewarded with the return of capital and recovery of the currency and

bond prices. The financial community had finally deemed Lula “credible.” Horst Kohler, the managing director of the IMF, described him as “really a leader of the 21<sup>st</sup> century.”<sup>26</sup> This sudden change of heart towards Lula can be seen quite tellingly in some of the *Financial Times* headlines of the period, featured in Table 2.

Table 2: *Financial Times* Headlines on Brazil

May 10, 2002	Leftist Fears Hit Brazil
June 21, 2002	Election Fears Send Brazilian Markets Tumbling
July 27, 2002	Brazilian Markets in Record Slump
August, 28, 2002	Poll Boost for Serra Cheers Brazil Markets
September 24, 2002	Lula’s Strong Poll Showing Sends Markets Tumbling
September 25, 2002	Real Hits Historic Low on Lula Lead
October 1, 2002	Lula Decries Market Fears of Brazil Debt Default
October 23, 2002	Lula’s Party Stands Ready to Calm Investor Fears
----- <i>Lula Wins Presidential Election</i> -----	
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October 30, 2002	Lula Soothes Worried Investors
November 1, 2002	Brazilian Markets Rally as Fears Over Lula Fade
November 20, 2002	Brazil Budget Plans Please IMF
December 9, 2002	IMF Praises Brazil Leader
January 16, 2003	Pragmatic Start by Brazil’s Ex-Trotskyist
January 27, 2003	Business Audience Hails Lula Speech
February 11, 2003	Brazil Slashes Budget But Gives Welfare Pledge

March 31, 2003  
Good Start

Lula's 100 Days; The Brazilian Leader Has Made a Surprisingly

### **The Capital Mobility Hypothesis Confirmed**

This recent episode in Brazilian democracy seems to validate the capital mobility model's hypothesis that the free flow of money *does* indeed allow financial actors to instill exorbitant constraints on the policies of sovereign states. As Lula's popularity rose among the public, the financial markets reacted by pulling their capital out and speculating against the currency. Before the presidential race, Brazil was praised virtually across-the-board for its sound economic conditions; but, as soon as it seemed that Lula had a chance of becoming the next leader, the market panicked and headed for the exits. In the end, the *real* had dropped nearly 50 percent and the country's risk premiums skyrocketed to an unprecedented 2500 basis points.<sup>27</sup> The turmoil that ensued displayed the financial sector's ability to cause serious repercussions for a capital dependent country like Brazil.

In response, Lula had no choice but to play the "confidence game," and attempt to signal his credibility to the markets. This was the unmistakable motivation behind Lula's "Letter to the Brazilian People,"<sup>28</sup> his campaign's visits to the Brazilian Stock Exchange, and his pledge to honor the strictures of the IMF agreement.<sup>29</sup> He was later forced to set priorities at odds with some of his promises to the electorate and make major policy commitments prior to even being elected.

The options available to Lula were clearly limited by the particularly intense financial reaction that his administration faced. To pursue any path, other than that which calmed and reassured investors, would have exacerbated the panic and potentially wrought major damage on society. This was especially true given Brazil's notorious history of high inflation, crippling debt, and economic vulnerability. If capital flight and devaluation of

the country's currency continued in the direction they were heading, it would have further compounded Brazil's overwhelming debt burden—which was above 50 percent of GDP by the end of the Cardoso regime—and dried out the external funding the country is so heavily dependent upon. Furthermore, the effects of the 1998 Russian crisis and the nearby crash of Argentina's economy in 2001 were still fresh on the minds of Brazilians as they elected their new president. These episodes demonstrated the true damage a financial crisis could potentially bring to bear on a country, both in economic and political terms.

In effect, Lula realized he had no choice but to place financial stability as his number one priority. Maintaining stability in the economy emerged as a prerequisite for the success of his administration and would largely take precedence over policies in other spheres of society. It was believed that orthodox measures had to be adopted in order to avert an all-out disaster. Like other administration officials, Lula's General Secretary and long-time comrade-in-arms, Luiz Dulci, confirmed this state of affairs when he complained that, "Our suffering comes from having to put monetary stability before our program and having to use the classic instruments of monetary austerity." Another close Lula aide, Frei Betto, lamented, "We are in government but not in power. Power today is global power, the power of big companies, the power of financial capital."<sup>30</sup>

Nevertheless, the depth of the panic compelled Lula to muster an adequate response. Interestingly enough, the approach his administration chose was to not only maintain the orthodox policies of the past, but to surpass them and implement austere measures beyond even the demands of the financial community. By doing so, they sought to create a "credibility shock" which would reverse the outflow of capital and eliminate any misgivings investors had about the government.<sup>31</sup> This was the thinking behind the decision to surpass the IMF's surplus target and set aside 4.25 percent of the GDP for debt payment. Such moves were intended to signal to foreign investors Lula's emphatic determination to avert the looming disaster his administration saw so detrimental to their visions for long-awaited governance of the country.

Through this dramatic series of interactions between Lula and the financial markets, the threats posed by capital mobility proceeded to pose paramount constraints

on the incoming government; that they helped largely mold the direction of Lula's macroeconomic policies seems indisputable. Yet, strangely enough, while many analysts writing on Brazil have acknowledged the significance of this episode in the Brazilian electoral cycle, most have chosen to look past the effects of these events when explaining why Lula, ultimately, moderated his economic platform and accelerated the policies of his predecessor.

For instance, some argue that Lula's commitment to financial orthodoxy reflects the moderation of his views for the purpose of winning the presidential elections. This argument asserts that Lula learned from his previous failed bids for the presidency and realized that the population would not accept his "populist" policies, which were discredited over the years in Brazil. It is suggested that he compromised key aspects of his platform as part of an electoral strategy geared toward garnering enough votes to be victorious.<sup>32</sup> However, what is not noted by the proponents of this view is the fact that it was precisely his image as an alternative to the economic model of the previous regime which made Lula an attractive candidate for the population. Lula and the PT's genuine social democratic reputation earned them credibility in the eyes of a citizenry that was discontent with the center-right measures of Cardoso. Indeed, it has been regularly pointed out that even Jose Serra, the candidate from Cardoso's own party, took pains to distance himself from Cardoso's low-growth, tight monetary policies.<sup>33</sup> For Lula to adopt financial orthodoxy as a strategy for winning votes would be counterintuitive, at best.

Although it is certainly true that, overall, Lula had early on decided to take a more pragmatic approach in his electoral campaign—by such moves as aligning with the right-wing Liberal Party (PL) and toning down the PT's socialist rhetoric—he also ran on a platform that was distinctly critical of the economic policies of the incumbent regime. He promised to introduce substantial change through an expansionist policy that would invest in areas such as education, health care, employment, agrarian reform, and poverty reduction. It is precisely because he promised a new economic trajectory that many received with shock Lula's acceleration of Cardoso's fiscal policies.

More importantly, the sequence of events clearly shows that it was only in the midst of a market panic in which Lula committed fully to the austere measures being demanded of him. He frequently expressed frustration with such market pressures, publicly describing them as “financial terrorism.”<sup>34</sup> Thus, it is essential to recognize that the market reaction set the context in which Lula was compelled to adopt the economic policies he had so openly criticized and ran against during his campaign.

Other authors such as David Samuels, Alvaro Bianchi, and Ruy Braga argue that internal structural changes in the PT, resulting from its successive electoral victories, are what is truly to account for Lula’s transformation, with the former arguing that the party’s membership has moderated its radical views and the latter arguing that the leadership has become a market-oriented political bureaucracy distant from its original social base.<sup>35</sup> The assumption here is that Lula and his colleagues became more “practical” as they entered the establishment, shedding the radically unrealistic views they maintained while in the opposition. Though there may be elements of truth to these arguments, they fail to fully explain the larger economic context that renders certain policies “practical” and others “radical.” The very real financial reaction against Lula’s potential victory demonstrated some of the constraints that capital can present on what is and is not possible for any administration seeking to govern Brazil. That Lula saw these realities and was forced to move in a manner that took them into consideration is a more accurate way of describing what has transpired during his administration. Brazil’s vulnerability to capital flight and the financial reaction to Lula in 2002 effectively constrained the viable options available for the new administration.<sup>36</sup>

Furthermore, the commitments he was obliged to make to calm the market panic, such as the IMF loan agreed to in August, served to set certain parameters that his incoming administration would be responsible for adhering to. For instance, the vast majority of that loan was to be disbursed after Lula’s government came to power and only if his economic policies conformed to IMF strictures. Failing to meet these requirements would have led to the loan being withheld and sent a damaging signal to the market that Brazil was headed in the wrong direction. Quite apart from how the PT’s internal structure may have evolved, challenging these underlying constraints without threatening economic hardship would have been difficult, if not impossible, for any incoming regime.

The policies of economic orthodoxy, which Lula had come to accept are, thus, inseparable from the constraints to governance financial actors had the position to impose. This very recent electoral episode confirms the modern relevancy of the capital mobility hypothesis and suggests that social democratic or left-leaning policies may be especially subject to attack in the present era of financial liberalization. It is beyond doubt that Lula was met with fierce opposition in the capital markets and deemed unacceptable—regardless of his popularity among the citizenry of Brazil—due to his social democratic platform and radical background. It was only after he met and surpassed the explicitly articulated requirements of the financial community that the panic subsided and things began to calm. In the words of Krugman, Lula was forced to choose whether to “play the confidence game” and “mollify market sentiment” or face a “self-fulfilling speculative attack.”<sup>37</sup> Obviously, these conditions limited the practical options available for the incoming government and forced them to put economic orthodoxy above all other priorities. To gain a better understanding of how this state of affairs has affected policymaking in Brazil, it is important to take a more extended look at how Lula has responded to the threats posed by capital mobility since coming into power.

## **The Lula Effect Part II**

Although the financial community was pleased by Lula’s adoption of economic orthodoxy and his choice of market-oriented cabinet ministers, this did not mean a complete end to the confidence game. At various points during his first term, the constraints of capital reappeared for Lula, though on a smaller scale than in 2002. Each time, a mistrust of Lula and his socialist background lurked just beneath the surface. For instance, when the government was mired in a series of high profile and controversial corruption scandals in 2004, many investors began to worry that Lula would seek to revamp his popularity by increasing social spending. Worries over whether Lula was “losing his grip” or that “Brazil’s embrace of pragmatism and orthodoxy may owe more to expediency than conviction” abounded. The jitters were expressed in a slight decline in government bonds in April of 2004, followed by a sinking *real* in May. The business

press dubbed what was occurring, the “Lula Effect II,” a minor replication of the earlier panic that seized the markets in the lead-up to the 2002 presidential elections.<sup>38</sup>

Another similar episode occurred in March 2006, when the Finance Minister, Antonio Palocci, was forced to resign over allegations of corruption and was replaced by the former head of the National Development Bank, Guido Mantega. Investors were concerned that Mantega, who was known for calling for larger interest rate cuts and criticizing the government’s large fiscal surpluses, would put pressure on the Central Bank to lower interest rates and push for higher spending. Almost immediately, the value of the currency slid and stocks began to tumble. Assets recovered about a week later, however, following Mantega’s public reassurances and the appointment of two market-friendly officials to key posts in the Ministry.<sup>39</sup>

After Lula was reelected for a second presidential term in 2006, a market reaction once again became apparent. This time, it seemed to be over the statements of Tarso Genro, Lula’s Minister of Institutional Relations. He made statements following the election to the effect that the “Palocci era” was over and that the new term would lead to an end of the administration’s “neurotic preoccupation” with inflation at the expense of other priorities such as wealth redistribution.<sup>40</sup> As in previous incidents, the *real* fell in the markets and stocks briefly went downward as investors wondered whether they would see an abandonment of the orthodoxy they had come to expect from Lula. Confidence was restored only after Lula made televised appearances where he promised to continue targeting inflation and stay on the same fiscal course as in his previous term.

What is noteworthy in these above cases is that mere statements and events unrelated to economic fundamentals proved enough to merit a sharp backlash. Although brief and not of much consequence in comparison to the panic experienced in 2002, they point to a much nuanced interplay between the financial markets and the government of Brazil. The administration has had to stay vigilant in its constant reassurance of market confidence. Any slight shift in the perceptions of investors could set off another harmful and unnecessary panic. These exchanges have served as vivid reminders for the administration and have convinced them to refrain from any moves which would question their resolve toward the orthodoxy required from investors.

In fact, the government chose to further raise the budget surpluses above the 4.25 percent threshold toward the end of Lula's first term, reaching 4.6 percent of GDP in 2004 and 4.8 percent in 2005.<sup>41</sup> Part of the motivation behind these moves was to alleviate any possible concerns the financial community may have raised over the administration. This was an extension of the earlier "credibility shock" strategy. Other such similar moves included relaxations in regulations governing the repatriation of currency, lower taxes for foreign investors purchasing bonds, and permitting corporations to buy unlimited amounts of foreign currency for overseas investment. By increasing financial liberalization in this manner, the government has sought to do away with any doubt concerning its loyalty to the capital markets, once again demonstrating the not-so-always subtle power of financial interests in the shaping of policy.

However, at the same time that Lula has taken pains to please the financial markets, the government has also been using its surpluses to amass a stockpile of foreign reserves and reduce its vulnerability. Since Lula's inauguration in 2002, foreign reserves in proportion to the total foreign debt have risen from 17.95 to 31.75 percent in 2005.<sup>42</sup> In the same period, the overall public debt was reduced from 62 to 51.3 percent of GDP.<sup>43</sup> Paying off the debt and building up foreign currency in this manner has largely been aimed at safeguarding the economy against any future external shocks and reducing Brazil's financial dependence. Such steps are being taken in the hope that they will weaken the grip of financial markets over the country's future. A key part of this safeguard strategy has also included ending the country's reliance on international financial institutions. Most strikingly, in March 2005, the Lula government announced that it would be paying off the remaining balance of its \$33.7 billion loan to the IMF.<sup>44</sup> By doing so Brazil, much like Argentina, has successfully detached itself from the tutelage of this powerful international body.

These major turnarounds have come at a time when the economy is experiencing some of its most significant growth in decades. As the *Financial Times* reported, the second-quarter of 2007 saw the Brazilian economy grow by 5.5 percent, more than double the average of the last fifteen years, and witnessed the creation of 1.2 million jobs.<sup>45</sup> Such improvements have helped considerably reduce Brazil's foreign vulnerability and allowed Lula greater room to maneuver in the area of government spending. His second

term in office has already been marked by a greater focus on stimulating the economy through social spending. Plans for creating new public sector jobs, investing in logistical and electrical infrastructure, providing tax incentives for private investment, and financing further housing construction were all outlined as part of the government's economic strategy coming in to 2007.<sup>46</sup>

Evidently, the emphasis now is on taking Brazil from a state of economic stability to one of meaningful growth and income distribution. Lula regularly articulated this vision during his reelection campaign, with such declarations as, "My second term of office will be named development, development with income distribution and quality education." The assumption is that the groundwork for stable growth was set during the first four years and the mission now "is to scale up the process and create a new dynamic" in society.<sup>47</sup> This "new dynamic" refers to a vision of a more just, equitable, and prosperous Brazil.

Thus, after accelerating the austerity of the Cardoso years in order to avert the panic of 2002, the Lula government seems to now be intent on reducing its external vulnerability, building on the improved economic conditions, and accelerating state policies aimed at stimulating development and growth. In this manner, it has struck an impressive balance between financial stability and socio-economic transformation.

### **Minimizing Financial Constraints**

The tremendous financial hurdles encountered by Lula during his ascension to the presidency and his subsequent governance of Brazil provides valuable insight into the impact of capital mobility on policymaking in the developing world. We have seen how the international financial community can have a major impact on the overall economic decisions of a sovereign state. The possibility of a leftward shift in Brazil's economic direction was enough to spark a major panic in the capital markets and threatened to undermine the stability of the new administration even before it took office. Lula had to

gain the confidence of financial actors in order to avert the potentially debilitating effects of widespread capital flight. Consequently, the policy options available to his incoming administration were constrained within the parameters of the credibility game. Economic orthodoxy, surprisingly, took top priority over all other considerations of the newly elected government.

The experience of Brazil over the last few years, thus, seems to confirm Andrews' capital mobility hypothesis that financial liberalization has served to constrain those macroeconomic policies which diverge from the conventional interests of capital markets. In the post-Bretton Woods era, states have become less able to control the movement of capital and must increasingly attend to the needs of the financial community. Policies must be deemed "credible" or "sound" by financial markets before governments can move forward with their socio-economic agenda. Failure to attain such approval can otherwise lead to crippling flights of capital and the drying up of investment.

Of course, the more a country is in debt and dependent on foreign capital, the more susceptible it becomes to the constraints posed by financial actors. By definition, developing countries tend to be especially dependent on attracting investment and, therefore, have to consider the interests of capital more closely when mapping out their national economic priorities. This, coupled with the more volatile nature of capital flows in the developing world, makes the structural constraints in the developing world even more pronounced.

Yet, as the case of Lula also shows, there *are* ways of pursuing effective development objectives even in the face of such constraints. Although the room left for Lula to maneuver in the area of macroeconomic policy was certainly narrowed, he realized early on that he still had various options open on the microeconomic side that could help alleviate some of the inequities affecting Brazil. His administration was able to expand social programs and investment in human capital while still maintaining tight fiscal discipline and investor confidence.

The Lula government also understood that Brazil's history of financial fragility and dependence on foreign investors made it especially susceptible to the constraints of

capital. In response, they have sought to make 'foreign vulnerability reduction' one of the main pillars of the government's economic strategy. Breaking with the IMF was part of this larger goal and marks a milestone shift in the country's economic trajectory. It demonstrates a grasp of the fact that financial constraints can be mitigated by undermining the conditions that sustain their influence. It is not a question of shunning financial markets, but how best to foster equitable and efficient ties with them. Lula has shown that the state is by no means powerless in its interaction with financial actors. Indeed, in a large emerging market like Brazil, it has an important role to play in maximizing the benefits of international investment.

## **Conclusion**

This article has sought to explain the financial community's reactions to Lula's 2002 presidential victory and the subsequent impact capital markets have had on policy making in Brazil. It has argued that the single-most decisive factor behind Lula's surprising adoption of strict economic austerity after coming into power has been the constraints imposed by capital markets on macroeconomic policy. Financial market constraints have also been highlighted as an important variable to consider when analyzing the economic policies of developing economies, especially those which espouse an expansionary or social democratic agenda.

The Brazilian experience provides important lessons regarding the current interaction between international investors and politics in developing economies. The field of study focusing on the political economy of financial markets would do well to conduct more in-depth analysis on how financial interests shape policy making in the developing world. This is especially true given the recent increases in capital flows to emerging market economies. More detailed research is needed to get a closer view of the underlying perceptions motivating the actions of financial actors in these emerging economies. The differences and similarities in behavior among the numerous categories of investors must also be examined in more detail. This calls for both greater qualitative and quantitative research in this arena.

In addition, more comprehensive research needs to be done on the effects of financial actors in emerging markets that have transitioned to democracy in the post-Bretton Woods era. For instance, at around the same time as Brazil, countries such as Poland, South Africa, and Turkey went through varying degrees of democratic transition from authoritarian rule. These countries are considered to be some of the leading emerging markets in the developing world and have had their own history of run-ins with financial turbulence. In recent years, they have also seen the rise of social democratic or non-elite elements in their governments and the simultaneous volatility of capital markets, in a nature very similar to that of Brazil under Lula. Comparative studies are needed to uncover the pattern of such market reactions to politics and electoral change in these states. In sum, much further research is needed to gain a clearer understanding of the divergent set of impacts capital mobility can have on the politics of emerging market democracies.

### **Endnotes**

<sup>1</sup> One of the leading slogans of Lula's campaign was, "If You Don't Change, Brazil Won't Change." See Luis Felipe Miguel, "From Equality to Opportunity: Transformations in the Discourse of the Workers' Party in the 2002 Elections," *Latin American Perspectives* 33(4), 132 (2006).

<sup>2</sup> See Benjamin J. Cohen, "Phoenix Risen: The Resurrection of Global Finance," *World Politics* 48(2), 268-96 (1996) for a concise review of some of the varying explanations concerning this reemergence of financial capital in the post-War era.

<sup>3</sup> By 2004, the average rate of trade in foreign exchange had reached \$1.9 trillion per day—127 times the daily rate of \$15 billion in 1973. "World Forex Trading Hits Record," *Financial Times*, 1, September 29, 2004.

<sup>4</sup> Fernando A. Broner and Roberto Rigobon, "Why Are Capital Flows So Much More Volatile in Emerging Than in Developed Countries?" in *External Vulnerability and Preventive Policies*, ed. Ricardo Caballero et al. (Santiago: Banco Central de Chile, 2006), 16.

<sup>5</sup> Guillermo Calvo, "Globalization Hazard and Weak Government in Emerging Markets," *IADB Working Paper* (December 2001).

<sup>6</sup> In fact, many regimes in Brazil have broken down as a result of financial pressure. See Peter R. Kingstone, "Brazil: Short Foreign Money, Long Domestic Political Cycles," in *Financial Globalization*, ed. Armijo (1999), where the author argues that the blame for almost all of Brazil's regime dissolutions in the twentieth century can be laid largely at the door of balance-of-payment crises.

<sup>7</sup> David M. Andrews, "Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations," *International Studies Quarterly* 38(2), 193-218 (1994).

<sup>8</sup> Susan Strange, *Casino Capitalism* (Oxford: Basil Blackwell, 1986). In her later work, Strange argues that financial globalization is one of the most critical issues facing the world today, going so far as to equate the threat of financial collapse with the threat of nuclear war or environmental destruction. See her *Mad Money: When Markets Outgrow Governments* (Ann Arbor: University of Michigan Press, 1998), 2.

<sup>9</sup> Paul Krugman, "The Confidence Game," *The New Republic*, 23-25, October 5, 1998.

<sup>10</sup> Leslie Elliott Armijo, ed., *Financial Globalization and Democracy in Emerging Markets* (New York: St. Martin's Press, 1999); Layna Mosley, *Global Capital and National Governments* (New York: Cambridge University Press, 2003).

<sup>11</sup> Jude C. Hays et al., "Exchange Rate Volatility and Democratization in Emerging Market Countries," *International Studies Quarterly* 47 (2003): 202-228.

<sup>12</sup> M. Ayhan Kose et al., "Financial Globalization: A Reappraisal," *IMF Working Paper*, WP/06/189 (August 2006); Jagdish Bhagwati, *In Defense of Globalization* (New York: Oxford University Press, 2004), 98.

<sup>13</sup> Dani Rodrik, "How Far Will International Economic Integration Go?" *The Journal of Economic Perspectives* 14(1), 180 (2000).

<sup>14</sup> World Bank, *Global Development Finance 2006, Vol. 1* (Washington, DC: World Bank, 2006), 139.

<sup>15</sup> Such initiatives often require expansionary policies and national spending on popular provisions such as social security, employment, education, housing, health care, and other social services.

<sup>16</sup> Juan Martinez and Javier Santiso, "Financial Markets and Politics: The Confidence Game in Latin American Emerging Economies," *International Political Science Review* 24(3), 363-85 (2003); Nathan M. Jensen and Scott Schmith, "Market Responses to Politics: The Rise of Lula and the Decline of the Brazilian Stock Market," *Comparative Political Studies* 38, 1245-70 (2005); Wendy Hunter and Timothy J. Power, "Lula's Brazil at Midterm," *Journal of Democracy* 16(3), 130 (2005).

<sup>17</sup> David Samuels, "From Socialism to Social Democracy: Party Organization and the Transformation of the Workers' Party in Brazil," *Comparative Political Studies* 37(9), 999-1024 (2004); Alvaro Bianchi and Ruy Braga, "Brazil: The Lula Government and Financial Globalization," *Social Forces* 83(4), 1745-62 (2005); Fabricio Augusto de Oliveria and Paulo Nakatani, "The Brazilian Economy Under Lula: A Balance of Contradictions," *Monthly Review* 58(9), 39-49 (2007); and Gary S. Becker, "If Lula Wins, Free Markets Will Survive," *Business Week*, 30, October 21, 2002.

- <sup>18</sup> Richard Lapper, "Between a Rock and a Hard Place," *Financial Times*, 1, September 25, 1998.
- <sup>19</sup> "Brazilian Real Slides on Negative Credit Rating, Lula Fears," *Agence France Presse*, June 21, 2002.
- <sup>20</sup> For a thorough documentation of the reaction of private firms and market analysts to Lula's rising poll numbers, see Martinez and Santiso, "Financial Markets."
- <sup>21</sup> See Jensen and Schmith, "Market Responses" for stock market declines related to Lula.
- <sup>22</sup> This phrase was used by the financial media to describe the 1989 attack on Argentina's currency. Hector E. Schamis, "The Political Economy of Currency Boards: Argentina in Historical and Comparative Perspective," in *Monetary Orders*, ed. Kirshner, 137.
- <sup>23</sup> Christopher Swann, "Real Hits Historic Low on Lula Lead," *Financial Times*, 12, September 25, 2002.
- <sup>24</sup> Alan Beattie, Raymond Colitt, and Richard Lapper, "Lula Tries to Marry Populism with Austerity," *Financial Times*, 10, October 29, 2002.
- <sup>25</sup> Jonathan Wheatley, "Lula Soothes Worried Investors," *Financial Times*, 34, October 30, 2002.
- <sup>26</sup> Richard Lapper, "IMF Praises Brazil Leader," *Financial Times*, December 9, 2002.
- <sup>27</sup> Javier Santiso, *Latin America's Political Economy of the Possible: Beyond Good Revolutionaries and Free-Marketeers* (Cambridge: MIT Press, 2006), 123.
- <sup>28</sup> This infamous letter was, in fact, issued a week ahead of schedule because of the intensifying crisis occurring in the financial markets.
- <sup>29</sup> This was evidently recognized quite clearly among financial actors. See Jensen and Schmith, "Market Responses" (2005).
- <sup>30</sup> Sue Branford and Bernardo Kucinski, *Lula and the Workers Party in Brazil* (New York: The New Press, 2003), 5-6.
- <sup>31</sup> Branford and Kucinski, *Lula* (2003), 8.
- <sup>32</sup> Gabriel Loperena, "Learning Curve: Da Silva on the National Scene," *Harvard International Review* 25(3), 14 (2003); Augusto de Oliveira and Nakatani, "The Brazilian Economy;" Becker, "If Lula Wins."
- <sup>33</sup> Hunter and Power, "Lula's Brazil," 129; Jensen and Schmith, "Market Responses," 1251.
- <sup>34</sup> Branford and Kucinski, 7.
- <sup>35</sup> Samuels, "From Socialism;" Bianchi and Braga, "Brazil: The Lula Government."
- <sup>36</sup> For a discussion on how Brazil's ideological spectrum has also, more generally, been narrowed by international economic integration, see Bolivar Lamounier, "Brazil: Inequality Against Democracy," in *Democracy in Developing Countries: Latin America*, 2<sup>nd</sup> ed., ed. Larry Diamond et al. (Boulder: Lynne Rienner Publishers, 1999); Kurt

Weyland, "The Growing Sustainability of Brazil's Low-Quality Democracy," in *The Third Wave of Democratization in Latin America: Advances and Setbacks*, ed. Frances Hagopian and Scott P. Mainwaring, (New York: Cambridge University Press, 2003).

<sup>37</sup> Krugman, "The Confidence Game," 25.

<sup>38</sup> Jonathan Wheatley, "Is Lula Losing His Grip?" *Business Week*, June 7, 2004, Finance: Banking section, p. 59.

<sup>39</sup> "Markets Fear New Finance Minister in Brazil," *International Herald Tribune*, March 29, 2006, Finance section, p. 13, and Jonathan Wheatley, "Mantega Pleads to Maintain Brazil Success," *Financial Times*, April 1, 2006, World News section, p.6.

<sup>40</sup> Jonathan Wheatley, "Workers Party Needs Clear Strategy for Second Term Growth," *Financial Times*, 38, November 1, 2006; Paulo Prada, "Brazil Leader is Hearing Calls for a Version of the New Deal," *New York Times*, C4, November 4, 2006.

<sup>41</sup> Augusto de Oliveira and Nakatani, "The Brazilian Economy," 41.

<sup>42</sup> Ibid.

<sup>43</sup> James Mehring, "Brazil: Playing by the Numbers," *Business Week*, 32, October 10, 2005.

<sup>44</sup> Jonathan Wheatley, "Lula to Take Credit for Debt Deal," *Financial Times*, 47, December 15, 2005.

<sup>45</sup> Jonathan Wheatley, "No Bric Bats Expected by Brazil," *Financial Times*, 12, September 10, 2007.

<sup>46</sup> Jonathan Wheatley, "Lula to Unveil Measures Aimed at Unlocking Brazil's Growth," *Financial Times*, 4, January 22, 2007.

<sup>47</sup> *President Lula's Government Platform, 2007-2010*,  
[http://www.pt.org.br/sitept/index\\_files/pdf/plano\\_governo/ProgramaIngles.pdf](http://www.pt.org.br/sitept/index_files/pdf/plano_governo/ProgramaIngles.pdf).